THE LEGAL REGULATION OF CORPORATE GOVERNANCE WITH REFERENCE TO INTERNATIONAL TRENDS

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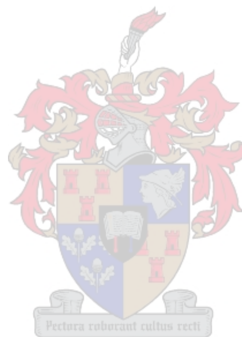

I the undersigned, hereby declare that the work contained in this thesis is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

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SUMMARY

Corporate governance is defined as the system by which companies are managed and controlled. The concept came to the fore with the Cadbury Report in England in 1992 and has since been the topic of much academic discussion. The recent collapse of companies like Enron and WorldCom raised serious questions about international corporate governance practices. This has resulted in widespread reform. In the United States large-scale prescriptive measures were implemented through the enactment of the Sarbanes-Oxley Act. The United Kingdom persisted with their principle-based approach of comply or explain, although some amendments were made to the Combined Code through a joint effort by the Co-ordinating Group on Audit and Accounting Issues, the Smith Report and the Higgs Report. In Australia change took the form of the ASX Corporate Governance Principles and CLERP 9. South Africa, influenced by its common law background, followed a similar approach to that of the United Kingdom but has recently adopted a more prescriptive approach similar to that of the US. The King Committee was set up to review corporate governance in South Africa and two reports report were published – one in 1994 and another in 2002. Amendments to the JSE Listings Requirements followed. The Konar Report made recommendations on the reform of the accounting and auditing profession. The Department of Trade and Industry has recently launched a review of South African company law in conjunction with a review of the audit and accounting professions. These recent developments in company law will however not be discussed in depth as it is at a very early stage and is still subject to change. The aim of this study is to evaluate and determine whether or not the reform in South Africa is adequate to address the questions raised by recent corporate scandals in South Africa. The question also has to be asked whether South Africa should follow international trends in reform just for the sake of reforming. This requires an understanding of the principles underlying corporate governance and the reasons for the existence of corporate governance rules. With the increasing separation between ownership and control the accountability of directors has waned considerably. When addressing corporate governance issues, this must be kept in mind constantly. While the focus of recent reform has been on the company, its directors and auditors, the role of shareholders should not be ignored. What is needed to prevent directors and managers from abusing their positions of power are more informed and involved shareholders. The different role players must also cooperate in developing a culture of ethical behaviour and an environment of openness and accountability.

OPSOMMING

Korporatiewe bestuur word omskryf as die stelsel waardeur maatskappye bestuur en beheer word. Die konsep het na prominensie geskiet na die Cadbury-verslag in Engeland in 1992 en was sedertdien die onderwerp van talle akedemiese besprekings. Die onlangse ineenstorting van maatskappye soos Enron en WorldCom het ernstige vrae oor internasionale korporatiewe bestuurspraktyke laat ontstaan. Dit het gelei tot grootskaalse hervorming. In die Verenigde State is grootskaalse voorskriftelike maatreëls ingestel deur middel van die Sarbanes-Oxley Act. Alhoewel sekere veranderings aan die *Combined Code* gemaak is deur ‘n gesamentlike poging van die *Co-ordinating Group on Audit and Accounting Issues*, die Smith-verslag en die Higgs-verslag, het die Verenigde Koninkryke volgehou met hulle beginselgebaseerde benadering van voldoen of verduidelik. Australië het ook korporatiewe ineenstorting ervaar in die vorm van HIH Insurance, GIO Insurance, Ansett Australia en One.Tel. Suid-Afrika, met sy gemeenregtelike agtergrond, het ‘n soortgelyke benadering gevolg as die Verenigde Koningkryke, maar het onlangs ‘n meer voorskriftelike benadering aanvaar soortgelyk aan die van die VSA. Die King Komitee is aangestel om korporatiewe bestuur in Suid-Africa te ondersoek en twee verslae het gevolg – een in 1994 en daarna weer in 2002. Wysigings aan die *JSE Listings Requirements* het ook gevolg. Die Konar-verslag het voorstelle gemaak oor die hervorming van die oudit- en rekenmeestersberoepe. Die Departement van Handel en Nywerheid het onlangs ‘n hersiening van die Suid-Afrikaanse maatskappyereg geloods wat hand-aan-hand sal loop met die hersiening van oudit- en rekenmeestersberoepe. Hierdie onlangse verwikkelinge sal egter nie in diepte bespreek word nie aangesien dit steeds onderhewig is aan veranderinge. Die doel van hierdie studie is om vas te stel of die hervorming in Suid-Afrika voldoende is om die vraagstukke, wat ontstaan het weens onlangse korporatiewe ineenstortings in Suid-Afrika, aan te spreek. Die vraag moet ook gevra word of Suid-Afrika bloot internasionale neigings in hervorming moet volg bloot om hervormingsonthalwe. Dit vereis ‘n begrip van die beginsels onderliggend aan korporatiewe bestuur en die redes vir die bestaan van korporatiewe bestuur-reëls. Met die toenemende skeiding tussen eienaarskap en beheer het die toerekenbaarheid van direkteure aansienlik verswak. Wanneer aspekte rondom korporatiewe bestuur aangespreek word moet hierdie beginsel gedurig in gedagte gehou word. Terwyl die fokus van onlangse herforming op die maatskappy, sy direkteure en ouditeure val, moet die rol van die aandeelhouers nie geïgnoreer word nie. Wat nodig is om te voorkom dat direkteure en bestuurders hul posisies van mag

misbruik, is meer ingeligde en betrokke aandeelhouers. Die verskillende rolspelers moet ook saamwerk in die ontwikkeling van ‘n kultuur van etiese gedrag en ‘n omgewing van openheid en toerekenbaarheid.

ACKNOWLEDGEMENTS

This thesis has been a fascinating journey, the result of which pleases me no end. It was completed in memory of my dad, Van Wyk, and I dedicate it to my mom, Elrina. Thank you for everything you have done for me in the past and all the opportunities you created for me. Wilna Coetzee, thank you for your patient support during all my years of studies. I wish you all the best for the future. The rest of my family, thank you for showing interest in what I do. A special word of thanks to my supervisor, Professor Philip Sutherland, for his academic leadership and insight. I also want to mention my South African and Dutch colleagues, Cobus Louw, Erwin Bos and Kasper Hermans, who assisted me in various aspects of this thesis. To all my friends who were always there to lend an ear and everyone who supported me, I appreciate it. The producers of fine wine and quality coffee: keep up the good work!

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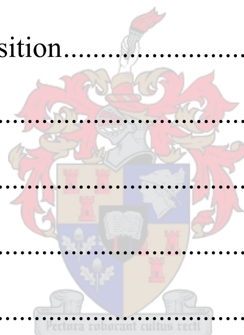

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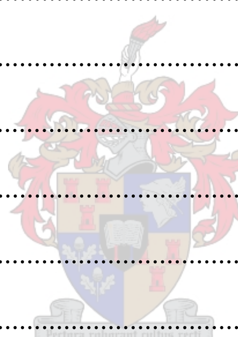

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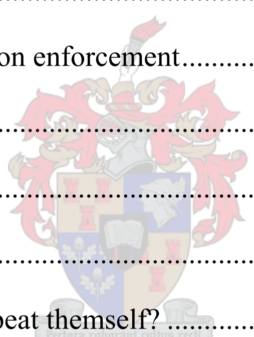

LIST OF TERMS & ABBREVIATIONS

1985 Companies Act	Companies Act 1985 (c.6)
ABI	Association of British Insurers
ACCA	Association of Chartered Certified Accountants
AISB	Auditor Independence Supervisory Board
APB	Auditing Practices Board
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
Banks Act	Banks Act 94 of 1990
Blue Ribbon Report	Report of the National Association of Corporate Directors Blue Ribbon Commission on Improving Corporate Audit Committees (1998)
Bosch Report (1991)	Working Group on Corporate Practice and Conduct (Chair: Henry Bosch), *Corporate Practice and Conduct* (1991)
Bosch Report (1995)	Working Group on Corporate Practice and Conduct (Chair: Henry Bosch), *Corporate Practice and Conduct* (1995)
BTR	Blackout Trading Restriction
CA	Chartered Accountant
CALDB	Companies Auditors and Liquidators Disciplinary Board
CalPERS	Californian Public Employees Superannuation Fund
CEO	Chief executive officer
CFA	Certified Financial Accountant
CFO	Chief financial officer
CLERP	Corporate Law Economic Reform Programme (Australia)
CGAA	Co-ordinating Group on Audit and Accounting Issues (UK)
Cadbury Report	Committee on the Financial Aspects of Corporate Governance (Chair: Sir Adrian Cadbury) *Final Report & Code of Best Practice* (December 1992)

Combined Code	Appendix to but not part of the London Stock Exchange *Listing Rules* which applies to all LSE listed companies. It is a consolidation of the codes compiled by the Cadbury, Greenbury and Hampel Reports.
Companies Act	Companies Act 61 of 1973
Corporations Act	Corporations Act 50 of 2001 (Cth)
DTI	Department of Trade & Industry
FRC	Financial Reporting Council
FSB	Financial Services Board
GAAP	Generally Accepted Accounting Practice
GAO	General Accounting Office
GDP	Gross Domestic Product
Greenbury Report	Study Group on Director's Remuneration (Chair: Sir Richard Greenbury) *Final Report & Code of Best Practice* (July 1995)
HIV/AIDS	Human Immunodefiency Virus/Acquired Immune Deficiency Syndrome
HM Treasury	Her Majesty's Treasury
Hampel Report	Committee on Corporate Governance (Chair: Sir Ronald Hampel) *Final Report & Combined Code* (January 1998)
Higgs Report	Review of the role and effectiveness of non-executive directors (Chair: Derek Higgs) *Final Report* (January 2003)
ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants in Ireland
ICAS	Institute of Chartered Accountants in Scotland
IODSA	Institute of Directors in Southern Africa
IFAC	International Federation of Accountants
IRBA	Independent Regulatory Board for Auditors
JSE	Johannesburg Stock Exchange
King Report	King Committee on Corporate Governance (Chair: Mervyn King) *King Report on Corporate Governance 1994*

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	(November 1994)
King II	King Committee on Corporate Governance (Chair: Mervyn King) *King Report on Corporate Governance for South Africa 2002* (March 2002)
Konar Report	Ministerial Panel for the Review of the Draft Accountancy Profession Bill (Chair: Len Konar) *Report to the Minister of Finance* (September 2003)
LLP	Limited Liability Partnership
LSE	London Stock Exchange
Ltd	Limited
NACD	National Association of Corporate Directors
NAPF	National Association of Pension Funds
NBER	National Bureau of Economic Research
NYSE	New York Stock Exchange
NYSE Manual	NYSE Listed Company Manual
OECD	Organisation for Economic Co-operation and Development
PCAOB	Public Company Accounting Oversight Board
Plc	Public Limited Company
POB	Public Oversight Board
(Pty) Ltd	Proprietary Limited
SA	South Africa
S	Section
SAAS	South African Auditing Standards
Sarbanes-Oxley Act	The Public Company Accounting Reform and Investor Protection Act of 2002
Ssub	Subsection
S&P 500 Index	Standards & Poors 500 Index (NYSE)
SACOB	South African Chamber of Business
SEC	United States Securities and Exchange Commission

Securities Exchange Act	Securities Exchange Act of 1934 (15 U.S.C.)
Smith Report	Audit Committees: Combined Code Guidance (Chair: Sir Robert Smith) *Final Report* (January 2003)
SPE's	Special Purpose Entities
UK	United Kingdom
US	United States of America
USC	United States Code
VOC	*De Generaele Vereenigde Nederlandsche Geoctroyeerde Oost-Indische Compagnie* or the Dutch East-Indian Company

CHAPTER 1: INTRODUCTION

> "[C]orporate governance is simply the system by which companies are directed and controlled. While it is simple to state the concept, it has become more complicated by virtue of the various interest groups or stakeholders which have an involvement in corporate governance in modern corporations. This occurred because of the change from founders of companies to professional officers managing companies and controlling shareholding changing from families to institutions."[1]

1 Background

1 1 What is a company?

A company is generally defined as an association of persons who combine their resources with the aim of achieving common objectives.[2] The main reasons for the creation of companies were, among others, the maximisation of wealth by the pooling together of resources and the advantages of limited liability.[3] The company exists separate from the people that incorporate it.[4] From separate legal personality flows a number of consequences. The most significant being that the company obtains rights and duties in its own name. Shareholders are not liable for the debts of the company.[5] In return for their contribution shareholders receive the right to vote at shareholders' meetings, which in effect gives them a share of control in the company.[6] Shareholders provide funding to the company which is used for, among other purposes, the acquisition of assets. These assets are the sole property of the company.[7] Shareholders are only entitled to the proceeds of the assets after the company is liquidated and all the company's debts are paid.[8]

[1] Mervyn King, chairperson of the King Committee on Corporate Governance 1994.
[2] Gower *Gower's Principles of Modern Company Law* 5th Ed (1995) 3; Cilliers & Benadé *Korporatiewe Reg* 3d Ed (2000) 1.06 5. For the purpose of this study "company" and "corporation" refers to public companies that are listed on stock exchanges.
[3] Wixley & Everingham *What you must know about Corporate Governance* (2002) 1.
[4] *Salomon v Salomon & Co Ltd* 1897 AC 22 (HL); *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530; *Lee v Lee's Air Farming Ltd* 1961 AC 12.
[5] *Salomon v Salomon & Co Ltd* 1897 AC 22 (HL); *Rayner (Mincing Lane) Ltd v Dept of Trade* 1989 Ch 72.
[6] Although this is only the starting point it is possible to manipulate voting rights in terms of s 195 of the Companies Act.
[7] *Short v Treasury Commissioners* 1948 AC 534.
[8] *S v De Jager* 1965 2 SA 616 (A).

1 2 A brief history of SA company law

A discussion of corporate governance is difficult outside of its historical context.[9] Companies with separate legal personality as we know them in South Africa originated in the United Kingdom. Initially incorporation was granted by way of a royal charter. It was a concession granted by the Crown for charitable reasons or in cases where the company was an extension of the Crown.[10] Consequently, incorporation was a privilege only achieved in limited circumstances. The abuse of incorporation by way of charter was the order of the day during the late seventeenth and early eighteenth century. The era was marred by speculative businesses and a frenetic upsurge in incorporation, the highpoint of which was the South Sea Company.[11] In 1720 the Bubble Act[12] put an end to the abuse of royal charters. The Act prohibited the use of incorporation "tending to the common Grievance, Prejudice and Inconvenience of His Majesty's subjects".[13] This included the following conduct:

> "[A]cting or presuming to act as a Corporate Body or Bodies, the raising or pretending to raise transferable Stock or Stocks, the transferring or pretending to transfer or assign any Share or Shares in such Stock or Stocks, without legal Authority, either by Act of Parliament, or by any Charter from the Crown, to warrant such acting as a Body Corporate, or to raise such transferable Stock or Stocks, or to transfer Shares therein, and all acting or pretending to act under any Charter, formerly granted from the Crown…and all acting or pretending to act under any obsolete Charter…shall for ever be deemed to be illegal and void…"[14]

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Apart from a few exceptions business was now run through sole proprietors or partnerships.[15] After a while shrewd businessmen started using so-called deed of settlement companies.[16] These companies were nothing more than partnerships.[17] Incorporation by registration was

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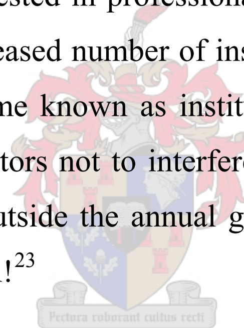
[9] For the history of company law see Gower *Gower's Principles*; Lombard "'n Historiese perspektief op die ontwikkeling van die maatskappy as ondernemingsvorm, met besondere verwysing na die posisie van maatskappyskuldeisers en die aanspreeklikheid van direkteure (Deel 1)" 2003 *De Jure* 236.
[10] Gower *Gower's Principles* 19.
[11] The company epitomised the mood of the time when it offered to take over the British National Debt of about £31 million. See Gower *Gower's Principles* 25.
[12] 1720 Bubble Act 6 Geo 1 c 18.
[13] S 18 of the Bubble Act.
[14] S 18 of the Bubble Act.
[15] Ss 22-27 of the Bubble Act exempted certain entities like partnerships and the South Sea Company. Canals and railways were also seen as exceptions and therefore legislation was enacted specifically for those purposes.
[16] The companies were established using a document which was a combination of the articles of association of a modern company and a trust deed. See Farrar "A brief thematic history of corporate governance" 1999 *Bond LR* 259 262.
[17] Lombard 2003 *De Jure* 243.

finally made possible when the Joint Stock Companies Act was passed in 1844.[18] Although the Act made incorporation easy, limited liability for the members only came in 1855.[19] Incorporation was no longer a privilege granted by the crown, but an everyday occurrence, which could be achieved with little difficulty.

British company law was exported to South Africa and other countries through colonialism.[20] Initially banks played a vital role in the development of company law in the colonies, as they were the major sources of investment capital. Finance was usually made available in the form of loans. Due to the rapid increase in the size of companies the need for additional capital arose. As a result shares were issued to members of the public. Initially only preference shares were used to accumulate funds as it prevented the transfer of control in the company.[21] Presumably due to the unfavourable nature of preference shares, ordinary shares were later issued instead. The period was characterised by managerial capitalism as the power to control and manage companies vested in professional managers.[22] The period after World War II was characterised by an increased number of institutional investors investing in public companies. This phenomenon became known as institutional investor capitalism. It was the tendency of these institutional investors not to interfere with the management of companies. They left their voting to be done outside the annual general meeting by doing the so-called "Wall Street Walk" – if in doubt, sell![23]



The next key phase in company law was that of the 1990's. This was arguably the most fascinating time in modern company law. It was characterised by the dot-com boom in the US and performance-based remuneration of executives.[24] The dot-com bubble coincided with a rapid expansion of the telecommunications sector. Loose monetary policy created ample opportunity to obtain credit effortlessly. By March 2000 the dot-com bubble burst and the

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[18] 7 & 8 Vict c 110 & 111. Although the 1844 Joint Stock Companies Act only provided for unlimited companies with personal liability for its members, it was the first act which provided for incorporation.

[19] 18 & 19 Vict c 133. The Act created mechanisms by which members' liability was limited to the amount they contributed.

[20] In the Cape the Joint Stock Companies Limited Liability Act 23 of 1861 (C) was largely centred around the English Limited Liability Act of 1855 (18 & 19 Vict c 133) and was later replaced by the Cape Companies Act 25 of 1892 (C) based on the English Companies Act of 1862 (25 & 26 Vict c 89). See Pretorius et al *Hahlo's South African Company Law through the cases* 6th Ed (1999) for a brief history of company law in South Africa.

[21] Farrar 1999 *Bond LR* 266. Although the term "preference" is used, it is misleading as preference shareholders normally receive less than ordinary shareholders when dividends are declared.

[22] Farrar 1999 *Bond LR* 266.

[23] Farrar 1999 *Bond LR* 269.

[24] Bartholomeusz "After Enron: The new reform debate" 2002 *UNSW Law Journal* 580 582.

telecommunications sector followed suit. According to Colvin the full economic effect of the collapse in the telecommunications sector, which fell by approximately $2,5 trillion, will not be felt until 2010.[25] Another factor that contributed to the problems of the 1990s was performance-based remuneration. To serve as incentives during the dot-com boom, executives were paid by means of share options, as the companies did not have the necessary cash flow to pay their salaries.[26] The argument was that by aligning the interests of the shareholder and director, the directors would be encouraged to promote the well-being of the company and more specifically the share price.[27] Another reason for the popularity of share options in the US was accounting standards. When executives exercised share options, generally accepted accounting practice (GAAP) determined that it was not expensed against the income of the company. Instead, the company was allowed to make a tax deduction for accounting purposes.[28] In effect share options therefore increased the company's earnings. Coupled with this, was an astonishing rise in the compensation that executives received. Crystal analysed the remuneration of executives between 31 May 1999 and 31 May 2000. He found that eight chief executive officers received compensation of $100 million or more. The best-paid executive was Charles Wang, chief executive officer (CEO) of Computer Associates International Inc. with a package of $511 million per year.[29]

As was originally intended with the use of share options, company executives and shareholders now had the same interest namely the maximisation of share prices. Simultaneously, the terms of office of directors shortened considerably. The ancient sin of greed joined the party and corporate ethics went out the back door. Large-scale manipulation of financial statements followed. The end result was the collapse of a number of major corporations in the late 1990s and early 2000s.

[25] Colvin "When scandal isn't sexy" *Fortune* (Chicago) (2002-06-10) 56.
[26] Bartholomeusz 2002 *UNSW Law Journal* 583.
[27] George "Accounting, auditing and auditors – What is to be done?" 2002 *Australian Journal of Corporate Law* 51 53.
[28] Financial Accounting Standards Board *Statement of Financial Accounting Standards (SFAS) 123: Accounting for Stock-Based Compensation* (1995). Also see Bartholomeusz 2002 *UNSW Law Journal* 583.
[29] Crystal "Eight CEOs make the $100 million club: Bloomberg pay survey" *Bloomberg News wire service* (2000-06-22).

1 3 Corporate governance

1 3 1 Defining corporate governance

But what is corporate governance exactly? Much has been written about the concept, yet there is no certainty as to the exact meaning of the expression. Many economists, academics and other commentators have attempted to define it. World-renowned economist Milton Friedman was one of the first commentators to take a stab at a definition. He stated that corporate governance is to conduct the business in accordance with owner or shareholders' desires, which generally will be to make as much money as possible, while conforming to the basic rules of society embodied in law and local customs.[30] It is obvious that this definition focuses primarily on the interests of the shareholder. He recognised, however, that this interest must be balanced with that of society. Naturally, he based his definition on economic perceptions. It is very narrow in its recognition of stakeholders. Sir Adrian Cadbury gave us a very short and concise definition of corporate governance:

> "[C]orporate governance is the system by which companies are directed and controlled."[31]

Cadbury's definition is still seen by many as the most authoritative and, from a legal point of view, a paramount description of what corporate governance really is. Although his definition leads us in the right direction, it is still too vague for academic purposes. The most significant feature of Cadbury's view is that it internalises corporate governance. The Australian Stock Exchange's (ASX) Corporate Governance Council gives an even better definition:

> "[C]orporate Governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised.
> Good corporate governance structures encourage companies to create value (through entrepreneurism, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved."[32]

[30] <http://www.indiainfoline.com/nevi/what.html> (30 May 2003).
[31] Committee on the Financial Aspects of Corporate Governance (Chair: Sir Adrian Cadbury) *Final Report & Code of Best Practice* (December 1992) ("Cadbury Report") par 2.5.
[32] ASX Corporate Council *Principles of Good Corporate Governance and Best Practice Recommendations* (March 2003) ("ASX Principles") 3.

The Organisation for Economic Co-operation and Development (OECD) makes use of Cadbury's definition, but is more expansive:

> "[C]orporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."

The OECD definition encompasses not only the internal part of corporate governance but takes into account other stakeholders and the impact of the company on them. The definition also recognises that it is possible to have different corporate governance systems or structures.

In its simplest form corporate governance is about the system of accountability and responsibility of the directors to the shareholders – who entrust the control of the company to them. It is necessary for the directors to be accountable as they are in control of the company's assets and money. This is the result of the separation of ownership and control. For effective corporate governance (or control over directors) there should be sufficient checks and balances to prevent directors from abusing their position of power and authority. These checks and balances are achieved through, amongst others, common law principles, legislation, codes of conduct and the financial reporting process.

The corporate governance debate revolves mainly around the three major groupings in company law, namely the company itself, the directors and the shareholders. They are described as the principal stakeholders. It is therefore not surprising that this component of company law is also known as the "internal company law".[33] Pivotal to the success of the interrelationship between the company, shareholders and the board is the role of the auditor. Although not part of the internal company law, the company auditor is very important. He plays a vital part in balancing the power of the directors. It is his duty to oversee the activities of the board of directors. This is achieved by evaluating whether the financial situation of the company is fairly represented in the company's financial reports.[34] Accordingly, the debate

[33] Naudé "Die regsposisie van die maatskappydirekteur met besondere verwysing na die interne maatskappyverband" 1970 *SA Merc LJ* 4.
[34] Eg ss 281, 282, 300 and 301 of the Companies Act.

also touches on the position of the auditor. An evaluation of corporate governance is therefore incomplete without a brief look at the role of the auditor.

Until recently the focus of corporate governance did not go beyond the internal company law. No mention was made of other important players such as the employees of the company, customers, suppliers, creditors and the community as a whole. The role of each of these stakeholders is yet to be defined precisely. Many commentators feel that the company plays a vital role in the community and therefore has a so-called "social responsibility".[35] The company should not only look at its own well-being but must also take into consideration the welfare of the community. Take for example the role of the South African company. Due to the political situation of the country during the Apartheid era, black people were prevented from meaningful participation in the economy. Since the first democratic election in 1994, this situation has changed. Through the process of black economic empowerment companies are encouraged to assist black people in taking their rightful place in the economy.[36] Companies now have a secondary duty. While the shareholders are not directly benefiting from the process, the company is ensuring that more people are economically active and is subsequently expanding its possible client/customer base.

It is perhaps fitting to end this section by referring to Horrigan's view of the uncertainties surrounding corporate governance:

> "[C]orporate governance is one of those fundamental yet nebulous concepts which many claim to understand and implement but which few can define comprehensively or even succinctly."[37]

1 3 2 The history of corporate governance

Although the term corporate governance has only recently become prominent due to a number of reports, commissions and corporate failures, the notions behind it are not new. The principles underlying corporate governance are as old as company law itself and developed from the seventeenth to twentieth century to what they are today.[38] Consequently, a strong

[35] See in general the King Committee on Corporate Governance (Chair: Mervyn King) *King Report on Corporate Governance for South Africa 2002* (March 2002)("King II") Section 4 Chapter 5 111-116; Horrigan "Fault lines in the intersection between corporate governance and social responsibilities" 2002 *UNSW Law Journal* 515.
[36] See King II chapter 5 111-116.
[37] Horrigan 2002 *UNSW Law Journal* 515 521.
[38] Although the term corporate governance was not used as a legal term until the late twentieth century its origins can be traced back to the earliest forms of companies.

connection can be drawn between the history of the company and the development of corporate governance.

The first major event in the history of corporate governance was the incorporation of *De Generaele Vereenigde Nederlandsche Geoctroyeerde Oost-Indische Compagnie* or the Dutch East-Indian Company (the VOC). The VOC was granted the monopoly for sea trade in the area between the Cape of Good Hope and the Magellan Strait for a period of 21 years.[39] The company had approximately 70 directors but management of the company vested in seventeen individuals, known as the *Here Sewentien*.[40] Although not the first company to be granted limited liability for its members it was nevertheless the first company to issue shares to members of the public on such a large scale.[41] The incorporation of the VOC is important for purposes of corporate governance as it can be described as the "big bang" of corporate governance: the separation of ownership and control. While shareowners provided the funds for the company control in the company vested in the directors. Soon the buying and selling of shares became a common every-day practice.[42] The first stock exchanges were created with the aim of dealing in commodities, bills of exchange and notes. In due course these stock exchanges emerged as the focal point of formal trading in company shares.[43] The separation between ownership and control was given a new dimension due to this formal trading in shares. The number and geographical location of shareholders complicated the running of companies and diminished the accountability of directors to shareholders.[44]

The next major influence on corporate governance for South African purposes was the English Joint Stock Companies Act of 1844.[45] The Act regulated what could today be

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[39] The VOC was a Dutch trading company incorporated in 1602 under the "*octroy opte verenige der compagnieën*" on 20 March 1602. The company was created following the merger of a number of so-called "*voorkompanjies*" of which the most famous was the *Compagnie van Verre* and the *Nieuwe Compagnie*. See Frentrop *A History of Corporate Governance 1602 - 2002* (2003); Albertyn (Ed) *Ensiklopedie van die Wêreld* (1977) Vol 10 217; Schuling "De Verenigde Oostindische Compagnie" 2 available on http://www.histocasa.nl/artikel/voc.shtml. The charter establishing the VOC can be found in Cau *Groot Placaet-Boeck* I 529-538 or Valentyn *Beschrijving van Oud en Niewe Oost-Indien* I 1st piece 186-191.

[40] Frentrop *A History of Corporate Governance* 60-64.

[41] After incorporation in 1602 the share capital of the VOC stood at 6 424 588 guilders. See <http://www.voc-kenniscentrum.nl/themas.html#Participation> (30 September 2003).

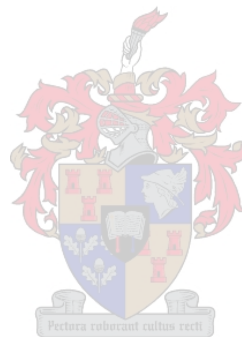
[42] During the late seventeenth and early eighteenth century the UK played witness to a frenzied escalation in the dealing of shares of privately owned companies culminating in the Bubble Act of 1720. See Lombard 2002 *De Iure* 240.

[43] The first stock exchange can be traced back to the 12th century in France but the first stock exchange to formally trade in shares was Amsterdam's Bourse in 1785.
See <http://www.ulearntoday.com/magazine/physics_article1.jsp?FILE=stockexchange> (30 September 2003).

[44] Turnbull "Stakeholder governance: A cybernetic and property rights analysis" in Tricker (ed) *Corporate Governance* (2000) 401-413 referred to in Mongalo "The emergence of corporate governance as a fundamental research topic in South Africa" 2003 *SALJ* 173 184.

[45] See par 1 2 A brief history of SA company law *supra*.

described as key corporate governance issues. Firstly, s 27 required company directors to perform certain corporate governance activities.[46] According to s 34 the company had to prepare and balance financial accounts.[47] Directors were given the task to present the shareholders with a balance sheet.[48] Auditors had to be appointed and the appointment registered with the Registrar of Joint-Stock Companies.[49] The company was controlled through the general meeting and the board of directors. The board played the biggest role while in contrast with modern company law, the shareholders followed a hands-on approach when it came to company management. Although an extensive list of checks and balances was unnecessary, limitations were nevertheless placed on directors' authority through the company's constitution,[50] duties of care and skill,[51] the principle of capital maintenance,[52] financial disclosure requirements and economic pressure.[53] These mechanisms were further refined by subsequent legislation.[54]



[46] Mongalo 2003 *SALJ* 180 identifies "*conducting and managing the affairs of the company, appointing the secretary, clerks and servants, calling and holding periodical meetings of the members of the company and appointing a chairman to preside at such meetings*" as corporate governance activities required by the Joint Stock Companies Act.
[47] Mongalo 2003 *SALJ* 180.
[48] S 36 of the Joint Stock Companies Act.
[49] S 38 of the Joint Stock Companies Act.
[50] *In re Alma Spinning Company (Bottomley's Case)* 16 ChD 681; *In Re Haycraft Gold Reduction Co* 1900 2 Ch 230; *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* 1906 2 Ch 35; *John Shaw & Sons (Salford), Ltd v Shaw* 1935 2 KB 113 (CA) 134.
[51] See Easterbrook & Fischer *The Economic Structure of Corporate Law* (1991) Chapter 4; Cilliers & Benadé *Korporatiewe Reg* 10.11 140.
[52] *Trevor v Whitworth* 1887 12 App Cas 409 (HL).
[53] The argument was that investors would only support well-governed companies.
[54] See the Limited Liability Act of 1855 (18 & 19 Vict c 133), the Joint Stock Companies Act of 1856 (18 & 19 Vict c 47), the Companies Act of 1862 (25 & 26 Vict c 89) and the Companies Act 1985 (c. 6) and in South Africa the Joint Stock Companies Limited Liability Act 23 of 1861 (C), the Cape Companies Act 25 of 1892, the Companies Act 46 of 1926 and the Companies Act 61 of 1973.

The insufficiency of these controls became increasingly evident with the increased separation of ownership and control typical of the modern corporation. Due to the enormous number of investors, individual shareholders would only hold nominal shareholdings: making it impossible for them to influence control in corporations.[55] The problem was further amplified by the practice of institutional investors to diversify their investments.[56] Herman summed the situation up as follows:

> "[W]ith larger corporate size comes a greater dispersion of stock ownership, a steady reduction in the power and interest of the shareholder, and gradual enhancement of managerial authority, that is a separation ownership from control."[57]

[55] Accordingly individual investors lost their power to hold management accountable. This caused a considerable deterioration of the ultimate corporate governance safeguard.
[56] Mongalo 2003 *SALJ* 184.
[57] Quoted in Ferran *Company Law and Corporate Finance* (1999) 117. See Mongalo 2003 *SALJ* 183.

CHAPTER 2: THE NEED FOR CORPORATE GOVERNANCE AND FINDING THE CORRECT CORPORATE GOVERNANCE BALANCE

> "[S]ince the public interest is the foundation of the legitimacy of companies, it follows that society is entitled to ensure that corporate power is exercised in a way which is consistent with that interest. To describe companies as social enterprises is thus to make a claim about the grounds of their legitimacy, and its practical significance is to hold that the state is entitled to prescribe the terms on which corporate power may be possessed and exercised."[58]

1 The need for good corporate governance

There are a number of reasons why good corporate governance is a prerequisite for well-functioning economies. The first one is to serve as protection for investors. Take for example the increasing burden on the state to provide social welfare in the form of pensions for retirees. Individuals now look towards the private sector, and more specifically investment companies, to address this need. They spend their hard earned money by taking out policies or retirement annuities, buying stocks and bonds or even by putting their money in savings accounts. Just imagine what the consequences for these people are if companies go bankrupt. Although good corporate governance does not guarantee the success of a company, it will definitely improve the chances for survival of a company. A well-governed company has less risk of going belly-up than a mismanaged one. Thus the company's effective functioning depends heavily on a good system of corporate governance. Yet, well-governed companies can still succumb to the pressures of strong competition and economic factors.[59] Nevertheless, the most recent cases illustrated that bad corporate governance has been a major cause of corporate failure.[60]

Good corporate governance practices also attract investors. This is clearly illustrated by a study of McKinsey & Company in June 2000.[61] The survey showed that 80% of shareholders in the United Kingdom are prepared to pay a premium for shares in a company with good governance. This premium ranged from 18% to 27% in the United Kingdom and Indonesia

[58] Parkinson *Corporate Power and Responsibility* (1993) 23.
[59] Segal "Corporate governance: substance over form" 2002 *UNSW Law Journal* 320 320.
[60] Enron, WorldCom, LeisureNet are all examples where the management cared more about their own welfare than for those that entrusted their money to them.
[61] McKinsey & Company *Investor Opinion Survey on Corporate Governance* (June 2000). See also King Report par 19 13; Corcoran "Investors strongly influenced by accounting disclosure, finds survey" (July 2003) *The Accountant* 5.

respectively. The study also showed that 75% of investors regarded good board practices to be as important as financial performance. The findings were confirmed by a similar survey in July 2002.[62] Although the survey showed that the premium investors are willing to pay for good corporate governance has decreased in most countries, many countries have implemented corporate governance reforms since 2000. Investors do however still consider corporate governance just as important as financial performance when making an investment decision. These findings of the McKinsey & Company-study were repeated by other similar reports.[63]

A third reason for good corporate governance is the maximisation of wealth. This is achieved due to more efficient use of resources, which in turn causes the company's performance to improve. Economic analysis of law is at the base of this reasoning. A number of surveys also confirm this statement.

A survey of 400 companies in 27 developing countries in 1999 showed that there is a direct correlation between investor protection and share values.[64] Studies by Wilshire Associates of the US on behalf of CalPERS prove the point that there is a connection between good corporate governance and company performance.[65] CalPERS publishes an annual list of underperforming companies. It then puts pressure on these companies to improve their corporate governance. The Wilshire studies showed huge improvements in the share price of the 42 companies covered by the survey. On average the gap between the S&P 500 Index and the share price of the underperforming companies was 66% for the five years before intervention by CalPERS. After intervention these companies outshone the Index by 52,5% for the subsequent five years.[66]

In 1997 Business Week published a survey of the 25 best and worst boards in the US.[67] The magazine identified a number of good governance practices and evaluated 295 companies using these guidelines. A mark out of ten was given for each company. The top 25 companies scored better than seven out of ten for company performance, while 22 of the 25 worst companies scored three or less out of ten for performance.

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[62] McKinsey & Company *Global Investor Opinion Survey* (July 2002).
[63] Stanford University *Report on Corporate Governance* (March 2001); Russell Reynolds *Corporate Governance in the New Economy – International Survey of Institutional Investors* (2000).
[64] La Porta, Lopez-de-Silanes, Schleifer & Vishny *Investor Protection and Corporate Value* (1999).
[65] Wilshire Associates *The CalPERS Effect* (July 1995) [unpublished] referred to in Bosch "The changing face of corporate governance" 2002 *UNSW Law Journal* 270 271.
[66] Bosch 2002 *UNSW Law Journal* 272.
[67] Bosch 2002 *UNSW Law Journal* 272.

A more recent study by the National Bureau of Economic Research (NBER) in the US illustrated that there is a positive relationship between company performance and strong shareholder rights.[68] The survey studied 1 500 US companies' performance between September 1990 and December 1999. A "Governance index" was built using 24 corporate governance provisions. On the one side of the scale were the so-called "Management portfolio" companies, which had the weakest shareholder rights, and on the other side the "Shareholder portfolio" companies with the strongest shareholder rights. During the period under assessment the Management portfolio companies were outperformed by the Shareholder portfolio companies by 8,5% per year.

A further reason for corporate governance is the role modern corporations play in society. This is clear from the following comment made by Berle and Means:

> "[T]he rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state – economic power versus political power, each strong in its own field…The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but possibly even superseding it as the dominant form of social organisation."[69]

The economic power of corporations were already illustrated by the South Sea Company in the 1700's when it tried to take over the British government's debt.[70] In 2002 thirteen companies made revenues of more than $100 billion.[71] These companies own assets to the value of $4 280,8 billion and employ about 3 787 993 people. Compare this to the gross domestic product (GDP) of a few countries and the economic power of the modern corporation is clearly illustrated. Table 1 compares the thirteen companies that realised revenues of more than $100 billion with the GDP of selected countries. While no company can compete with countries like the UK or the US, Wal-Mart, General Motors and Exxon Mobil can for example compete financially with countries like Finland, Ireland and Portugal. The table shows clearly the critical role modern corporations play in current society.

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[68] Gompers, Ishii & Metrick *Corporate Governance and Equity Prices* (August 2001) available at <http://papers.nber.org/papers/W8449>.

[69] Berle & Means *The Modern Corporation and Private Property* (1932) (rev ed 1967) 313.

[70] Chapter 1 par 1 2 A brief history of SA company law *supra*.

[71] Editorial "The 500 largest corporations in the world" *Fortune Magazine* (2003-07-21) F-1.

Table 1 – Comparison between the world's thirteen largest corporations and the GDP of selected countries

Company	Revenue $ bil	Country	GDP $ bil
Wal-Mart Stores	246,5	US	10,383.1
General Motors	186,8	UK	1,563.6
Exxon Mobil	182,5	Australia	411.9
Royal Dutch/Shell Group	179,4	SA	369,0
BP	178,7	Sweden	240.3
Ford Motor	163,9	Norway	190.5
DaimlerChrysler	141,4	Turkey	183.1
Toyota Motor	131,8	Denmark	172.1
General Electric	131,7	Finland	131.5
Mitsubishi	109,4	Portugal	121.7
Mitsui	108,6	Ireland	119.9
Allianz	101,9	Hungary	65.8
Citigroup	100,8	New Zealand	59.3

Source: *Fortune Magazine* (21 July 2003) & the OECD <http://www.oecd.org/dataoecd/48/4/2371304.pdf>

The importance of modern-day corporations is highlighted by the following comments by Worthington:

> "[C]ompanies contribute enormously to the economic and social well-being of our society… [their] pervasiveness is such that few individuals are left untouched by their activities."[72]

2 Philosophical foundations of modern corporations

In order to find the correct corporate governance structure for a particular country it is necessary to have an understanding of the particular company model applicable to that particular society. Company models depend largely on the way companies are seen in a specific society. Therefore:

[72] Worthington "Corporate governance: Remedying and ratifying directors' breaches" 2000 *LQR* 638.

> "[T]he models of companies that have been adopted in various jurisdictions are shaped by the theories concerning the place of companies within society. Different theories concerning the origin and purpose of corporations influence the model of company adopted and thus shape the relationship that companies have with all the participants in their economic activity and with their regulators."[73]

Some theories on companies are based on companies' origins whereas others look at the way companies operate in society.[74] The former are known as foundational theories and the latter as operational theories.[75] According to Dine one way of determining which model a society has adopted, is to look at how the corporate veil is seen.[76] The relationship between the company on the one side and the regulator and participants on the other is symbolised by the strength and purpose of the corporate veil. If this test is applied to South African company law, it will show that separate corporate personality is not regarded as absolute.[77] The two-pronged test of the *Cape Pacific* case holds that separate legal personality should not be abused to the detriment of the broader society.[78] The corporate veil is therefore subordinate to the broader public interest. This tends to lean towards a so-called stakeholder model.[79]

Recent developments in corporate governance regulation have mainly been the result of the reconsideration of the role which public companies play in the larger scheme of things. The focus has shifted away from shareholders' interest towards the so-called stakeholders' interest. This approach is sometimes referred to as the "triple bottom line" and includes the concept of "corporate social responsibility".[80] Botha makes an interesting point when he criticises the

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[73] Dine *The Governance of Corporate Groups* (2000) 1.
[74] King II Section 4 Chapter 1 91-97.
[75] Dine *The Governance of Corporate Groups* 1.
[76] Dine *The Governance of Corporate Groups* 1.
[77] See *Daimler Co Ltd v Continental Tyre and Rubber Co (Great Britain) Ltd* 1916 2 AC 307; *In re Yenidje Tobacco Co Ltd* 1916 2 Ch 426 (CA); *Lategan v Boyes* 1980 4 SA 191 (T); *Botha v Van Niekerk* 1983 3 SA 513 (W); *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A). For arguments against lifting the corporate veil see the minority decision of Van Heerden JA in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A); Larkin "Piercing the corporate veil - a new direction?" 1989 *SA Merc LJ* 277.
[78] Smalberger JA stated in *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A) 803: "*[I]t is undoubtedly a salutary principle that our Courts should not lightly disregard a company's separate personality, but should strive to give effect to and uphold it. To do otherwise would negate or undermine the policy and principles that underpin the concept of separate corporate personality and the legal consequences that attach to it. But where fraud, dishonesty or other improper conduct (and I confine myself to such situations) is found to be present, other considerations will come into play. The need to preserve the separate corporate identity would in such circumstances have to be balanced against policy considerations which arise in favour of piercing the corporate veil.*"
[79] See the discussion of the managerial model par 2 2 The managerial model *infra*.
[80] For a discussion on corporate social responsibility see Lubbe "Die King-verslag en belanghebbendes: 'n nuwe gedagte vir die sakesektor?" 1996 *Journal for Juridical Science* 97.

King Report for failing to define the purpose and role of the limited liability company in South Africa.[81] He argues that before questions surrounding corporate governance can be addressed adequately, the nature and role of the modern company must be defined. The answer to this is rooted in the American concept of economics of law. Although there are a number of company law models, the debate has traditionally been between the contractarians (the non-regulators) and the managerialists (the regulators).[82] Currently the question revolves around whether the company's activities only concern the shareholders (the contractarians) or whether the public as a whole also has an interest (the managerialists). For purposes of this study it is unnecessary to go into detail about the two models or to discuss other models. The following discussion about the contractarians and managerialists will therefore suffice.

2 1 The contractarian model

In short the point of departure of the contractarian model is that the shareholders own the corporation and therefore the company has one goal: the maximisation of wealth for the benefit of shareholders. The contractual theories on companies are divided between legal contractualism and economic contractualism. Economic contractualism was developed in America by Ronald Coase and is based on the neo-classical free market model.[83] Companies are seen as a method of reducing transaction costs. The company consists of a series of contracts.[84] In concluding these contracts the company is achieving its goal – namely the maximisation of wealth – and society as a whole benefits. As efficient market forces determine the conclusion of the contracts, the contractarian approach shies away from any formal regulation. The major criticism of the model is that market efficiency cannot be used as the sole determining factor for the regulation of companies.[85] Its approach also creates the risk that decision-making will only be made in the short-term interests of the company.[86]

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[81] Botha "Confusion in the King Report" 1996 *SA Merc LJ* 26 27.
[82] For a detailed discussion on contractualism see Dine *The Governance of Corporate Groups*.
[83] Coase "The appointment of Pigou as Marshall's successor" 1972 *Journal of Law and Economics* 473; Coase "The nature of the firm" 1937 *Economica* 390; Dine *The Governance of Corporate Groups* 8.
[84] The expression "contract" does not only refer to its legal meaning but includes any economic arrangements between parties. See Cheffins *Company Law: Theory, Structure and Operation* (1997) xlviii.
[85] Botha 1996 *SA Merc LJ* 26.
[86] Dine *The Governance of Corporate Groups* 14.

The shareowner dominant theory has been rejected in several jurisdictions.[87] The reason for this is simple. The company exists separately from its members. Upon registration it becomes a juristic person which cannot be owned by another person. Shareholders only receive a right to vote and a right to dividends once it is declared. They do not own the company.

The full demise of the shareholder model is clearly illustrated by the decision of the Delaware Chancery Court in *Paramount Communications v Time Inc*.[88] The court decided that the directors of Time could reject a take-over bid despite the fact that the offer was made at a premium price. According to the court the directors of a company have no duty to maximise shareholders' short-term value.[89] Company directors are also not compelled to follow the majority shareholders' wishes. In the UK the move away from contractualism is illustrated in four scenarios:[90]

- where the interests of creditors are given more consideration;[91]
- when courts nullify the ratification of a decision by majority shareholders;[92]
- the courts' power to invalidate an alteration to the articles of association by a majority shareholders;[93]
- in the determination of the division of powers within a company.[94]

It is apparent that the interests of the broader society are beginning to be regarded as at least equal to that of shareholders. In South Africa this move is evident from the recognition of the interests of employees and broader society.[95] The contractual theory is therefore losing ground internationally as an established company model.

[87] King Report par 17.3 11.
[88] 571 A 2d 1140 1989, 571 A 2d 1145 (Del 1990).
[89] Perhaps this case is not authority for the view that there is a move away from the shareholder dominant theory but rather the view that long-term maximisation is superior to short-term maximisation of profits.
[90] Dine *The Governance of Corporate Groups* 33.
[91] *Lonhro v Shell Petroleum* 1980 1 WLR 627; *Liquidator of West Mercia Safetywear Ltd v Dodd* 1988 BCLC 250; *Winkworth v Edward Baron* 1987 BCLC 193; *Brady v Brady* 1988 BCLC 20; *Standard Chartered Bank v Walker* 1992 1 WLR 561.
[92] *Prudential Assurance Co Ltd v Newman Industries (No 2)* 1981 Ch 257; *Alexander v Automatic Telephone Co* 1900 2 Ch 56; *Estmanco (Kilner House) Ltd v Greater London Council* 1982 1 WLR 2; *R v Gomez* 1992 3 WLR 1067.
[93] *Allen v Gold Reefs of West Africa* 1900 1 Ch 656; *Dafen Tinplate v Llanelly Steel Co Ltd* 1920 2 Ch 124; *Greenhalgh v Arderne Cinemas* 1951 Ch 286.
[94] *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* 1906 2 Ch 34; *Quinn & Axtens v Salmon* 1909 AC 442; *Breckland Group Holdings Ltd v London and Suffolk Properties Ltd* 1989 BCLC 100.
[95] See for example the Labour Relations Act 66 of 1995, Basic Conditions of Employment Act 75 of 1997; the Employment Equity Act 55 of 1998; the National Environmental Management Act 107 of 1998; and the Promotion of Access to Information Act 2 of 2000 which recognise the protection of other stakeholders' interests.

2 2 The managerial model

The managerialist model takes account of three divergent factors. The creation of wealth for the shareholders is no longer the sole objective of the company. Management must take into account the impact of the company on the environment and the community as a whole.[96] The company therefore functions as a social institution.[97] This model can also be described as the stakeholder model. Managerialists take into account the interests of other groups like employees, customers, suppliers and the community. The directors owe duties not only to the shareholders but also to the various stakeholders. The company is seen as a public concern with the shareholders residual owners of the profits and assets of the company. They are only entitled to dividends, or residual capital, at liquidation, after short and long term creditors are paid. In this model customers, suppliers and the company work together to achieve profits. The employee is also seen as a contributor to the company but in the form of human capital. They too are protected. In the UK, for example, the directors must take into account the interest of the employees when managing the company.[98] South African company law places no such duty on directors. Employees are protected by separate labour legislation.[99] The community too is seen as indirectly contributing to the company's capital.[100]

Big companies are often not subjected to economic pressures when it comes to pricing, salaries, etc. In such cases competition legislation limits their powers. The same goes for managers. If their power remains unfettered they would ignore their social responsibilities. Regulation is therefore justified.

An important consideration, which must also be kept in mind throughout the debate, is the historical development of companies. The Anglo American company developed from a common law tradition where freedom of contract was the most important principle and there

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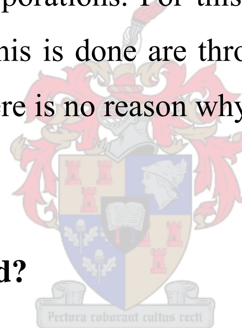
[96] These three factors are also described as the triple bottom line, which refers to the company's ability to balance its profitmaking with the interests of the community and the environment.
[97] For this reason the theory should be seen as an operational theory. See Dine *The Governance of Corporate Groups* 1; Dean *Directing Public Companies: Company Law and the Stakeholder Society* (2001) 4.
[98] S 309 (1) of the 1985 Companies Act but in terms of s 309 (2) the company's employees cannot enforce this duty. South African company law does not place such a duty on directors; instead their responsibility towards employees is regulated through the Labour Relations Act 66 of 1995, the Basic Conditions of Employment Act 75 of 1997 and the Employment Equity Act 55 of 1998.
[99] See the Labour Relations Act 66 of 1995, the Basic Conditions of Employment Act 75 of 1997 and the Employment Equity Act 55 pf 1998. See also the discussions in Chapter 3 par 5 1 The King ReportTPF and Chapter 4 par 7 Worker participation *infra*.
[100] Botha 1996 *SA Merc LJ* 35.

was no duty on anyone to bargain in good faith.[101] Since then the positions of the relevant parties have been protected and regulated by law. The *raison d'être* for regulation has been market failure. The best example of market failure is that of unequal bargaining power. The process of industrialisation caused the centralisation of power in the hands corporations. They have control over the money, knowledge and skills. The economy was about survival of the fittest – and the companies were the fittest. As a result there was a need for government to protect the weak despite the existence of a free market system. This is also very clear from the South African experience after the Apartheid government's racial policy was ended in the early nineties. Although the majority of the population could contribute to the economy after 1994, they weren't capable of doing so. They were still lagging behind due to problems like the lack of education, crime and diseases like HIV/AIDS and tuberculosis. The most telling reason for their disadvantage, however, was and still is the inaccessibility of capital. But the problem also exists outside the racial context. The normal person on the street does not have the same resources as the major corporations. For this reason government must intervene to protect him/her. Examples of how this is done are through collective bargaining, affirmative action, consumer protection, etc. There is no reason why this principle should not be applied to management of companies.[102]



2 3 How much regulation is needed?

The question now remains: to what degree should government place restraints on corporate freedoms? The approach of many regulators has long been that of self-regulation. Both the Cadbury Report and King Report contained codes of best practices and conduct. The London Stock Exchange (LSE) and Johannesburg Stock Exchange (JSE) adopted these codes as part of their listing requirements. Companies were obliged to adhere to these codes.[103] It was a system that promoted form over substance. Lately there has been a global move towards the opposite.[104]

[101] Dean "The future of UK company law" 2001 *The Company Lawyer* 104.
[102] For discussion of this see King II Section 6 142-155.
[103] It must however be mentioned that companies were only required to declare in their periodical financial statements that they complied with these codes.
[104] King II Section 6 142-155.

The risk with regulation is that directors will focus so much on conformance that they will neglect their principle task, namely profit-making of the company.[105] Another dilemma facing regulators is the question of how much social responsibility should be required from corporations. Some authors are of the opinion that by putting environmental and social responsibility on a par with shareholders' interests, accountability will be undermined:[106]

> "[T]he idea of corporate social responsibility (CSR) poses a threat to free enterprise. The [so-called] solution is a new model of capitalism based on the principle of environmentally sustainable development. This is a principle that is ill-defined and potentially harmful because there is no attempt to recognize the substantial costs involved and set them against the (often small) benefits. Businesses, most notably the large [multinational corporations] most subject to the demands of CSR, have sought to appease their critics. The greatest potential harm comes from the attempt to impose global governance – common international standards across widely different countries – which can only cripple international trade and investment flows and hold back the poorest countries."[107]

South Africa – and the rest of Africa – is already moving in the direction of sustainability rather than corporate social responsibility. Instead of requiring companies to make a direct contribution to society, there is the idea that all initiatives should be sustainable, both economically and socially, over a long period of time.[108] But we have to ask ourselves the question: is sustainable development not just another form of corporate social responsibility?

Pectora roborant cultus recti

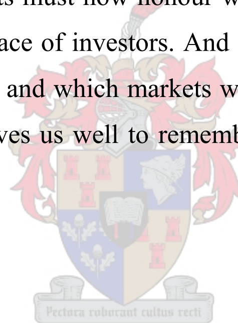
King II[109] addresses the problem of corporate social responsibility to a certain extent.[110] According to the Report a clear distinction must be drawn between accountability and responsibility.[111] Accountability refers to a person being "liable to render an account".[112] By requiring the board to be responsible means that they should take to heart the interests of all relevant stakeholders. The company must be directed for the benefit of all - not only the shareholders. To hold the board of directors accountable to all stakeholders would be impossible. The Report advances a so-called inclusive approach whereby (a) the relevant stakeholders are defined, (b) the company's purpose is defined and (c) the values by which the

[105] Bosch 2002 *UNSW Law Journal* 276.
[106] Bosch 2002 *UNSW Law Journal* 290.
[107] Wood "To thrive, capitalism needs room to breathe" *The Australian* (Sydney) (2001-05-15) 11.
[108] The New Partnership for African Development (NEPAD) was created in 2002 and is an initiative to promote Africa's economic and social well-being. One of its long-term goals is to promote sustainable development throughout Africa. See <http://www.nepad.org>.
[109] See Chapter 3 par 5 4 King IITPF *infra*.
[110] King II par 5.1 7.
[111] King II par 5.1 7.

company will carry on business are identified and communicated to the stakeholders. In this way the company can achieve its financial goals without neglecting the community.

The major driving force behind business is free enterprise. Companies are the heartbeat of modern business. By requiring corporations to adhere to corporate standards, regulators are placing more and not necessarily healthier restrictions on entrepreneurship. The protection of all stakeholders' interests, not only investors, should be the main objective of any regulation but not to the detriment of business. To put it in the words of the King II: the key challenge is to seek and embrace an appropriate balance between enterprise (performance) and constraints (conformance). If this balance is not achieved, the consequences for the country will be dire:

> "[I]f a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast a particular company's practices may be – suffer the consequences. Markets must now honour what they perhaps, too often, have failed to recognise. Markets exist by the grace of investors. And it is today's more empowered investors that will determine which companies and which markets will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investors' capital."[113]



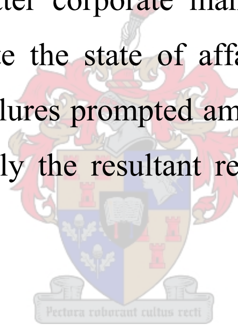
[112] King II par 5.1 7.
[113] Arthur Levitt, former chairman of the US SEC quoted in King II par 16 10.

CHAPTER 3: RECENT CORPORATE GOVERNANCE EVENTS

> "[L]ying. Cheating. Arrogance. The public's worst fears about the ethics of much of Corporate America are proving to be justified…
> It now appears that a culture of narcissism and entitlement arose in the mid-90's and people began playing by their own rules. It was worse in markets created by deregulation and new technologies, but it spread. Enron officers manipulated newly deregulated markets to their advantage and teamed with Arthur Andersen LLP to play accounting games to fake profits and amass personal gains…
> The daily drip of one terrible revelation after another is eroding the public's trust in market capitalism and undermining the conservative political agenda."[114]

1 Recent events

To illustrate the need for corporate governance, it is necessary to refer to some practical examples. The spate of recent international corporate failures throughout the world has sparked huge public outcry for better corporate management. This has prompted various commissions and reports to evaluate the state of affairs. In some cases legislative reform followed while in other cases the failures prompted amendments to existing codes of conduct and listing rules. To understand fully the resultant regulation in the various countries it is necessary to discuss these events.



2 The US experience

2 1 Enronitis

Except for attempts by US stock exchanges in 1998, little was done to promote good corporate governance in the US.[115] It was left to the investor to ensure that the companies in which they invested complied with good governance practices.[116] It is not surprising that the biggest corporate failures happened as a result of the *laissez faire* attitude of the US regulators. The first major corporate collapse in the US occurred in October of 2001 in the form of

[114] Editorial "Investors' nightmares made real" *Business Week* (2002-05-20) 68.
[115] See the Report of the NACD Blue Ribbon Committee on Audit Committees (Chair: Ira Millstein & John Whitehead) (1999) ("Blue Ribbon Committee") and discussion of regulation in the US par 2 3 Regulation in the US *infra*.
[116] For a discussion of the US corporate governance structure see International Task Force on Corporate Governance *Who Holds the Reins* (1995) International Capital Markets Groups 253.

Enron.[117] The company was created in 1985 and became the largest dealer in gas and electricity in the UK and North America.[118] It eventually shifted its focus to the development of derivatives, coal, paper and metals. In 2001 Fortune Magazine named Enron "The Most Innovative Company in America" for the sixth year running.[119] In 2000 it reported an operating profit of $1,3 billion.[120] But the seventh largest company in the US announced a $618 million third quarter loss in October 2001. The news reverberated through international stock markets, sending them spiralling downwards. In December Enron filed for Chapter 11 bankruptcy after a possible merger with Dynegy fell through.[121]

The reason for Enron's collapse was the use of thousands of so-called "special purpose entity partnerships" (SPE's) which were run by Enron's chief financial officer (CFO), Andrew Fastow. Enron had about 3 000 subsidiaries and lent about $5,4 billion to companies in which it had interests but which were kept off the company's balance sheet.[122] The off balance sheet partnerships, such as limited liability partnerships (LLP's), were used to hide debts and losses and eventually to overstate profits in the financial statements. The various securities laws do not regulate SPE's. Consequently, their existence and activities are not disclosed to the public or even to shareholders. In this way they are used to hide debts and losses.[123] The question remains, however, whether the biggest failure was that of the regulator or that of the auditor. One US commentator described the collapse as "corruption on massive scale".[124] Enron's collapse was firstly a huge embarrassment for the US regulator. It showed that their so-called robust checks and balances had failed dismally. It was even more embarrassing for Enron's Chicago based auditor, Arthur Andersen. Enron was Andersen's biggest client at its Houston offices. Apart from receiving $25 million in audit fees from Enron in 2000, Andersen was also paid an additional $27 million for non-audit services (which included consulting fees).[125] If this was not a big enough conflict of interest, present and ex-Andersen staff filled most of the

[117] See Coffee "What caused Enron? A capsule social and economic history of the 1990's" 2004 *Cornell Law Review* 269. Cruver *Enron: Anatomy of Greed* (2002). The corporate scandal at Enron was followed by other cases which included Tyco International, Global Crossing, Xerox, Adelphia Communications, Qwest Communications and WorldCom (*infra*).
[118] The company was result of a merger between Houston Natural Gas and InterNorth. See Bartholomeusz 2002 *UNSW Law Journal* 584.
[119] Diba & Munoz "Who's up, who's down" *Fortune* (Chicago) (2001-02-19) 64 referred to in Bartholomeusz 2002 *UNSW Law Journal* 585.
[120] Bartholomeusz 2002 *UNSW Law Journal* 585.
[121] Tomasic 2002 *Australian Journal of Corporate Law* 195.
[122] Tomasic 2002 *Australian Journal of Corporate Law* 195.
[123] Bartholomeusz 2002 *UNSW Law Journal* 585.
[124] Nussbaum "Can you trust anyone anymore?" *Businessweek* (2002-01-28) 39.

key positions at Enron, including that of CFO and chief accountant. It was the task of Enron's audit committee to check whether Andersen remained independent. This task was made very difficult by the fact that three of the six audit committee members held shares in Enron worth approximately $7,5 million.[126] One commentator even went as far as to say that these shares bought the audit committee's silence.[127]

Founded in 1929 by Arthur Andersen, the accounting firm was one of the so-called "Big Five". It is rather ironic that an auditor, whose founding ambition was to restore credibility to the financial reporting and auditing profession, was part of the biggest corporate bankruptcy in the US that brought the accounting profession into renewed disrepute. By the time Andersen was found guilty of obstruction of justice[128] on 15 June 2002, it had already lost 690 of its 2 311 public companies, 17 000 of its 27 000 employees and still faced the prospects of possible liability of hundreds of millions of dollars in civil lawsuits.[129] The firm later announced that it would cease auditing public companies. The Enron scandal effectively killed off Andersen.

Bill Keller summed the Enron saga up by stating that:

> "[T]he company embodied the get-obscenely-rich-quick cult that grew up around the intersections of digital technology, deregulation and globalization. It rode the 'zeitgeist' of speed, hype, novelty and swagger. Petroleum was hopelessly uncool, derivatives were hot. Companies were advised to unload baggage of hard assets, like factories or oilfields, which hold you back in the digital long jump, and concentrate on buzz and brand. Accountants who tried to impose the traditional discipline of the balance sheet were dismissed as 'bean-counters', stuck in the old metrics. Wall Street looked to the new metrics, new ways of measuring the intangible genius of innovation, and the most important metrics were the daily flickers of your stock price. Above all, everyone was looking for the killer…world-beating opportunity…"[130]

Pectora roborant cultus recti

[125] Bartholomeusz 2002 *UNSW Law Journal* 586.
[126] Tomasic 2002 *Australian Journal of Corporate Law* 196.
[127] Lavelle "Enron: how governance rules failed" *Businessweek* (2002-02-21) 38-39.
[128] The charge related to the shredding of documents by Nancy Temple, a member of Andersen's legal department, after she ordered the removal of a sentence describing a conversation between Enron's lead audit partner and an Enron executive. See Peterson "Arthur Andersen is found guilty of obstructing Justice" *The Accountant* (June 2002) 1.
[129] Peterson (June 2002) *The Accountant* 1.
[130] Keller "Enron for dummies" *New York Times* (2002-01-26).

2 2 WorldCom's demise[131]

Mississippi based WorldCom filed for the largest corporate bankruptcy in the US on Sunday, 21 July 2002, just seven months after the Enron collapse and four months after the telecommunications company Global Crossing in January of the same year. WorldCom, with a client base of 20 million in over 60 countries, was the owner of MCI Communications, the second largest long-distance data carrier in the US,[132] and UUNet, which carries 50% of the country's internet traffic. The company was founded as LDDS Communications – a small telephone company under Bernard Ebbers, hotel chain owner.[133] Through the dot-com boom it acquired 72 smaller companies in a period of seventeen years,[134] incurring $41 billion in debt.[135] Towards its peak, WorldCom's capitalisation stood at $180 billion. This aggressive spree of acquisitions led to chief executive Ebbers being dubbed Borg, the Star Trek villain who tried to absorb the whole universe.[136]

On 25 June 2002 WorldCom announced that an internal audit found "accounting improprieties of unprecedented magnitude".[137] Some of these were to treat ordinary expenses as capital spending, which could be dispensed with over a couple of years.[138] This inflated the company's earnings by $3,9 billion.[139] A case of civil fraud was immediately opened by the US Justice Department. The announcement came just ten days after WorldCom's previous auditor, Arthur Andersen, was convicted of obstruction of justice in connection with the Enron debacle. Andersen was however already replaced by KPMG in May 2002.[140]

2 3 Regulation in the US

The US government did little to strengthen corporate standards until the collapse of WorldCom. This can be illustrated by the failure of attempts by the former chairperson of the SEC, Arthur Levitt, to reform the accounting and auditing industry. The feeling in the US has

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[131] See Bartholomeusz 2002 *UNSW Law Journal* 580; Wallack *San Francisco Chronicle* (2002-07-22).
[132] Second only to AT&T.
[133] Wallack *San Francisco Chronicle* (2002-07-22).
[134] Bartholomeusz 2002 *UNSW Law Journal* 587.
[135] Wallack *San Francisco Chronicle* (2002-07-22).
[136] Wallack *San Francisco Chronicle* (2002-07-22).
[137] Securities and Exchange Commission, *SEC Statement Concerning WorldCom*, Press Release on 26 June 2002 <http://www.sec.gov/news/press/2002-94.htm> (04 July 2003).
[138] Wallack *San Francisco Chronicle* (2002-07-22).
[139] Later it was found that the mistake actually resulted in a loss of $7,2 billion.
[140] Peterson *The Accountant* (June 2002) 1

long been that regulation would impact too much on market efficiency and competitiveness. Their approach rested on the premise that market forces and peer pressure would compel companies to exercise good governance practices. This is also the view advocated by Harvey Pitt, Levitt's successor as chairperson of the SEC. WorldCom's collapse, however, confirmed the perception created by Enron that all was not well with financial reporting practices in the US. It even raised a few eyebrows in the White House. President George Bush announced that the government would investigate and prosecute any person guilty of fraudulent accounting practices. By then widespread legislative reform proposed by Paul Sarbanes, Democratic Senator for Maryland and Chairman of Senate Committee on Banking, Housing and Urban Affairs (the Senate Banking Committee), had already met stiff resistance from a red-faced Bush administration and accounting lobbyists. Sarbanes's proposals were tougher than those of Michael Oxley, Republican member of the House of Representatives and Chairman of the House Committee on Financial Services.[141] When both Houses of Congress passed the Public Company Accounting Reform and Investor Protection Act of 2002[142] (the Sarbanes-Oxley Act) on 30 July 2002 the writing was on the wall. A new era for the regulation of auditors and public companies in the US had dawned. Gone are the days of self-regulation. It must however be kept in mind that the Sarbanes-Oxley Act is a product of massive political pressure. The drafting took place in a matter of a few months, the speed of which should indicate the importance of the Act to the US economy and business. It is therefore not surprising that it was promulgated under huge controversy.

The aim of the Sarbanes-Oxley Act is very clear from the preamble:

> "[T]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[143]

[141] Although it met fierce resistance from business and the Republicans, the tougher proposals of Paul Sarbanes prevailed in the eventual act. See Alexander "The need for international regulation of auditors and public companies" 2002 *The Company Lawyer* 341.
[142] S 2673 Pub L No 107-204 116 Stat 745 (2002). For discussions of the Sarbanes-Oxley Act see the Report of the Committee on Banking, Housing and Urban Affairs of the United States Senate to accompany S 2673 (3 July 2002) ("Report of the Senate Banking Committee"); Report of the Committee on the Judiciary to accompany S 2010 (6 May 2002) ("Report of the Judiciary Committee"); Van Ginneken "De 'Sarbanes-Oxley Act of 2002': Het Amerikaanse antwoord op Enron (I)" 2003 *Ondernemingsrecht* 63; Alexander 2002 *The Company Lawyer* 341; Friedland "The Sarbanes-Oxley Act: corporate governance, financial reporting and economic crime" 2002 *The Company Lawyer* 384; Editorial "Recent legislation" 2002 *Harvard LR* 728; Editorial "The good, the bad, and their corporate codes of ethics: Enron, Sarbanes-Oxley, and the problems with legislating good behaviour" 2003 *Harvard LR* 2123; George "The Public Company Accounting Reform and Investor Protection Act of 2002: Any implications for Australia" 2002 *Australian Journal of Corporate Law* 286; Wardell "The current state of play under the Sarbanes-Oxley Act of 2002" 2003 *North Carolina Journal of International and Commercial Regulation* 935.
[143] Preamble to the Sarbanes-Oxley Act of 2002.

The Act is divided into eleven titles. Although its scope is very wide, the most important aspects of the Act deal with the establishment of the Public Company Accounting Oversight Board (PCAOB) and aspects surrounding auditor independence, improved financial disclosure and improved corporate and criminal fraud accountability. Title VII of the Act also require a number of studies which include a study on the consolidation of public accounting firms,[144] credit rating agencies;[145] a study on violators and violations of the Federal securities laws;[146] a study of the enforcement actions;[147] and a study on whether investment banks assist in the manipulation of accounts.[148]

The Act is in the true US financial regulation-style of rule making as opposed to the principle-based approach followed in countries like the UK and Australia.[149] Some commentators are of the opinion that the Act will not encourage executives to apply better governance principles. Instead, it will only persuade them to find legislative loopholes for self-reward.[150]

According to the Senate Banking Committee the effect of the Sarbanes-Oxley Act will be to modernise auditing oversight through the establishment of the PCAOB, enhance the quality and transparency of accounting and reinforce auditor independence. Furthermore, it will improve the competition between accounting firms and promote the accuracy of information provided to investors.[151] The combined effect of this will be to address the shortcomings and general weaknesses of the financial and auditing profession which have caused investors to loose faith in the US capital markets.

Shortly before the enactment of the Sarbanes-Oxley Act the New York Stock Exchange (NYSE) made attempts to reform corporate governance practices of listed companies. Former chairman of the SEC, Harvey Pitt, requested the NYSE to review its corporate governance listing standards on 13 February 2002.[152] A Corporate Accountability and Listing Standards Committee was established to review the listing standards with the specific aim to enhance the accountability, integrity and transparency of all listed companies. The Committee submitted its

[144] S 701 of the Sarbanes-Oxley Act but see Chapter 5 par 6 Competition for audit services *infra*.
[145] S 702 of the Sarbanes-Oxley Act.
[146] S 703 of the Sarbanes-Oxley Act.
[147] S 705 of the Sarbanes-Oxley Act.
[148] S 705 of the Sarbanes-Oxley Act.
[149] George 2002 *Australian Journal of Corporate Law* 293.
[150] George 2002 *Australian Journal of Corporate Law* 293.
[151] Report of the Senate Banking Committee 57.

recommendations to the NYSE Board of Directors on 6 June 2002.[153] These recommendations of the Committee were to be codified in s 303A of the NYSE Manual. On 16 August 2002 the NYSE submitted the proposed s 303A to the SEC for approval. The section was subsequently amended twice before finally being approved by the SEC on 4 November 2003.[154] Section 303A consists of thirteen subsections, with one subsection being reserved.[155] The sections are accompanied by commentary which gives guidance to listed companies on its application. The subsections together with the commentary are aimed at all companies listed on the NYSE, with specific exclusion of certain types of companies.[156] The effective date for compliance with s 303A was the company's first annual general meeting since 15 January 2004 or 31 October 2003, whichever occurred the earliest.

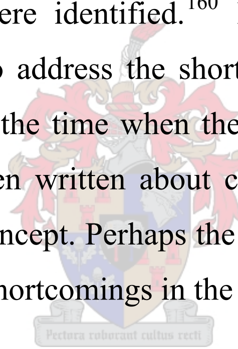
2 4 Evaluation of the US position

Through the enactment of the Sarbanes-Oxley Act the US regulator has persisted with the "black-letter" law approach, which prescribes rules rather than principles. The past has proven that this approach is dubious. The Sarbanes-Oxley Act will therefore most likely have little effect on the promotion of better corporate governance practices. While the Act is commendable on a number of aspects, the one aspect that is questionable is its focus. The approach focuses on what not to do, rather than what to do. In a sense corporate governance regulation is like a parent educating a little child, if the child is repeatedly told what not to do, it will not know how to behave itself. Corporate governance works on the same principle. If corporations are told what the best practice is, they will follow it. What is therefore needed in the US is a culture of good corporate governance. The proposed listing standards on corporate governance of the NYSE are one way of achieving this culture. Additional initiatives are required from the regulator.

[152] Amendment No 2 to the NYSE's Corporate Governance Rule Proposals 1.
[153] See <http://www.nyse.com/pdfs/corp_gov_pro_b.pdf> (24 November 2005).
[154] An amended version was published on 4 April 2003 and the latest on 8 October 2003.
[155] Proposed 303A (8) relates to shareholder approval of equity-compensation plans and was filed separately.
[156] So-called controlled companies, limited partnerships and companies in bankruptcy do not have to comply with ss 303A (1), (4) and (5). Closed-end management companies must only comply with s 303A (6), (7) and (12) (b). Foreign private issuers are allowed to follow their home country practices but must at least comply with ss 303A (6), (7) (a) and (c), (11) and (12) (b). Trusts, derivatives and special purpose securities are completely exempted from s 303A. See s 303A "General Application" of the NYSE Manual.

3 Failure in the UK and the government's reaction

Although the president of the Institute of Chartered Accountants in England and Wales (ICAEW), Peter Wyman, recently declared that the "UK has the best accounting standards and corporate governance regime in the world",[157] the UK was initially not spared from corporate shame. Early in the 1990's it experienced its fair share of corporate collapses. These include Robert Maxwell's Mirror Group News (Maxwell's), Polly Peck International Plc and the Bank of Credit and Commerce International S.A. (BCCI).[158] Where the US government persisted with a *laissez faire* approach, the UK followed a system of continuous introspection and self-correction.[159] When the first bad apples fell from the tree in the form of Maxwell, Polly Peck and BCCI, the government was quick to appoint a committee to investigate the reasons for the collapse of these companies. Soon other committees and groups were appointed to investigate other aspects of corporate governance. To the government's credit it never inflicted wholesale changes when the shortcomings were identified.[160] Instead, it kept its cool and advised business on what route to follow to address the shortcomings. Little was known about the concept of corporate governance at the time when the Cadbury Committee was established. Eleven years later so much has been written about corporate governance, yet there is still much uncertainty surrounding the concept. Perhaps the most important feature of those earlier reports was that they illustrated the shortcomings in the Anglo-American company law model.



3 1 The BCCI

The BCCI was a Luxembourg company.[161] The sheikh and government of Abu Dhabi were the majority shareholders.[162] In July 1991 the bank applied for an order placing it in provisional liquidation. It was subsequently closed and depositors throughout the world lost substantial amounts. After a lengthy investigation it was found that fraud was the reason for its

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[157] Speech made by Peter Wyman at the ICAEW annual conference July 2002. See Corcoran "Wyman defends soundness of UK accounting system" *The Accountant* (July 2002) 6.

[158] Some of these scandals made their way to the courts. See for example *Guinness Plc v Saunders* 1990 2 AC 663; *Polly Peck International Plc v Asil Nadir* 1992 2 Lloyd's Rep 238; *Re Polly Peck International Plc (in administration)* 1996 2 All ER 433.

[159] For a discussion on the UK's corporate governance structures see International Task Force on Corporate Governance *Who Holds the Reins* 286.

[160] See discussions of the UK position throughout.

[161] For general details in BCCI see in general <http://www.guardian.co.uk/business/story/0,3604,280547,00.html> (19 July 2003).

[162] Atkinson "BCCI liquidators sue sheikh for £289m" *The Guardian* (1999-08-11).

closure. The bank was riddled with so-called "black holes" in its accounts, totalling a staggering $13 billion dollars.[163] It was described as the greatest financial scandal in the history of the United Kingdom. More significantly, BCCI was a bank and when a bank fails the foundation of not only the investor world is shaken but depositors also lose faith in the banking industry. Not surprisingly the collapse of BCCI was one of the contributing factors for the establishment of the Cadbury Committee in 1992.[164]

3 2 The Cadbury Report

In 1992 the UK government appointed a committee to investigate the financial aspects of corporate governance. The dual reasons for the creation of the committee were, firstly, the view that companies in the UK were not competitive enough and, secondly, the lax accounting standards in the UK and fraud surrounding the collapse of major corporations.[165] The result was published on 1 December 1992 in the form of the Cadbury Report. Although the Report was limited to financial aspects concerning corporate governance, it set the tone for the UK and many other countries. The Committee, headed by and named after Sir Adrian Cadbury, was set up under the auspices of the Institute of Directors, the Confederation of British Industry, the Consultative Committee of Accountancy Bodies, the LSE, the National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI).

The most important aspect of the Cadbury Report was the Code of Best Practice, the aim of which was to promote high standards of corporate governance. The Code was based on three principles namely openness, integrity and accountability.[166] The idea was that all companies had to endorse the Code before they could be listed on the LSE.[167] Other unlisted companies were also encouraged to meet the requirements of the Code. The Cadbury Report was the first of a number of reports on the topic of corporate governance in the UK.

[163] Atkinson *The Guardian* (1999-08-11).
[164] See Preface to the Cadbury Report 1.
[165] Cadbury Report pars 2.1-2.2 14.
[166] Cadbury Report par 3.2 16.
[167] Cadbury Report pars 3.7-3.9 17.

3 3 The Greenbury Report[168]

While the Cadbury Report focussed on financial aspect surrounding corporate governance, the Greenbury Report focussed specifically on directors' remuneration.[169] As with the Cadbury Report, the Greenbury Report included a Code of Best Practice with which listed companies had to comply. If companies did not comply with the Code, they had to give reasons for their failure to do so.

One of the significant recommendations made by the Committee was the appointment of a remuneration committee consisting exclusively of non-executive members which would determine the compensation of executives.[170] This committee should report directly to the shareholders on executive remuneration. The chairperson of the committee should also attend annual general meetings to answer shareholders' questions on remuneration.[171] The report must contain remuneration levels, individual components of remuneration, performance measurement, pension provisions, contracts of service and early termination compensation.[172] More detailed information like salaries, benefits in kind, bonuses, share options or other incentive schemes and pension entitlements should also be stated in the annual report to shareholders.[173] Whenever remuneration is performance based, it should be designed to align the interests of directors to those of shareholders.[174] The Greenbury Report also recommended that share options should not be exercisable within three years after granting and directors must be encouraged to keep these shares for a certain period after exercising the options.[175]

3 4 The Hampel Report[176]

Chaired by Sir Ronald Hampel,[177] the Committee was set up by the LSE and set out to review amongst others the Cadbury Committee's Code of Best Practices, the Greenbury Committee's Code of Best Practices and the role of the non-executive director, shareholder

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[168] Study Group on Directors' Remuneration (Chair: Sir Richard Greenbury) *Report & Code of Best Practice* (July 1995) ("Greenbury Report").
[169] For a full discussion on director remuneration see Chapter 4 par 9 Directors' remuneration *infra*.
[170] Greenbury Report pars 4.3-4.7.
[171] Greenbury Report par 5.27.
[172] Greenbury Report pars 5.4-5.7.
[173] Greenbury Report pars 5.8-5.23.
[174] Greenbury Report par 6.16.
[175] Greenbury Report pars 6.23-6.34.
[176] Committee on Corporate Governance (Chair: Sir Ronald Hampel) *Report* (January 1998) ("Hampel Report").
[177] Chairperson and former chief executive officer of ICI plc.

and auditors in corporate governance. While their task was to promote high standards of corporate governance in the interest of investor protection the Committee even went as far as to study the German two-tier board system.[178] In the end the Committee contributed little more to corporate governance than its two predecessors. The feeling was that it was too soon to judge whether the Cadbury and Greenbury reports had a positive impact on practices. They did however comment that the corporate sector was unhappy with the so-called "box-ticking" approach of, especially, institutional investors when it came to the assessment of companies' compliance with governance practices.[179] Furthermore the Committee produced a document which included some of the its own recommendations, a set of corporate governance principles and a revised code of good corporate governance.[180]

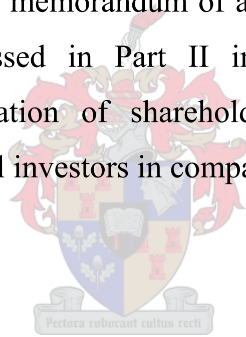
Some of the principles set out by the committee are still central to corporate governance namely: a healthy balance between executive and non-executive directors;[181] separation of the role of chairperson of the board and CEO;[182] a link between corporate and individual performance and remuneration levels;[183] disclosure of executive remuneration policies;[184] better communication between companies and institutional investors;[185] balanced and understandable financial reporting;[186] sound internal controls;[187] and healthy relationships with the auditors.[188]

Soon after the Hampel Report was published, the LSE Committee on Corporate Governance published *The Combined Code: Principles of Good Governance and Code of Best Practice* ("Combined Code") in January 1998. As the name indicates the Combined Code has two parts namely the Principles and the Code which elaborates on the Principles. The Code is applicable to all companies listed on the LSE. Listed companies must disclose whether they comply with the Code and if they do not they must explain why.

[178] Hampel Report par 3.12 26.
[179] Hampel Report par 1.13.
[180] Hampel Report Chapter 7 "Summary of Conclusions and Recommendations".
[181] Hampel Report par 3.14 7.
[182] Hampel Report par 3.l7 28.
[183] Hampel Report par 4.2 32.
[184] Hampel Report pars 4.14-4.27 37-38.
[185] Hampel Report pars 5.10-5.12 43-44.
[186] Hampel Report pars 6.16-6.18 54-55.
[187] Hampel Report par 6.11 52.
[188] Hampel Report pars 6.5-6.9 50-52

3 5 Company Law Review for a Competitive Economy

In March 1998 the then Secretary of State for Trade and Industry, Margaret Beckett MP, launched the Company Law Review for a Competitive Economy to examine modernisation of company law in the UK.[189] As part of the programme the government published a White Paper "Modernising Company Law" on 16 July 2002.[190] Although the White Paper is a broad restatement of company law, it does include a few recommendations on corporate governance. Part II of the White Paper is mainly concerned with improving corporate governance. The White Paper also includes a draft Companies Bill. The White Paper endorses so-called shareholder superiority although it stated that company law should balance the interests of shareholders, directors, employees, creditors and customers.[191] Furthermore, the point of departure for company law should be the small company with additional provisions for larger companies.[192] A further important aspect raised by the White Paper on corporate governance is the substitution of the articles and memorandum of association with a single constitutional document.[193] Other aspects discussed in Part II include the members' meetings and decisions,[194] mediation and arbitration of shareholder disputes,[195] rights of beneficial owners[196] and the role of institutional investors in company decisions.[197]



3 6 The Higgs Report[198]

The Committee, headed by Derek Higgs, was appointed by the Co-ordinating Group on Audit and Accounting Issues (CGAA).[199] The Committee assessed the *status quo* on non-executive directors, debated issues concerning them and made recommendations to the

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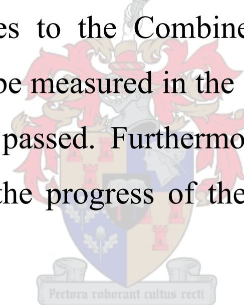
[189] For a discussion on the history of UK company law and possible future trends see Dean 2001 *The Company Lawyer* 104.
[190] White Paper "Modernising Company Law" (Cm 5553 I & II) (July 2002) available at <http://www.dti.gov.uk/companiesbill> (08 September 2003). See in general Editorial "White Paper 'Modernising Company Law' – special issue" 2002 (13 & 14) *Sweet & Maxwell's Company Law Newsletter* 1.
[191] White Paper Part II par 1.3 15.
[192] White Paper Part II pars 1.3-1.6 15-16.
[193] White Paper Part II pars 2.2-2.3 17.
[194] White Paper Part II pars 2.6-2.35 17-22.
[195] White Paper Part II par 2.36 22.
[196] White Paper Part II pars 2.37-2.41 23.
[197] White Paper Part II pars 2.42-2.48 24-25.
[198] Review of the Role and Effectiveness of Non-executive Directors (Chair: Derek Higgs) *Final Report* (January 2003) ("Higgs Report"). See in general Editorial "Corporate governance reports published – good news or yet more interference?" 2003 (2) *Sweet & Maxwell's Company Law Newsletter* 1.
[199] The appointment of Derek Higgs emphasised that the review was independent of the government.

government.[200] Aspects touched on by the Review include the number of non-executive directors in the UK, their "independence, effectiveness and accountability", issues surrounding their remuneration and the role of the Combined Code.[201] The initiative was announced on 27 February 2002, together with a similar initiative on audit committees,[202] and Higgs was appointed as head on 15 April 2002. On 7 June 2002 Higgs published a consultation paper whereby he invited responses from the public to the issues under review. The Final Report was published on 20 January 2003.[203] The Review's recommendations were based on the results of three "substantial pieces of primary research".[204] For the first part Hemscott Group Limited supplied the review team with data on listed UK companies. This data consisted of the size, composition and membership of 2 200 UK listed company boards and committees together with the age and gender of these directors. Secondly, 605 directors, both executive and non-executive, and chairpersons were surveyed with the help of the MORI Social Research Institute. The third piece of primary research consisted of interviewing 40 directors of FTSE 350 boards. This research was done with the help of three academics.[205]

The Report recommended changes to the Combined Code as soon as possible.[206] The Report's success will however only be measured in the change of attitudes and behaviours and only after a considerable time has passed. Furthermore, the Report recommended that the government and the FRC reassess the progress of the Report's recommendations after two years.[207]



The feeling is that the Report's requirement that boards should consist of a majority of independent non-executive directors, though very welcome, could result in non-executive directors focusing primarily on compliance and not on the entrepreneurial needs of the company.[208] The Report was also heavily criticised by UK businessmen. Donny Gordon, chairperson of Liberty International, described the report as "unrealistic, impractical and likely to be seriously detrimental if fully adopted".[209] Sir Stanley Kalms, former chairperson of

[200] Higgs Report Annex K - Terms of Reference 118.
[201] Higgs Report Annex K – Terms of Reference 117.
[202] See the discussion of the Smith Report par 3 8 The Smith ReportTPF *infra*.
[203] The full research can be found at <http://www.dti.gov.uk/cld/non_exec_review> (04 July 2003).
[204] Higgs Report 17.
[205] Dr Terry McNulty (University of Leeds), Dr John Roberts and Dr Philip Stiles (both of the University of Cambridge).
[206] Preferably before 1 July 2003. This was done and a new Combined Code was applicable since 1 July 2003.
[207] Higgs Report par 17.11 74.
[208] Hinks "Smith report strikes at the heart of corporate governance" (2003-01-30) *AccountancyAge.com* available at <http://www.accountancyage.com/Print/1132384> (16 July 2003).
[209] "Malls boss mauls Higgs" *The Guardian* (2003-02-13) quoted in the Myburgh Report 7.

Dixons, criticised the Report as “ludicrous” and as “a new high in lows”.[210] Hirt felt that without significant amendments to the Report’s proposals, it would not contribute to improving corporate governance in the UK. He criticises the Report on a number of aspects.[211] Firstly, the definition of independence poses a few problems. By not regarding retired executives as independent for a period of five years after retirement,[212] it is unlikely that the pool of independent non-executive directors will increase. This problem is partly resolved by the Combined Code’s principle of comply or explain. Companies are allowed to deviate from the Code but must justify doing so.[213] The requirement that at least half of the board should be independent will cause boards to become cumbersome and less effective.[214] While he commends the Report’s emphasis on independence, Hirt also feels that by making non-executive directors more dependent on shareholders, executives will be more accountable. He felt that the Report should have made more of this issue.[215] In addition, the Report failed to address the deficiencies in the enforcement of directors’ duties.[216]

3 7 Co-ordinating Group on Audit and Accounting Issues – Final Report[217]

The Co-ordinating Group on Audit and Accounting Issues (CGAA), set up by the Chancellor of the Exchequer and the Department of Trade and Industry (DTI) to ensure a co-ordinated review of the regulatory framework for auditing and accounting, published its Final Report on 29 January 2003. Ms Melanie Johnson, MP and Under-Secretary of State for Trade and Industry along with Ms Ruth Kelly, MP and Financial Secretary to the Treasury, headed the Group.[218] Although the Group’s main aim was to review accounting and audit issues, they did touch on some aspects of corporate governance.[219]

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[210] “Kalms says that Higgs’ report is ludicrous” *Financial Times* (2003-03-05) quoted the Myburgh Report 7.
[211] Hirt “The review of the role and effectiveness of non-executive directors: A critical assessment with particular reference to the German two-tier board system: Part 2” 2003 *International Company and Commercial Law Review* 261 272.
[212] See Higgs Report Box at end of Chapter 9 37.
[213] Hirt 2003 *International Company and Commercial Law Review* 271.
[214] Hirt 2003 *International Company and Commercial Law Review* 270.
[215] Hirt 2003 *International Company and Commercial Law Review* 262.
[216] Hirt 2003 *International Company and Commercial Law Review* 267.
[217] Co-ordinating Group on Audit and Accounting Issues (Chairs: Melanie Johnson & Ruth Kelly) *Final Report* (January 2003) (“CGAA Report”).
[218] Editorial “Report published on audit and accounting issues” 2002 (15) *Sweet & Maxwell’s Company Law Newsletter* 1.
[219] See discussion of the CGAA Report throughout.

3 8 The Smith Report[220]

On the same day as the Higgs Report was published, the independent group appointed by the Financial Reporting Council (FRC) to investigate the role and responsibilities of audit committees, published their Final Report. The group, headed by Sir Robert Smith,[221] was appointed in the wake of major US corporate collapses. The CGAA requested the FRC to appoint an independent group to focus specifically on aspects of audit committees and to develop this aspect of the Combined Code. The group was established on 12 September 2002. The Report replaces sections D.3.1 and D.3.2 of the Combined Code with new sections D.3.1 - D.3.5. The terms of reference for the group state that the group had to improve the Combined Code taking into account the recommendations of the CGAA in its interim report.[222] The Group's task was limited to the role and effectiveness of audit committees. In the process the Group had to work closely with Derek Higgs and the Auditing Practices Board (APB).

According to the Report's introduction the aim of the group's work was to assist company boards on aspects of audit committees and directors who serve on these committees.[223] If companies do not comply with the Report's essential recommendations, they must explain why.[224] The Report does however recognise that in some circumstances certain Code requirements are inappropriate, especially in cases involving smaller companies where detailed rules are unnecessary.[225] The specific audit committee actions of a company depend heavily on the circumstances of that particular company. Specific factors to take into account are the size, complexity and risk profile of that particular business.[226]

The guidance on audit committees is applicable to all companies listed in the UK. Where groups of companies exist, the audit committee of the holding (or parent) company must assess audit activities of its subsidiary and the group as a whole.[227] Furthermore, the guidance

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[220] Audit Committees: Combined Code Guidance (Chair: Sir Robert Smith) *Final Report* (January 2003) ("Smith Report"). See in general Editorial 2003 (2) *Sweet & Maxwell's Company Law Newsletter* 4.
[221] Member of the FRC and chairperson of The Weir Group plc.
[222] The CGAA published an interim report in July 2002 which served as a progress report of the group's work and proposed further initiatives such as the Smith Report.
[223] Smith Report par 1.1 3.
[224] Smith Report par 1.2 3.
[225] Smith Report par 1.3 3.
[226] Smith Report par 1.6 3.
[227] Smith Report par 1.13 5.

is effective and applies to all companies, financial reporting periods of which started on or after 1 July 2003.[228]

The Report contains specimen terms of reference[229] and an outline for the report on the activities of the audit committee.[230] Appendix III of the Report compares international audit committee trends. Countries which are looked at include the US, Ireland, France, Canada and Australia. The recommendations contained in the Final Report of the European Union High Level Group of Company Law Experts are also mentioned in this section.

A recent survey of FTSE 350 companies suggests that the Smith Report could cause individuals to be discouraged from taking up positions as audit committee members. The survey, which was carried out for 118 audit committee members, did however show that the Smith Report had the effect of making audit committee members more aware of their responsibility. Almost 90% of the respondents indicated that they would be more involved with the company's policy development.[231]

3 9 Evaluation of the UK position

Despite the multitude of committees and reports in recent years, the UK corporate governance system is perceived as being healthy.[232] Central to the success of the approach was the role of the Combined Code. LSE Rule par 12.43A states that a company must disclose in its annual report how it applied the principles set out in Section 1 of the Combined Code[233] and also a statement:

> "[W]hether or not it has complied throughout the accounting period with the Code provisions set out in Section 1 of the Combined Code. A company that has not complied with the Code provisions, or complied with only some of the Code provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, must

[228] Smith Report par 1.15 5.
[229] Smith Report Appendix I 29.
[230] Smith Report Appendix II 33.
[231] Zea "Audit committees face NED shortage" *Accountancy Age.com* (2003-03-20) available at <http://www.AccountancyAge.com/News/1132918> (14 August 2003).
[232] See comment made by Peter Wyman, chairman of the ICAEW, referred to in par 3 *supra*.
[233] S 12.43A (a) of the LSE Listing Rules.

> specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any noncompliance…"[234]

Much of the success can also be attributed to the conservative approach of the UK regulators. They left the promotion of good corporate practices to the business sector. Their only involvement came with the appointment of the various committees and groups. These committees and groups consisted predominantly of members from the private sector. Even when the government had the opportunity to force their will on business, they chose to follow the recommendations of committees and groups. Their motto of "comply or explain" proved to be very effective. It is questionable whether this approach will be successful in a robust and liberal business environment like the US or SA.

4 Australia: A tale of two insurers

4 1 The Bosch Report[235]

Like the UK, Australia followed a principle-based approach, avoiding the use of legislation to compel business to promote better corporate governance practices. In 1991 the Bosch Committee published the first major report on corporate governance standards in Australia. Amongst the recommendations made by the committee were the separation of the roles of chairperson and chief executive; the majority of board should consist of non-executive directors; the appointment of an audit committee of which the majority should be non-executive directors; and the development of a code of ethics by all public companies.[236] The Committee also published a set of principles in the form of the Corporate Practices and Conduct. Public companies had to disclose annually whether they complied with this code and, if not, why the company did not comply with it.[237] The ASX found in 1994 that compliance with the Code was at a very low level.[238] Australia was also lagging behind international trends with respect to corporate governance listings rules. Consequently, in 1996 Listing Rule 4.10.3 of the ASX Listing Rules was introduced. Henceforth companies had to

[234] S 12.43A (b) of the LSE Listing Rules.
[235] Working Group on Corporate Practices and Conduct (Chair: Henry Bosch), *Report on Corporate Practice and Conduct* (1991) ("Bosch Report 1991"). The next major report was the third edition of the Bosch Report which followed in 1995.
[236] Segal 2002 *UNSW Law Journal* 322.
[237] Bosch Report 1991 1.
[238] ASX Discussion Paper *Disclosure of Corporate Governance Practice by Listed Companies* (1994).

state annually the main corporate governance practices employed by the company. This statement had to include among others the processes in place for nomination of an external auditor and reviewing external audit dealings. Rule 4.10.2 required companies to disclose whether they had a properly appointed audit committee and if not, reasons for this omission.

4 2 Collapses in Australia

Australia also had its fair share of corporate scandals in the late 1990s and early 2000s.[239] The recent collapse of Ansett Australia, a passenger airline, can mostly be ascribed to competitive pressures in the airline industry rather than bad corporate governance. The most notorious cases of corporate misdemeanour concerned the two insurance giants HIH Insurance Ltd and GIO Insurance Ltd. The collapse of HIH Insurance has been described as the biggest in Australian corporate history.[240] The company collapsed in March 2001 mainly due to widespread fraud within the company. The collapse had far reaching effects on the public, due to the significant role the company played in the Australian insurance market.[241] More than $3 billion dollars in general insurance was lost. It is perhaps coincidental that HIH Insurance had the same auditor as Enron, namely Arthur Andersen. Moreover, this was not the only correlation between the two, as the CEO of HIH Insurance, Ray Williams, was also a previous managing partner at Arthur Andersen.[242] The collapse led to an intensive investigation by a Royal Commission.[243] The Australian Securities and Investments Commission (ASIC) also joined the hunting expedition by instituting civil actions against Rodney Adler, former director, Ray Williams, former CEO and Dominic Fodera, former CFO. They were found guilty of breaching their duties as directors of the company.[244] Amongst other penalties Adler, Williams and Adler Corporation (Pty) Ltd had to pay compensation to the value of AUS$ 7,958,112 to HIH Casualty and General Insurance Ltd (a HIH Insurance subsidiary).[245] Adler

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[239] They include Rothwell's, Bell Resources, Hooker Corporation, HIH Insurance, GIO Insurance, One.Tel, Harris Scarfe and Ansett Australia.
[240] For a comparison between HIH Insurance and Enron see Tomasic 2002 *Australian Journal of Corporate Law* 183.
[241] Segal 2002 *UNSW Law Journal* 327.
[242] George 2002 *Australian Journal of Corporate Law* 55.
[243] The HIH Royal Commission <http://www.hihroyalcom.gov.au> (04 July 2003). See the Commission's final report, HIH Royal Commission (Commissioner: Hon Justice Neville Owen) *Final Report* (April 2003) ("Owen Report").
[244] *Re HIH Insurance Ltd (in prov liq) and HIH Casualty & General Insurance Ltd (in prov liq); Australian Securities & Investments Commission v Adler* 2002 41 ACSR 72; 2002 42 ACSR 80; Segal 2002 *UNSW Law Journal* 328.
[245] Segal 2002 *UNSW Law Journal* 328.

was banned from being a director of any company for a period of twenty years and Williams ten years.[246] As the Royal Commission has released its report on the investigation into the demise of HIH Insurance Adler, Williams and Fodera still await the prospects of criminal liability.[247] Since the collapse of HIH Insurance ASIC has been responsible for several enforcement actions against corporate offenders.[248] These include civil proceedings against officers of HIH Insurance and other companies, like Harris Scarfe Holdings and One.Tel, where corporate crimes recently took place.[249] The government refused to implement draconian legislation to address apparent shortcomings.

4 3 The Corporations Act & CLERP

In 1997 the Australian government announced a reform programme called the Corporate Law Economic Reform Programme (CLERP). The aim of the programme was to develop corporate law bearing in mind the changing economic and business environment in Australia. In the process due consideration had to be taken of free market principles, investor protection and quality financial reporting. In 1997 the programme focused specifically on directors and corporate governance.[250] Among the aspects discussed in the paper were directors' duties and roles;[251] the business judgement rule;[252] the difference between executive and non-executive directors;[253] directors' liability for negligent breach of common law duties;[254] audit committees;[255] and international corporate governance practices.

The latest phase of the Corporate Law Economic Reform Programme, CLERP 9, was published on 18 September 2002 and focuses on improved audit regulation and corporate

[246] Segal 2002 *UNSW Law Journal* 328.
[247] The report is available at <http://www.hihroyalcom.gov.au>.
[248] For a discussion on the role of ASIC in Australian corporate governance see Du Plessis "Reverberations after the HIH and other recent Australian corporate collapses: The role of ASIC" 2003 *Australian Journal of Corporate Law* 225.
[249] See *Re HIH Insurance Ltd (in prov liq) and HIH Casualty & General Insurance Ltd (in prov liq); Australian Securities & Investments Commission v Adler* 2002 41 ACSR 72; 2002 42 ACSR 80; *R v Hodgson* (Unreported case, District Court of South Australia, Judge Bright, 26 June 2002); *Australian Securities & Investments Commission v Rich* 2003 42 ACSR 682.
[250] Corporate Law Economic Reform Programme *Directors' Duties & Corporate Governance: Facilitating innovation and protecting investors (CLERP 3)* (1997).
[251] See Chapter 4 par 14 Directors' duties *infra*.
[252] See Chapter 4 par 15 The business judgement rule *infra*.
[253] See Chapter 4 par 5 Executive and non-executive directors *infra*.
[254] See Chapter 4 par 14 Directors' duties *infra*.
[255] See Chapter 4 par 13 1 Audit committee *infra*.

disclosure.[256] CLERP 9 is divided into eleven parts, most of which relate to accounting and auditing issues. Corporate governance receives attention throughout the Report and there are continuous references to international trends. On 4 December 2003 the Corporate Law Economic Reform Programme (Audit Reform and Corporate Disclosure) Bill 2003 was tabled. ASIC published its timetable and policy guidelines for implementation of the Bill on 5 February 2004.[257]

4 4 The Horwath Report[258]

The Horwath Report of 2002 was compiled from research on governance structures of the top 250 Australian businesses. It analysed the independence of the various companies' boards of directors and audit, remuneration and nomination committees. The perception was that the Australian corporate governance system has yet to be tested systematically and objectively.

4 4 1 Criteria for the research

The Report makes use of certain criteria in evaluating a company's corporate governance "performance". The criteria used were the composition of the board of directors, audit committee, remuneration committee and nomination committee.

For the best possible performance, a company should have a board with an independent chairperson and consisting of a majority of independent directors. The board should meet at least six times a year.

Although not required by Australian company law, the Report is of the opinion that it would be in the best interest of a company to appoint an audit committee consisting solely of independent directors. The committee should be able to meet with both the internal and external auditor in the absence of management. Furthermore, the chairperson should be independent and the committee should meet at least four times a year.[259]

It is also good practice for the board to appoint a remuneration committee whose task it is to consider executive remuneration and advise the board on remuneration trends. For purposes of

[256] Corporate Law Economic Reform Programme *Corporate Disclosure: Strengthening the financial reporting framework (CLERP 9)* (September 2002).
[257] See ASIC Information Release 04.029 at <http://www.asic.gov.au>.
[258] Psaros, J & Seamer, M *Horwath 2002 Corporate Governance Report* ("Horwath Report").
[259] Horwath Report Section 2 10.

the study all the members of the remuneration committee and the chairperson should be independent.[260]

The nomination committee has the responsibility of advising the board on the appointment of new board members. Again the chairperson should be the chair of the committee, consisting solely of independent directors.[261]

4 4 2 The result

The Study showed that there is a huge disparity between companies that comply with good corporate practices and those who do not. Only nine out of a possible 250 companies complied with the criteria set out above. This represents a percentage of only 3,6%. On the other side of the scale a massive 29,2% of the 250 companies observed followed poor corporate governance practices. Only 43,2% of the top 250 companies followed even what can be regarded as generally good corporate principles. Another key finding of the study was that most companies that excelled were large companies – six of the top nine were some of the largest Australian companies. Although many companies alleged that they had good practices, it was found that many of the non-executive directors appointed as so-called "independent directors" were in fact not independent.[262] It seems that Australian companies still have a lot more to do before they can rightfully claim that their corporate governance practices relating to boards and the various committees are sound.

Pectora roborant cultus recti

4 5 The ASX Corporate Governance Principles

The ASX Corporate Governance Council released its Principles of Good Corporate Governance and Best Practice Recommendations in March 2003.[263] The Council, chaired by Karen Leslie Hamilton, was formed in August 2002 to develop a broad and flexible framework for corporate governance in Australia. They persisted with the so-called "if not, why not" approach typical of many commonwealth states, including Australia. The Principles

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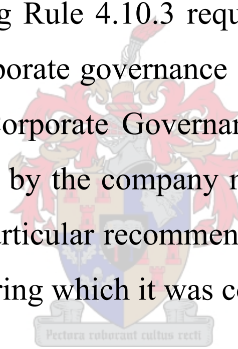
[260] Horwath Report Section 2 10-11
[261] Horwath Report Section 2 11.
[262] For a discussion of the results see Horwath Report Section 4 15-20 & Section 5 21.
[263] ASX Principles.

are applicable to all listed entities and in certain cases to trusts.[264] The Recommendations are based on ten core principles. These principles are:

- laying a solid foundation for management and oversight;
- assembly of a board with a good balance of skills, experience and independence;
- active promotion of ethical and responsible decision-making;
- safeguarding the internal and external integrity of company reporting;
- providing timely and balanced disclosure;
- recognising and respecting the rights of shareholders;
- managing risk through effective oversight and internal control;
- reviewing and encouraging improved board and management effectiveness;
- fair and responsible remuneration levels that attract and retain skilled executives; and
- recognising the legal and other interests of stakeholders.

As of 1 January 2003 ASX Listing Rule 4.10.3 requires all listed companies to include in their periodic financial reports a corporate governance statement disclosing to what extent the company complies with the ASX Corporate Governance Council Recommendations. Those recommendations not complied with by the company must be identified and reasons must be given for not following them. If a particular recommendation is only complied with for a part of the financial period, the period during which it was complied with must be stated.



4 6 Evaluation of the Australian position

The feeling in Australia is that their corporate governance practices are of a high quality.[265] But as the recent corporate collapses and the Horwath Report indicated there are still some areas where there is room for improvement. Even so, with both CLERP 9 and the ASX Principles of Good Corporate Governance they are moving in the right direction and in true Australian style provide us with fresh ideas. But as evidenced by the HIH-scandal, the Australian approach is open to abuse and perhaps the time is right for sweeping changes in the regulation of the relationship between auditors and their clients.[266]

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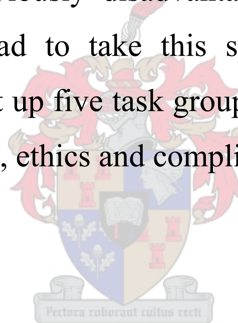
[264] ASX Principles 7.
[265] Horwath Report Section 5 21.
[266] George 2002 *Australian Journal of Corporate Law* 293.

5 The South African experience

5 1 The King Report[267]

South Africa too experienced a few cases of high-profile corporate failure in the early 1990's.[268] The first King Report on Corporate Governance was, however, published mainly as a result of the Cadbury Report in the United Kingdom and not because of these corporate failures in SA. In 1994 the Institute of Directors in Southern Africa (IODSA) appointed the King Committee chaired by former judge of the Supreme Court, Mervyn King.[269] Although the Committee's task was similar to that of the Cadbury Committee, its terms of reference were much wider. First and foremost the Committee had to develop a Code of Corporate Practices and Conduct to which South African corporations had to adhere. The period during which the first King Committee was set up was characterised by big political change in South Africa.[270] This meant that the previously disadvantaged community could now enter the business world. The Committee had to take this special circumstance into account. In achieving its goal, the Committee set up five task groups which had to investigate the specific areas of audit, directors, stakeholders, ethics and compliance.[271]



[267] King Committee on Corporate Governance (Chair: Mervyn King) *King Report on Corporate Governance 1994* (November 1994) ("King Report"). For a discussion on the King Report see Armstrong "The King report on corporate governance" 1995 *Juta's Business Law* 65; Lubbe 1996 *Journal for Juridical Science* 97; Hippert "Compliance with the King Code" 1997 *Juta's Business Law* 86; Hippert "The King Report's recommended 'business judgement test'" 1997 *Juta's Business Law* 18; Botha 1996 *SA Merc LJ* 26; Botha & Jooste "A critique of the recommendations in the King Report regarding a director's duty of care and skill" 1997 *SALJ* 65; Lubbe & Vorster "Die nakoming van sekere korporatiewe beheerbeginsels in jaarverslae van genoteerde Suid-Afrikaanse maatskappye" 2000 *Journal for Juridical Science* 88; Boltar "Legislative Reform" 1994 *Annual Survey of SA Law* 402.

[268] These include Macmed Healthcare, TTB Holdings, Masterbond and Supreme. Masterbond and Supreme made use of the same methods of finance as LeisureNet, ie debentures. The principle was simple: the promoters of the scheme remained in control while the debenture holders provided most of the funds.

[269] The initiative was supported by the South African Chamber of Commerce (SACOB), the Chartered Institute of Secretaries and Administrators (CISA), the South African Institute of Chartered Accountants (SAICA), the JSE and the South African Institute of Business Ethics.

[270] See also discussion in Chapter 2 par 2 2 The managerial model *supra*.

[271] The Director task group, headed by Michael Katz, focused on the role of executive and non-executive directors and information to stakeholders. Auditors, internal auditors and the various board committees received attention from the Audit task group under Guy Smith. The various stakeholders and the links between them were examined by the Stakeholder Links task group, chaired by Peter Joubert. Peter Wrighton headed the Ethics task group whose task it was to develop a Code of Conduct. Ensuring compliance with the recommendations were considered by the Compliance task group, chaired by Roy Andersen.

The Committee published its report on 29 November 1994. The Report's recommendations were aimed at all JSE-listed companies, large public entities,[272] banks, financial and insurance entities, large quasi-state entities and large unlisted "dependent companies".[273] The chapter on ethics was, however, aimed at all businesses in South Africa.

The King Report's recommendations formed the Code of Corporate Practices and Conduct, a set of good corporate governance standards, which was incorporated into the JSE Listings Requirements on 1 July 1995. All listed companies had to make a statement on the degree of their compliance and non-compliance with the Code. It was sufficient if the statement formed part of separate section of the company's annual financial reports. The aim of the statement was to inform shareholders about the details of the company's compliance with the Code. The question was not whether the company complied, but how.[274] The Code should however not be seen as an all-encompassing set of principles but rather a broad outline of good practices.

Some legislative reform resulted from the King Report. It exerted some influence over the Labour Relations Act,[275] Basic Conditions of Employment Act,[276] Employment Equity Act[277] and the National Environmental Management Act which, amongst others, encourages worker participation in company management and implements affirmative action programmes.[278] Some recommendations of the King Report even found their way into the Companies Act. Most notable of all is the mandatory appointment of a company secretary by all public companies with share capital.[279] Some commentators were of the opinion that the King Report would do little to improve corporate governance practices in South Africa; that the Code would only have had an impact if it was incorporated in legislation[280] and by combining elements of mandatory and enabling provisions the Report faltered in addressing issues of enforcement.[281]

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[272] S 1 of the Reporting by Public Entities Act 93 of 1992 defines "public entity" as "[a]n institution that operates a system of financial administration separate from the national, provincial, and local spheres of government and in which the State has a material financial interest…". Examples include South African Airways and Transnet.
[273] A "dependent company" is a company where the owner of capital is dependent on directors to control the company or *vice versa*.
[274] Hippert 1997 *Juta's Business Law* 86.
[275] Act 66 of 1995.
[276] Act 75 of 1997.
[277] Act 55 of 1998.
[278] Act 107 of 1998.
[279] King Report par 24.8 and ss 268A – 268J of the Companies Act, which was inserted by the Companies Amendment Act 37 of 1999. See also Chapter 4 par 18 The company secretary *infra*.
[280] Boltar 1994 *Annual Survey of South African Law* 406.
[281] Botha 1996 *SA Merc LJ* 38.

5 2 LeisureNet[282]

The dream of Rodney Mitchell and Peter Gardener to create a gymnasium group with no equal in South Africa started in 1986. A series of sixteen companies that specialised in the marketing of debentures was incorporated. At the head of the sixteen companies was Health & Racquet Club Holdings.[283] The debentures were interest free and the capital was repayable after 40 years. During this period the debenture holder was allowed to use the group's new gymnasium facilities free of charge.[284] In 1990 the Health & Racquet Club was registered as a company. This company was renamed LeisureNet and listed on the JSE on 11 April 1994.[285] In 1991 the debenture scheme as a source of finance dried up and other alternatives had to be found. The debenture scheme was substituted with a system of membership contracts that ranged from one and two years at established clubs to five and ten years at developing clubs. Membership fees were paid up front in one payment. Until 1999 it was company policy to recognise a substantial part of this payment as income in the first year of the contract. Then the company was obliged to change its accounting policy. The effect of the change on the financial statements for the 1999 financial year was significant: a net profit before tax of R159 038 million was turned into a loss of R155 422 million. At the end of 1999 Health & Racquet consisted of 85 clubs, provided gymnasium facilities for more than 900 000 members and employed 5 000 employees.[286] Of these 900 000 members, 65 000 were original debenture holders. These members were entitled to services although their memberships did not generate any income.

Despite these flaws, some commentators are of the opinion that the actual reason for LeisureNet's downfall was their aggressive overseas expansion. By the time the company was liquidated it had 22 operational overseas clubs in seven countries together with seventeen developing clubs. These clubs were the property of Healthland International, in which LeisureNet held a 58% stake. LeisureNet gave guarantees for 100% of the Healthland clubs'

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[282] See Cilliers "LeisureNet: A Strategic Analysis with Reference to Corporate Governance as Part of Company Strategy" Study Project: University of Stellenbosch Graduate School of Business (December 2002); Editorial "Health & Racquet Club Group Special Report: Healthy outlook" *Financial Mail* (1995-07-21) 49; Jones "Fiksheidsgroep se ongesonde verhaal" *Finansies & Tegniek* (2003-10-06) 46; Vermeulen "All tangled up in the net…" *PMR* (November 2000) 34; Basson "Skuldbriefspook gaan H&R-lede ry" *Finansies & Tegniek* (2001-02-23) 32; Basson "Naakte waarheid oor Health & Racquet" *Finansies & Tegniek* (2001-03-02) 8.
[283] Editorial *Financial Mail* (1995-07-21) 50-52.
[284] Basson *Finansies & Tegniek* (2001-03-02) 8.
[285] Editorial *Financial Mail* (1995-07-21) 52.
[286] Anonymous "LeisureNet execs face the whip" *Sake* (2001-06-18) <http://news24.co.za/contentDisplay/level4Article/0,1113,2_1040964,00html> (28 March 2002)

debts. The overseas clubs were however not profitable. Consequently the South African clubs had to bear the financial burden of their overseas counterparts.[287]

It is also alleged that directors made use of so-called “score sheets” for tax evasion purposes. The company paid the directors’ expenses and claimed the tax on those expenses. When the directors repaid the expenses, they could do so without paying tax.[288] There are also accusations that Gardener and Mitchell bought a 5% stake in Healthland International at a nominal rate.[289] Both lied to the board about the nature of the deal. Then there is also the allegation that Gardener and Mitchell made secret profits out of the sale of 50% in Healthland Germany in 1999 by Dalmore to LeisureNet. Gardener and Mitchell held a 20% stake in Dalmore, a company registered in the British Virgin Islands. LeisureNet paid DM10 million to Dalmore for the sale of Healthland Germany to LeisureNet. Two companies, also registered in the Virgin Islands, received the money on behalf of Gardener and Mitchell.[290] Gardener and Mitchell misled the LeisureNet board about this transaction too.[291]

In terms of the Insider Trading Act[292] the Financial Services Board (FSB) launched investigations into the rumours of massive share dumping just before the application for liquidation. The matter was referred to the Insider Trading Directorate.[293] Finding the reasons for the sudden collapse of the company is now the task of a commission of inquiry in terms of s 417 the Companies Act. The commission, headed by Advocate Peter Hodes, finished its public hearings in late August 2003 and hoped to publish its findings by the end of April 2005.

Pectora roborant cultus recti

A useful analogy can be drawn between LeisureNet and the dot-com boom of the 1990s in the US. LeisureNet provided a unique and innovative service to the public. The service it provided required expert and distinctive accounting practices and knowledge. This knowledge was not available at the time. This led to the use of questionable accounting methods by the

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[287] Jones “Fiksheidsgroep se ongesonde verhaal” *Finansies & Tegniek* (2003-10-06) 46
[288] Watson “LeisureNet bosses lived it up” *Beeld* (2001-10-03).
<http://news24.co.za/contentDisplay/level4Article/0,1113,2_1089226.00.html> (28 March 2002)
[289] Anonymous “LeisureNet execs face the whip” *Sake* (2001-06-18)
<http://news24.co.za/contentDisplay/level4Article/0,1113,2_1040964,00html> (28 March 2002)
[290] The companies have been identified as Clockwork and Ajax Way Investments
[291] Du Toit “New move for LeisureNet CEO’s” *Sake* (2002-04-03)
<http://news24.co.za/contentDisplay/level4Article/0,1113,2_1089226.00.html> (28 March 2002); Du Toit “New twist in LeisureNet case” *Sake* (2002-04-23)
<http://www.news24.com/News2…/0,6119,2-8-24_1171819,00.htm> (02 April 2003); Du Toit “LeisureNet probe halted” *Reuters* (2002-03-12)
<http://www.news24.co.za/contentDisplay/level4Article/0,1113,2_1156050,00.html> (28 March 2002).
[292] Act 135 of 1998.
[293] Insider Trading Directorate: Media Release (17 January 2002)
<http://www.fsb.co.za/media/reportbytheinsidertrading_media_release.htm> (14 January 2005)

company itself and sloppy oversight by auditors. As was the case with the dot-com boom, the growth of LeisureNet occurred at a very rapid rate. At its peak LeisureNet opened about twenty clubs per year. When the South African market was saturated, the company turned to Europe. They expanded without the necessary cash flow required. This led to the South African clubs "carrying" the European clubs. In return this resulted in the overseas clubs dragging the South African clubs down with them.

5 3 Saambou

Due to an abnormal outflow of funds and the resulting difficulties in maintaining the required levels of liquidity, the Minister of Finance, Trevor Manuel, placed Saambou Bank under curatorship on 9 February 2002.[294] Trading in the shares of its holding company, Saambou Holdings, was shortly thereafter suspended on the JSE. At the time Saambou was the seventh largest bank in South Africa. After the sale of most of Saambou's assets by the curator, John Louw, its 2 400 employees were made redundant. Thousands of depositors were left languishing before FirstRand gave them a lifeline and bought Saambou Bank for R1. Shortly thereafter depositors were allowed access to their money but not before they had to wait several unnerving months.[295]

Meanwhile the Minister of Justice asked the Directorate of Special Investigations for a probe into the affairs of Saambou. He gave the instructions based on an independent report by auditing firm KPMG that implicated executives in "highly suspicious and possibly illegal transactions"; insider trading during the period of August to September 2001; and mismanagement.[296] The report has since been handed over to the curator but he has not made it public yet.

5 4 King II[297]

On 26 March 2002, shortly after the collapse of Enron, the King Committee published their second report. The Committee was again headed by Mervyn King. It had similar terms of

[294] Anonymous "SBO plan voluntary winding up" *News24.com* (2003-02-26) <http://www.news24.com/News2…/0,6119,2-8-24_1325361,00.htm> (02 April 2003).
[295] Anonymous "Business as usual at Saambou as FNB guarantees 100% of Depositors' Funds" <https://www.fnb.co.za/FNB/popups/news/articles/20020517businessUsual.scml> (24 November 2005).
[296] Anonymous "Saambou put under spotlight" *SAPA* (2003-01-17) <http://www.news24.com/News2…/0,6119,2-8-24_1308257,00.htm> (03 April 2002).

reference but this time it had to review its own work of eight years earlier. Just like its predecessor, King II follows an inclusive approach in recognising the company's interaction with society and the environment. The Committee established four Guiding Principles for its review:[298]

- to review the King Report 1994 against local and international events;
- to review the inclusive approach of the 1994 King Report;
- to have regard to non-financial issues like social and ethical accounting, auditing and reporting (SEAAR) and safety, health and environment (SHE); and
- recommendations on the measurement of compliance with a new code of corporate governance for South Africa.

Again the Committee appointed five task teams to review specific fields of corporate governance. The five task teams focused on the following areas: (1) boards and directors; (2) accounting and auditing; (3) internal audit; (4) control and risk management, integrated sustainability reporting; and (5) compliance and enforcement. The Committee made various "new" recommendations but copied many of the 1994-recommendations. The Committee identified seven characteristics of good corporate governance, which form the backbone of its recommendations, namely discipline; transparency; independence; accountability; responsibility; fairness; and social responsibility.[299]

Following the 1994 King Report, the JSE amended its Listings Requirements in 1995 to bring it in line with international trends.[300] In 2002 similar amendments followed after the recommendations of King II.[301] Paragraph 7.F.5 of the Listings Requirements obliges all applicant issuers to make a pre-listing statement. The statement should show how the company applies the principles in the King Code of Conduct and explains to shareholders and possible investors how the principles have been applied and the reasons for each instance of non-compliance. Paragraph 8.63 of the Listings Rules requires companies to disclose, in addition to compliance with GAAP, Schedule Four of the Companies Act and Paragraph 3.84 of the Listings Requirements, information on compliance with the King Code.

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[297] See in general Loubser "Does the King II Report solve anything?" 2002 *Juta's Business Law* 135.
[298] King II Introduction and Background par 29 16.
[299] King II par 18 11.
[300] See Vermaas "The new JSE listing requirements" 1995 *Juta's Business Law* 175 and par 5 1 The King ReportTPF *supra*.
[301] See par 3.84, which was effective from 1 January 2004. Disclosure of compliance with Paragraph 3.84 came into effect for financial years commencing on 1 September 2003. See also par 20.4 of the JSE Listings Requirements.

5 5 Financial Reporting Bill[302]

Currently the Companies Act requires annual financial statements to fairly present the condition of the company in accordance with GAAP.[303] As there was no exact certainty as to what constituted GAAP, the Accounting Practices Board (APB) codified GAAP by adopting South African Statements on GAAP and in 1993 decided that the Statements on GAAP should be based on International Accounting Standards (IAS). The opinion was however already expressed in 1977 and 1987 that GAAP is very flexible and as a result many practices not codified by the Statements on GAAP also constitute GAAP. Taking into account this duality and the fact that countries like the US and Canada gave legal backing to accounting principles before 1950, the accounting profession decided to make a concerted effort to remove the uncertainty surrounding GAAP, to set uniform standards and provide for legal backing of accounting standards.[304] The result was the Financial Reporting Bill of 2002. The Bill provides for the establishment of the Financial Reporting Standards Council whose task it will be to set up, supervise and enforce uniform financial reporting standards. The Bill will also amend the Companies Act to require financial statements to comply with the standards set by the Financial Reporting Standards Council.

5 6 The Draft Accountancy Professions Bill[305]

In 2001 the Draft Accountancy Profession Bill was drawn up to provide for the consolidation of accounting and auditing laws. The Bill also provides for a Representative Council of Accountants, a Regulatory Board for Auditors and Independent Standard-setting Boards for Ethics and Auditing. On 5 December 2002 the Minister of Finance, Trevor Manual, established the Ministerial Panel for the Review of the Draft Accounting Profession's Bill. Members of the public had the opportunity to direct comments on the Bill to the Panel before 21 February 2003. The terms of reference for the Panel include reviewing the following:

- the regulatory framework of the accounting and auditing profession;
- the feasibility of separating the statutory audit and consulting services;

[302] Financial Reporting Bill, Draft 4 (29 July 2002).
[303] S 286 (3) of the Companies Act.
[304] Memorandum on the objects of the Financial Reporting Bill.
[305] Draft Accountancy Profession Bill 2001.

- the appropriateness of mandatory auditor rotation;
- the liabilities and disciplinary procedures for auditors;
- the usefulness of accounting standards; and
- the interrelationship between the Draft Accountancy Professions Bill and the Financial Reporting Bill.

The Panel handed its report (the Konar Report) over to the Minister on 30 September 2003.[306] The Panel made several recommendations about the auditing profession. These will be discussed later.[307] On 24 March 2004 the Minister of Finance, Trevor Manual, issued his reaction on the Panel's recommendations.[308] Although he agreed with most of the recommendations, he did have reservations about three areas. The Statement also indicated that the Bill will be redrafted to accommodate the recommendations of the Konar Report. The Draft Auditing Profession Bill[309] has since been tabled to replace the Draft Accountancy Professions Bill and will focus solely on the auditing profession.[310]

5 7 Corporate Governance in the South African banking industry

5 7 1 Myburgh Report[311]

On 30 April 2003 a report was published by the five major banking groups.[312] The report was commissioned by the Registrar of Banks to review corporate governance in the banking industry. Advocate Johan Myburgh SC headed the review. The purpose of the review related to among others the recommendations of King II concerning banks in general. The Report referred to a number of international developments including the King Reports, the Higgs Report and the Blue Ribbon Report[313] and compared it to current practices on South African bank boards. The Report also included in its discussions current legal requirements of bank

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306 Ministerial Panel for the Review of the Draft Accountancy Profession Bill (Chair: Len Konar) *Report to the Minister of Finance* (September 2003) ("Konar Report").
307 See discussion in Chapter 5 *infra*.
308 See *Statement by the Honorable Minister of Finance on the Recommendations of the Ministerial Panel for the Review of the Accounting Profession's Bill* on 24 March available at <http://www.treasury.gov.za>.
309 Draft Auditing Profession Bill 2004.
310 See discussion of the Bill in Chapter 5 par 3 Accounting and auditing oversight *infra*.
311 General Report on Corporate Governance in Banks (Chair: Adv J F Myburgh) (April 2003).
312 Absa Group Ltd, FirstRand Bank Holdings Ltd, Investec Ltd, Nedcor Ltd and Standard Bank Group Ltd.
313 Report of the National Association of Corporate Directors Blue Ribbon Commission on Corporate Audit Committees (1996).

boards as provided for in the Banks Act, its regulations and the Banks Amendment Bill of 2002.

5 7 2 The Banks Amendment Act[314]

One of the aims of the Banks Amendment Act is to improve corporate governance standards in banks. Banks are unique institutions and play an integral part in the modern economy. For this reason directors and managers must act with a higher degree of care and skill than what is expected from directors and managers of ordinary companies.[315] The Act includes provisions on auditor appointment, directors' duties and the formation of certain board committees. The approach in the Act is somewhat different to the one generally followed in South African corporate governance as the Act is very prescriptive. S 1 of the Act inserts a definition of corporate governance into the Banks Act:[316]

> "[I]n relation to the management of a bank or a controlling company, includes all structures, processes, policies, systems and procedures whereby the bank or controlling company is governed…"

The aim of the definition is to give the relevant parties greater clarity on the meaning of the expression. The Act also defines a director but only to the extent that it distinguishes between executive and non-executive directors.[317] What makes this significant is that this is the first time that the differentiation between the two positions is made in legislation. The definition was inserted due to the distinction drawn between the two types of directors in s 40 of the Act.[318]

The Act amends s 60 (1) of the Banks Act by placing a fiduciary duty and a duty of care and skill on any director, chief executive officer and any other executive officer of the company or holding company.[319] A chief executive officer is defined in s 1 of the Banks Act as a person authorised by the board to be responsible for the business of the company. By placing these

[314] The Banks Amendment Act 19 of 2003 was preceded by the Banks Amendment Bill of 2002 (B15-2003 Government Gazette No. 25020 of 7 March 2003).
[315] Par 7.1 of the Memorandum on the objects of the Banks Amendment Bill 2003.
[316] Act 94 of 1990. In this section "Act" refers to the Banks Amendment Act 19 of 2003 and not to the Banks Act 94 of 1990.
[317] The Act inserts a definition of director under s 1 of the Act and "[i]ncludes an executive director and non-executive director, unless expressly stated otherwise".
[318] S 40 (a) of the Banks Amendment Act amends s 60 of the Banks Act.

duties on directors, CEOs and other executive officers, the Act is extending and codifying the common law duties of directors of the executive management of the company. S 40 (b) of the Act explains the duties owed to the company by the directors, chief executive officer and executive officer. The duties include:

- to act *bona fide* in the interest of the bank;[320]
- to avoid any conflict of interests;[321]
- to possess and maintain the knowledge and skill reasonably expected from a person in the same position with similar functions;[322] and
- to exercise the care and skill which could reasonably be expected from a diligent person in the same position and with similar functions and who possess the same levels of knowledge and skills.[323]

The duties incorporated in the Act require an objective test.[324] The common law, on the other hand requires a more subjective test.[325] The duty to act in the best interest of the company arises from the factual position directors hold. They are in control of the company's assets and consequently the law requires them to act in the company's best interest. The meaning of the term "fiduciary duty" is not defined in the Act. It merely refers to relevant common law principles.[326] Furthermore, the bank and not the shareholders are the beneficiaries of the fiduciary duty.[327] The duties imposed by the Act do not however replace the common law duties of directors but are additional thereto. S 40 (b) of the Act gives the Registrar of Banks the authority to institute s 424 proceedings against any director of a bank who is knowingly a party to the reckless conduct of the business of the bank.[328] S 424 is traditionally a mechanism for the protection of the company's creditors[329] as the directors do not owe a fiduciary duty to the creditors.[330] The Registrar has the general authority to terminate the

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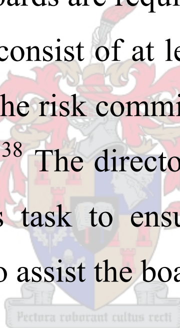
319 S 40 (a) of the Banks Amendment Act amends s 60 of the Banks Act.
320 S 40 (b) of the Act inserts s 60 (1A) (a) of the Banks Act.
321 S 40 (b) of the Act inserts s 60 (1A) (b) of the Banks Act.
322 S 40 (b) of the Act inserts s 60 (1A) (c) of the Banks Act.
323 S 40 (b) of the Act inserts s 60 (1A) (d) of the Banks Act.
324 Par 7.6 of the Memorandum.
325 *In re City Equitable Fire Insurance Co Ltd* 1925 1 Ch 407.
326 Par 7.6 of the Memorandum.
327 S 40 (b) of the Banks Amendment Act inserts s 60 (1A) of the Banks Act. This is in line with common law principles.
328 S 40 (b) of the Banks Amendment Act inserts s 60 (1B) of the Banks Act.
329 Pretorius et al *Hahlo's South African Company Law* 287. See also *Dorklerk Investments (Pty) Ltd v Bhyat* 1980 1 SA 443 (W); *Joh-Air (Pty) Ltd v Rudman* 1980 2 SA 420 (T); *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investment Properties (Pty) Ltd* 1980 4 SA 156 (W); *Philotex (Pty) Ltd v Snyman; Braitex (Pty) Ltd v Snyman* 1998 2 SA 138 (SCA).
330 *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* 1983 2 All ER 563 (CA).

appointment of a CEO, executive director or executive officer of a bank if the person is no longer a fit and proper person for the position or if it is not in the public interest for that person to hold such position.[331]

S 42 of the Act requires the appointment of a bank auditor to be approved by the Registrar of Banks. The Act requires banks with assets of more than R10 billion to appoint at least two independent auditors.[332] The Act also amends s 61 (3) of the Banks Act to implement some form of auditor rotation.[333] The Registrar may refuse the appointment of an auditor if the particular auditor has served as the bank's auditor for a certain period of time.[334] The Registrar may also withdraw an approval of appointment if an auditor is incompetent or unfit, has been convicted of an offence with an element of dishonesty or is subject to a Public Accountants' and Auditor's Board investigation.[335]

In terms of s 45 of the Act all bank boards are required to appoint a risk and directors' affairs committee.[336] The committees should consist of at least three members of whom at least two should be non-executive directors.[337] The risk committee's main function is to assist the board in the areas concerning company-risk.[338] The directors' affairs committee has more extensive functions. While it's the committee's task to ensure proper implementation of corporate governance by the board,[339] it must also assist the board in all aspects related to directors.[340]


Pectora roborant cultus recti

5 8 Evaluation of the South African position

In South Africa the government has departed somewhat from the traditional self-regulation style. This is evident from the provisions of the Banks Amendment Act, the Accountancy Profession's Bill and the Financial Reporting Bill. Although the JSE Listings Requirements still endorses the recommendations of the King Code, regulators are putting more and more pressure on companies to incorporate good corporate governance practices by requiring

[331] S 40 (f) of the Banks Amendment Act amends s 60 (6) (a) of the Banks Act.
[332] S 42 (a) of the Banks Amendment Act amends s 61 (1) of the Banks Act.
[333] S 42 of the Banks Amendment Act amends s 61 (3) of the Banks Act.
[334] The rotation period is governed by regulation.
[335] S 42 of the Bank Amendment Act amends s 61 (3) of the Banks Act.
[336] S 45 of the Banks Amendment Act inserts ss 64A & 64B of the Banks Act.
[337] Ss 64A & 64B of the Banks Act.
[338] For the committee's various tasks refer to s 64A of the Banks Act.
[339] S 64B (a) of the Banks Act.
[340] S 64B (b)-(f) of the Banks Act.

companies to adhere to prescriptive legislation. In doing so they are also moving away from their principle-based approach.

6 The diagnosis

It is very clear that one of the major reasons for the collapse of many companies was lax accounting and auditing standards. This is clearly illustrated by the Enron and LeisureNet-debacles. The financial statements of Enron and LeisureNet were in accordance with GAAP and audited in accordance with generally accepted auditing principles. At LeisureNet it was the practice to recognise a very substantial part of membership revenue in the first year of the membership contract.[341] Both these companies' financial statements complied with the requirements set by accounting legislation. This so-called "creative accounting" indicates only one thing: that the accounting and auditing principles of the US, UK and SA are inadequate. Other companies like HIH Insurance, Tyco and WorldCom echo the problem that current accounting standards only serve to mislead and defraud investors.

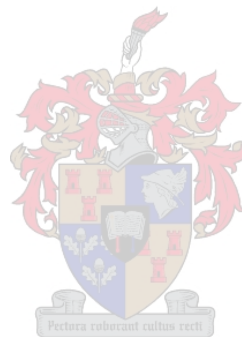
Another recurring feature of recent collapses was the lack of auditor independence. Andersen employees filled some key financial positions at both Enron and HIH Insurance and the fact that Andersen received $27 million in total from Enron for non-audit services raises the question how Andersen could have remained objective and independent.

But the ultimate reason for the collapse of companies like Enron, WorldCom and HIH Insurance is the ever-increasing separation between ownership and control. Due to this increasing division the accountability of directors to shareholders was slowly but surely whittled down to mere insignificance. On the other hand investors demanded maximum returns on their investments. In an environment of self-regulation, executives had *carte blanche*. Checks and balances designed to prevent mismanagement were used to deceive those very same investors they had to protect.

The key to addressing the problems associated with the Anglo-American model of company law, which was raised by recent corporate collapses, is to understand the phenomenon of separation of ownership and control. Regulators only need to look as far as this principle. The objective of all reform should be to close the gap between directors and shareholders where possible. Where this cannot be achieved, reform must ensure that additional checks and

[341] It can be argued that this was correct procedure as it was common knowledge that most of the members only used facilities in the first year of the contract and never again.

balances are developed to make directors (more) accountable to shareholders. It is with this in mind that this thesis discusses and evaluates the South African position against the backdrop of international developments.



CHAPTER 4: THE BOARD OF DIRECTORS

> "[E]nron and the scandals that followed in its wake at WorldCom, Tyco, Adelphia, and elsewhere teach us an important lesson: An effective board of directors is central to good corporate governance; and good corporate governance, in turn, is central to good corporate performance. Unfortunately, it took the recent wave of corporate corruption and abuses to focus our attention on the board of directors and on corporate governance more broadly. Having focused attention on the board, not everybody likes what they see. Shareholders, employees, creditors, and others place broad trust, confidence, and authority in directors to ensure the corporation's success."[342]

1 Introduction

As a general rule directors are primarily responsible for managing and leading the company. Shareholders delegate this authority to them through the articles of association.[343] Directors exercise this power through the board of directors, i.e. the directors acting together.[344] The board therefore forms the focal point of the company's management. In leading the company's commercial and economic business, the board must adopt an inclusive approach whereby it integrates the company's purpose, values and stakeholders. A company no longer functions *in vacuo*. It is the board's duty to ensure that the company's activities are compatible with and responsible towards the broader society.[345] In short, the board must find a balance between enterprise and conformance.[346]

Directors do not always realise the importance of the role modern boards play in business and the economy. Although it is a great honour to serve on a board of directors, there is more to it than just the prestige. Directors have to ensure that they have the time that is required by the job. The responsibility does not begin and end with board meetings, especially in the case of non-executive directors. They must ensure that the companies on whose boards they serve function properly and effectively.

[342] Paredes "Enron: The board, corporate governance, and some thoughts on the role of Congress" Washington University in St Louis, School of Law Faculty Working Paper Series (2003-02-03) 1.
[343] See Table A Reg 59, Table B Reg 60 of Schedule 1 of the Companies Act.
[344] Pretorius *Hahlo's South African Company Law* 343.
[345] King II par 8 48.
[346] King II par 2 47.

2 Board structure

The debate between the use of the unitary board as opposed to the two-tier board is of importance to the promotion of better corporate governance. In 1994 the King Committee evaluated the two-tier board structure.[347] Although there are other jurisdictions where the two-tier system is used, Germany is currently the best example. There the board is divided into the supervisory board (*Aufsichtsrat*) and the management board (*Vorstand*). The supervisory board has the task of appointing, remunerating and overseeing the management board. It is also responsible for approving the annual financial reports and appointing the external auditors. The management board is exclusively responsible for the company's management.[348] The King Committee of 1994 felt that with South Africa's unique labour situation, it was appropriate at least to consider the suitability of the two-tier system. The benefit of the two-tier board, with its division between supervisory and management functions, creates a higher level of interaction with regard to strategic issues and improved sharing of knowledge and expertise.[349] In most cases the two tier board system is also more susceptible to worker participation - an issue that is very relevant to South Africa. The conclusion was, however, that the unitary board could achieve the same objectives as the two-tier system. The distinction drawn by the two-tier system was regarded as artificial.[350] The unitary board with its balanced mix of executive and non-executive directors, requirements of independence and the establishment of board committees was perceived to be more than adequate to ensure that companies comply with good corporate governance practices.[351] The eventual board structure will be determined by the company's nature. In the light of South Africa's political history, King II recommended that the board's composition should however reflect the racial and gender demographics of South Africa.[352] Although the unitary board system is regarded by King II as the definitive board structure, one should highlight the need for non-executive directors to carry out their duties. Only then can the unitary board function correctly and achieve its objectives.

[347] For a detailed discussion on the two-tier system see International Task Force on Corporate Governance *Who holds the Reins?* 226.
[348] International Task Force on Corporate Governance *Who holds the Reins?* 226.
[349] Armstrong 1995 *Juta's Business Law* 66.
[350] King Report chap 4, par 10 6-7.
[351] For discussion of executive and non-executive directors, independence and board committees see par 5 Executive and non-executive directors, par 6 Independent directors and par 13 Board committees *infra*.
[352] King II par 3 47.

The South African board structure does not differ from the general structure used in countries like the US, UK and Australia, where the Anglo-American model is applicable. The point of departure for all of these countries is the unitary board consisting of directors who are classified as executive, non-executive and independent. An independent chairperson normally leads the board.[353] Due to the fact that modern boards of directors have vast responsibilities and duties, various board committees, consisting of members of the board, are appointed to improve the effective running of the company, especially within the unitary board system. By delegating issues like corporate social responsibility to a corporate governance committee, the board as a whole can still focus on the company's profitmaking, while the committee will focus on the company's interaction with stakeholders. Any delegation of powers to the various board committees should however only be done after the board identified its own levels of materiality, i.e. which issues are so important that it needs the attention and consideration of the whole board.[354] The board should assess the strengths and weaknesses of the company regularly, evaluating it against local and international competitors and best practice.[355] Directors should be cautious of possible conflicts of interests and where they occur, they ought to be fully and timeously disclosed to the board.[356] The company secretary is also central to the effective functioning of the unitary board. He/she is not only responsible for improving the communication on the board, but he/she will liaise with the various board committees informing them on aspects like their duties, responsibilities, tasks, legal requirements and international trends.[357] To ensure proper functioning of boards in South Africa, the JSE Listings Requirements state that company boards must adopt a policy whereby board responsibilities are divided to ensure a balance of power.[358] This policy must divide duties among the individual directors as well as the relevant board committees.

3 The chairperson

Internationally, the chairperson of the board is regarded as very important to the proper functioning of boards as it is the chairperson's main duty to manage the board. His role is also important away from the board of directors: it is the chairperson's task to preside over the

[353] See par 3 The chairperson *infra*.
[354] King II par 10 48.
[355] King II par 5 47.
[356] King II par 6 47. See also the discussion of directors' duties in par 14 Directors' duties *infra*.
[357] For full discussion of the role of the company secretary see par 18 The company secretary *infra*.
[358] JSE Listings Requirements par 3.84 (b).

annual general meeting.[359] His/her other duties include leading the board, participating in board selection; acting as a link between the board and management; and ensuring that the board is properly and timeously informed of all relevant facts and information.[360]

It is universally recognised that a clear distinction must be drawn between the duties of the chairperson, who has the responsibility to lead the board, and the CEO, who runs the business and implements the policies of the board, due to the important role of the chairperson and the different responsibilities associated with the two positions.[361] In the UK this division should also be made clear in writing.[362] According to King II exceptional circumstances may however justify the combination of the two positions.[363] The two positions can for example be combined where the deputy chairperson is an independent non-executive director or where the majority of the board is non-executive. If the board indeed decides to combine the two positions, it must explain the reasons for doing so to the shareholders.[364] Although this is similar to the approach followed by the King Report of 1994, King II requires explanation of the combination of the two positions to shareholders.[365] While as a general rule the positions must be separated very clearly, it is necessary for the chairperson and chief executive to have a very strong and healthy relationship. Although it is not yet required in South Africa, international best practice is that the CEO should also not become chairperson.[366] In the UK this recommendation was heavily criticised by Donny Gordon, chairperson of Liberty International, as "palpably absurd and unhelpful".[367] The risk with combining the positions of chairperson and CEO is that it might result in diminishing the effect non-executive directors have on the board. The independent chairperson is an important ally in achieving a balance between independence from and involvement in the company.

[359] King II par 2 51.
[360] King II par 3 51. See also the Higgs Report 23 & Annex D 99.
[361] See JSE Listings Requirements par 3.84 (c); King II par 4 52; Combined Code par A.2; the Higgs Report par 5.3 23 and ASX Principles Recommendation 2.3 21.
[362] Higgs Report par 5.5 24 and also Combined Code par A.2.1. It is not clear what is meant by "in writing" but in could refer to a board charter or the company's memorandum and articles of association.
[363] According to the King Report of 1994 these circumstances could include cases where the "founding family" member is the chairperson of the board but at the same time exercises executive duties. See the King Report Chapter 7 par 6 13; Armstrong 1995 *Juta's Business Law* 65.
[364] King II par 5 52.
[365] King Report 13.
[366] Higgs Report par 5.7 24; Guidance to ASX Principles Recommendation 2.3 21.
[367] "Malls boss mauls Higgs" *The Guardian* (2003-02-13) quoted in the General Report on Corporate Governance in Banks (Chair: Adv J F Myburgh) (April 2003) ("Myburgh Report") 7.

4 The chief executive officer

Many people aspire to the position of CEO due to the status associated with the position. It remains one of the most enigmatic positions in business. The responsibilities associated with the position are vast and include developing the company's strategy, annual business plans and budgets in support of the company's strategy, ensuring that the company meets its financial and operating goals and targets, formulation of and oversight over the company's major policies and acting as the company's chief spokesperson.[368] This is often reflected in the salary paid to individuals filling this position. Due to their duty to ensure the company's economic performance, CEOs will sometimes push the boundaries of what is morally acceptable and legal, occasionally resulting in situations similar to Enron and WorldCom. Unlike the chairperson, the chief executive officer is directly involved with the company's business. As the company's effective leader, the CEO should apply positive and ethical working standards which not only encourage and promote individual integrity and ethical practices but also attract and retain employees of high calibre.[369]

5 Executive and non-executive directors

The distinction between executive and non-executive directors is very important to proper corporate governance, especially within the context of the unitary board system. The difference between executive and non-executive directors is rooted in their position vis-à-vis the company. Non-executive directors are not in the full-time employment of the company and therefore have no direct knowledge about the company.[370] They rely heavily on information provided to them by the company. The chairperson and company secretary must ensure that information reaching non-executive directors is timely, accurate and in accordance with law in order to ensure their effectiveness. A good non-executive director on the other hand, will make sure that he/she makes sound judgements based on information that is appropriate and of sufficient quality. Non-executives must apply a certain degree of self-clarification on these matters.[371] On the other hand, executive directors normally are full time employees of the company.[372] Due to their involvement in the company they have first-hand knowledge about

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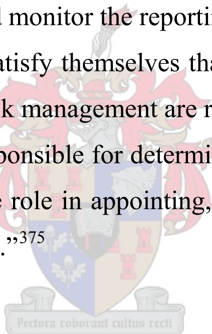
[368] King II par 2 53.
[369] King II par 3 53.
[370] See also the discussion of King II on this topic *infra*.
[371] Higgs Report par 11.27 51.
[372] See also the discussion of King II on this topic *infra*.

the affairs of the company. This results in an asymmetry of knowledge. But it is also this asymmetrical relationship that is so crucial for effective functioning of the unitary board. With their objective, uninterested views non-executive directors ensure proper conduct of the executive management by acting as counterweights to them and ensuring that their power is not unfettered. King II acknowledges this role of the non-executive director and highlights three qualities of a good non-executive director, namely courage, wisdom and independence.[373]

The Higgs Report extensively reviews the role of non-executive directors.[374] The Report identifies four important tasks of the non-executive director:

> "[S]trategy: Non-executive directors should constructively challenge and contribute to the development of strategy.
> Performance: Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.
> Risk: Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.
> People: Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning."[375]



The two most challenging tasks are strategy and performance. These tasks are perceived as contradictory. The Report expresses the opinion that, despite the tension, both tasks, if balanced, contribute to the effectiveness of a non-executive director. According to the Higgs Report non-executive directors have among others the following attributes: expertise, skill, experience, sound judgement and integrity.[376] Non-executive directors need to assess this on a regular basis.[377] The company too, must ensure that it develops and refreshes the skills, knowledge and expertise of non-executive directors.[378] The board as a whole also needs to evaluate itself, its committees and its members individually in terms of its strengths and weaknesses.[379] This will enable the chairperson to lead the board more effectively.

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[373] King II par 4 55.
[374] See Chapter 3 par 5 Executive and non-executive directors *supra*.
[375] Higgs Report box at the beginning of Chapter 6. See Combined Code par A.1 Supporting Principles.
[376] Higgs Report par 6.12 29.
[377] Higgs Report par 11.12 48.
[378] Higgs Report par 11.14 49 but see Combined Code par A.4 Supporting Principles.
[379] Higgs Report par 11.22 50 but see Combined Code par A.6 Supporting Principles.

King II provides extensive definitions of executive and non-executive directors. It deviates from the approach of the 1994 King Report, which gave a broader definition of a non-executive director.[380] An executive director is normally a full time employee of the company who is involved with the day-to-day running of the company.[381] A non-executive director on the other hand is not a full-time employee of the company, nor is he/she involved in the day-to-day activities of the company. In certain circumstances a full time employee of the holding company or subsidiary can be classified as a non-executive director as long as it can be construed that he/she is not involved in the day-to-day management of the company and its subsidiaries.[382] Although these exceptions are inconsistent with international practice they are justifiable in the sense that they are seemingly in line with the Committee's views on the shortage of skilled individuals in South Africa.[383] The only downside to the Committee's concession is that if companies do appoint individuals from their holding companies or subsidiaries, they will have less non-executive directors who can be regarded as independent.[384]

King II encourages executive directors to take up other non-executive directorships on condition that it does not interfere with their responsibilities as executive director of the company.[385] This is seemingly to extend the pool of skilled and knowledgeable directors in South Africa.[386] While the Combined Code discourages full time executive directors to take up more than one non-executive directorship in big companies,[387] King II only warns non-executive directors to be very cautious with the number of positions they take up. Non-executive directors are burdened with major responsibilities. Many non-executive directors do not realise this. By advising them to be cautious when taking up other non-executive positions, the Committee was highlighting the importance of the position of non-executive directors. The Committee is not consistent in only warning non-executive directors. Just as non-executive

[380] King Report 10.
[381] King II par 7.1 56.
[382] King II par 7.2 56.
[383] See par 6 Independent directors *infra*. See however the reservations expressed about this view in the same paragraph.
[384] See requirements of independence par 6 Independent directors *infra*.
[385] King II 57. The Combined Code differs somewhat from this approach as it recommends that no full time executive director of listed companies should hold the position of more than one non-executive directorship or chairmanship of a major company. See Combined Code par A.4.5.
[386] This was the reason proposed by the first King Report and in the absence of any other suggestions it must be concluded that the reasoning stayed the same. See King Report Chapter 1 par 19 12.
[387] See Combined Code par A.4.5.

directors should be cautious, so too should executives when they want to take up more than one other non-executive directorship.

While the King Report of 1994 did not prescribe a specific term of appointment for non-executive directors; it did recommend that executive directors should not serve for more than five years.[388] King II places a three-year limit on executive directors' terms of office but no such limit is placed on non-executive directors.[389] In contrast to both King Reports, the Combined Code limits a non-executive director's term of office to two three-year terms after which he/she may only be re-elected annually.[390] South African companies should consider limiting the term of office of their non-executive directors. Due to the important role non-executive directors play it is necessary to avoid them becoming too involved in the companies where they are appointed. If non-executive directors are re-appointed after serving for a period of more than five or six years, it should be explained in the annual financial statements and the fact that they served for such a long period should be taken into account when determining their status as independent non-executive directors.[391]

6 Independent directors

An independent director can broadly be described as a non-executive director who has no relationship with the company other than serving as a member of the board of directors. This means that they are not employees of the company, do not contract with the company, have no shareholding in the company, etc. The advantage of independent directors is that they contribute some degree of objectivity to the board regarding the company's business affairs. In a sense they can be regarded as the voice and ears of investors on the board.[392] Hirt's view is that it is because of this function that independent directors should rather be regarded as dependent directors – dependent on the shareholders.

It can be argued that the aim of independent directors is already achieved with the appointment of non-executive directors. But in certain cases companies appoint ex-employees, employees from their holding company or subsidiaries and major shareholders to act as non-executive directors. Furthermore, a non-executive director who serves for a period of more than six years can hardly be described as being independent. While it is true that these

[388] King Report Chapter 6 par 18 12; Armstrong 1995 *Juta's Business Law* 66.
[389] King II par 20 59.
[390] Combined Code par A.7.2.
[391] See discussion in par 6 Independent directors *infra*.
[392] See Hirt 2003 *International Company and Commercial Law Review* 272.

directors are not part of the day-to-day running of the business and therefore qualify as non-executive directors, it is quite evident that they are not sufficiently independent and objective to ensure proper conduct by the executive management. They will also have some relationship that can jeopardise their independent judgements as non-executive directors.[393] For this reason much emphasis is placed on independent non-executive directors.

In terms of the recently enacted NYSE corporate governance rules the majority of board members should be independent to ensure effective functioning of boards.[394] To qualify as an "independent" director, the company's board of directors must determine that the director has no material relationship with the company.[395] The relationship can be direct or in the form of a partnership with, shareholding in, or serving as an officer of an organisation with which the company has a relationship. The NYSE does not regard ownership of stock in a company *per se* as an impediment on independence. Companies are required to disclose which directors are designated as independent. In determining the independence of a particular director the board must take into account all relevant facts and circumstances. The basis for determining whether the company does not regard a specific relationship as material must be disclosed in the company's annual proxy statement or Form 10-K report filed with the SEC. Companies may adopt standards to assist the board in determining independence. These standards must be disclosed. If a particular director does not meet the standards but is nevertheless regarded by the board as independent, the company must disclose this finding and the basis for such a finding.[396] The new NYSE Manual rules also contain a presumption that a director is not regarded as independent if certain circumstances exist:

- if a director or an immediate family member is an executive officer of the company;[397]
- if a director or an immediate family member receives more than $100 000 compensation per year from the company over and above compensation as director, committee fees, pension or other compensation for prior service;[398]
- if a director or an immediate family member is affiliated or employed by a present or former internal or external auditor;[399]

[393] Even if they sometimes are independent and objective, third parties may easily perceive them to be non-independent and subjective.
[394] S 303A (1) of the NYSE Manual.
[395] S 303A (2) (a) of the NYSE Manual.
[396] Commentary on S 303A (2) (a) of the NYSE Manual.
[397] S 303A (2) (b) (i) of the NYSE Manual.

- if a director or an immediate family member is employed as an executive officer of another company where any of the company's present executives serve on the remuneration committee;[400] or
- if a director or an immediate family member is an executive officer of another company that either accounts for the greater of 2 % or $1 million of the listed company's consolidated gross revenues, or for which the company accounts for the greater of 2 % or $1 million of the other company's consolidated gross revenues.[401]

The presumption only ends three years after any of the abovementioned circumstances cease to exist.[402] An "immediate family member" includes a person's spouse, parents, children, siblings, mother and father-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone who shares a home with the person.[403] The NYSE Manual does not define "affiliated" but might refer to a person who is employed by the auditor, works on a consulting basis or even a person who was employed by the auditor in the recent past.

Independence in the UK is discussed broadly in Chapter 9 of the Higgs Report. The Report requires non-executive directors to have independence of mind. In a factual sense, non-executive directors should also be independent with respect to remuneration, shareholding and auditing. The Report recommends that at least 50% of the board, excluding the chairperson, should be independent.[404]

Independence has received much attention after the recent spate of corporate failures. The question however remains: what does this independence, or rather distance, from the company exactly mean? The previous Combined Code used a very subjective test. It left the task of determining whether a particular non-executive director is independent, to the board itself. To determine independence, the question the board had to ask itself was whether the particular director is "[i]ndependent of management and free from any business or other relationship" that could materially affect his independent judgement?[405] This definition looked at different relationships. It was not limited to the director's relationship with the company and referred to

[398] S 303A (2) (b) (ii) of the NYSE Manual.
[399] S 303A (2) (b) (iii) of the NYSE Manual.
[400] S 303A (2) (b) (iv) of the NYSE Manual.
[401] S 303A (2) (b) (v) of the NYSE Manual.
[402] S 303A (2) (b) (i)-(v) of the NYSE Manual.
[403] S 303 (2) (A) of the NYSE Manual.
[404] Higgs Report par 9.5 35.
[405] Higgs Report par 9.7 36.

the director's relationship with other companies and individuals too. The Higgs Report expresses the opinion that independence should not be defined by statute. The Combined Code should simply state that a director must make decisions on objective grounds and in the best interests of the company.[406] It should also define independence as follows:

> "[A] non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement."[407]

Nevertheless, the Report was amended to identify some of these "relationships or circumstances" that could affect a director's judgement:[408]

- if he/she is a former employee of the company in the previous five years;
- if he/she has had a substantial business relationship with the company in the last three years;
- if he/she has received, in addition to his/her fee as director, remuneration or an opportunity to participate in share options;
- if he/she is part of the company's pension scheme;
- if he/she has close family ties with directors, senior employees or advisers of the company;
- if he/she holds a cross-directorship;
- if he/she has a significant shareholding; or
- if he/she served as member of the board for more than ten years.

Again it is required of the board to identify which members it considers to be independent. To facilitate improved communication between shareholders and the non-executive directors, the Report recommends that a senior independent director be identified. He/she will function as a conduit for concerns which have not been resolved through the normal channels.[409] He/she will also head all meetings between non-executive directors where the chairperson is not attending.[410] The Higgs Report also recommends that the senior independent director should attend the discussions between management and major shareholders to get a sense of the concerns of shareholders. He/she ought to convey these issues to the non-executive directors,

[406] Higgs Report par 9.10 36.
[407] Higgs Report par 9.11 36.
[408] Higgs Report Box at end of Chapter 9 17.
[409] Higgs Report par 7.5 31 but see Combined Code par A.3.3.
[410] Higgs Report par 7.5 31 but see Combined Code par A.1.3.

and where appropriate, to the whole board.[411] The Combined Code was amended to bring it in line with the recommendations of the Higgs Report regarding the senior independent director.[412] A survey by the Confederation of British Industry showed that 82% of FTSE 100 chairmen felt that if these recommendations on senior independent directors were applied, it would undermine their positions as chairpersons and divide their boards.[413]

According to the second ASX Principle the board must be assembled in such a way that it is effective in structure, size and commitment. For this reason it is recommended that the board should consist of a majority of independent directors.[414] The Principles echo the definition of independent director used by the Investment and Financial Services Association (IFSA), which defines an independent director as a non-executive director who:[415]

- does not represent a substantial shareholding in the company;
- has not been employed by the company as an executive;
- is not a founder member of the company;
- does not provide professional advice or is the principal of someone who gives professional advise;
- is not a major customer or supplier of the company;
- does not contract with the company other than in his capacity as director; and
- is free from any relationship, which could possibly interfere with his/her ability to promote the best interests of the company.

It is also recommended that the chairperson be an independent director.[416]

The King Report of 1994 recommended that non-executive directors should be independent in the sense that they are not part of the company's pension or medical aid fund, are free from any business relationship and independent from management.[417] According to the Committee the problem in South Africa is the enormous shortage of people with experience in the corporate environment. Finding someone who is independent in the true sense of the word was

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[411] Higgs Report par 15.15 69 but see Combined Code par D.1.1.
[412] See Combined Code par A.3.1-A.3.3.
[413] "Leave some room for the chairs" *The Guardian* (2003-03-10); "Top chairmen condemn Higgs" *Timesonline* (2003-03-10); "Higgs overlooks investor behaviour" *Financial Times* (2003-03-10) quoted in the Myburgh Report 8.
[414] ASX Principles Recommendation 2.1 19.
[415] Investment & Financial Services Association Guidance Note No. 2.00 *Corporate Governance: A Guide for Fund Managers and Corporations* ("IFSA Blue Book") par 11.3 18.
[416] ASX Principles Recommendation 2.2 21.
[417] King Report Chapter 6 par 16 12.

therefore regarded as a daunting task for any company. Consequently the Committee endorsed the idea that a director is independent if he/she is a director of a holding company or a former executive director of a subsidiary and has no executive responsibilities in the company where he/she is appointed as non-executive director.[418]

This compromise of the King Report of 1994 is contrary to recent international requirements of what constitutes an independent director. In no way should an independent director be allowed to have any relationship with a company other than serving on the particular company's board. A further two aspects are also of importance here. Firstly, while it is true that South Africa has a limited number of people with corporate expertise and experience, the Committee lost sight of the fact that South Africa has, in comparison with countries like the UK, US and Australia, less registered companies. The Committee's views on shortages are therefore exaggerated. Secondly, by relaxing the requirements for independence, the Committee was defeating the whole purpose of independent directors. They form the checks and balances that ensure proper functioning of the unitary board system. Directors of holding companies or subsidiaries can never be independent from their subsidiaries or holding companies respectively.

It is therefore not surprising that King II uses a more traditional definition of independence. An independent director is a non-executive director who:[419]

- does not represent a shareholder who has the ability of controlling or significantly influencing the management or board;[420]
- has not been employed in an executive position for the company in the three preceding financial years;[421]
- is not an immediate family member of a person who has been employed in an executive position for the past three financial years;[422]
- is not, other than in his/her capacity as director, a professional advisor of the company;

[418] King Report Chapter 6 par 16 12.
[419] King II par 7.3 56.
[420] The Report does not exclude a person who is himself/herself a significant shareholder from being an independent director. It uses the words "[a] representative of a shareowner who has the ability to control or significantly influence management". This could be seen as a mistake by the Committee. Surely, a substantial shareholder cannot be regarded as independent.
[421] The Higgs Report's independence requirement is much more stringent. A non-executive director is not regarded as independent if he served on the board for more than ten years. This is in line with the Report's six-year limit on the term of office of a non-executive director. After a period of ten years a non-executive director's relationship with the management cannot be regarded as independent.
[422] The Report fails to define the meaning of an "immediate family member".

- is not a significant supplier or customer of the company;
- is in no significant contractual relationship with the company;[423] and
- is free from any business or other relationship which could materially affect his/her capacity to act independently.

Although the law requires all directors, whether executive, non-executive or independent, to act independently, the meaning of "independent" in this sense differs from that of an independent director. An independent director is independent in the stricter sense of the word, i.e. independent from any relationship with the company or group. Where it is required from directors to act independently, it means that they should exercise their authority unfettered and without being influenced by other individuals.[424] Independent directors should have excellent leadership qualities and highly developed communication skills. To protect minorities, King II recommends that a sufficient number of directors should be independent.[425] In terms of the JSE Listings requirements each director must be categorised as executive, non-executive and/or independent. The categorisation is done exactly as set out in King II.[426]

The JSE Listings Requirements do not prescribe the percentage of independent directors that should be present on the board. The King Committee only requires a "sufficient" number to ensure protection of minorities[427] but in the interest of good corporate governance at least half of the board should consist of independent non-executive directors. The requirement of the NYSE Listed Manual and the ASX Principles, that a majority of directors should be independent, is not suitable for South Africa. Too many independent directors could hamper the functioning of the company as a whole. A ratio of somewhere in the region of 1:1 between the independent and non-independent representation on the board will be in the best interest of the company. Companies should furthermore disclose in their annual financial statements which directors they regard as independent. This will give investors the opportunity to see who is representing their interests on the board. And together with a statement by the board on the responsibilities of the various board members it will indicate whether these individuals are doing their job.

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[423] This provision should perhaps read "[i]n no significant contractual relationship with the company, other than in his capacity as director…".

[424] For a detailed discussion of a director's duty to act with an unfettered discretion see *Coronation Syndicate Ltd v Lilienfield and New Fortuna Co Ltd* 1903 TS 489; *Thorby v Goldberg* 1964 112 CLR 597; *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 4 SA 156 (W); *Fulham Football Club v Cabra Estates plc* 1992 BCC 863.

[425] King II par 3 47.

[426] See JSE Listings Requirements par 3.84 (f).

The approach to determining whether a director is regarded as independent in SA and Australia differs somewhat from that of the UK. The Combined Code contains a general statement that directors are independent if their judgement and character are independent and they have no relationship with the company that could affect their independent judgement. It then proceeds to identify the circumstances which could affect a director's independence.[428] The approach in Australia and SA is to identify the circumstances in which a director is regarded as independent but these circumstances include a catch-all provision which refers to any relationship that could interfere with a director's independence.[429]

One shortcoming of King II's definition of independence is that it does not look at the period a non-executive director has served on the board. While it can be argued that the catch-all provision in the definition takes care of this issue, it is not clear enough.[430] Holding the position of non-executive director for a long period is surely just as important as being employed in an executive position at the company for purposes of determining whether a director is independent. The Combined Code makes use of a ten-year period, after which a director cannot be regarded as independent. This period is too long and should in fact be five or six years.

The definition in King II also does not take into account if the director is part of the company's pension fund scheme.[431] As many companies' pension fund schemes form part of their corporate structures, the fact that a director is part of that scheme could affect his independent judgement. This factor should be taken into account when determining a director's independence.

A further dissimilarity between the Combined Code and King II's definition is that the Combined Code refers to any substantial business relationship only, while King II distinguishes between being a major customer or supplier, being a professional adviser of the company and any major business relationship. The term major business relationship encompasses a company's customers, suppliers and professional advisors and therefore their use is tautological.

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[427] *Supra*.
[428] Combined Code par A.3.1.
[429] See the definition of independence in South Africa and Australia *supra*.
[430] See King II's definition of an independent director *supra*.
[431] See the Higgs Report's definition of an independent director *supra*.

Being a family member of a director, senior employee or consultant is also not taken into account by King II's definition. This relationship definitely poses a threat to any director's independent judgement and should be incorporated into the definition of independence.

7 Worker participation

At the time when the King Report of 1994 was published, South Africa was going through political rebirth. The adoption of a Bill of Rights meant the legal recognition and entrenchment of a number of basic human rights, which included the right to fair labour practices.[432] Consequently, the Committee emphasised the importance of worker participation in the management of companies. Each company had to develop its own system by taking into account the company's business and the culture of the corporation, management and workers.[433] This is somewhat confusing. The Committee endorsed worker participation in the corporation but at the same time it was left to corporations to develop their own different approaches. This could have resulted in a situation where companies did nothing at all to involve employees in management. In the end the legislature got involved and adopted employment legislation which included the Labour Relations Act[434] and the Employment Equity Act.[435] It is doubtful whether the King Committee had this kind of prescriptive legislation in mind when they made recommendations on worker participation in the management of companies. The legislation has not had the desired impact on worker participation as very few workplace forums were set up since the enactment of the legislation. The reason for this might lie in the fact that trade unions are reluctant to lose their power in the workplace.

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[432] See s 27 of the Interim Constitution Act 200 of 1993.
[433] King Report Chapter 4 par 12 7.
[434] The Labour Relations Act 66 of 1995 forced companies to implement worker participation programmes by providing for organisational rights for trade unions, collective agreements in the form of agency shop and closed shop agreements, bargaining councils and statutory councils. The purpose of the Act includes creation of "[a] framework within which employees and their trade unions, employers and employers' organisations can…(i) collectively bargain to determine wages, terms and conditions of employment and other matters of mutual interest; and (ii) formulate industrial policy…" See s 1 of the Act.
[435] The purpose of the Employment Equity Act 55 of 1998 was to promote equal opportunities and fair treatment of workers and the implementation of affirmative action measures in order to redress the disadvantages in employment.

8 Black Economic Empowerment

An aspect of corporate governance that is very unique to South Africa is Black Economic Empowerment. The political history before and developments in South Africa since 1990 have been well documented. With the abolition of racially discriminating legislation and the subsequent election of a democratic government in 1994, the black community is emerging as the major economic force in South Africa. The King Committee of 1994 encouraged companies to play a bigger role in the community and to be more sensitive to its social needs.[436] Companies should get more involved in their communities. The eradication of poverty should not only be the government's concern. This does not however mean that companies should now forget that they should maximise shareholder wealth. They can assist the government in various ways like donations to schools, timely and diligent payment of taxes, sponsoring of social upliftment programmes, HIV/AIDS education in the working environment, etc. Affirmative action is a process through which the racial and sexual imbalances in South African businesses are addressed. The 1994 King Report recommended that companies should implement financially viable affirmative action programmes.[437] The Committee did however warn against tokenism. In doing so the Committee attempted to avoid the possible tension which can arise due to the promotion of members of the previously disadvantaged community.[438] Recommendation 15.3, for example, directs boards to train new directors with no prior board experience before they can take up their positions on the boards. The South African Chamber of Business (SACOB) has developed a number of guidelines on affirmative action. They are available from the IODSA or SACOB. The King Report of 1994 contained a summary of SACOB's proposals on affirmative action.[439] King II dealt with Black Economic Empowerment in Section 4 under social and transformation issues.[440] The Broad Based Black Economic Empowerment Act[441] was passed and commenced in April 2004. The Act will allow economic transformation of all black people which include in terms of s 1 of the Act Africans, Coloureds and Indians in South Africa.

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[436] King Report Chapter 16 par 3.1 23.
[437] King Report Chapter 17 par 2 24.
[438] Boltar 1994 *Annual Survey of SA Law* 404.
[439] King Report 66.
[440] King II Section 4 Chapter 5 114. Due to the fact that Black Economic Empowerment is such a vast and elaborate field of study, it is not practical to have a detailed discussion of the topic.
[441] Broad-Based Black Economic Empowerment Act 53 of 2003.

9 Directors' remuneration

Directors' remuneration, especially the use of share-based compensation, has been under the spotlight since the end of the dot-com boom. While the idea behind share-based compensation – the aligning of the interests of directors with that of shareholders – is understandable, the problems with the practice became very evident.[442] Directors were more interested in the performance of their own shares than in the interests of the company. They started manipulating financial statements to "enhance" the financial condition of companies. Profits were overstated and debts were hidden away. Directors were given shares and share options as part of their remuneration. When these companies inevitably run into trouble, directors dump their shares as they are normally the ones with first hand information about the companies. The ordinary investors are left with the worthless stock. Due to these problems the use of shares, share options, etc. to compensate directors has been the subject of considerable debate.

Although the proposed amendments to the NYSE Listed Companies Manual relating to the use of share based compensation is still reserved for later comment, it is fitting to make a few comments on subsection 8.[443] In terms of this rule shareholders will be allowed to vote on all equity-compensation plans. This will give shareholders more control over the granting of these plans. The idea is that shareholders will consider each individual case of equity-based compensation to ensure that it is not given under questionable circumstances. Hopefully, the problems surrounding the practice will then be limited to an acceptable degree, if not totally resolved.

A major development in UK company law was the drafting of new remuneration regulations.[444] These regulations have been in force since 1 August 2002.[445] The regulation is in line with the LSE Listing Rules par 12.43A and inserted Schedule 7A in the existing 1985 Companies Act.[446] The regulations require boards to publish as part of their annual directors' report, a report on the remuneration of directors. Amongst others the report must contain:

- individual directors' pay;
- considerations taken by the board in determining the remuneration;

[442] See Chapter 1 par 1 2 A brief history of SA company law s*upra*.
[443] Proposed s 303A (8) of the NYSE Manual.
[444] Directors' Remuneration Report Regulations 2002 (SI 2002/1986).
[445] The rules are applicable to financial year-ends on or after 31 December 2002.

- the remuneration committee membership;[447]
- whether and how the remuneration relates to director performance;
- the directors' remuneration policy of the company; and
- a graph comparing company performance against the relevant market index.[448]

A more formal provision on the disclosure of directors' remuneration is however in the pipeline. In 1999 the UK Government issued a consultative document on directors' remuneration which was supplemented by a similar document in December 2001. A document was later presented to Parliament. The document requires, among other things, that companies publish as part of their annual financial statements, a report on directors' remuneration. The report must contain details of individual remuneration packages, the company's policy on remuneration and the role of the compensation committee and board in determining directors' remuneration. When finally enacted the provision will require shareholder approval of this report.[449]

The Higgs Report also gives a number of general guidelines on directors' remuneration. It recommended levels of remuneration for non-executive directors that are in line with the specific director's workload, responsibilities and the requirements of the particular company.[450] Remuneration of non-executive directors should consist of an annual fee, attendance fees and additional fees for chairmanship of committees or the position of senior independent director.[451] The chairperson and chief executive must determine non-executive directors' remuneration. The use of shares instead of cash has, according to the Report, its merits. Payment in the form of share options is however discouraged.[452] According to the Report the reason for this is obvious: the director's focus will be shifted away from company performance towards share performance. If share options are however used, this must be approved by the shareholders and the director must retain the shares obtained in that manner for at least one year after he/she has left the board.

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[446] See Editorial "Legislation: Directors' Remuneration disclosure and report required" 2003 (15) *Sweet & Maxwell's Company Law Newsletter* 6 and the discussion of the section *infra*.
[447] For a discussion of the remuneration committee see par 13 2 Remuneration committee *infra*.
[448] Editorial 2003 (15) *Sweet & Maxwell's Company Law Newsletter* 6.
[449] White Paper Part II par 3.22 29.
[450] Higgs Report par 12.24 56.
[451] Higgs Report par 12.24 56.
[452] Higgs Report par 12.27 57 but see Combined Code par B.1.3.

The ASX Principles recommend executive remuneration levels that are fair and responsible. This can be achieved by disclosing the remuneration policies of the company annually.[453] By disclosing the policies investors will understand the costs and benefits of the policies and the relationship between company performance and individual performance. Details such as the components of remuneration, objectives of remuneration and the board structure could assist shareholders in evaluating the remuneration of individuals. Remuneration packages can consist of fixed, performance and equity-based remuneration. There should however be a clear distinction between the remuneration structure of executive and non-executive directors.[454] The remuneration of non-executive directors should consist of standard fees and not options and bonuses. Executive remuneration on the other hand should represent a direct connection with company performance and can include share options and bonuses. When payment is in the form of share-schemes, shareholders should approve the details and the company should not deviate from it.[455]

As a general rule s 222 of the Companies Act prohibits the issue of shares to directors without prior consent of the general meeting.[456] Furthermore, s 223 of the Act requires members to approve the granting of share options to directors by special resolution. The prohibition on share options does however not apply if the option is granted to a director in his/her capacity as a salaried employee of the company.[457] In terms of s 297 (2A) (c) of the Act companies must disclose annually directors' bonuses and performance related compensation. Companies should also disclose the gains made by directors in the exercise of share options.[458]

King II recommends that companies disclose each individual director's earnings, share options, restraint payments and other benefits.[459] At the same time, companies should disclose in their annual statements a so-called "Statement of Remuneration Philosophy". The statement should explain the board's remuneration policy and the criteria used to calculate remuneration

[453] ASX Principles Recommendation 9.1 51.
[454] ASX Principles Recommendation 9.3 56.
[455] ASX Principles Recommendation 9.4 56.
[456] S 222 (b)-(d) of the Companies Act also allows for other circumstances under which shares may be issued to directors.
[457] S 223 (b) of the Companies Act negates the whole purpose of the prohibition on share options. By now allowing companies to grant share options to directors in their capacity as salaried employees of the company, companies can circumvent the prohibition.
[458] S 297 (2A) (g) of the Companies Act.
[459] King II par 11 57.

of directors on the verge of retirement.[460] According to the Committee, the granting of share options to non-executive directors can jeopardise the particular director's independence. This is also the view in several foreign jurisdictions.[461] The use of share options in the remuneration of non-executive directors is therefore opposed. When share options are used to remunerate executive and non-executive directors, the following should be kept in mind:[462]

- the board should prescribe a vesting period during which directors are not allowed to sell shares;[463]
- shareholders should approve any proposed share option re-pricing; and
- shareholders should also approve the granting of share options at a discount.

The company must disclose all payments, benefits and incentives paid to the individual directors.[464] Each board should appoint a remuneration committee. International trends indicate that the committee should consist solely of independent non-executive directors.[465] The chief executive should work closely with this committee but should not be involved with the determination of his/her own remuneration. The underlying principle in determining directors' remuneration is the attraction and retention of skilled and appropriate individuals. Some part of remuneration should therefore be performance related.

A number of basic principles can be deduced from the above discussion. The first one is that the use of share options must be approached with caution, especially where non-executive directors are involved. Whenever share options are used a minimum vesting period must be instituted. Shareholder-approval of all share-based compensation is a pre-requisite. Approval may only be given after full details of the compensation are disclosed to shareholders. With regard to directors' remuneration in general, companies, and more specifically remuneration committees, should develop remuneration policies. These policies must be disclosed to shareholders, stating the individual directors' remuneration, the composition of remuneration and the purpose of remuneration. Whenever directors' remuneration is aligned with company performance, the board must disclose how this alignment is achieved.

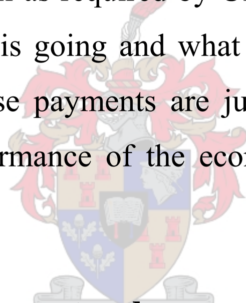
Amendments to the Companies Act should also be considered. The current loophole in s 223's prohibition, that share options may be granted to a director in his capacity as employee

[460] King II par 12 57.
[461] King II par 14 58.
[462] King II par 16 58.
[463] This would dissuade directors to make any short-term decisions which would only benefit himself/herself.
[464] King II par 18 58. See also *supra*.
[465] King II par 19 59.

of the company, must be removed. Alternatively, the whole provision should be scrapped as it does not serve its purpose and has little effect on promoting good corporate governance. The Act should also be amended to require a statement in the annual financial statements similar to what is required by the LSE Listing Rules par 12.43A.[466] The statement must disclose the following information:

- details of individual directors' compensation;
- composition/structure of director remuneration;
- whether share options were used in remunerating directors;
- the vesting period for share options;
- the company's remuneration policies;
- the remuneration committee's membership;
- graphs comparing directors' remuneration with relevant data.

Although companies are required by current legislation to disclose director remuneration, it does not have to be in as much detail as required by UK company law. Shareholders need to know where the company's money is going and what part of it lands in directors' pockets. They need to evaluate whether these payments are justified in the light of the company's performance compared to the performance of the economy as a whole, stock markets and competitors.



10 Directors' appointment, development and removal

Although shareholders have the ultimate say in the appointment and removal of directors, in practice it is left to the board.[467] History has shown that when vacancies occur, boards seldom looked beyond the so-called "old boys club". As one of the ingredients of an effective board is a well-planned, thorough and fair system of recruitment and retirement of board members, much more emphasis should be placed on the appointment and development of directors. By selecting the right candidates boards will save themselves the trouble of dealing with unfit and inadequate directors and other problems associated with ineffectiveness. Director appointment

[466] *Supra*.
[467] In the absence of any contrary provision in the company's constitution, s 208 (2) of the Companies Act deems the subscribers as the directors of the company until the first directors are appointed, while s 209 of the Act allows the majority subscribers to appoint the first directors of the company. The most general way of appointing directors is through the articles of association. See Table 1 Reg 36 & Table 2 Reg 35 of Schedule 1 of the Companies Act. In terms of s 220 of the Act the members can, notwithstanding anything in the articles of association or otherwise, remove a director by ordinary resolution.

and development is also important in light of the King Committee's views on skills shortages in SA.[468]

The Higgs Report spends a good deal of time on this subject. Every listed company must appoint a nomination committee, which has a majority of independent non-executive directors, to deal exclusively with board appointments.[469] The annual report must describe the activities and process used by the nomination committee.[470] The nomination committee must ensure that new appointees are well informed on what is expected of them.[471] The board should provide shareholders with reasons for appointing a certain individual.[472] To ensure smooth transition on the board, the chairperson and chief executive are advised to implement so-called executive development programmes based on three principles:[473]

- The senior independent director or deputy chairperson should supervise the process.
- In identifying the skills and expertise necessary for the position a systematic process should be followed.
- Candidates should be short-listed.

Annex F of the Report contains the principal duties of the nomination committee.

King II also highlights the importance of director appointment and development. The induction process is absolutely crucial for a well-informed and competent board. Newly appointed directors must be informed about the company, their duties and responsibilities and what is expected of them by the board and chairperson.[474] The induction process should be designed around the company's needs and requirements. The chairperson, supported by the company secretary, must lead the process.[475] The company secretary should also inform directors on any legal as well as business developments.[476] The board should develop programmes of succession to ensure a correct mix of experience and knowledge at all times. In

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[468] For the Committee's views on the skills shortage in SA see par 6 Independent directors *supra*.
[469] Higgs Report par 10.9 40 but see Combined Code par A.4.1. See also Annex F of the Report which provides a summary of all the duties of the nomination committee.
[470] Higgs Report par 10.9 40 but see Combined Code par A.4.6.
[471] Higgs Report par 10.9 40 but see Combined Code par A.4 Supporting Principles.
[472] Higgs Report par 10.11 41 but see Combined Code par A.4.6.
[473] Higgs Report par 10.35 45.
[474] King II par 7 63.
[475] King II par 8 63.
[476] King II par 13 64. Currently, s 268G (b) requires the company secretary to inform directors on the law and legislation applicable to the company and says nothing about business developments, but notwithstanding this s 268G is not a closed list of duties of the company secretary.

some cases this will require the removal of unfit and incompetent directors.[477] The nomination committee could play a significant role in the appointment and removal of directors.[478]

The JSE Listings Requirements give general guidelines as to what procedure companies must follow when appointing directors. In terms of the Requirements companies must firstly adopt a policy on their procedures for board appointments. The appointments must comply with the requirements of formality and transparency. The whole board, assisted where necessary by a nomination committee, must be part of the process. The nomination committee must be made up of non-executive directors of whom the majority must be independent.[479] When directors are appointed at the annual general meeting, a brief curriculum vitae of each candidate must accompany the notice of the annual general meeting.[480] This will inform members on which candidates are suitable and would give them enough time to make informed decisions in the best interests of the company.

While the JSE Listings Requirements are very general in giving guidance, they are nonetheless helpful. The guidance should also emphasise the importance of proper selection and development of directors and the role of the nomination committee in the process. As is the practice in the UK, an individual, preferably the chairperson or chairperson of the nomination committee, should head the process. It is not enough to provide the members with brief CV's. Candidates must be interviewed, shortlisted and thoroughly scrutinised before shareholders are given the opportunity to vote. When finally appointed, appointees must go through a thorough induction process, again headed by a designated individual. The nomination committee should ensure that all the necessary information is provided to the newly appointed individuals on their appointment and thereafter on an ongoing basis. If it is evident that a particular director is incompetent, he/she must be removed.

11 Board and director appraisal

Just as a proper director appointment process is necessary for an effective board, so too is continuous appraisal. It must be determined whether directors are performing to their ability. It is of no use appointing a capable individual if he/she is not regularly evaluated. The King Committee argues that a board that knows it is under constant evaluation will focus more on

[477] King II par 1 62.
[478] See the discussion in par 13 3 Nomination committee *infra*.
[479] JSE Listings Requirements par 3.84 (a).

good corporate governance.[481] Although it could be argued that continued surveillance would improve corporate governance, the risk is that the board will focus too much on this aspect and neglect the proper running of business. What needs to be found is a balance between surveillance and self-control.

Performance evaluation of individual directors should take place formally on an annual basis towards the end of the year.[482] The chairperson is responsible for the assessment of the individual directors. He/she must communicate to the director that he/she is under scrutiny, the criteria used to assess him/her and the procedure which is followed.[483] Indicators such as market performance, company performance and contemporaries will be helpful during the process. Evaluation should take place openly, constructively, peacefully and jointly.[484] Evaluation of the board as a whole is also necessary. This will be done less frequently and preferably when the board composition is stable.[485] The evaluation should be taken a step further. In terms of the ASX Principles companies should disclose the performance evaluation process applied by the company to evaluate the board, its committees, executives and the individual members.[486]

12 Disqualification of directors

One way of promoting good corporate governance is through the disqualification of individuals who are unfit to serve as directors. By ensuring that unsuitable individuals are not involved in the management of companies, the interests of the investing public are protected.

The US follows a somewhat different approach to that of South African company law when it comes to the disqualification of directors.[487] As a general rule individuals who are regarded as "unfit" are not allowed to be appointed as directors.

The Sarbanes-Oxley Act contains two provisions on director qualification. Firstly, s 305 of the Act prohibits violators of securities laws from being appointed as officers or directors of

[480] JSE Listings Requirements par 3.84 (e).
[481] King II par 2 65.
[482] King II par 7 65.
[483] King II par 6 65.
[484] King II par 8 65.
[485] King II par 10 66.
[486] ASX Principles Recommendation 8.1 47.
[487] Director disqualification in the US is governed by various state laws and therefore it will be impractical to discuss the director disqualification regime in the US.

public companies if they prove to be "unfit".[488] S 305 also provides for the imposition of fines for such violators. Securities laws previously prohibited a person from serving as an officer or director of a public company if he/she was "substantially unfit". The feeling was that this was an "inordinately high" standard and that it had to be lowered.[489] Consequently, the requirement was lowered by disqualifying those who are unfit. A further important aspect of s 305 is that it allows for additional financial relief. Previously, disgorgement was only allowed if the securities laws violator had received money "as a result of the violation".[490] S 305 now allows for financial relief if it is appropriate or in the interests of investors. Secondly, s 1105 of the Sarbanes-Oxley Act grants the SEC the power to prohibit a person from serving as an officer or director of a company.[491] This power of the SEC is limited to cease-and-desist proceedings where a person has contravened s 10 (b) of the Securities Exchange Act, s 17 (a) (1) of the Securities Act[492] or any rules and regulations under those two acts and the conduct of the person demonstrates that he/she is unfit to serve as an officer or director of a company.

Director disqualification in the UK is governed by a separate Act.[493] The Act provides for three categories of disqualification, namely disqualification for general misconduct,[494] disqualification for unfitness[495] and other cases of disqualification.[496] A person who contravenes a disqualification order is guilty of an offence and can be imprisoned for up to 2 years[497] and is furthermore personally liable for the company's debts.[498]

Pectora roborant cultus recti

In Australia no individual under the age of eighteen may be appointed as director of a company.[499] S 206B of the Corporations Act provides for automatic disqualification,[500] while

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[488] S 305 of the Sarbanes-Oxley Act amends s 21 (d) (2) of the Securities Exchange Act and s 20 (e) of the Securities Act by striking "substantial unfitness" and replacing it with "unfitness".
[489] Report of the Senate Banking Committee 27.
[490] This disgorgement is not in terms of s 304 of the Sarbanes-Oxley Act ("Forfeiture of certain bonuses and profits") but in terms of other securities laws. See Report of the Senate Banking Committee 27.
[491] S 1105 (a) of the Sarbanes-Oxley Act amends s 21C of the Securities Exchange Act and s 8A of the Securities Act by inserting subs (f) under the respective acts.
[492] Act of 1933 (15 USC).
[493] The Company Directors Disqualification Act 1986 (c 46).
[494] Ss 2-5 of the Company Directors Disqualification Act 1986 (c. 46) disqualifies a person who was found guilty of an indictable offence, who persistently breaches companies legislation, who was guilty of fraudulent trading, fraud or committed a breach of his duty as officer of the company or who has received a summary conviction.
[495] In terms of ss 6-9 of the Company Directors Disqualification Act 1986 (c. 46) a person is disqualified if he/she has been a director of an insolvent company and his/her conduct makes him/her unfit to manage a company.
[496] Ss 10-12 of the Company Directors Disqualification Act 1986 (c.46) disqualifies a person who participated in wrongful trading, who is an undischarged bankrupt or fails to pay under a county court administration order.
[497] S 13 of the Company Directors Disqualification Act 1986 (c. 46).
[498] S 15 of the Company Directors Disqualification Act 1986 (c. 46).
[499] S 201B (1) of the Corporations Act.

s 206C – 206E gives the court authority to disqualify an individual.[501] In terms of s 206F ASIC has the power to disqualify an individual for a period of five years if he/she was a director of two or more companies and during that period, or within twelve months after ceasing to be a director of such a company, any of those companies are wound up. A disqualified individual may apply to court for leave to manage a company if he/she was disqualified by ASIC in terms of this provision.[502]

Currently ss 218 and 219 of the Companies Act regulate the disqualification of directors in South Africa. S 218 of the Act places an absolute prohibition on certain individuals from becoming directors of a company.[503] The court has the authority to allow certain disqualified individuals to take up the position of company director.[504] S 219 of the Companies Act enables the court to disqualify certain persons. King II requests that a duty be placed on boards to determine whether a potential director is disqualified in terms of s 218.[505] Furthermore anyone should be allowed to be director of a company that is not a bank, if the company's shareholders are of the opinion that the person is fit and capable of being a director.[506] King II nevertheless recommends the establishment of a register for delinquent directors containing the names of disqualified directors and the creation of a readily available database of delinquent directors.[507] S 421 of the Companies Act requires the Registrar of Companies to keep a register of directors of companies that have been liquidated because they were unable to pay their debts. According to King II this register is however not used in practice.[508] The Committee also requests more effective implementation of s 424 of the Companies Act, which deals with the liability of directors for fraudulent conduct of the business of the company.[509]

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[500] In terms of S 206B a person is automatically disqualified if he is found guilty of certain offences or if he is an undischarged bankrupt.

[501] In terms of ss 206C-206E of the Corporations Act the court has the authority to disqualify an individual if he/she is in contravention of a civil penalty provision, within the previous seven years has been an officer of and was partly responsible for two or more corporations that have failed, has been an officer of a corporation that contravened the Act or has contravened the Act at least twice. In each of these circumstances the court must be satisfied that the disqualification is justified.

[502] S 206G of the Corporations Act.

[503] S 218 (1) of the Companies Act places an absolute bar on the following persons from becoming director of a company: juristic persons (so-called "corporate directors"), minors or any other persons with contractual incapacity and persons who are disqualified from being a director in terms of a court order.

[504] This include an unrehabilitated insolvent, someone who has been dismissed from a position of trust due to misconduct and a person found guilty of theft, fraud, forgery, perjury, a crime involving dishonesty or a crime during the founding, formation or management of a company. See s 218 (1) of the Companies Act.

[505] King II par 4 66.

[506] King II par 5 67.

[507] King II par 5 42.

[508] King II par 1 66.

[509] King II par 6 42.

Until recently, s 218 and 219 of the Companies Act did not disqualify individuals who are regarded as "unfit". This was out of step with director disqualification provisions in the UK and US. In 2004 the Act was amended to disqualify any person who has been removed from office, in terms of an act of Parliament, for not being "fit and proper" person to serve in a position of trust by reason of an act involving dishonesty.[510] The Act was also amended to provide for joint and several liability for the company's debt during the period which the disqualified individual was a director of the company.[511] This added another dimension to the disqualification of directors. It would act as a deterrent for those who wish to get involved in the management of companies despite them being prohibited from doing so.

King II's recommendation that anyone should be allowed to become a director of a company that is not a bank, is totally unacceptable. The Committee is implying that other boards are not as important to investor protection as bank boards. This is definitely not the case, particularly in view of recent scandals. By allowing any Tom, Dick and Harry to control companies will do little to improve corporate governance or to restore investors' confidence.

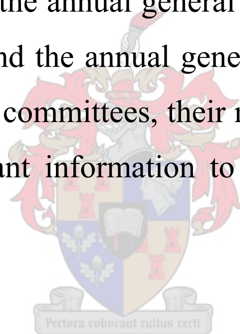
13 Board committees

Board committees contribute to the effective functioning of the board. Due to the multitude of duties and responsibilities of modern boards, companies appoint board committees to which some of these duties and responsibilities are delegated. The board does however remain ultimately responsible for the duties delegated to the various board committees.[512] The most common board committees are the audit, nomination and remuneration committees. The legitimacy of board committees is essential. When a board committee is appointed the board must ensure that it has proper terms of reference, a pre-determined life span and a clearly stipulated role and function.[513] The committees should consist of members of the board and only in exceptional cases include specialists from outside the board. The committees should, however, be able to consult with specialists on a need-to-know basis.[514] All companies should at least have audit and remuneration committees. Other committees include governance, information technology, risk, environmental and nomination committees. The committees

[510] See s 218 (1) (d) (iv) of the Companies Act.
[511] See s 218 (2) (b) of the Companies Act.
[512] King II par 1 67.
[513] King II par 4 67.
[514] King II par 5 68.

which the board should appoint depend on the nature of the business and industry.[515] It is mandatory for all companies listed on the JSE to appoint an audit and remuneration committee but the Listings Rules only require risk and nomination committees to be appointed if the nature of the business and composition of the board require it.[516] The Listings Requirements should however be amended to make the appointment of a nomination committee mandatory. The reason for this is the important role the committee plays in the appointment and development of directors.[517]

The terms of reference of all board committees should include committee composition, objectives, purpose, activities, delegated authorities, tenure and reporting mechanisms.[518] Each committee should have a chairperson and secretary. The chairperson must report to the board after each committee meeting.[519] An independent non-executive director should chair each committee. With the exception of the audit committee, the chairperson of the board is allowed to be the chairperson of the various committees.[520] The board should disclose detailed information on board committees to the annual general meeting. Furthermore, the chairperson of the various committees must attend the annual general meeting.[521] Each company's board must disclose the composition of the committees, their mandates, the number of meetings held by the committees and other relevant information to the members in the annual financial statements.[522]



13 1 Audit committee

Current international practices place much emphasis on the role of audit committees. Without a shadow of a doubt it is the most important board committee. The audit committee has been the subject of much discussion and controversy in legal as well as commercial literature. The leading authorities on audit committees are the Sarbanes-Oxley Act and the UK's Smith Report, which focus specifically on guidance for audit committees.

[515] King II par 6 68.
[516] JSE Listings Requirements par 3.84 (d).
[517] See par 10 Directors' appointment, development and removal *supra*.
[518] King II par 8 68 and Appendix V.
[519] King II par 12 68.
[520] King II par 13 69.
[521] King II par 14 69.
[522] JSE Listings Requirements par 3.84 (d).

It is mandatory for all US companies listed on the NYSE to appoint an audit committee.[523] The NYSE Manual also requires the committee to have a formal written charter that must be assessed annually and which sets out the following:

- the committee's responsibilities and how they are carried out;[524]
- that the external auditor is accountable to the board and the audit committee;[525]
- that the audit committee and board is responsible for the appointment, evaluation and removal of the external auditor;[526]
- that the audit committee is responsible to ensure that the external auditor submits a statement declaring all relationships between the auditor and the company;[527] and
- that the audit committee communicates with the external auditor regularly.[528]

The committee should consist of at least three independent directors of whom all must be financially literate.[529] One member must have accounting or relevant financial management skills.[530] S 301.01 (B) (3) (a)-(d) sets out additional requirements for the independence of audit committee members. A director may not become a member of the audit committee if he/she was an employee of the company in the previous three years prior to appointment as member of the audit committee.[531] A director is precluded from serving on the audit committee if he/she is a partner, controlling shareholder or executive officer of an organisation with whom the company has a business relationship or if he/she has a direct business relationship with the company, unless the board determines that the relationship does not impede the director's independent judgement.[532] A director may also not serve on the audit committee if he/she is an executive director of another company where any of the company's directors serve as members of the compensation committee.[533] If a director's immediate

[523] See par s (1) (A) of the NYSE Manual.
[524] S 303 (1) (B) (1) (a) of the NYSE Manual.
[525] S 303 (1) (B) (1) (b) of the NYSE Manual.
[526] S 303 (1) (B) (1) (b) of the NYSE Manual.
[527] S 303 (1) (B) (1) (c) of the NYSE Manual.
[528] S 303 (1) (B) (1) (c) of the NYSE Manual.
[529] S 303 (1) (B) (2) (a)-(b) of the NYSE Manual.
[530] S 303 (1) (B) (2) (c) of the NYSE Manual.
[531] S 303 (1) (B) (3) (a) of the NYSE Manual.
[532] S 303 (1) (B) (3) (b) of the NYSE Manual. The director may however serve on the audit committee three years after the termination of the relevant business relationship.
[533] S 303 (1) (B) (3) (c) of the NYSE Manual.

family member is an executive officer of the company, the director may also not serve on the audit committee.[534]

Amendments to the NYSE Manual now place much emphasis on independence for purposes of the audit committee. According to new NYSE Manual rules the requirements of Rule 10A-3 (b) (1) of the Securities Exchange Act applies to members of the audit committee.[535] Rule 10A-3 establishes two further criteria for independence. Firstly, the director is not independent if he/she has received any fees from the company other than as director or committee member. A director is also not regarded as independent if, apart from being a board or committee member, he/she is affiliated to the company or any subsidiaries of the company. All listed companies must appoint an audit committee consisting of at least three members of which all must meet the requirement of independence.[536] The audit committee must have a written charter that addresses the same issues as the other two previous committees, namely the committee's purpose, duties and responsibilities and the annual performance evaluation.[537] The committee's purpose must include at least:

- assisting the board in overseeing the integrity of the company's financial statements, compliance of the company with the law, the external auditor's qualification and independence and the performance of the internal audit function and external auditor; and
- preparation of the company's proxy report to be included in the annual proxy statement or Form 10-K filing with the SEC.[538]

In terms of Rule 10A-3 (b) (2), (3), (4) and (5) of the Securities Exchange Act, the audit committee is responsible for:

- the appointment, compensation, evaluation and dismissal of the external auditor;
- the establishment of procedures to address complaints from employees regarding the company's accounting, internal controls and auditing matters;
- the establishment of procedures for confidential and anonymous submissions by employees regarding questionable accounting and auditing practices;
- obtaining external advice from legal, accounting or other advisors on audit committee duties;

[534] S 303 (1) (B) (3) (d) of the NYSE Manual. A director may serve on the audit committee three years after the termination of the immediate family member's employment.
[535] S 303A (6) of the NYSE Manual.
[536] S 303A (7) (a) of the NYSE Manual.
[537] As set out in S 303A (7) (c) (i)-(iii) of the NYSE Manual.
[538] S 303A (7) (c) (ii) (A)-(B) of the NYSE Manual.

- receiving appropriate funding from the company for the payment of external advisors.

The amendments to the NYSE Manual also make the audit committee responsible for:

- obtaining the external auditor's report about the company's internal controls;[539]
- discussing with management the annual and quarterly financial statements;[540]
- discussing the earnings press release and guidance for financial information and earnings given to analysts and rating agencies;[541]
- discussing risk assessment and risk management policies;[542]
- meeting separately with management, internal auditors and the external auditor;[543]
- reviewing audit problems and the response by management on the audit with the external auditor;[544]
- adopting policies for the hiring of current and former employees of the external auditor;[545] and
- regularly reporting to the company's board of directors.[546]

Furthermore, the Sarbanes-Oxley Act requires the company's audit committee to pre-approve all auditing as well as non-audit services provided by the external auditor.[547] According to s 204 of the Act accounting firms must report to the audit committees of the companies they audit. Their report must contain:

- the accounting policies and practices used by the auditor;
- alternative treatments of financial information;
- any accounting disagreements between management and the external auditor; and
- all material written communications between the accounting firm and management of the issuer.[548]

S 301 of the Act lays down audit committee standards.[549] The SEC is instructed to direct the various securities exchanges and associations to bar the listing of any company that does not

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[539] S 303A (7) (c) (iii) (A) of the NYSE Manual.
[540] S 303A (7) (c) (iii) (B) of the NYSE Manual.
[541] S 303A (7) (c) (iii) (C) of the NYSE Manual.
[542] S 303A (7) (c) (iii) (D) of the NYSE Manual.
[543] S 303A (7) (c) (iii) (E) of the NYSE Manual.
[544] S 303A (7) (c) (iii) (F) of the NYSE Manual.
[545] S 303A (7) (c) (iii) (G) of the NYSE Manual.
[546] S 303A (7) (c) (iii) (H) of the NYSE Manual.
[547] See discussion of s 201 of the Sarbanes-Oxley Act in Chapter 5 par
4 Non-audit services *infra*.
[548] S 204 of the Sarbanes-Oxley Act amends S 10A of the Securities Exchange Act by inserting subs (k).

comply with the requirements set out in s 301.[550] In terms of s 301 it is the sole responsibility of the audit committee to appoint, compensate and supervise the auditor.[551] In return, the accounting firm in charge of the audit must report directly to the audit committee. The provision also provides for audit committee independence.[552] All the members of the audit committee must be independent members of the board of directors of the company. No member of the audit committee is allowed to receive compensation from the company other than in his/her capacity as member of the board, nor may that member be affiliated to the company or to a subsidiary of the company.[553] Recent events like Enron and WorldCom illustrated the need for strong, competent and independent audit committees to supervise auditors. At Enron three of its audit committee members collectively owned $7,5 million worth of shares in the company. In addition, Lord Wakeham, one of the committee members, received $72 000 consultation fees per year in addition to the $50 000 he received as director.[554] The Act endorses the Blue Ribbon Report's recommendation about auditor independence and prohibits audit committee members from receiving consultation fees or being affiliated to the company or its subsidiaries.[555] The Act does not define "affiliated person". It is left to the various securities exchanges to provide companies with guidance on this aspect.

S 407 instructs the SEC to adopt rules requiring all companies to divulge whether or not at least one of the members of their audit committees is a financial expert, i.e. someone who understands GAAP and audit committee functions and has experience with financial statements and internal accounting controls. The SEC must also define the term "financial expert". The SEC adopted rules on audit committee financial experts on 15 January 2003.[556] According to the rules an audit committee financial expert is someone who:

- has an understanding of GAAP and financial statements;

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549 S 301 of the Sarbanes-Oxley Act inserts subs (m) under s 10A of the Securities Exchange Act.

550 The SEC adopted rules on 1 April 2003 and were effective from 25 April 2003 "Standards Relating to Listed Company Audit Committees" [17 CFR Pts 228, 229, 240, 249 & 274].

551 Although the audit committee is responsible for the appointment, compensation and oversight of the external auditor, the committee remains a sub-committee of the board and consequently the whole board is responsible for compliance with the law by the audit committee.

552 For a discussion on audit committee independence see Richardson & Baril "Can your audit committee withstand the market's scrutiny of independence?" *Financial Executive* (January/February 2003) 35.

553 S 301 of the Sarbanes-Oxley Act.

554 Richardson & Baril (January/February 2003) *Financial Executive* 35.

555 It is somewhat incomprehensible why it took the US government five years to finally implement the committee's recommendations on audit committee independence.

556 The rules were effective from 3 March 2003 "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" [17 CFR Parts 228, 229 & 249]. See also SEC Press Release 2003-6 available at <http://www.sec.gov/news/press/2003-6.htm> (16 July 2003).

- can assess the application of GAAP to the accounting of estimates, accruals and reserves;
- has experience in the preparation, auditing, analysis or evaluation of financial statements with the complexity that can reasonably be expected of the particular company's financial statements;
- understands internal controls and procedures; and
- understands audit committee functions.

The rules further provide that the designation of an audit committee member as a financial expert does not result in any duties, obligations or liabilities that are greater than those placed on the other audit committee members, nor does the absence of such a designation detract from any duties, obligations or liabilities placed on audit committee members.

Like its US counterpart, it is mandatory for all companies listed on the LSE to appoint an audit committee.[557] The UK is in a unique position regarding audit committees as the Smith Report focused specifically on this topic. The Report recommends that all UK listed companies should have an audit committee whose main responsibilities include:[558]

- the monitoring of the financial report's integrity;
- reviewing the internal controls and risk management systems;
- reviewing the effectiveness of the internal audit function;
- advising the board on the appointment and remuneration of the external auditor;
- reviewing the external auditor's independence, objectivity and effectiveness; and
- the development and implementation of policies on the provision of non-audit services by the external auditor.

If the committee has concerns about any of these activities it must bring it to the immediate attention of the board and recommend what the board must do in order to solve the problem.

The audit committee should consist of at least three members of whom all should be independent non-executive directors.[559] The Report discourages membership of the chairperson of the board from being a member of the audit committee.[560] The nomination committee must assist the board and chairperson of the audit committee in appointing

[557] See Combined Code par C.3.1.
[558] Smith Report par 2.1 6 but see Combined Code par C.3.2.
[559] Smith Report par 3.1 6.
[560] Smith Report par 3.2 6.

members of the audit committee. The Report recommends that a member's term of office be limited to three three-year terms.[561]

Although the members of the audit committee act independently from the executive, they are still directors of the company and form part of the board. They must promote the welfare of the company at all times but more specifically the aspects surrounding financial reporting and internal control systems. The Report also requires the directors' annual report to contain a section explaining the activities of the audit committee.[562]

For the audit committee to play an effective role, the relationship between itself, its chairperson, the board chairperson, the chief executive and the finance director has to be one of honesty and accessibility. The audit committee needs to be assertive, while other relevant parties should be prepared and able to listen to and discuss the committee's views and issues. Information should be freely available to the committee and it is here where management must play a key role.[563] Cooperation of all the relevant company organs and employees is required. Members of the board are after all under a common law duty to provide all directors with information needed to discharge their duties as directors.

The main functions of audit committees can be summarised in three words: oversight, assessment and review.[564] They are not appointed as substitutes for other organs of the company. The committee is purely a supervisory organ whose task it is to reassure investors that the relevant checks and balances are in place. Their task is however not to be taken lightly. It requires dedication and time – something the company must consider when determining the committee members' compensation.[565]

The frequency of committee meetings depends on the committee's role and responsibilities in that specific company. The chairperson and company secretary must decide when meetings should take place. The committee should however meet at least three times per year. Only members of the audit committee and the committee's chairperson are allowed to attend the meetings.[566] For practical reasons it will sometimes be necessary for the lead audit partner attends these meetings but then only on invitation from the committee. The committee should also liaise with both the internal and external auditors in the absence of management at least once a year. For the audit committee to be effective its members must keep close contact with

[561] Smith Report pars 3.3-3.4 7.
[562] Smith Report par 1.7 3.
[563] Smith Report pars 1.8-1.9 4.
[564] Smith Report par 1.10 4.
[565] Smith Report par 1.12 4.
[566] Smith Report par 3.6 7.

the board chairperson, the chief executive and finance director, the lead audit partner and the head of the internal audit department.[567]

For the effective discharge of the committee's duties, sufficient resources should be allocated to the audit committee.[568] The company secretary and other staff members must assist in this regard. It is the secretary's duty to provide the committee with the relevant information on a timely and accurate basis. Furthermore, funds should be made available to the committee by the board of directors.

Members of the audit committee must be compensated for their time, effort and responsibilities. The Report leaves it to the company to decide on the remuneration of committee members. When considering the remuneration of audit committee members the time required for the position, members' skills, duties conferred on them, the value of work done by them and fees paid to other board members must be considered.[569]

The Report recommends that at least one of the committee's members should have recent and applicable experience in the financial sector.[570] This would for example be a person who had experience as an auditor, finance director or any person with a professional qualification such as a CA or CFA. The other members are only required to have some degree of corporate financial experience. This will however depend heavily on the nature of the company's business. As with non-executive directors, members of the audit committee must undergo a proper induction process. Members' skills and knowledge on aspects like financial statements, accounting standards, company law and the auditing process should also be updated on an ongoing basis using various methods like seminars, conferences, courses and briefings.

Written terms of reference, modified to the needs of the particular company, should be provided for the audit committee.[571] Along with the committee's effectiveness, the committee must review the terms of reference annually. The board should review the effectiveness of the committee once a year.

The first major responsibility of the committee is to review all significant financial reporting issues.[572] This involves all aspects of the preparation and disclosure of financial statements, interim reports and other documents. It is not the committee's task to prepare and issue financial reports. The audit committee should advise and consider whether the company's

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[567] Smith Report 3.9 7.
[568] Smith Report par 3.11 8.
[569] Smith Report par 3.15 8.
[570] Smith Report par 3.19 9 but see Combined Code par C.3.1.
[571] Smith Report par 4.1 9 but see Combined Code par C.3.3.
[572] Smith Report par 5.1 10 but see Combined Code par C.3.2.

accountants are using appropriate accounting policies. If the committee is unhappy with any aspect pertaining to the company's financial reporting, it must bring it to the attention of the board.[573]

While management is responsible for internal control systems and risk monitoring, the audit committee has the task of assessing the integrity of the company's internal control systems and, in the absence of a properly appointed risk committee, reviewing the effectiveness of the company's risk management systems.[574] The responsibility of reviewing the internal auditing of the company is also assigned to the audit committee.[575] The committee must evaluate annually the need for an internal audit system in circumstances where the company has no internal auditing programme.[576]

The audit committee plays an important role in the relationship of the company with the external auditor. The committee is primarily responsible for:

- the appointment and removal of the external auditor;[577]
- checking whether the external auditor possesses the necessary ability, knowledge, resources and effectiveness;[578]
- approving the external auditor's terms of engagements;[579]
- ensuring that the external auditor is independent and objective;[580]
- reviewing, in consultation with the external auditor, the result and effectiveness of the audit;[581] and
- developing company policy on non-audit services performed by the external auditor, ensuring that the auditor remains objective and independent.[582]

In developing the company's non-audit policy, the committee should refrain from appointing the external auditor for non-audit services if the appointment would result in the auditor auditing his own work or the auditor taking over management's functions.[583] Due consideration must also be given to the ethical guidance issued by the Consultative Committee

[573] Smith Report par 5.3 10.
[574] Smith Report pars 5.5-5.6 11 but see Combined Code par C.3.2.
[575] Smith Report par 5.10 11 but see Combined Code par C.3.2.
[576] Smith Report par 5.10 11 but see Combined Code par C.3.5.
[577] Smith Report par 5.15 12 but see Combined Code par C.3.2.
[578] Smith Report par 5.17 13 but see Combined Code par C.3.2.
[579] Smith Report par 5.19 13 but see Combined Code par C.3.2 & C.3.6.
[580] Smith Report par 5.22 13 but see Combined Code par C.3.2.
[581] Smith Report pars 5.33 & 5.36 16.
[582] Smith Report par 5.26 14.
[583] Smith Report par 5.29 15 but see Combined Code par C.3.2.

of Accountancy Bodies. The Report also recommends that the non-audit policy be explained to the shareholders.[584]

The annual report should contain a section on the role and responsibilities of the audit committee.[585] This section should include the identity of the audit committee members, the number of committee meetings held during the year and the attendance of members. The chairperson of the committee is accountable to the annual general meeting on the committee's conduct and responsibilities.

The Corporations Act in Australia does not require companies to appoint an audit committee. The Australian Institute of Company Directors (AICD) and the Australian Institute of Internal Auditors published the Audit Committees: Best Practice Guide, which reiterates the important role audit committees play in overseeing accounting disclosure, internal controls, risk management systems and general auditing issues. The Ramsay Report requested the ASX to amend its listing rules to require all companies to appoint an audit committee. The Rules and accompanying Guidance Note should also assist companies in the make-up of the committees, their duties and responsibilities, drawing up of their written terms of reference and any aspects which the ASX thinks relevant. CLERP 9 proposes that it should be mandatory for the top 500 listed companies to appoint an audit committee.[586]

In terms of the ASX Principles it is mandatory for all ASX companies to appoint an audit committee.[587] The committee should consist of at least three non-executive directors of whom the majority are independent. An independent chairperson, who is not the chairperson of the board, should chair the committee.[588] Although not a formal requirement, audit committee members should be financially literate and at least one member should have financial expertise.

In terms of the JSE Listings Requirements all listed companies must appoint an audit committee.[589] Companies must disclose the composition, responsibilities, number of meetings and other relevant information of the committee annually.[590] The committee must develop the

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[584] Smith Report par 5.30 15 but see Combined Code par C.3.7.
[585] Smith Report par 6.1 17.
[586] CLERP 9 Proposal 8 77.
[587] See ASX Principles Recommendation 4.2 29.
[588] ASX Principles Recommendation 4.3 30.
[589] JSE Listings Requirements par 3.84 (d).
[590] JSE Listings Requirements par 3.84 (d).

company's policies on the provision of non-audit services by the external auditor.[591] The Konar Report recommends that audit committees, with the exclusive authority to appoint the external auditor and to approve audit fees, should be made mandatory for all "relevant entities".[592] These entities include not only companies listed on the JSE but also public entities, unit trusts and medical schemes, pension funds and asset management corporations with more than 150 members.

The King Committee dealt with audit committees in detail in 1994 and this theme was again picked up in King II. The main benefit of the audit committee is that it offers the board a mechanism to monitor the company's internal controls.[593] This is however not the only advantage of the committee.

The committee should consist of a majority of independent non-executive directors who are financially literate.[594] King II remarks that internationally there is not unanimity as to the financial literacy of audit committee members.[595] While the Combined Code only requires one member to have recent and applicable financial experience, the Sarbanes-Oxley Act requires one member to be a financial expert. In the writer's opinion all audit committee members should have some degree of financial literacy. This will ensure that all members know what they are doing. One member should have an understanding and knowledge of accounting as well as auditing issues. The reason for this is the need for someone to take the lead in issues which require expert accounting and auditing knowledge.

As to the number of committee members, international practice requires at least three directors.[596] King II is silent on this aspect. The size of the committee should promote the efficient communication with the external auditor and the board as a whole. It should also allow the committee to perform its many duties and responsibilities. Membership should therefore be between three and six. More than six members would impede the committee's functioning.

King II does not prescribe the number of meetings to be held by the committee. The Smith Report recommends that it should meet at least three times per year.[597] This should be the absolute minimum. Although the audit process occurs only once a year, there should be continued communication between the committee and the auditor. This will sometimes require

[591] JSE Listings Requirements par 3.84 (g).
[592] Konar Report par 4.23.1 33.
[593] King II pars 5.2 129 & 5.8 130.
[594] King II par 5.3 129.
[595] *Supra*.
[596] *Supra*.

the lead audit partner to attend the committee's meetings. Companies should be encouraged to have these meetings regularly.

An independent non-executive director, preferably not the chairperson of the board, should chair the committee. Furthermore, it would be appropriate if the board's chair were not a member of the committee at all. He/she may however from time to time attend the meetings of the audit committee on invitation.[598]

The audit committee should have a written charter which sets out the committee's membership, authority and duties.[599] Internationally this is a prerequisite for any audit committee. It grants legitimacy to the activities of the committee.

Among the duties conferred on the audit committee are reviewing the company's internal control system, internal audit function, risk areas and compliance with the law, articles of association, code of conduct and rules of the board.[600] The audit committee is also responsible for:

- encouraging communication between the board, management, internal auditors and the external auditor;[601]
- confirming the internal auditors' charter;[602]
- ensuring that the external auditor expresses an independent judgment on the appropriate accounting policies employed by the company;[603]
- communicating independently, directly and regularly with the external auditor;[604]
- having discussions with the external auditor at least once a year without the presence of the executive directors;[605]
- reviewing the external audit's scope, results, cost effectiveness, independence and objectivity;[606]
- reviewing the non-audit services provided by the external auditor;[607]
- considering possible audit partner or senior staff rotation;[608] and

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[597] *Supra*.
[598] King II par 5.4 129.
[599] King II par 5.5 130.
[600] King II par 5.7 130.
[601] King II par 5.8 130.
[602] King II par 5.9 130.
[603] King II par 5.10 130.
[604] King II par 5.11 130.
[605] King II par 5.12 131,
[606] King II par 5.13 131.
[607] King II par 5.13 131. See also the discussion in Chapter 5 par 4 Non-audit services *infra*.
[608] King II par 5.15 131.

- making recommendations to the board on the appointment and removal of the external auditor.[609]

These duties are very similar to audit committees of the other jurisdiction under consideration. It should however be emphasised that the audit committee's most important role should be to serve as a link between the company and the external auditor by requiring the external auditor to report to the audit committee exclusively. This link can be strengthened enormously. This is what s 204 of the Sarbanes-Oxley Act attempted to do.[610] The interaction between the audit committee and the external auditor can alleviate many of the problems surrounding auditor independence such as non-audit services, auditor rotation, etc.[611]

The other important function of the audit committee is the development of policies for the provision of non-audit services by the company's external auditor, especially in view of the principled approach followed in South Africa regarding non-audit services.[612] This would go further than just the approval of non-audit services as required by the Sarbanes-Oxley Act.[613] The Committee will have to develop definitive guidelines and principles on which non-audit services the external auditor may perform. This is not an easy task. When developing these policies the committee must keep in mind the auditor's independence and objectivity and the interests of maintaining the integrity of the audit process.

Another key function, highlighted by the NYSE Manual, is the committee's task of developing procedures whereby employees can confidentially express concerns about accounting and auditing practices within the company. Due to the important role of whistleblowing in the promotion of corporate governance, audit committees, as the appropriate board committee, should be given the responsibility of developing whistleblowing procedures.[614]

The board should review and assess the audit committee's activities and effectiveness annually.[615] Companies should disclose in their annual reports:

- whether the audit committee has adopted a formal charter;[616]
- whether the audit committee has performed its responsibilities;[617] and
- membership of the audit committee.[618]

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[609] King II par 5.17 131.
[610] *Supra*.
[611] See Chapter 5 par 1 Introduction *infra*.
[612] See Chapter 5 par *infra*.
[613] See s 201 of the Sarbanes-Oxley Act *supra* and Chapter 5 par *infra*.
[614] See Chapter 6 par 5 Whistleblower protection *infra*.
[615] King II par 5.19 131.
[616] King II par 5.20 131.

The chairperson of the audit committee should attend the annual general meeting to answer shareholders' questions on auditing aspects.[619]

While there is, theoretically speaking, definitely advantages in the appointment of audit committees, there is as yet no hard evidence that they prevent accounting and audit failure. Take, for example, at both Enron and WorldCom. Both these companies had properly appointed audit committees in terms of the NYSE Manual and it still did not prevent accounting and audit failure. These two examples should however be seen as the exception rather than the rule. In many companies with properly appointed audit committees, the accounting and auditing policies and principles applied are sound and healthy.

13 2 Remuneration committee

As discussed earlier, executives' remuneration has become a very controversial subject.[620] The remuneration committee plays an important role in addressing the issues surrounding directors' remuneration.

The amendments to the NYSE Manual require all listed companies to appoint a compensation committee that consists entirely of independent directors.[621] Similar to the nominating committee, the compensation committee must have a written charter addressing the committee's purpose, duties and goals and the committee's annual performance evaluation.[622] The compensation committee's duties and responsibilities must include at least:

- the review and approval of corporate objectives relevant to CEO compensation, the CEO's performance evaluation against these objectives and the authority to determine CEO compensation;[623]
- the recommendation of non-CEO compensation and plans regarding incentive and equity-based compensation;[624] and

[617] King II par 5.20 131.
[618] King II par 5.21 131.
[619] King II par 5.21 131.
[620] See par 9 Directors' remuneration *supra*.
[621] Par 303A (5) (a) of the NYSE Manual.
[622] Par 303A (5) (b) (i)-(ii) of the NYSE Manual
[623] Par 303A (5) (b) (i) (A) of the NYSE Manual.
[624] Par 303A (5) (b) (i) (B) of the NYSE Manual.

- the production of an annual executive remuneration report in the company's proxy statement or Form 10-K filing with the SEC;[625]

In terms of the Combined Code it is mandatory for all UK listed companies to appoint an audit committee consisting of at least three independent non-executive members.[626] The committee is responsible for determining the compensation of directors and senior management.[627] The committee should disclose its terms of reference and whether external consultants are used.[628]

Australian best practice provides that all listed companies should appoint a remuneration committee, whose task it is to review and recommend remuneration packages.[629] The committee must also assist the company in developing a remuneration policy which would motivate directors and executives to promote the welfare of the company on a long-term basis. The policy should also illustrate the relationship between company performance and remuneration levels.

In line with international best practice, King II recommends the appointment of a remuneration committee. The committee should consist solely of independent non-executive directors. While CEOs should not attend the committee's meetings when their remuneration is discussed, they can provide the committee with advice.[630] Other aspects not touched on by King II include the committee's task of developing the company's remuneration policy. This would include all the aspects discussed under directors' remuneration.[631]

13 3 Nomination committee

The appointment and development of directors are very important in corporate governance.[632] The nomination committee can assist the board in employing individuals with

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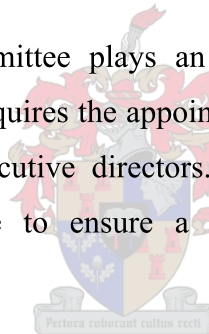
[625] Par 303A (5) (b) (i) (C) of the NYSE Manual.
[626] See Combined Code par B.2.1.
[627] See Combined Code par B.2.2.
[628] Combined Code par B.2.1.
[629] ASX Principles Recommendation 9.2 54.
[630] King II par 19 59.
[631] See par 9 Directors' remuneration *supra*.
[632] See par 10 Directors' appointment, development and removal *supra*.

the necessary skills and qualities. It is therefore very surprising that the committee's role was only recognised recently in South Africa.[633]

In terms of the amended NYSE corporate governance rules all listed companies are required to have a nominating or corporate governance committee which consists entirely of independent directors.[634] The committee must have a written charter that addresses its purpose, goals and responsibilities and the committee's annual performance evaluation.[635] The committee's purpose must at least include:

- the identification of qualified individuals to serve on the board of directors;
- the selection or recommendation of the board nominees for the next annual general meeting; and
- the development and recommendation of a set of corporate governance principles for the company.[636]

In the UK the nomination committee plays an important role in the appointment of directors.[637] The Combined Code requires the appointment of a nomination committee having a majority of independent non-executive directors. Companies should also implement an executive development programme to ensure a systematic and reasonable recruitment system.[638]



The appointment of a nomination committee is also regarded as best practice in Australia.[639] The committee should be made up of a minimum of three members of whom the majority must be independent directors. The chairperson must also be independent. The committee must draw up a written charter setting out its responsibilities. This should include at least assessing the ability of board members, implementation of succession plans, board evaluation and recommendation of new appointments and dismissals.[640]

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[633] *Infra*.
[634] S 303A (4) (a) of the NYSE Manual.
[635] S 303A (4) (b) (i)-(ii) of the NYSE Manual.
[636] S 303A (4) (b) (i) of the NYSE Manual.
[637] See discussion in par 10 Directors' appointment, development and removal *supra*.
[638] Combined Code par A.4.
[639] See ASX Principles Recommendation 2.4 21.
[640] See Commentary and Guidance to ASX Principles Recommendation 2.4 21.

The King Report of 1994 was opposed to the appointment of a nomination committee. The Committee felt that the board as a whole should be responsible for appointments. Contrary to this view, King II expresses the opinion that the nomination committee could assist the board in the process of appointment and removal. The structure and composition of the committee should be similar to the other board committees, i.e. at least three independent non-executive directors, lead by a chairperson who should preferably be an independent director. Although the committee's main duty is the appointment of directors other duties include the development of directors already serving on the board, evaluating the board and individual directors and advising shareholders on removal of incompetent or underperforming directors. Before making an appointment, the committee must evaluate the skills mix on the board. In the process three principles need to be kept in mind:[641]

- the knowledge required by an individual to fill the vacancy;
- an individual's capacity to affect outcomes through his/her conduct; and
- whether the candidate has the opportunity and is available to contribute meaningfully to the board.

The nomination committee should also review the qualities of the board and assess the effectiveness of the board, its committees and the individual members.[642]

In the US the task of developing corporate governance principles is also assigned to the nomination committee.[643] In the absence of a corporate governance committee, the nomination committee will be the ideal committee to deal with this issue.

14 Directors' duties

Directors' duties are an excellent means for advancing good corporate governance. By setting definitive guidelines for directors' conduct and informing them on these duties, the interests of investors will definitely be safeguarded. For purposes of directors' duties the discussion of the international position will focus on the UK. Currently most duties on UK directors are imposed by the common law, although these duties are sometimes bolstered by legislation.[644] In principle only the company can apply for an interdict or institute an action by

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[641] King II par 4 63.
[642] King II par 6 63.
[643] *Supra*.
[644] S 309 of the 1985 Companies Act.

way of a claim for damages, as the duty is owed exclusively to the company.[645] The Company Law Review Steering Group in the UK has identified the problems surrounding directors' duties and has included statutory provisions on directors' duties in the White Paper.

According to the White Paper directors should strive to promote the success of the company in the best interests of the shareholders. In achieving this, directors must take into account certain "material factors".[646] These factors include, but are not limited to, ensuring good relationships with employees, customers and suppliers, taking into account the company's impact on the community, maintaining the company's reputation and the need to achieve an outcome that is fair among its members.[647] Although this indicates an inclusive approach, the company is still the beneficiary of directors' duties.[648]

The pioneering recommendation of the White Paper is a codification of what are currently still directors' common law duties.[649] These duties are owed to the company and arise out of the position held by directors. Schedule 2 of the White Paper states seven principles by which directors are bound.

- Principle 1: Directors must act within the company's constitution and exercise their powers for their proper purpose.[650]
- Principle 2: Directors must exercise their powers in good faith and promote the best interest of the company. In doing so, they must take into account the interests of employees, suppliers, customers, the community and standards of business conduct.[651]
- Principle 3: Except where authorised, directors must not delegate their powers or fail to exercise independent judgements.[652]
- Principle 4: Directors must exercise the care, skill and diligence a reasonably diligent person with the knowledge, skill and experience a director in his position has or may reasonably be expected to have.[653]

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[645] See *Foss v Harbottle* 1843 2 Hare 461 for the application of the so-called "proper plaintiff-rule" and on the beneficiaries of directors' duties see *Peskin v Anderson* 2001 1 BCLC 372.
[646] White Paper Part II par 3.3 26 and Draft Companies Bill Schedule 2, Clause 2.
[647] White Paper Part II par 3.3 26 and Draft Companies Bill Schedule 2, Clause 2 (2) (a)-(d).
[648] In *Peskin v Anderson* 2001 1 BCLC 372 the Court of Appeal decided that directors' duties are owed to the company alone.
[649] Clause 19 read with Schedule 2 of the Draft Companies Bill.
[650] White Paper: Draft Companies Bill Schedule 2 par 1.
[651] White Paper: Draft Companies Bill Schedule 2 par 2.
[652] White Paper: Draft Companies Bill Schedule 2 par 3.
[653] White Paper: Draft Companies Bill Schedule 2 par 4.

- Principle 5: Directors must not encourage the company to contract with them or contract with the company themselves if they have an interest in the transaction.[654]
- Principle 6: Directors or former directors must not use company property or information for their own interests unless the company has properly authorised it.[655]
- Principle 7: Directors or former directors should not accept any benefit due to their positions as directors unless properly authorised to do so by the company or the benefit is incidental to the proper performance of their duties.[656]

The provisions will replace the existing common law duties of directors and s 309 of the 1985 Companies Act.[657] The aim of these provisions is to create more clarity on the issue of directors' duties in order to promote the efficiency of the board. The provisions do not, however, attempt to address the issue of directors' fiduciary duties to creditors.

In SA directors' duties similarly are governed primarily by the common law with a few other duties imposed by the Companies Act, companies' articles of association[658] and contracts between companies and directors.[659] Directors owe the company a duty to act with the care and skill that may be expected from a reasonable man in the same position with the same skill and expertise.[660] Some duties also arise from the fiduciary position directors hold. These duties include the duty to avoid a conflict of interests,[661] the duty not to exceed their

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[654] White Paper: Draft Companies Bill Schedule 2 par 5.
[655] White Paper: Draft Companies Bill Schedule 2 par 6.
[656] White Paper: Draft Companies Bill Schedule 2 par 7.
[657] Whether these provisions will be enacted remains to be seen as there have been other occasions where the regulator attempted to codify directors' duties. See the Companies Bills of 1973 and 1978 and *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties Law Commission Consultation Paper No 153/1998*.
[658] See Table A Reg 59, Table B Reg 60 of Schedule 1 of the Companies Act.
[659] See in general Blackman *Companies* in Joubert (ed) *The Law of South Africa* Vol 4 (1) (1995) par 116; Havenga "Directors' fiduciary duties under our future company-law regime" 1997 *SA Merc LJ* 310; Du Plessis "Direkteure se vertrouenspligte en die grondslag van aanspreeklikheid vir die verbreking daarvan" 1993 *THRHR* 11; Fourie "Vertrouenspligte en intrakorporatiewe verhoudings" 1985 *Tydskrif vir Regswetenskap* 119; McClennan "*Directors Fiduciary Duties and the Companies Act*" 1983 *SALJ* 417.
[660] See *In re Brazilian Rubber Plantations and Estates Ltd* 1911 1 Ch 425; *In re City Equitable Fire Insurance Co Ltd* 1925 1 Ch 407; *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 4 SA 156 (W); *Multinational Gas & Petrochemical Co Ltd v Multinational Gas & Petrochemical Services Ltd* 1983 2 All ER 563 (CA).
[661] *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168; *Regal (Hastings) Ltd v Gulliver* 1942 1 All ER 378 (HL); *Peacock v Peacock* 1956 1 SA 413 (T); *Peffers v Attorneys, Notaries and Conveyancers Fidelity Guarantee Fund* 1965 2 SA 53 (K); *Industrial Development Consultants Ltd v Cooley* 1972 2 All ER 162; *Bellairs v Hodnett* 1978 1 SA 1109 (A); *Novick v Comair Holdings Ltd* 1979 2 SA 116 (W); *Atlas Organic*

powers,[662] the duty not to fetter their discretion[663] and the duty to exercise their powers for the correct purposes.[664] Nowhere in SA company law is there a provision similar to that of Schedule 9 of the Draft Companies Bill. The approach of the Bill is however followed to a limited degree in SA by s 40 of the Banks Amendment Act.[665] The section places statutory duties on directors of banks. The section neither detracts from nor substitutes directors' common law duties but it shows some similarity to the Bill. The DTI's Guidelines for Corporate Reform is however contemplating the introduction of a statutory provision on directors' duties.[666]

Although SA common law duties originate from the UK, it is debatable whether the approach in the Bill should be adopted in SA. South Africa has recently adopted a Bill of Rights. The effect of the Bill of Rights will be to change the norms and standards that govern society and, more importantly, the conduct of directors.[667] It will still be a while before the open-ended standards developed through the years in the UK and SA, which were based on public policy, will reach a point where they can be regarded as hard and fast rules.

The argument that a statutory duty will educate directors on their duties does not hold water either. This is illustrated by the UK government's response to the request that all directors sign a statement that they have read and understood the statement containing their duties. The government denied this request, as certification would give the impression that the statement is a comprehensive statement on director's duties. Instead, Companies House[668] should inform directors on their legal duties.[669] A statutory provision replacing the common law duties of directors will therefore not serve to educate directors on their duties.[670]

Fertilizers (Pty) Ltd v Pikkewyn Ghwano (Pty) Ltd 1981 2 SA 173 (T); *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 2 SA 54 (T).

[662] *S v De Jager* 1965 2 SA 616 (A).

[663] *Coronation Syndicate Ltd v Lilienfeld and New Fortuna Co Ltd* 1903 TS 489; *Fulham Football Club Ltd v Cabra Estates plc* 1992 BCC 863.

[664] *Punt v Symons & Co Ltd* 1903 2 Ch 506; *Piercy v S Mills & Co* 1920 1 Ch 77; *Mears v African Platinum Mines* 1922 WLD 57.

[665] Act 19 of 2003.

[666] See *South African Company Law for the 21st Century: Guidelines for Corporate Reform* (May 2004) ("Guidelines for Corporate Reform") 36-41 available at <http://www.dti.gov.za/ccrdlawreview/companylaw.htm>.

[667] For a detailed discussion on the effect of the Bill of Rights on directors' duties see Havenga 1997 *SA Merc LJ* 310.

[668] The Companies House is responsible for among other things, the registration, de-registration and striking-off of companies and enforcing legal requirements relating to company law.

[669] White Paper Part II par 3.17 29.

[670] The government's response is very confusing. If Schedule 9 will eventually replace directors' common law duties it is very difficult to comprehend how it cannot be regarded as a comprehensive statement on directors' duties.

15 The business judgement rule

Directors, whether they are executive or non-executive, owe the company a duty to act in good faith and with a duty of care and skill.[671] While there is definitely a difference between the levels of knowledge about and involvement in the company of executive and non-executive directors, South African company law does not draw this distinction for the purpose of the duty to act with care and skill.[672] In light of this, the King Committee in 1994 recommended the use of the so-called "business judgement rule" in determining the liability of a director for the breach of the duty of care and skill.[673] The business judgement rule is a US innovation and historically not a part of South African company law.[674] According to the rule a director should not be liable for a breach if he made a business judgement in good faith and if the decision:

- was an informed decision based on all the facts;
- was rational; and
- did not involve any self-interest.

The Committee recommended that the Advisory Committee on Company Law consider a statutory provision on the directors' duty of care and skill.[675] In contrast to the recent UK Companies Bill,[676] this was however not done. Instead, the recommendation regarding the adoption of the business judgement rule has been severely criticised by a number of academics and commentators.[677] According to King II it is unnecessary to incorporate the rule into South African company law. In terms of s 248 of the Companies Act the court can exempt a director

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[671] See *Fisheries Development Corporation of SA Ltd v Jorgenson; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 4 SA 156 (W) 165F-166D; *In Re City Equitable Fire Insurance Co Ltd* 1925 Ch 407 427; *Wolpert v Uitzigt Properties (Pty) Ltd* 1961 2 SA 527 (W) 267D-F on a director's duty of care and skill.

[672] See Armstrong 1995 *Juta's Business Law* 66, s 1 of the Companies Act defines "director" to include "[a]ny person occupying the position of director or alternate director of a company, by whatever name he may be designated…" but never makes the distinction between executive and non-executive directors.

[673] King Report Chapter 5 par 3 9. See Hippert 1997 *Juta's Business Law* 18; Havenga "The business judgement rule – Should we follow the Australian example?" 2000 *SA Merc LJ* 25.

[674] For a detailed discussion on the business judgement rule see Arsht "The business judgment rule revisited" 1979 *Hofstra LR* 93; Christy "Corporate mismanagement as malpractice: A critical reanalysis of corporate managers' duties of care and loyalty" 1984 *Houston LR* 105; Eisenberg "The duty of care and the business judgment rule in American corporate law" 1997 *Company Financial and Insolvency LR* 185; Hansen "The Duty of Care, the Business Judgement Rule, and the American Law Institute Corporate Governance Project" 1993 *The Business Lawyer* 1355; McMurray "An historical perspective on the duty of care; the duty of loyalty, and the business judgment rule" in Whitson (ed) *Special Project: Director and Officer Liability* 1987 *Vanderbilt LR* 605; Havenga "The business judgement rule – should we follow the Australian Example? 2000 *SA Merc LJ* 25; Hippert 1997 *Juta's Business Law* 18; Botha & Jooste 1997 *SALJ* 65.

[675] King Report Chapter 5 par 3 9.

[676] See par 14 Directors' duties *supra*.

[677] Botha & Jooste 1997 *SALJ* 65; Hippert 1997 *Juta's Business Law* 18; Havenga 2000 *SA Merc LJ* 25.

from a breach of the duty of care and skill if the court is of the opinion that the director acted honestly and reasonably.[678] The application of the rule is therefore superfluous and does little more than add confusion to the law.[679]

16 Insider trading

The trading in shares or other securities of a company by directors and officers of the company has long been regarded as dangerous to the issuers of the securities. When directors and officers trade shares of their own company, the question immediately arises whether they acted on insider information. Another aspect of insiders' dealings in shares, which is illustrated by the Enron saga, is the dumping of shares just before the knowledge that the company is in financial difficulty becomes public.[680] These areas of corporate governance must be addressed to regain investors' confidence in capital markets. As insider trading is a wide subject, the following comparison of the SA position with the Sarbanes-Oxley Act will have to suffice.

S 306 of the Sarbanes-Oxley Act places a prohibition on insider trading in shares by directors and executive officers during pension fund black outs. According to the prohibition directors and executives are not allowed to purchase, sell or otherwise acquire shares during pension fund blackout periods. The prohibition only applies to shares that were acquired by a director or executive officer in connection with his/her employment or service. Any profits realised from such a transaction by such officials are recoverable irrespective of their intention.[681] The company must however notify its directors and executive officers of any impending blackout on a timely basis. S 306 (a) (4) defines a "blackout period" as any period of more than three consecutive business days during which period the ability to purchase, sell, acquire or transfer any interest in equity of at least 50% of the participants or beneficiaries of a retirement plan is temporarily suspended by the company or a fiduciary of the plan. The SEC

[678] For application of s 248 of the Companies Act see *In re Claridge's Patent Asphalte Co Ltd* 1921 1 Ch 543; *Ex parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T). In terms of s 727 of the 1985 Companies Act UK directors can escape liability for a breach of their duties if their conduct was honest and reasonable. Directors' levels of skill and knowledge are taken into account when judging whether they are liable for a breach of their duties.
[679] See also Hippert 1997 *Juta's Business Law* 18.
[680] *Infra*.
[681] S 306 (a) (2) (A) of the Sarbanes-Oxley Act.

adopted Regulation BTR (Blackout Trading Restriction) on 15 January 2003.[682] The most important aspect of Regulation BTR is that it determines when shares are acquired in connection with a director or executive officer's employment. Regulation BTR treats any shares sold during a blackout period as "acquired in connection with service or employment as a director or executive officer" unless the individual can prove that the shares were acquired from another source. The reason for the prohibition is clear from the testimony of former SEC chairman, Richard Breeden, before the Senate Banking Committee:

> "[T]he spectacle of corporate insiders plundering their own companies or selling their stock quietly in advance of a looming collapse has awakened a sense of revulsion among investors who were left with worthless stock."[683]

S 403 of the Sarbanes-Oxley Act inserts provisions regarding the disclosure of principal stakeholders under s 16 of the Securities Exchange Act.[684] Any change in the beneficial ownership of an officer, director or shareholder, who holds 10% or more, must be filed with the SEC by the end of the second business day after the date of the transaction.[685] Before the enactment of s 403 of the Sarbanes-Oxley Act, s 16 (a) of the Securities Exchange Act required the disclosure of insider transactions by the tenth day of the month following the month in which the transaction took place. The idea behind the disclosure is that investors look to trading by insiders as an indication of the financial condition of the company. The disclosure indicates to investors whether it is desirable or not to invest in the particular company.[686] The idea behind s 403 is, however, questionable to say the least. If the public can look to insiders to determine the condition of the company, then the regulator is admitting that these individuals are acting on insider information, which is not known to the public, and are therefore in contravention of insider trading laws.

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[682] The rules were effective from 26 January 2003 "Insider Trades During Pension Fund Blackout Periods" [17 CFR Parts 240, 245 & 249]. See also SEC Press Release 2003-6 available at <http://www.sec.gov/news/press/2003-6.htm> (16 July 2003).
[683] Testimony of Richard Breeden, former chairman of the SEC, before the Senate Banking Committee. See Report of the Senate Banking Committee 27.
[684] S 16 of the Securities Exchange Act is amended by striking the heading and subsection and inserting a new s 16.
[685] The SEC adopted rules on 27 August 2002 and were effective from 30 June 2003 "Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5" [17 CFR Parts 230, 232, 239, 240, 249, 250, 259, 260, 269 & 274]. See also SEC Press Release 2002-128 available <http://www.sec.gov/news/press/2002-128.htm> (16 July 2003).
[686] Report of the Senate Banking Committee 31.

One recommendation of the King Report of 1994 that did result in legislative reform was the regulation of insiders' dealings in a company's shares.[687] The Insider Trading Act was promulgated in 1998.[688] The Act prohibits three types of insider trading acts. Firstly, it is illegal for an individual to deal in shares to which insider information relates.[689] It is also illegal to encourage or discourage another to deal in the relevant shares.[690] Thirdly, it is an offence to improperly disclose insider information.[691] This is commonly known as tipping. To be found guilty the prosecution need only prove that the offender knew that he was in possession of insider information and that he dealt in the relevant shares. S 4 (1) of the Act established defences which an offender can use to escape liability. In terms of s 5 of the Act a person who is found guilty of an offence in terms of the Act can be fined R2 million, imprisoned for 10 years or both. S 6 allows for an extensive civil penalty. If someone conducted his affairs in contravention of the Act he/she can be liable for up to three times the profit he/she made, or the loss he/she avoided, plus interest.[692] If someone encouraged someone else, disclosed insider information or conducted affairs for someone else, he/she can be liable to the same extent as the person he/she encouraged or assisted plus commission or compensation received.[693]

The Insider Trading Act was repealed by the Securities Services Act[694] in February 2005. Although the provisions of the Securities Services Act relating to insider trading are couched in somewhat different terms, the effect thereof remains mainly the same. The Directorate of Market Abuse established in terms of the Securities Services Act is responsible for enforcing insider trading provisions and instituting civil proceedings against person contravening the Act.[695]

The prohibition on trading with insider information could be made more effective with the use of black-out periods. The problem with the enforcement of insider trading prohibitions has traditionally been the burden of proof as it is relatively difficult to prove that someone acted upon insider information. The problem was addressed by the Insider Trading Act.[696] It can also be solved by the introduction of black-out periods, similar to the Sarbanes-Oxley Act's

687 King Report Chapter 5 par 4 9.
688 Insider Trading Act 135 of 1998.
689 S 2 (1) (a) of the Insider Trading Act 135 of 1998.
690 S 2 (1) (b) of the Insider Trading Act 135 of 1998.
691 S 2 (2) of the Insider Trading Act 135 of 1998.
692 S 6 (1) of the Insider Trading Act 135 of 1998.
693 S 6 (2)-(3) of the Insider Trading Act 135 of 1998.
694 Securities Services Act 36 of 2004.
695 Section 83 of the Securities Services Act 36 of 2004.
696 Act 135 of 1998.

pension fund black-outs, during which certain individuals such as directors and senior officials are prohibited from trading in the shares of a company. These periods would typically be around the release of the company's annual or quarterly financial statements or prior to a profit warning. By preventing specific individuals from trading in companies' shares there is no need to prove that they traded shares based on insider information. The JSE has introduced measures which prohibit certain individuals from trading in companies' shares during specific periods.[697] In terms of par 3.69 and par 3.70 of the JSE Listings Requirements directors are not allowed to trade in company shares during prohibited periods or when they are in possession of unpublished price sensitive information. These insider trading provisions are further enhanced by par 3.63 (a) of the JSE Listings Requirements, which requires all listed companies to disclose details of any transactions in the companies' shares by a director of that company. The required information includes the transaction date, price, number and total value of the shares involved. "Transaction" has a wide meaning and includes sale, purchase, agreements to sell or purchase and share options.[698]

Partly to ensure enhanced disclosure of trading in listed shares, s 140A of the Companies Act was enacted in 1999. In terms of s 140A (3) any registered shareholder who is not the beneficial owner of those shares must disclose to the company, every three months, the person for whose benefit he/she holds the shares. S 140A (8) instructs all listed companies to keep a register of all the disclosures in terms of s 140A (3). Furthermore, they should disclose in their annual financial statements all beneficial owners holding more than 5% of the company's issued shares.[699] Whilst the differences between s 140A and s 403 of the Sarbanes-Oxley Act is very clear, both provisions strive to put an end to insider trading in listed shares.

17 Loans to directors and officers

Personal loans by a company to its directors are also a corporate governance issue. They are of huge concern to investors. History has shown that these loans are often granted under the most questionable circumstances and generally lead to losses for investors. For example,

[697] See JSE Listings Requirements refers to these periods as "closed periods" and includes (a) the period between financial year end and the publication of periodical statements, (b) the six month period after the financial year-end, (c) the publication of the interim financial statements and the period between the expiration of the second six months of the financial year and the publication of the interim financial statements, and (d) any period during which the company's shares are trading under a cautionary announcement. See the JSE Listings Requirements Definitions.
[698] See par 3.64 of the JSE Listings Requirements.
[699] S 140A (8) of the Companies Act.

Kenneth Lay, a senior official at Enron, received loans to the amount of $70 million in one twelve month period and repaid them with Enron stock he held. Bernard Ebbers, former CEO of WorldCom, received personal loans of $366,5 million.[700] The major problem with these loans is that company funds are applied for the wrong purposes. Money that should have been used to promote the interests of the company is now loaned to directors and in most cases this money is never recovered. Absolute prohibitions on loans to directors will send the message to investors that company funds will be applied for the correct purposes.

S 402 of the Sarbanes-Oxley Act places a prohibition on personal loans to executives, subject to certain exceptions.[701] The prohibition is not applicable to personal loans already made on the date of enactment of the Act,[702] provided that no material alteration is made to that credit-extension.[703] The basic prohibition is watered down further by the exceptions which are included under s 13 (k) (2) of the Securities Exchange Act. Accordingly, the prohibition does not preclude an extension of credit that:

- is made in the ordinary course of the company's consumer credit business;[704]
- is similar to the type of credit generally made available by the company;[705] and
- is made on market terms or terms that are not more favourable than those offered to the public.[706]

The Senate Banking Committee apparently hoped that this prohibition will lead to more timely disclosure of insider loans which will enable investors to make better investment decisions.[707] It is rather difficult to comprehend how a prohibition on insider loans will result in more timely disclosure. The Report of the Senate Banking Committee mentions a requirement of s 402 that companies must disclose within seven days all personal loans to executives, specifying the amount of the loan, the amount outstanding and any conflicts of interest.[708] However, s 402 of the Act makes no mention of this seven-day disclosure-requirement. Instead, it places an outright ban on the granting of loans to executives that do not meet the requirements set out in s 402.

[700] Report of the Senate Banking Committee 29 fn 59.
[701] S 402 (a) of the Sarbanes-Oxley Act amends s 13 of the Securities Exchange Act by inserting subs (k).
[702] 30 July 2002.
[703] S 402 (a) of the Sarbanes-Oxley Act.
[704] S 13 (k) (2) (A) of the Securities Exchange Act.
[705] S 13 (k) (2) (B) of the Securities Exchange Act.
[706] S 13 (k) (2) (C) of the Securities Exchange Act.
[707] Report of the Senate Banking Committee 30.

The Australian Corporations Act requires approval by shareholders of any financial benefit given by a public company to a related party.[709] S 228 of the Act defines a "related party" and includes a director of the company and even directors of companies controlling the company. The Act goes as far as giving examples of financial benefits which include giving finance and buying or leasing an asset to a director.[710]

S 226 of the Companies Act forms a somewhat complicated prohibition on loans to directors and officers of the company.[711] In its simplest form s 226 makes it unlawful for a company to make a loan or provide security to a director of the company, its holding company or a subsidiary of its holding company.[712] S 226 allows for several exceptions to this basic rule. A company can, for example, make a loan to its own directors if the general meeting, through a special resolution, consents to the loan.[713] Another exception, which is very similar to the Sarbanes-Oxley Act, allows companies to make loans that are bona fide in the ordinary course of the company's business.[714] The shortcomings in South African company law regarding loans to directors are twofold: firstly, the wording of s 226 itself and, secondly, the application of s 226 by the courts in the recent past, have been unsatisfactory.[715] To illustrate the first shortcoming, take the basic prohibition in s 226 (1). If a company has a holding company, s 226 (1) (a) (iii) prohibits the company from making a loan to a director of its subsidiary, whereas if the company had no holding company, the company is not prohibited from making the loan to its subsidiary. There are also a number of loopholes in the Act. In terms of s 226 (2) (f) a company may make an otherwise prohibited loan to the director of its subsidiary as long as the particular director is not a director of the company making the loan. Also, if for example, the company would like to make a loan to a director of a holding company, the prohibition in s 226 (1) (a) can be circumvented by using s 226 (2) (f): the director of the holding company must only be appointed as director of the subsidiary in order for him to qualify for the exception in terms of s 226 (2) (f).[716] The second problem is clearly illustrated

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708 Report of the Senate Banking Committee 30 & 54.
709 S 208 of the Corporations Act.
710 See s 229 (3) of the Corporations Act.
711 See Jooste "Loans to directors – an analysis of section 226 of the Companies Act" 2000 *SA Merc LJ* 269.
712 S 226 (1) (a) of the Companies Act.
713 S 226 (2) (a) of the Companies Act. See also *Bevray Investments* (*Edms) Bpk v Boland Bank Bpk* 1993 (3) SA 597 (A).
714 S 226 (2) (c) of the Companies Act.
715 See *S v Pouroulis* 1993 4 SA 575 (W), particularly the interpretation of Steggmann J of the words "directly" and "indirectly".
716 Jooste 2000 *SA Merc LJ* 287.

by *S v Pouroulis*.[717] In this case loans were made from a subsidiary (L) via the holding company (S) to several other companies over whom the director (Pouroulis) of both the subsidiary (L) and holding company (S) had control.[718] The prosecutors argued that s 226 prohibited the loans as they were made "indirectly" from L via S to the other companies. Stegmann J decided otherwise and found that s 226 did not cover cases of simulation or where a conduit is used. In cases of simulation, i.e. where the substance of the contract is in fact a loan between a lender and a prohibited person or company but cast in another way, the maxim *plus valet quod agitur quam quod simulate concipur* determines that the law will disregard the simulation and will look at the true substance of the transaction.[719] Where a company is used as a conduit, i.e. where the loan is made to a company not affected by the prohibition and that company proceeds to make a second loan to a third company, who would have been disqualified had the loan been made directly from the original lender to that third company, the prohibition in s 226 does not apply.[720] In the words of Stegmann J the use of the words "directly or indirectly" are "tautologous".[721] It was as if Stegmann J bent over backwards to accommodate the actions of Pouroulis. This approach is disheartening to those who take the fight against white-collar crime seriously. If regulators want to regain the confidence of investors they must enact legislation that is unambiguous. They will also need the assistance of the courts. The law must be interpreted in line with its purpose. All forms of white collar crime must be stopped. But the courts have often seemed loath to assist.

Pectora roborant cultus recti

18 The company secretary

The company secretary is not part of the board as such but he/she nevertheless plays a central role in the proper functioning of the board and the company as a whole. The position of company secretary has in recent years moved from obscurity to enormous prominence. This is clearly illustrated by the following *dictum* of Nestadt J in *Tuckers Land and Development Corporation (Pty) Ltd v Perpellief*:[722]

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[717] 1993 4 SA 575 (W).
[718] The term "control" in the context of s 226 means that the person holds more than 50% of the issued equity capital of the company or if the person can appoint or remove the majority of directors of the company. See s 226 (1A) (b) (i)-(ii) of the Companies Act.
[719] 590G-591C.
[720] 601A-J.
[721] 593F-G.
[722] 1978 2 SA 11 (T) 17G-H.

> "[R]ecently there has in England been judicial recognition of an enhancement of [the company secretary's] humble status. In *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* (1971) 3 All ER 16 (CA) Lord Denning MR said the following of a company secretary: 'He is an officer of the company with extensive duties and responsibilities. He is no longer a mere clerk. He regularly makes representations on behalf of the company and enters into contracts on its behalf which come within the day-to-day running of the company's business. So much so that he may be regarded as held out as having authority to do such things on behalf of the company. He is certainly entitled to sign contracts connected with the administrative side of the company's affairs, such as employing staff, and ordering cars, and so forth. All such matters now come within the ostensible authority of a company secretary.'"

In terms of s 283 of the 1985 Companies Act all UK public companies must appoint a company secretary. The Higgs Report places much emphasis on the company secretary's role in contributing to an effective board. The Combined Code confirms this by requiring the company secretary to ensure good information flow within the company and the various board committees.[723] In Australia, too, the appointment of a company secretary for public companies is mandatory in terms of s 204A (2) of the Corporations Act.

Subsequent to the King Report in 1994, s 268A – 268J were inserted in the Companies Act. The provisions require all companies with share capital to appoint a company secretary.[724] The provisions also regulate the appointment, removal and duties of the secretary. The main function of the company secretary is to guide and assist the board in the performance of its duties and responsibilities.[725] King II also highlights some core functions of the company secretary.[726] In essence the company secretary is responsible for the proper running of the company by advising the board on various matters, including compliance with regulations and internal procedures, and by forming the link of communication between the shareholders on the one side and the company and board of directors on the other side.

19 Shareholder links

Probably the biggest stumbling block in the way of effective corporate governance is communication with shareholders. The information gap between management and

[723] Combined Code par A.5.
[724] S 268A of the Companies Act.
[725] S 268G (a) of the Companies Act.
[726] King II par 3 71 and see ss 268G (a)-(e) of the Companies Act.

shareholders contributes massively to the lack of accountability of directors. This is an international problem and in various jurisdictions regulators are seeking to address it.

As the Higgs Report focuses specifically on non-executive directors, the Report made a number of observations about communication between non-executive directors and shareholders. Although the relationship between non-executive directors and shareholders is very important, it receives little, if any, active attention. Modern trends of shareholding place the majority of shares in the hands of institutional investors. Non-executive directors seldom communicate with these major shareholders.[727] This is in stark contrast with executive directors, who discuss company issues with major shareholders at least once a year. The Higgs Report therefore recommends that non-executive directors should attend the annual general meeting.[728] Their role in these meetings should be to engage in discussions with members on issues relating to their position as non-executive directors. Non-executive directors should also be allowed to attend meetings between management and major shareholders if they choose to do so. These meetings could also take place at the request of the shareholders.[729] Part of the induction process should include a meeting between the newly appointed non-executive director and major shareholders.[730] The annual report should state how the board has promoted a balanced understanding by non-executive directors and other board members of the views held by major investors.[731] Again the company secretary is central to communication between non-executive directors and major shareholders.[732]

One of the biggest concerns about corporate governance in Australia too is the active role of shareholders in the management of companies. Shareholders participate in the running of the company through the annual general meeting. This participation is however impaired due to a number of reasons. One of these reasons is the form in which notices are given of members' meetings. CLERP 9 proposes the use of shorter, more comprehensible notices.[733] Another reason is so-called "bundled resolutions". This occurs in circumstances where a number of resolutions are required to approve a single scheme. Often the documents sent to the shareholder in connection with this scheme are so confusing that the member has little

[727] Higgs Report par 15.5 67.
[728] Higgs Report par 15.10 68 (Suggested Code provision C.2.3).
[729] Higgs Report par 15.16 69 (Suggested Code provision C.1.2).
[730] Higgs Report par 15.17 69 (Suggested Code provision C.1.3).
[731] Higgs Report par 15.18 69 (Suggested Code provision C.1.1).
[732] Higgs Report par 15.19 69.

understanding of what is actually required of him/her. CLERP 9 accordingly proposes the use of explanatory material for bundled resolutions.[734] This requires the issuing of best practice guidelines. The guidance will assist companies in providing explanatory material for bundled resolutions; the provision of fuller information for those who require more information; and an explanation on which resolutions should only be passed separately and not bundled.

The ASX Principles also recognise the importance of shareholder links. In conducting the business of the company due respect should be given to the rights of shareholders.[735] For this reason companies should design and publish their strategy to promote effective communication between the company and shareholders and encourage shareholder participation at the annual general meeting.[736] Although not mandatory in terms of the Corporations Act, auditors may also attend the annual general meeting.[737]

Information technology has become an integral part of modern corporations. With the click of a few buttons information about the company can be sent to all corners of the world via e-mail or websites. Computer software can transform financial information to provide users with different interpretations of accounting data, which could inform investors even better than current financial statements. The use of shortened, reconstructed and simpler financial statements will provide investors with the ability to evaluate the conduct of directors and managers.

The Company Law Review in the UK recognises the importance of technology in corporate governance. In Part II of the White Paper, the Government expresses the view that company law should allow for flexibility regarding possible future technological advances.[738] Clause 88 of the Draft Companies Bill, for example, allows companies to supply members with the companies' financial statements via e-mail or companies' websites.

Australia is also a world-leader in the use of information technology for communication between companies and their shareholders. CLERP 9 proposes the use of electronic aids, including proxy voting and internet casting, to promote shareholder participation.[739] This requires legislative change and guidance by the ASX Corporate Governance Council and ASIC. They also propose the electronic distribution of annual reports and notices.[740] To

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[733] CLERP 9 Proposal 37 186.
[734] CLERP 9 Proposal 38 188.
[735] Principle 6 of the ASX Principles.
[736] ASX Principles Recommendation 6.1 39.
[737] See ss 249K, 249V and 250 of the Corporations Act on the auditor's attendance of the annual general meeting.
[738] White Paper Part II par 1.9 16.
[739] CLERP 9 Proposal 39 192.
[740] CLERP 9 Proposal 41 194.

promote more efficient use of information technology in Australia, the ASX Principles already recognises the use of electronic resources like e-mail, internet, electronic voting and media briefings.

King II recognises the role of information technology in the improvement of corporate governance, especially in the areas of internal control systems, reporting and business in general.[741] Modern corporations make increasing use of websites, e-mail and other electronic means to communicate with their shareholders. Companies need to consider replacing current forms of communications with technologically improved means of communications, stakeholders' access to electronic information and more frequent reporting.[742] King II also encourages the use of electronic communication, especially electronic voting and transmissions of proxies. This would improve governance and communication between the company and shareholders.[743] The Companies Act should also permit the use of summarised annual financial statements.[744] An attempt was made to amend the Companies Act to promote greater use of technology but this was done rather formalistically and many matters still need to be considered properly.

20 Conclusion

Although there are a number of aspects surrounding the role of directors in promoting good corporate governance, the main issues, for the time being, remain the role of the independent non-executive director and the possible reform involving fiduciary duties of directors. The main challenge for South Africa will be to address these issues with due regard for the process of black economic empowerment and the dire skills shortage.

[741] King II par 4 137-139.
[742] King II par 4.2 138.
[743] King II par 8 43.
[744] The use of so-called Concise Financial Reports should be on the basis that whenever a full set is required, it can be obtained from the company. See King II par 11 43.

CHAPTER 5: AUDITING & ACCOUNTING

> "[I]n certifying the public reports that collectively depict a corporation's financial status the independent auditor assumes a public responsibility…[The auditor] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[745]

1 Introduction – Independence

Auditors are central to the proper functioning of internal company law. They serve as a check on the powers of directors. The annual audit is therefore one of the fundamental components of good corporate governance. It gives shareholders the opportunity to see from an objective and independent point of view whether the directors are fulfilling their duties as "trustees" of the company.[746] The key requirement for an effective audit is auditor independence. Auditor independence plays a central role in the public's confidence in the integrity of financial statements. For this reason "an independent public or certified accountant" must approve financial statements.[747]

Although shareholders ultimately elect auditors who perform their duties in the shareholders' interests, auditors have to work closely with management in performing their task. This could result in an impairment of their objectivity and independence. The audit committee plays an important role in overcoming this possible stumbling block. It can act as discussion forum for differences between management and the auditors or it can even be a place where auditors express their concerns about the company.[748]

For auditors to perform an effective audit they should be compensated accordingly. Audit fees should not be seen as a cost saving opportunity for the company. Companies should not shop around for the cheapest auditor in town. In appointing the particular auditor they must look at experience, infrastructure and resources. A company specialising in production and export of high-tech software with a turnover of R10 million should not appoint an audit firm

[745] *United States v Arthur Young* 465 US 805 1984 at 817-818.
[746] King II par 1.1 125 and see also Chapter 4 par 15 The business judgement rule *supra*.
[747] There is no specific statutory provision in South African company law requiring auditors to be "independent" but see s 300 of the Companies Act, s 20 of the Public Accountants' and Auditors' Act 80 of 1991 for the duties of an auditor and Part 1 Section 2 of the SAICA Code of Professional Conduct which requires auditors to be "objective". See also *Caparo Industries plc v Dickman* 1989 1 All ER 798; 1990 1 All ER 568; *Pacific Acceptance Corporation Ltd v Forsyth* 1970 92 WN 29 (NSW) 50-53; 55-58.
[748] King II par 1.2 125. See also the discussion in Chapter 4 par 13 1 Audit committee *supra*.

with seven employees of whom one is the secretary and another the tea girl. The key indicator in appointing an external auditor should be value for money.

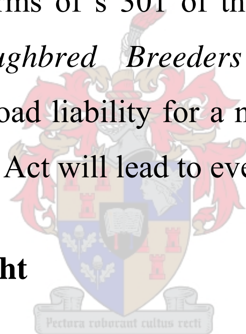
Another factor contributing to the problems surrounding external auditors is the economic significance of particular audit clients that could cause the fear of losing the particular client. This could impair the auditor's independence significantly. Auditors must be given guidance on this threat to auditor independence. In this regard the recommendations of the CGAA are particularly appropriate. Audit firms should disclose the fees received from an audit client that represent more than 5% of the auditor's total fees received.[749] Auditors must develop auditor independence policies, procedures and processes internally. These policies, procedures and processes must be disclosed annually.[750]

2 Statement of independence by auditors

In October 2001 the Australian government issued the Ramsay Report on Independence of Australian Company Auditors (the Ramsay Report).[751] The Report identified three causes for the non-independence of auditors, namely employment relationships, financial relationships and the provision of non-audit services by external auditors.[752] Subsequently the Ramsay Report recommended that the Corporations Act be amended to give a general statement on when an auditor will be regarded as independent. It was contended that this statement ought to include that auditors are not independent if they are unable, or a reasonable person with knowledge of all the relevant facts would assume that they are unable, to exercise an objective and unbiased judgement, taking into account all relationships auditors have with their clients.[753] CLERP 9 endorses this recommendation of the Ramsay Report.[754] Australian auditors will also be required to make an annual statement to the board of the companies they audit that, taking into account all relevant circumstances, they remained independent throughout the audit process.[755]

[749] CGAA Report pars 1.62-1.66 36-37.
[750] CGAA Report pars 1.69-1.70 38.
[751] *The Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform – Report to the Minister for Financial Services and Regulation* (Prof Ian Ramsay) (October 2001) ("Ramsay Report") available at <http://www.treasury.gov.au/contentlist.asp?classification=14&titl=Publications> (23 July 2002).
[752] CLERP 9 par 4.5 44.
[753] CLERP 9 par 4.6.1 45. See also general discussion regarding independence in par 1 Introduction – Independence *supra*.
[754] CLERP 9 Proposal 2 46.
[755] CLERP 9 Proposal 3 47.

There is no such requirement in SA and perhaps this should be considered. At the moment South African auditors are only required to declare that the annual financial statements of a company "fairly present" the condition of that company.[756] This statement must be made after the auditor fulfilled his duties in terms of s 300 of the Companies Act and only if the auditor "has carried out his audit free from any restrictions whatsoever".[757] It is not necessary for the auditor to state whether the audit was done free from any "restrictions". An assumption to this effect is made. If a statement regarding the auditor's independence is elevated to the same level as the statement regarding the financial reports, it could enhance auditor independence dramatically. Shareholders will know that despite any existing relationship between the company and its auditor, the auditor exercised an independent judgement in evaluating the company's financial statements. By attaching some kind of liability, similar to the certification of financial statements by CEOs and CFOs required by the Sarbanes-Oxley Act,[758] auditors can then be held accountable if the statement appears to be false just as they can be held accountable to their statement in terms of s 301 of the Act.[759] Although application of the principles laid down in *Thoroughbred Breeders' Association of South Africa v PriceWaterhouse*[760] will result in broad liability for a negligent auditor, a statutory provision similar to that of the Sarbanes-Oxley Act will lead to even greater liability.



3 Accounting and auditing oversight

The US audit profession features arguably the most extensive and robust auditing oversight system of all the countries under review. The Sarbanes-Oxley Act commences with probably the "most critical and distinctive feature" of the Act – the creation of a mandatory Board to supervise the accounting industry.[761] The PCAOB (the Board) replaces the previous self regulatory Public Oversight Board (POB) which was created by the accounting industry in 1977. The POB was a voluntary organisation, it had little enforcement authority and it did

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[756] S 301 of the Companies Act.
[757] S 301 of the Companies Act. The requirement that the audit must be performed free from any restrictions could possibly refer to the auditor's independence.
[758] See par 11 Corporate responsibility for financial reports *infra*.
[759] For enforcement of auditors' duties to certify that the financial reports fairly present the financial condition of the company see s 20 (9)-(12) of the Public Accountants' and Auditors' Act 80 of 1991. The section attaches liability for "[a]ny opinion expressed or certificate given or report or statement made or statement, account or document certified…in the ordinary course of his duties…" that is negligent or dishonest.
[760] 2001 4 SA 551 (SCA).
[761] S 101 (a) of the Sarbanes-Oxley Act. See George 2002 *Australian Journal of Corporate Law* 288.

little to improve proper corporate governance.[762] It was created in an era of self-regulation. Consequently, the POB could be excused for having little effect on the raising of corporate governance ethics. Other reasons for the POB's failure were a lack of public representation on the board, members' opposing views on the profession's priorities, a "slow and ineffective" disciplinary system and a lack of communication and the necessary leadership.[763] The Board, in contrast, is given a wide range of powers and responsibilities to ensure the promotion of good corporate practices. The reason for the Board's wide-ranging powers and responsibilities was mainly the need for a truly independent and effective oversight body with the power to investigate and discipline accountants.[764] According to the Report of the Senate Banking Committee, the Board will perform responsibilities which have in the past been the task of "a bewildering array of monitoring groups".[765]

Amongst the duties conferred on the Board are the registration of public accounting firms, the establishment of standards by which audit reports are to be compiled, ongoing inspection of all registered public accounting firms and the investigation and conducting of disciplinary proceedings where necessary.[766] The SEC, in consultation with the Federal Reserve Board and the Department of the Treasury, is responsible for the appointment of Board members.[767] The Board consists of five members of which only two are allowed to have an accounting background.[768] One of the two members with an accounting background can be the chairperson. In such a case the chairperson is not allowed to have been a practising accountant for the five years preceding his appointment as a member of the Board. Each member shall serve for a full time period of five years.[769] The initial members' terms will however expire in annual increments of one year. No member may serve more than two terms.[770] To ensure independence, members may not be involved in any other business activities or receive

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[762] Shaun O'Malley, chairman of the 2000 POB Panel on Audit Effectiveness, laid down the immediate challenge for the PCAOB when he described the US accounting oversight system as follows: "*[T]he current system of governance lacks sufficient public representation, suffers from divergent views among its members as to the profession's priorities, implements a disciplinary system that is slow and ineffective, lacks efficient communication among its various entities and with the SEC, and lacks unified leadership and oversight.*" See Report of the Senate Banking Committee 5.

[763] Testimony of Shaun O'Malley, former chairman of the POB Panel on Audit Effectiveness, before the Senate Banking Committee on 6 March 2002. See Report of the Senate Banking Committee 5.

[764] Testimony of Arthur Levitt, former chairman of the SEC before Senate Banking Committee on 12 February 2000. See the Report of the Senate Banking Committee 4; George 2002 *Australian Journal of Corporate Law* 289.

[765] Testimony of John H. Biggs, chairperson, president and CEO of TIAA-CREF and former member of the Public Oversight Board before the Senate Committee. See the Report of the Senate Banking Committee 5.

[766] S 101 (c) of the Sarbanes-Oxley Act.

[767] S 101 (e) (4) of the Sarbanes-Oxley Act.

[768] S 101 (e) (1) & (2) of the Sarbanes-Oxley Act.

[769] S 101 (e) (5) of the Sarbanes-Oxley Act.

payments from accounting firms.[771] The Board has wide ranging powers, which include the power to sue and be sued; to appoint employees, accountants and attorneys; to collect fees in accordance with s 109 of the Act; and any other acts incidental to its operations.[772] As the Board is not an agent of the US government, none of its members are either.[773] The Board must submit an annual report to the SEC. This report must include audited financial statements of the Board itself.[774] The SEC has the responsibility to supervise the activities of the Board.[775] Any rule made by the Board will only be effective after the SEC has approved it.[776]

The Act provides for mandatory registration with the Board of all public accounting firms within 180 days after the date of establishment of the Board.[777] To compel accounting firms to register, the Act makes it illegal for anyone that is not registered with the Board to prepare, issue or to participate in the preparation of audit reports.[778] When applying for registration with the Board the accounting firm must provide certain information which includes a list of all the issuers[779] for which the firm issued and prepared audit reports in the previous year and is expecting to provide audit reports in the current year.[780] All registered public accounting firms are required to provide an annual report to the Board.[781] In addition, each registered accounting firm must pay a registration fee as well as an annual fee.

According to s 103 the Board is required to establish auditing rules and standards that are to be used by all public accounting firms registered with the Board. These rules must include the requirements that accounting firms must:

- maintain their audit working papers for at least seven years;
- exercise so-called “second partner review” of all audit reports; and
- describe the scope of the testing of the company’s internal controls and procedures.[782]

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[770] S 101 (e) (5) of the Sarbanes-Oxley Act.
[771] S 101 (e) (3) of the Sarbanes-Oxley Act.
[772] S 101 (f) of the Sarbanes-Oxley Act.
[773] S 101 (b) of the Sarbanes-Oxley Act.
[774] S 101 (h) of the Sarbanes-Oxley Act.
[775] S 107 (a) of the Sarbanes-Oxley Act.
[776] S 107 (b) (2) of the Sarbanes-Oxley Act.
[777] S 102 (a) of the Sarbanes-Oxley Act.
[778] S 102 (a) of the Sarbanes-Oxley Act.
[779] An “issuer” is defined as an issuer in terms of the s 3 of the Securities Exchange Act. For purposes of this discussion “issuer” has the same meaning as “company” and refers to public companies that are required to submit audited financial statements to the SEC.
[780] S 102 (b) (2) of the Sarbanes-Oxley Act.
[781] S 102 (d) of the Sarbanes-Oxley Act.
[782] S 103 (a) (2) (A) of the Sarbanes-Oxley Act.

The Act also provides for the establishment of more comprehensive standards by the Board relating to among others the monitoring of ethics and independence, supervision of audit work and internal inspections.[783]

The Board is obliged to conduct inspections of accounting firms on a continuous basis.[784] These inspections will measure the level of compliance of all accounting firms with the rules of the Act, the Board and the SEC.[785] The objective is to detect any problems with an accounting firm's procedures, training and culture before it causes an audit failure.[786] The frequency of these inspections depends on the amount of companies the accounting firm provides with audit reports. If the figure is more than 100 the Board should inspect the accounting firm annually.[787] If the number of companies is less than 100, an inspection should be held not less than once every three years.[788] During these inspections the Board must examine selected audit activities of the firm, assess the competence of the firm's quality control systems and perform other tests on the audit or quality control procedures of the firm that are necessary.[789] A report on the inspection must be conveyed to the SEC and in appropriate detail made available to the public.[790]

The Board must establish fair procedures for the investigation and disciplining of accounting firms and persons associated with such firms.[791] The Board has the power to investigate any activities of an accounting firm that:

> "[M]ay violate any provision of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligation and liabilities of accountants with respect thereto…"[792]

If someone refuses to assist in the Board's investigation, the Board has the power to suspend such person from being associated with the accounting firm, suspend or even revoke the registration of that particular accounting firm, or invoke any lesser sanction which the Board deems suitable.[793] The Board also has the power to refer such an investigation to the SEC or

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[783] S 103 (a) (2) (B) of the Sarbanes-Oxley Act.
[784] S 104 (a) of the Sarbanes-Oxley Act.
[785] S 104 (a) of the Sarbanes-Oxley Act.
[786] Report of the Senate Banking Committee 9.
[787] S 104 (b) (1) (A) of the Sarbanes-Oxley Act.
[788] S 104 (b) (1) (B) of the Sarbanes-Oxley Act.
[789] S 104 (d) of the Sarbanes-Oxley Act.
[790] S 104 (g) of the Sarbanes-Oxley Act.
[791] S 105 (a) of the Sarbanes-Oxley Act.
[792] S 105 (b) (1) of the Sarbanes-Oxley Act.
[793] S 105 (b) (3) of the Sarbanes-Oxley Act.

even the Attorney General of the United States.[794] Although none of the employees of the Board are members of the federal government, they are immune from civil liability arising from the investigation to the same extent as an employee of the federal government.[795] The Board may impose any disciplinary sanctions on an accounting firm or person who violated the Act, rules of the Board, provisions regarding securities laws that relate to audit reports and the obligations of accountants relating to audit reports. These sanctions include:

- suspension or revocation of registration;
- temporary or permanent suspension of a person associated with an accounting firm;
- limitation on the activities or operations of such firm or person;
- a civil penalty of not more than $100 000 for a natural person or $2 000 000 for any other person;[796]
- censure;
- additional professional training; or
- any appropriate sanction in the rules of the Board.[797]

Apparently the Board is only allowed to invoke these sanctions subsequent to an investigation envisaged by s 105. If it appears from the normal course of proceedings, e.g. during investigations into the bankruptcy of a company, that an accounting firm or person associated with that firm has violated the provisions of the Act or any securities laws, the Board will not have jurisdiction to impose disciplinary measures. It will be left to the SEC or federal government to discipline the offenders. The idea behind s 105 is to provide the Board with some form of enforcement power.[798] Oversight without effective enforcement is like a gun without bullets!

S 106 is a very controversial and, in a geographical context, the most far-reaching provision of the Act. It provides that any foreign accounting firm that offers audit services to a company subject to US securities laws, i.e. a company listed on one of the US stock markets, is subject to the provisions of the Act and the rules of the Board and the SEC as if that accounting firm was subject to the laws of the US. A "foreign accounting firm" is any accounting firm that

[794] S 105 (b) (4) (B) of the Sarbanes-Oxley Act.
[795] S 105 (b) (6) of the Sarbanes-Oxley Act.
[796] In cases where the accounting firm's or associated person's conduct is intentional or knowingly, which include reckless, or repeatedly negligent, conduct the penalty may be as high as $750 000 for a natural person and $15 000 000 for any other person – see s 105 (c) (4) (D) (i) read with s 105 (c) (5) (A) & (B) of the Sarbanes-Oxley Act.
[797] S 105 (c) (4) of the Sarbanes-Oxley Act.

functions and exists under the regulations of a foreign government.[799] The Board also has the power to declare that a foreign accounting firm, which does not issue audit reports but nevertheless plays a substantial part in the provision of audit reports for a company listed on one of the US stock exchanges, should be treated as an accounting firm in accordance with the Act.[800] The SEC and even the Board may exempt such a foreign accounting firm from the Act or rules of the Board and the SEC if they deem it appropriate.[801] According to the Report of the Senate Banking Committee the absence of s 106 would result in the creation of a loophole that could affect investor protection negatively.[802] What would happen if s 106 was not enacted, is that the financial statements and audit processes of "overseas" companies, whose shares are traded on US stock markets to US investors, will not be subject to the rules of the Sarbanes-Oxley Act. The whole purpose of the Act - that of protecting US investors from Enron and WorldCom repeating themselves - will be defeated. While this evoked much debate the US government had to restore trust in its own capital markets and ensure that investors are protected. There are various foreign companies listed on US stock markets. These companies' financial statements are set up and audited under other countries' laws and by different standards. The government had to decide whether they should trust these foreign accounting and auditing standards, therefore leaving overseas companies' auditors untouched by Sarbanes-Oxley Act, face the risk of more corporate collapses and if in fact it did occur, being crucified by the public for not even attempting to protect their interests. They decided not to take the risk and therefore s 106 was enacted.

The challenge for the PCAOB is not only to apply its rules and regulations but also to regain investors' faith in the accounting industry. Although the preamble to the Act only focuses on investor protection, the legislature had a broader aim, namely that of rekindling the confidence of the investor in the US securities markets. The government wants to lure the investor back with the guarantee that if you invest with us, your money is safe![803]

Unlike the USA, supervision of audit firms in the UK is the responsibility of various supervisory bodies (so-called Recognised Supervisory Bodies) in terms of the 1989

[798] Testimony before the Senate Banking Committee highlighted the need for the PCAOB to have the ability to enforce its standards and rules. See Report of the Senate Banking Committee 10.
[799] S 106 (d) of the Sarbanes-Oxley Act.
[800] S 106 (a) (2) of the Sarbanes-Oxley Act.
[801] S 106 (c) of the Sarbanes-Oxley Act.
[802] Report of the Senate Banking Committee 11.

Companies Act.[804] The ICAEW, Institute of Chartered Accountants in Scotland (ICAS) and Institute of Chartered Accountants in Ireland (ICAI) inspect their members through the Joint Monitoring Unit, while the Association of Chartered Certified Accountants (ACCA) has a similar unit.[805] Professionally qualified inspectors ensure that audit firms are visited at least once in five years. A more watchful eye is kept on the firms that audit listed companies or other clients in which the broader public has an interest. They are inspected annually with a full inspection every three years. Where regulations or ethical codes are violated, auditors are disciplined by imposing fines, being declared ineligible to conduct statutory audits or even by the threat of expulsion from a licensing body. More serious contraventions are referred to the Joint Disciplinary Scheme.[806]

Because of the particular expertise and extensive resources needed to audit listed companies, there has been a concentration of auditors that audit these companies. Consequently, inspectors with similar expertise and resources must do the monitoring of such auditors. The Accountancy Foundation's Review Board has proposed that a specialist group that monitors auditors of listed companies and companies with public interest should be formed within the Joint Monitoring Unit.

In Australia ASIC is given wide powers to enforce accounting requirements under the Corporations Act, the Australian Securities and Investments Commission Act[807] and the various State Crimes Acts. Together with the Companies Auditors and Liquidators Disciplinary Board (CALDB) ASIC is ensuring that auditors are complying with legislation and professional standards. Between 1992 and 2002 ASIC referred 249 company auditors to the CALDB. Of these 249 cases, 146 auditors were found to be in breach of their duties and had their registration cancelled or suspended. More recently, ASIC launched a surveillance project aimed at identifying offences relating to capitalised and deferred expenses, recognition of revenue and recognition of controlled entities and assets. These offences are similar to those which recently brought the whole US accounting industry into disrepute. CLERP 9 further instructs ASIC to review both the civil and criminal penalties to ensure their efficiency.[808] The

[803] The fact that the PCAOB has moved into Arthur Andersen's vacated offices in K Street, Washington DC is a fitting illustration of the sweeping changes in US corporate governance. See Editorial "US PCAOB makes use of space left by Andersen" (January 2003) *The Accountant* 2.
[804] Companies Act 1989 (c 40).
[805] CGAA Report par 5.7 66.
[806] CGAA Report par 5.8 66.
[807] Act 51 of 2001 (Cth).
[808] CLERP 9 Proposal 32 73.

Ramsay Report recommended a restructuring of the CALDB, in order to make it more effective and independent, and give it more powers. CLERP 9 endorses most of these recommendations.[809]

In SA, auditor oversight is currently provided for in the Public Accountants' and Auditors' Act.[810] The Act, and the profession as a whole, is currently under review.[811] As the review process is still underway, the following comments will suffice. The Konar Report expresses the opinion that the Draft Accountancy Profession Bill should not deal with accounting issues but should rather focus on auditing only.[812] The Report is also of the opinion that the self-regulatory system in the South African auditing profession is due to the fact that the government did not exercise its oversight powers conferred on it by the Public Accountants' and Auditors' Act. Consequently, the auditing regulatory framework is inadequate and a complete overhaul is needed. A new auditing oversight body to succeed the PAAB must be established.[813] A single body similar to the PCAOB of the US would ensure that oversight is done efficiently and effectively. The Minister of Finance should appoint the members of the new body from nominations received from auditors, government and academics.[814] Perhaps the Minister should be assisted by the FSB. After all, auditors play an important role in maintaining the integrity of financial markets. A minority of the board should however consist of individuals from the auditing profession.[815] This recommendation is similar to the PCAOB where only two of the five members are allowed to have an accounting or auditing background.[816] The new body must have the same powers as the current PAAB with appropriate committees assisting the body in exercising these powers.[817] These committees should be allowed to consult with individuals from the accounting and auditing profession. The Konar Report also recommends that the new body submit an annual report about its activities to the Minister of Finance and Parliament.[818] This report will indicate to the Minister of Finance and Parliament whether the body is performing its functions effectively. It will also

[809] CLERP 9 Proposal 34 178.
[810] Act 80 of 1991.
[811] See Chapter 3 par 5 6 The Draft Accountancy Professions BillTPF *supra*.
[812] Konar Report par 1.1-1.2 12. The Draft Accountancy Profession Bill's title should therefore refer to auditing and not accounting.
[813] Konar Report pars 1.3-1.4 13.
[814] Konar Report par 1.5 13-14.
[815] Konar Report par 1.5 14.
[816] *Supra*.
[817] Konar Report par 1.8-1.9 15-16. These powers include accreditation of auditors, examinations, quality control, audit standards setting and enforcement. See also Konar Report par 1.8 15.
[818] Konar Report par 1.12 16.

give members of the public an idea of the body's activities. In addition, all auditors and auditing firms must register. This will allow the disciplining of audit firms as well as individual auditors.[819] The Act replacing the Public Accountants' and Auditors' Act[820] must provide for expulsion, fines and penalties in cases where auditors are guilty of misconduct, fraud or dishonesty.[821] The Minister of Finance agreed with these proposals and noted that a new body, totally independent from the profession, would replace the current PAAB. The DTI and National Treasury, through combined efforts, should however lead changes to the regulatory framework of South African corporate governance.[822] The Draft Auditing Profession Bill, 2004 has since been tabled. As the Bill is still in the early stages of drafting, the following comments will suffice. In terms of the Bill, which will replace the Public Accountants' and Auditors' Act, an Independent Regulatory Board for Auditors (IRBA) will be established together with a Standard-Setting Board for Auditor Ethics (SBE) and a Standard-Setting Board for Auditing (SBA). The IRBA will consist of ten members appointed by the Minister of Finance.[823] The IRBA will have wide ranging powers and it is authorised "to do anything which is reasonable or necessary to achieve its objectives".[824] These objectives include protection of the public interest through auditing; oversight of both the SBE and SBA; implementing qualification standards for the auditing profession; taking disciplinary action when necessary; registering auditors and maintaining such a register; and liaising with other professional bodies.[825] Auditing firms as well as individual auditors will be registered with the IRBA.[826] The Bill provides for various disciplinary actions which include appointment of investigatory committees and a tribunal to investigate misconduct.[827] Offences in terms of the Bill include false statements by auditors relating to audits; failing to appear before an investigatory committee; and employing an auditor that is suspended or no longer a registered auditor due to misconduct or any person whose application for registration was declined.[828]

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[819] Konar Report par 5.6 37.
[820] Act 80 of 1991.
[821] Konar Report par 5.17.7-5.17.9 41.
[822] See *Statement by the Honorable Minister of Finance on the Recommendations of the Ministerial Panel for the Review of the Accounting Professions' Bill* 24 March 2004 available at <http://www.treasury.gov.uk>.
[823] S 3 of the Draft Auditing Profession Bill, 2004.
[824] S 5 of the Draft Auditing Profession Bill, 2004.
[825] S 4 of the Draft Auditing Profession Bill, 2004.
[826] Ss 6 - 13 of the Draft Auditing Profession Bill, 2004.
[827] S 25 - 31 of the Draft Auditing Profession Bill, 2004.
[828] S 32 - 34 of the Draft Auditing Profession Bill, 2004.

4 Non-audit services

Shareholders and the general public rely heavily on the audit process for an objective view on the financial position of a company. It is therefore vital that the external auditor remains independent. The provision of non-audit services, however integral a part of the service provided by the auditor it may be, has proven to be very controversial in recent years. It is also the biggest impairment on auditors' independence. According to King II the competition between auditors in relation to non-audit services ought not to impair the effectiveness of their audit performance.[829] In 1999 31% of the big five US accounting firms' income came from accounting and auditing services, while a staggering 50% arose from consulting services.[830] More recent data shows that non-audit services represent 73% of accounting firms' income.[831] The CGAA Report also recognises the importance of auditor independence. For this reason they welcomed the move by the ICAEW and ICAS to strengthen auditor independence requirements.

The argument for the provision of non-audit services is that it ensures that auditors keep up to date with current business practices and that it promotes a more effective audit process. After the collapse of Arthur Andersen it has been the practice of many accounting firms to separate their consulting division from their auditing division. But this is a good example of form over substance. Ownership of these entities will still vest in the same hands and as a result it will have little effect on the independence of the auditor.

In light of recent problems the US government felt it appropriate and timely to place a partial prohibition on performance by accounting firms of certain non-audit activities. This is not surprising as most of the problems with the provision of non-audit services by the external auditor occurred in the US.[832] According to s 201 (a) of the Sarbanes-Oxley Act it is unlawful for a public accounting firm to provide audit and non-audit services to the same company simultaneously.[833] The prohibition is in line with the testimony of former SEC Chairman Arthur Levitt before the Senate Committee on Banking, Housing and Urban Affairs (the

[829] King II par 1.4 125.
[830] Report of the Senate Banking Committee 14.
[831] Report of the Senate Banking Committee 15.
[832] See discussion of the Enron-saga Chapter 3 par 2 1 Enronitis *supra*.
[833] S 201 (a) of the Sarbanes-Oxley Act amends s 10A of the Securities Exchange Act by inserting subs (g).

Senate Banking Committee).[834] The idea of s 201 is to prevent another Enron-Andersen situation where more than 50% of the services Andersen, Enron's external auditor, provided were non-audit related. Non-audit services are defined in s 2 as:

> "[A]ny professional services provided to an issuer by a registered public accounting firm, other than those provided to an issuer in connection with an audit or a review of the financial statements of an issuer."

Although this is a very wide definition, s 201 (a) lists the precluded non-audit services. These include bookkeeping, financial information systems design and implementation, appraisal or valuation services, fairness opinions, actuarial services, internal audit outsourcing services, management functions, human resources, broker services, investment advice, legal services and expert services unrelated to the audit.[835] Although the Senate Banking Committee considered a complete prohibition on non-audit services, it chose to follow a more flexible approach.[836] A total prohibition on non-audit services could create the risk that the auditor's expertise is weakened and consequently reduce the effectiveness of the audit considerably.[837] An accounting firm may therefore provide any non-audit services which is not included in the list of s 201 (a). For example, it may provide audit clients with tax services[838] and it may provide any of the prohibited services to non-public companies or public companies of which it isn't the auditor. The company's audit committee must pre-approve non-audit services that are not prohibited by s 201.[839] Auditors must keep in mind that they are investors' watchdogs. They must ensure that the company's accountants and bookkeepers are doing their jobs by reflecting to the public what really goes on inside the company. If they are involved in the so-called "internal activities" of the company their vision will be clouded and so too the vision of the investor.[840] The provision of non-audit services by companies' external auditors could also result in a conflict of interests. They will be in the position of auditing themselves. The prohibition on non-audit services is definitely a move in the right direction. It is in line with the requirements that an auditor should remain objective and independent.

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[834] George 2002 *Australian Journal of Corporate Law* 290.
[835] S 201 (a) (1)-(9) of the Sarbanes-Oxley Act.
[836] Report of the Senate Banking Committee 16.
[837] See Riesenberg "The non-audit services restrictions of the Sarbanes-Oxley Act" *Daily Tax Report* J-1-J-5 (24 September 2002) (http://www.aicpa.org/info/bna_020924.htm) (14 August 2003).
[838] Tax services are expressly excluded from the prohibited list but pre-approval by the company's audit committee is required. See s 201 (a) of the Sarbanes-Oxley Act.
[839] S 201 (a) of the Sarbanes-Oxley Act amends s 10A of the Securities Exchange Act by inserting subs (h).

In contrast with the US, the CGAA recommends that the provision of non-audit services in the UK should be guided by principle and not statute. There is however a need for tougher safeguards to ensure that the simultaneous provision of audit and non-audit services does not impair the independence of auditors. The Group recommends that:

- the circumstances under which auditors are allowed to provide internal audit services should be limited;[841] and
- the circumstances under which valuation services, taxation services and financial information technology design and implementation are allowed should also be clarified.[842]

The Group especially welcomed the recommendations by the Smith Report that the audit committee must play a central role in adopting company policy on the provision of non-audit services.[843] Companies should furthermore disclose the nature and extent of non-audit services provided by the company's external auditor.[844] Consequently, the Group recommends that the DTI amend statutory disclosure requirements.

The Combined Code only requires companies, and more specifically their audit committees, to adopt a policy on the provision of non-audit services.[845]

In Australia non-audit services received much attention in the Ramsay Report. The Report defined these services as any services which fall outside the scope of the audit contract between the auditor and the client.[846] The Report recommended, firstly, a revision of the Australian professional accounting bodies' ethical rules, secondly, mandatory disclosure of non-audit services and fees, thirdly, strengthening of audit committee responsibilities and, lastly, the establishment of the Auditor Independence Supervisory Board (AISB) to monitor among other things the disclosure of non-audit services. CLERP 9 responded with a number of proposals. The first is the use of Professional Statement F1 on Professional Independence, which is based on the equivalent statement of the International Federation of Accountants

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[840] See *United States v Arthur Young* 465 US 805 1984; *Caparo Industries Plc v Dickman* 1989 1 All ER 798; 1990 1 All ER 568.
[841] External auditors should not be involved in internal auditing in cases where they give an opinion on management's assessment of internal controls and internal audit services should only be provided in exceptional cases. See CGAA Report par 1.42 30.
[842] CGAA Report par 1.42 31.
[843] CGAA Report par 1.53 34.
[844] CGAA Report par 1.55 34.
[845] Combined Code par C.3.2.
[846] CLERP 9 par 4.9.1 57.

(IFAC).[847] The statement requires identification by the auditor of any threats on auditor independence and application of the necessary safeguards to guarantee independence. Professional Statement F1 recognised the following services as non-audit services:[848]

- accounting, valuation, internal audit, legal and IT systems services;
- temporary staff employment;
- recruitment of senior management by the auditor; and
- corporate finance.

CLERP 9 also proposes amendments to current law to facilitate mandatory disclosure of non-audit fees and to clarify when the particular non-audit services are compatible with auditor independence.[849] Although the government avoided a complete ban on the provision of non-audit services, FRC is given the task of monitoring the independence of audit firms.

King II avoids proposing an outright ban on non-audit services. Instead, it recommends that the audit committee should ensure the independence of accounting firms on an *ad hoc* basis by laying down principles for the provision of non-audit services by the external auditor.[850] The fees for non-audit services as well as the detail of the services provided should be disclosed to the shareholders separate from the annual audit fees.[851] Furthermore the nature of the non-audit services and the amounts paid for the particular services should be disclosed annually.[852]

The Konar Report echoes the feeling of King II that a blanket prohibition on non-audit services is inappropriate. Non-audit services should also not be regulated by statute.[853] According to the Report auditors should not perform non-audit services in circumstances which will result in them auditing themselves.[854] Fees received for non-audit services from a client should not be disproportionate to audit fees as this could compromise auditor independence.[855] Audit committees should determine, in light of the nature and extent of the non-audit services, principles for the restrictions on non-audit services provided by the company's auditor.[856] This is also the approach of the JSE Listings requirements.[857] Although

[847] CLERP 9 Proposal 6 68.
[848] CLERP 9 par 4.9.3 69.
[849] CLERP 9 Proposal 7 69.
[850] King II pars 9 & 10 134.
[851] S 283 of the Companies Act require separate disclosure of audit and non-audit services.
[852] King II par 12 134.
[853] Konar Report par 2.9 22.
[854] Konar Report par 2.7 21.
[855] Konar Report par 2.8 22.
[856] Konar Report par 2.10 22.
[857] JSE Listings Requirements par 3.84 (g).

the Minister of Finance agreed with this proposal, he did add that the new oversight body replacing the PAAB should have the authority to issue regulations governing the provision of non-audit services by companies' external auditors.[858] The South African approach, as recommended by King II and the Konar Report, is a step in the right direction. A blanket ban on non-audit services will not be appropriate for South Africa. The auditing profession faces huge shortages due to the demand for their specialist services. Furthermore, the problems with the provision of non-audit services were limited to the US. There has been little indication that this is also a problem in SA. What needs to be implemented, and is indeed recommended by King II and the Konar Report, is a principle based approach with the audit committees of companies playing a central role. In light of the Minister of Finance's views, this position could be changing in the very near future with the PAAB's successor taking on the responsibility of determining the principles whereby non-audit services may be provided by a company's external auditor. The Minister felt that although some degree of flexibility should be allowed, there are specific non-audit services which a company's auditor should not be allowed to perform and which should prohibited by the auditing oversight body. These services include bookkeeping, accounting and internal auditing.[859]

5 Auditor Rotation

The issue of auditor rotation is currently very controversial. The problems with a long-lasting auditor-client-relationship include the risks that the auditor and client could develop a personal relationship and the auditor becoming complacent. This could impact negatively on the auditor's independent and objective judgement. Although there is no empirical proof of the consequences of a long-lasting auditor-client relationship, it is human nature to become more familiar with another person through long-term interaction. It is also human nature to become complacent after a certain exercise has been repeated several times. Concerns about auditor independence are therefore justified. It would ensure that the relationship between the auditor and client does not develop into one that could potentially compromise auditor independence and objectivity if auditors, audit partners and senior audit personnel are required to rotate on a regular basis. It is therefore settled that some form of auditor rotation is necessary. The only question remaining is the type of the rotation.

[858] See *Statement by the Honorable Minister of Finance on the Recommendations of the Ministerial Panel for the Review of the Accounting Professions' Bill* on 24 March 2004.

The first possibility is entire audit firm rotation. The argument against this type of rotation is that it takes a while for auditors to develop a degree of knowledge about and experience with the audit client that would ensure the effectiveness of the audit. This argument is altogether unsound. The audit function requires a number of basic steps, which the auditor has to take at the commencement of an audit. One of these is to acquire knowledge about the business entity.[860] The information gathered at the commencement of the audit must be reviewed and evaluated regularly – and probably at least on an annual basis. What this means is that there is no difference between the continuation of an existing auditor-client relationship and the appointment of a new auditor. In the case of an auditor taking over the work of another, there is no reason why this process would hinder the provision of an effective audit. Full auditor rotation is therefore workable.

At this stage many regulators have, instead, opted for audit partner and lead audit personnel rotation as a type of middle way instead of full auditor rotation.[861] In doing so they are satisfying both the audit profession and investors. This approach is however open to question. It is difficult to see what would be achieved by only requiring the audit partner to rotate. The audit firm will, despite the rotation of the audit partner, remain the same entity with the same interests.

S 203 of the Sarbanes-Oxley Act, which requires audit partner rotation, is one of the ground-breaking provisions of the Act. The section prohibits US accounting firms from providing audit services if the lead audit partner or review partner was responsible for the company's audit in each of the previous five years.[862] Although the Senate Banking Committee considered entire audit firm rotation, they decided on audit partner rotation instead.[863] They did however leave the back-door open by directing the Comptroller General of the US GAO to conduct a study in terms of s 207 on the effects of mandatory auditor rotation.[864] This report must be submitted no more than one year after the enactment of the Act. The positioning of this provision raises the question why it is not included under Title VII - Studies and Reports. A possible explanation for this is that the outcome of the study is regarded as extremely

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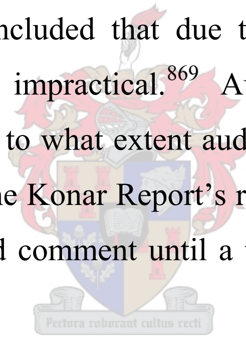
[859] See *Statement by the Honorable Minister of Finance on the Recommendations of the Ministerial Panel for the Review of the Accounting Professions' Bill* on 24 March 2004.
[860] In South Africa SAAS 310 require the auditor to gather information of a new client.
[861] *Infra*.
[862] S 203 of the Sarbanes-Oxley Act amends s 10A of the Securities Exchange Act by inserting subs (j).
[863] Report of the Senate Banking Committee 21.
[864] S 207 (a) of the Sarbanes-Oxley Act.

important – even more important than the other studies which have to be concluded under Title VII.[865]

In line with movements in the US, the CGAA Group in the UK recommends an audit partner rotation programme of five years for the audit partner and seven years for other key partners, but rejected full audit firm rotation.[866] The ICAEW and ICAS require audit partners in the UK to rotate every five years.[867]

In Australia CLERP 9 follows international trends in endorsing the Ramsay Report's recommendation on audit partner rotation. It, however, disagrees with the Report's seven-year period and recommended a rotation program at least every five years.[868] The rotation affects the lead partner and the review partner.

In contrast with international trends both King II and the Konar Report considered mandatory auditor rotation, but concluded that due to the skills shortage in SA and the increase in audit fees, it will be impractical.[869] Audit committees are given the sole responsibility to decide whether and to what extent auditor rotation should take place.[870] The Minister of Finance did not accept the Konar Report's recommendations regarding mandatory auditor rotation. Instead, he reserved comment until a thorough examination of international trends has taken place.



6 Competition for audit services

Another factor which could impede auditor independence is competition among auditors. While competition is needed in a free market economy, the risk of losing a client to another auditor, who offers his services at a premium rate, could encourage auditors to make favourable opinions in order to ensure that he/she is re-appointed as external auditor. The recent consolidation of auditors has contributed to the problems surrounding competition in the audit profession. The centralisation of resources under the "big four" made it virtually

[865] For the studies in terms of Title VII of the Sarbanes-Oxley Act see Chapter 3 par 2 3 Regulation in the US *supra*.
[866] CGAA Report pars 1.20-1.22 24-25.
[867] CGAA Report par 1.22 25.
[868] CLERP 9 Proposal 9 83.
[869] Konar Report pars 3.4-3.5 24-25.
[870] Konar Report par 3.6 25.

impossible for other smaller audit firms to compete on an equal footing with the big firms when it came to the provision of value-for-money audit services.

Under Title VII of the Sarbanes-Oxley Act the US GAO, headed by the Comptroller General, must conduct a number of studies. The most notable is the one on the consolidation of public accounting firms. This study refers to the so-called "big four" accounting firms.[871] The study must identify the factors which led to the reduction of accounting firms since 1989; the impact of the consolidation on capital formation and securities markets; and present solutions for the problems subsequent to the consolidation.[872] Some of the problems that have resulted from the consolidation of accounting firms are identified by the Act and include higher costs, lower quality, impairment of independence and lack of choice.[873]

The concentration of accounting and audit firms in the last few years has also caused the CGAA in the UK to recommend that the DTI and HM Treasury consult with the Office of Fair Trading on this aspect. These consultations took place and on 22 November 2002. The Office of Fair Trading issued a press release whereby the Office undertook to review the accountancy and audit market. According to the press release it was not regarded as necessary to refer the matter to the Competition Commission or to perform a market investigation.[874]

As to the threat of losing a client, supervisory bodies, such as the PAAB and SAICA, must provide guidelines for auditors, who are unhappy with the way they were dismissed. Companies should not be able to dismiss auditors solely due to the fact that they are unhappy with the auditors' opinions or if auditors do not dance to their tunes. After all, this is what auditors are supposed to do: they must declare whether the financial statements truly and reasonably reflect the condition of the company. If they now run the risk of losing a client due to the fact that they are acting in the best interest of investors, then the whole purpose of the exercise is negated.

Under South African company law a company can only remove an auditor before the end of his term of office if (a) he/she was appointed as the first auditor in terms of s 269, (b) he/she

[871] After the collapse of Arthur Andersen only four of the so-called "big five" were left. They are Deloitte & Touché, KPMG, PricewaterhouseCoopers and Ernst & Young.
[872] S 701 (a) of the Sarbanes-Oxley Act.
[873] S 701 (a) (2) of the Sarbanes-Oxley Act.
[874] For reasons why the Office of Fair Trading did not demand a market investigation or refer the matter to the Competition Commission see Annex I of the CGAA Report "Competition in Audit and Accountancy Services: a Statement by the OFT" 101.

was appointed in terms of s 271 where the general meeting refused to appoint an auditor or (c) he/she was appointed in terms of s 273 due to a casual vacancy.[875] If a company fails to reappoint an auditor, the directors must appoint an auditor within 30 days of the annual general meeting.[876] In all other cases an auditor may only be removed with a majority decision of 75% of the members who are entitled to vote and who are present at a general meeting.[877]

In terms of ss 277 and 278 of the Companies Act an auditor may however not be removed from office if he/she has reason to believe that "material irregularities" took place in the company which could cause the company, its members or creditors financial loss and before he/she has reported the irregularities to the board and PAAB in terms of ss 20 (5) (a) and (b) of the Public Accountants' and Auditors' Act.[878] This provision ensures that companies cannot dismiss an auditor who reports on irregularities.

7 Appointment of external auditor-employees

It has become international practice for companies to appoint staff of the external auditor in important financial positions, seemingly to exploit these individuals' skills and expertise. The risk with this practice – clearly illustrated by the Enron scandal – is that auditor independence is sacrificed.

The Sarbanes-Oxley Act attempts to prevent similar situations to Enron, where ex-auditor staff filled most of the key financial positions in their client, from again occurring in the US.[879] The Act makes it unlawful for a US accounting firm to perform audit services to a company if:

> "[A] chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit".[880]

[875] Ss 277 and 279 (1) of the Companies Act.
[876] S 271 (1) of the Companies Act.
[877] Ss 278 and 279 (1) of the Companies Act.
[878] Act 80 of 1991.
[879] See discussion of Enron Chapter 3 par 2 1 Enronitis *supra*.
[880] S 206 of the Sarbanes-Oxley Act.

This provision is inserted under s 10A of the Securities Exchange Act as s 10A (l) – "Conflicts of Interest". The one-year cooling-off period for ex-auditor employees is a very welcome provision. Whether one year is enough is questionable but at least it is a good starting point.

The CGAA Group in the UK welcomed ICAEW's two-year cooling-off period in cases where an audit partner wishes to be employed as a senior employee or director of an audit client.[881]

The Ramsay Report in Australia also recommended an amendment of the Corporations Act relating to the employment relationship between the auditors and their clients. Consequently, CLERP 9 includes a two year cooling-off period between the resignation of an audit partner and employment as director or senior manager of a previous audit client with whom the auditor was directly involved.[882] The Owen Report proposes a cooling off-period of four years for former audit partners and other key senior audit personnel, a two year-period for an audit partner not directly involved with the audit and a total prohibition on the appointment of more than one former audit partner as director or senior manager of a client.[883]

Although s 275 of the Companies Act prohibits certain individuals from being appointed as auditors of the company,[884] there is currently no prohibition in SA company law on audit clients appointing ex-employees of the external auditing firm in key financial positions. In the light of international trends, the time has come for SA to consider whether it is not in the best interest of investors to place some limitations on ex-audit personnel being employed by their clients. But to keep up with international practice purely for the sake of keeping up, is also not good. Like the issue of non-audit services and competition for auditors, the question has to be asked whether it is necessary to change the current position. Prohibiting ex-audit personnel from being appointed by clients can have a negative impact on South African business, especially with regards to black economic empowerment. With the number of experienced black auditors already limited, it can become virtually impossible for companies to find experienced black financial personnel.

Pectora roborant cultus recti

[881] CGAA Report par 1.61 36.
[882] CLERP 9 Proposal 4 49.
[883] Owen Report Recommendation 11.
[884] These include directors of the company, anyone doing secretarial work for the company or anyone in the employment of a director or officer of the company.

8 Audit firm transparency

Audit firms should be encouraged to publish aspects on their internal structures, processes and financial position. There is a need to reveal auditors' culture, procedures, safeguards and systems. By disclosing these aspects, auditors will increase their openness and transparency and ultimately increase the level of confidence the public have in them. For this reason the CGAA recommended that UK audit firms should be invited to disclose this information voluntarily on an annual basis. This invitation should apply to all auditors whose financial periods commenced on 1 January 2003. The DTI is requested to review the response of auditors after a year and if the response is inadequate, disclosure should be made mandatory.[885] Auditors therefore have little choice: if they do not disclose this information voluntarily, it will eventually be mandatory to do so. The Group gave some guidance on the contents of this report. It should at least cover aspects like financial information, operating details, governance issues, quality and auditor independence.[886]

Although it is not necessary for South African auditors to disclose to members of the public their procedures, practices, systems, etc., the PAAB is authorised to conduct inspections of premises, books, documents or assets of any auditor to promote the integrity, status and standards of the auditing profession.[887] Members of the public can however attain this kind of information through application of the Promotion of Access to Information Act.[888] In terms of s 50 of the Act an individual can request access to information held by a private entity, such as an audit firm, if the information is necessary for the exercise or protection of a right contained in the Bill of Rights. In terms of s 52 of the Act a private entity can voluntarily disclose certain information. If someone wishes to get information about an auditor's procedures, practices, etc. he/she only needs to show that the disclosure of the information is necessary for the exercise or protects one or more of his/her rights. Although the Promotion of Access to Information Act does not define these rights, it includes a person's constitutionally entrenched rights, contractual rights and any rights arising from a delictual claims.

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[885] CGAA Report par 3.6 51.
[886] CGAA Report par 3.7 51-52.
[887] S 22A (1) read with s 13 (p) of the Public Accountants' and Auditors' Act 80 of 1991. See also par 3 Accounting and auditing oversight *supra* for discussions of PAAB's duties and powers.
[888] Act 2 of 2000.

9 Enhanced disclosure in periodic statements

S 401 (a) of the Sarbanes-Oxley Act inserts two provisions on financial disclosure under s 13 of the Securities Exchange Act.[889] The first provision deals with the accuracy of financial statements.[890] All financial reports that are prepared in accordance with GAAP and filed with the SEC must reflect all material correcting adjustments. This means that whenever material changes take place in the company's financial condition or operations, it must be disclosed timeously and in understandable language.[891]

The other provision inserted by s 401 deals with so-called "off-balance sheet transactions". These transactions, and more specifically SPE's, were made (in)famous by the Enron scandal where they were used to hide millions of dollars worth of debts. According to the Act the SEC must adopt rules requiring all annual and quarterly financial statements to disclose any material off-balance sheet transactions which may have a material effect on the financial conditions of the issuer.[892] The purpose of s 401 is to provide investors with accurate and complete financial reports which enable informed investment decisions.[893] Testimony before the Senate Banking Committee showed major concerns about off-balance sheet transactions and other "inside information" relating to transactions between companies and their executives.[894]

S 401 (b) compels the SEC to issue rules on pro forma financial information.[895] The rules must provide that such information must be presented in such a way that:

- it does not contain any material false statement or omit any material fact which would cause the information to be misleading; and
- the pro forma information reconciles with the financial condition of the company.[896]

On 22 January 2003 the SEC voted to adopt rules in terms of s 401 (b) of the Act.[897]

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[889] S 401 (a) of the Sarbanes-Oxley Act amends s 13 of the Securities Exchange Act by inserting subss (i) & (j).
[890] Subs (i) of the Securities Exchange Act.
[891] Baker & Hostetler "Accounting reform and corporate governance legislation becomes law" Baker & Hostetler Executive Alert, August 2002 available at <http://www.bakerlaw.com/aboutus/news/acct_reform.asp> (17 July 2003).
[892] Subs (j) of the Securities Exchange Act.
[893] See the Report of the Senate Banking Committee 28; George 2002 *Australian Journal of Corporate Law* 292.
[894] Report of the Senate Banking Committee 28.
[895] Pro forma information is any financial information published by a company prior to such financial information being subjected to an independent audit. The SEC adopted rules on 15 January 2003 and were effective from 28 March 2003 "Conditions for Use of Non-GAAP Financial Measures" [17 CFR Parts 228, 229, 244 & 249]. See SEC Press Release 2003-06 available at <http://www.sec.gov/news/press/2003-6.htm> (16 July 2003).
[896] S 401 (b) (1) & (2) of the Sarbanes-Oxley Act.

S 401 also provides for a study, which has to be concluded within one year after the adoption of the rules in terms of s 401, to determine, firstly, the extent of off-balance sheet transactions and, secondly, whether these transactions are reflected in terms of GAAP.[898] Within six months after completion of the study the SEC must submit a report to the President, the Senate Banking Committee and the Committee on Financial Services of the House of Representatives on:

- the total amount of off-balance sheet transactions used by companies;
- the extent to which SPEs are used to facilitate off-balance sheet transactions;
- whether GAAP results in a true economic reflection of off-balance sheet transactions;
- whether GAAP results in the consolidation of SPE's; and
- any recommendations that will improve the transparency and quality of off-balance sheet transactions' reporting and disclosure in the financial statements.[899]

In South Africa the Financial Reporting Bill[900] is intended to provide the statutory financial reporting standards with which the "recognition, measurement, presentation and disclosure in the financial statements" of companies must comply.[901] The task of determining these standards is assigned to the Financial Reporting Standards Council. It is not yet clear what these standards will be but it can potentially include a requirement that CEOs and CFOs certify annual financial statements.

10 Enhanced quality of financial statements

The Sarbanes-Oxley Act attempts to prevent the practice of directors and other officials misleading the auditor. In doing so the Act indirectly enhances the integrity of financial statements. S 303 of the Act prohibits an officer or director from fraudulently influencing, manipulating or misleading the accountant engaged in the auditing of financial statements. The provision has a twist. For the influence or manipulation to be prohibited, it must be made for

[897] The rules were effective from 7 April 2003 "Disclosure In Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations" [17 CFR Parts 228, 229 & 249]. See also SEC Press Release 2003-10 available at <http://www.sec.gov/news/press/2003-10.htm> (14 August 2003).
[898] S 401 (c) (1) of the Sarbanes-Oxley Act.
[899] S 401 (c) (2) of the Sarbanes-Oxley Act.
[900] Draft 4, 29 July 2002 and see also Chapter 3 par 5 5 Financial Reporting BillTPF *supra*.
[901] Financial Reporting Bill 2002 Clause 4 (a).

the purposes of rendering such financial statements materially misleading.[902] The aim of the provision is to address fraud and misconduct during the audit process. The question can however be raised: would all manipulation or misleading of an accountant not be made in order to render the financial statements misleading? In other words, can the manipulation have a positive effect on the statements in the sense that it will render it more accurate?[903] This question is partially answered by the inclusion of the requirement that the influencing must make the financial statements "materially" misleading. Not any influence will constitute a transgression of the provision.

The Konar Report recommends the creation of a statutory offence in South Africa for executives who make false representations or material non-disclosures about the company's financial condition to the external auditors.[904] It should also be an offence for anyone, including company officials, consultants, attorneys and advisers, to knowingly take part in the preparation of financial statements that do not fairly represent the company's financial position.[905] The Report also suggests that the fine or penalty for these offenders should be linked with the damage suffered by investors due to the error in the financial statements.[906] This is an attempt to extend the reach of the prohibition to individuals beyond company officials and auditors. Auditors who, with knowledge, report recklessly on financial statements must be subject to a statutory offence.[907] This recommendation links up with the auditor's duties in terms of the Public Accountants' and Auditors' Act.[908]

11 Corporate responsibility for financial reports

Recently several questions have been asked about companies' financial statements. These questions were well founded in the light of various corporate scandals.[909] Investors lost confidence in the financial accounting systems. This confidence has to be regained in order to attract investors. One way of doing this is for executives to certify that financial statements are true and fair representations of the company's condition and results.

[902] S 303 (a) of the Sarbanes-Oxley Act.
[903] The SEC adopted rules on 24 April 2003 and were effective from 27 June 2003 "Improper Influence on Conduct of Audits" [17 CFR Part 240].
[904] Konar Report par 6.3 43.
[905] Konar Report par 6.4 43.
[906] Konar Report par 6.6 43.
[907] Konar Report par 5.5 37.
[908] Act 80 of 1991.

A landmark provision in the Sarbanes-Oxley Act is that of s 302 – “Corporate responsibility for financial reports”. According to this the executive officer(s) and the financial officer(s) must certify in each annual and quarterly report that:

- they have reviewed the report;[910]
- based on their knowledge, the financial statements do not contain any material false statement, or omit a material fact, which causes the financial statements to be misleading;[911]
- based on their knowledge, the financial statements are a fair presentation of the financial condition and results of the company in all material respects;[912]
- they are responsible for the establishment and maintenance of internal controls;[913]
- they have designed these internal controls;[914]
- they have evaluated their effectiveness;[915]
- they have presented their conclusions on the effectiveness in the report;[916]
- they have divulged all shortcomings in the internal controls and any fraud that involves employees who play an important part in the internal controls to the audit committee;[917] and
- whether there were any significant changes in the internal controls.[918]

This provision is a step in the right direction. It requires executives and financial officers to put themselves on the line for investors. After Enron, doubts arose whether audited financial statements were credible. For this reason management is now held responsible for financial statements. Whether the provision will be applied to the letter of the law remains to be seen. The drawback of the provision is that it will definitely complicate companies’ risk assessment

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[909] See Chapter 3 *supra*.
[910] S 302 (a) (1) of the Sarbanes-Oxley Act.
[911] S 302 (a) (2) of the Sarbanes-Oxley Act.
[912] S 302 (a) (3) of the Sarbanes-Oxley Act. The “fair presentation” standard has nothing to do with GAAP requirements and is a new standard open for interpretation. See “The Sarbanes-Oxley Act of 2002” *Seyfarth & Shaw Management Alert* (30 July 2002) 2 available at <http://www.seyfarth.com>.
[913] S 302 (a) (4) (A) of the Sarbanes-Oxley Act.
[914] S 302 (a) (4) (B) of the Sarbanes-Oxley Act.
[915] S 302 (a) (4) (C) of the Sarbanes-Oxley Act.
[916] S 302 (a) (4) (D) of the Sarbanes-Oxley Act.
[917] S 302 (a) (5) of the Sarbanes-Oxley Act.
[918] S 302 (a) (6) of the Sarbanes-Oxley Act.

and analysis and will eventually result in more expenses.[919] The SEC nevertheless adopted rules in accordance with s 302 of the Act on 27 August 2002.[920]

A somewhat obscure provision is inserted by way of s 404. It requires the SEC to adopt rules requiring management to include an internal control report in each annual report. Management must state their responsibility for establishing and maintaining internal controls and make an assessment of the effectiveness of these internal controls.[921] The purpose of this attestation by management is to enhance the quality of the statements and to rekindle investor confidence in financial accounts.[922] Although the requirement adds an extra element of credibility to financial accounts it nevertheless borders on overkill as s 302 (a) (c) already requires CEOs and CFOs to certify the financial reports.[923] In addition, the company's auditors must attest to this declaration by the management. The SEC nevertheless adopted rules in terms of s 404 on 27 May 2003.[924]

The fourth ASX Principle requires the safeguarding of the company's financial reporting. To achieve this the CEO and CFO should declare that the company's financial statements, in all material aspects, are a true and fair presentation of the company's condition and result and are in accordance with accounting standards. This declaration must be made to the board of directors.[925]

One aspect which King II failed to address in SA was an annual report by the directors on the financial statements. The King Committee of 1994 encouraged the accountability of directors to all relevant stakeholders through the use of the annual directors' report. Consequently, the Committee recommended that directors make a statement in the annual financial statements that they were responsible for the financial statements, that the financial statements present a fair reflection of the company's affairs, appropriate accounting policies and standards have been applied, the company has maintained a proper system of internal

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[919] Johnsson & Wiechart "New Regulations: preparing for the unplanned costs" (January/February 2003) *Financial Executive* 16.

[920] The rules were effective from 29 August 2002 "Certification of Disclosure in Companies' Quarterly and Annual Reports" [17 CFR Parts 228, 229, 232, 240, 270 & 274]. See also SEC Press Release 2002-128 available at <http://www.sec.gov/news/press/2002-128.htm> (16 July 2003).

[921] S 404 (a) (1) & (2) of the Sarbanes-Oxley Act.

[922] Report of the Senate Banking Committee 31.

[923] *Supra*.

[924] The rules were effective from 14 August 2003 "Management Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports" [17 CFR Parts 210, 228, 229, 240, 249, 270 & 274]. See also SEC Press Release 2003-66 available at <http://www.sec.gov/news/press/2003-66.htm> (16 July 2003).

control and if, in their opinion, there is doubt about the company's ability to remain a going concern, it must be disclosed.[926] Although it does not have the same legal force, it is very similar to the statement by directors now required by s 302 of the Sarbanes-Oxley Act.[927] The Konar Report expresses the opinion that the board as a whole is responsible for the company's financial statements and therefore a certification similar to the Sarbanes-Oxley Act is not appropriate. The CEO and CFO should however only be required to sign the financial statements.[928]

12 Conclusion

As mentioned above, the biggest concern about the effectiveness of the audit process is auditor independence. Although much can still be done to improve the independence of the external audit process in South Africa, the biggest stumbling block facing the profession remains the limited number of skilled auditing personnel. For example, a restriction on the movement of personnel from external auditor to client can create a shortage of available financial experts. Furthermore, the number of auditing firms with the resources to audit big listed companies prevents the possibility of implementing mandatory auditor rotation. Ensuring an effective auditing profession in South Africa therefore depends heavily on the development of skills in South Africa. Before that happens South Africa is not in the position to follow international auditing best practice just for the sake of following it.

A revolutionary alternative to address the problems of auditor independence would be a complete restructuring of the audit profession. This would involve the establishment of a single audit body responsible for the auditing of all companies. There will be no private auditing companies. All auditors will belong to this body. The body will be funded through a membership fee paid by all companies based on their size, turnover, nature, etc. Individual auditing teams, consisting of a leader and a number of qualified auditors, will be assigned to a company for a specific period of time. The advantage of such a system is that the possibility of a personal relationship between auditor and management will seldom come into being. These auditors will also not be allowed to provide non-audit services. For these services companies

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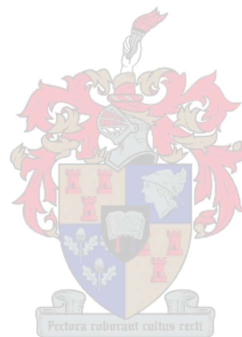
[925] ASX Principles Recommendation 4.1 29.
[926] King Report Chapter 5 pars 7.1-7.8 9-10. See also the discussion in par 9 Enhanced disclosure in periodic statements *supra*.
[927] *Supra*.

will have to make use of the services of private consulting firms. This system will also simplify the duties of the audit committee considerably as it will now only serve as a channel of communication between the auditors, the internal auditor and the board and to review the company's accounting policies and practices.

The failure of US accounting checks and balances has forced the US government to reconsider its position. The result was the implementation of widespread prescriptive legislation through the Sarbanes-Oxley Act requiring, for example, the CEO and CFO to certify annual financial statements and the publication of all off-balance sheet transaction. The feeling in the UK and Australia was that this was an overreaction on the side of the US government. Furthermore, they felt that the problems highlighted by the Enron and WorldCom scandals were limited to the US and therefore it was unnecessary for comprehensive reform.[929] South Africa should at least consider similar provisions.



[928] Konar Report par 6.9 44.
[929] See however the reservations expressed by George 2002 *Australian Journal of Corporate Law* 291 about the Australian approach in Chapter 6 par 4 Recovering losses of defrauded investors *supra*.

CHAPTER 6: ENFORCEMENT

> "[A]ccountability and transparency help our markets work as they should, in ways that benefit investors, employees, consumers and our national economy. The Enron debacle has arrived on our doorstep, and our job is to make sure that there are adequate doses of accountability in our legal system to prevent such occurrences in the future, and to offer a constructive remedy and decisive punishment should they occur. The time has come for Congress to rethink and reform our laws in order to prevent corporate deceit, to protect investors and to restore full confidence in the capital markets."[930]

1 Introduction

The previous two chapters focused on laws, rules and other standards with which companies have to comply regarding aspects of corporate governance. The question now arises: how can these standards be enforced and what will happen if companies do not observe them? This question is answered differently in the various jurisdictions. In the US, for example, the Sarbanes-Oxley Act and the Securities Exchange Act provide for severe penalties for both companies and individuals who are involved in securities laws violations, while the UK, Australia and South Africa follow a hybrid approach. Lastmentioned countries adopted codes of best practice which companies have to comply with. If companies do not comply with these codes, they have to explain why. These countries do however have a number of legislative prescriptions enforced by criminal and civil sanctions albeit not as prescriptive and detailed as the US system.

The recent legal reform in the US relating to corporate fraud must be seen against the background of Enron and WorldCom. After initially facing similar problems in the early nineties, the UK recovered and developed a system that could be described as very healthy.[931] The latter system's basic tenet of comply or explain has proven to be very successful and beyond question. This can be attributed to the culture of the UK business community, who respect the values of good business ethics. Similar events occurred in South Africa.[932] The question is: what approach should SA follow? With the democratisation of the country and the adoption of a Bill of Rights, the economic environment has moved towards a more liberal

[930] Report of the Senate Banking Committee 11.
[931] See Chapter 3 *supra*.
[932] See Chapter 3 *supra*.

approach, similar to the one in the US.[933] The emphasis has shifted to individuals' basic rights and, more particularly, their freedom. To prevent South Africa from following the US route of corporate collapse, regulators and the business community must act together. But it is suggested that this cannot only be achieved by legislating against bad behaviour like the Sarbanes-Oxley Act.

But the saying goes: prevention is better than cure. To prevent Enron, WorldCom, LeisureNet and Saambou from being repeated, a culture of respecting business ethics and rules needs to be developed. Failure to take proper notice of this constitutes the biggest shortcoming of the Sarbanes-Oxley Act.[934] Instead the Committee on the Judiciary chose to blame the US legal and ethical environment as the reason for corporate scandal.[935] According to the Committee the shortcomings were:

- the lack of "securities fraud" provisions in the criminal code;[936]
- the loopholes, ambiguities and limitations in obstruction of justice provisions;[937]
- the sentences for serious fraud and obstruction of justice are insufficient;[938]
- the time-limits on recouping losses and conviction of fraudsters;[939]
- obstacles in the way of the recovering losses from bankrupt debtors;[940] and
- insufficient whistleblower protection.[941]

Although it is difficult and probably impossible to regulate and enforce good business ethics,[942] the Committee and therefore the Act failed to take this important aspect of corporate governance into consideration.

Enforcement issues are discussed with reference to the shortcomings identified by the Committee on the Judiciary, general enforcement measures and an appropriate code of ethics/conduct.

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[933] See the discussion in par 3 Obstruction of justice *infra*.
[934] But see comment on legislating good business ethics *infra*.
[935] It is ironic that the Committee's report contained a heading "The legal and ethical landscape and the need for reform" but the reform focused mainly on legal aspects and did very little about ethics. See the Report of the Committee on the Judiciary 5.
[936] Committee on the Judiciary 6.
[937] Committee on the Judiciary 6-7.
[938] Committee on the Judiciary 7.
[939] Committee on the Judiciary 8.
[940] Committee on the Judiciary 10.
[941] Committee on the Judiciary 10.
[942] See Editorial 2003 *Harvard LJ* 2123.

2 Securities fraud provisions - Enhanced white-collar crime provisions

A major problem of the modern business environment has been the amount of corporate fraud. For too long law enforcers have turned their back on these types of crimes. If regulators want to regain the confidence of investors, they must be both resolute and ruthless in the conviction of white-collar criminals.

S 807 of the Sarbanes-Oxley Act creates a "new" offence under the heading "Criminal penalties for defrauding shareholders of publicly traded companies".[943] The paragraph provides for a fine, 25 years imprisonment or both for anyone who knowingly defrauds another or obtains, by fraudulent pretences, money or property in connection with shares. Although this creates a new criminal offence that is more accessible to investigators and prosecutors, it should be kept in mind that the existing mail and wire fraud statutes are adequate due to the court's expansive interpretation of these provisions.[944] In addition, s 32 (a) of the Securities Exchange Act allows the Justice Department to pursue Rule 10b-5 fraud actions and to impose criminal liability for wilful and knowing violations of the securities laws.[945] Moreover, s 1348 does not loosen the requirement of intent. Title IX[946] of the Act increases the maximum sentence for mail and wire fraud from five to twenty years.[947] It furthermore increases the criminal penalties for violations of the Employee Retirement Income Security Act of 1974 (29 U.S.C.).[948] S 905 of the Act directs the US Sentencing Commission to amend the sentencing guidelines for certain white-collar crimes. The CEO and CFO are required by s 906 to certify that the financial statements, which include all periodic statements, comply fully with ss 13 (a) and 15 (d) the Securities Exchange Act and that the information in that statements is a fair representation of the financial situation of the company in all material respects.[949] The provision inserts s 1350 in the US Code under the heading "Failure of

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[943] S 807 of the Sarbanes-Oxley Act amends Chapter 63 of Title 18 USC by inserting "S 1348 Securities Fraud".
[944] Editorial 2002 *Harvard LR* 732.
[945] Editorial 2002 *Harvard LR* 732; *Carpenter v United States* 484 US 19, 24 1987.
[946] Title IX is also referred to as the "White-Collar Crime Penalty Enhancement Act of 2002".
[947] S 903 of the Sarbanes-Oxley Act amends s 1341 & s 1343 of Title 18 USC by striking "5" and replacing it with "20".
[948] S 904 of the Sarbanes-Oxley Act amends the Employee Retirement Income Security Act of 1974 (29 USC 1131) by striking "$5 000", "one year" and "$100 000" and inserting "$100 000", "10 years" and "$500 000" respectively.
[949] S 906 is additional to the Order of the SEC published on 27 June 2002 requiring the CEO and CFO of the 947 largest companies to certify their financial records. See "Accounting reform and corporate governance legislation becomes law" Baker & Hostetler Executive Alert (August 2002) available at <http://www.bakerlaw.com/aboutus/news/acct_reform.asp> (17 July 2003).

corporate officers to certify financial reports".[950] The statement must certify that the financial statements fairly represents, in all material aspects, the financial condition of the company. If it is evident that the financial statements were certified knowing that it did not comply with the requirements of s 1350, the provision carries a sanction of up to a $5 000 000 fine, imprisonment of twenty years or even both.[951]

In terms of s 1104 of the Sarbanes-Oxley Act, the US Sentencing Commission is directed to review its securities and accounting fraud sentencing guidelines. In doing so the Sentencing Commission must have regard to among other considerations the serious nature of securities and accounting fraud and the need to prevent such offences.[952]

One of the major criticisms of the Sarbanes-Oxley Act is that although it creates more criminal offences and consequently widens criminal conduct, it does not lower the standards for indictment and conviction.[953] The Sarbanes-Oxley Act will therefore have little effect on the conviction of corporate fraudsters.[954] This is typical of the attitude in the US. Every so often the government creates a new statutory offences and soon thereafter someone identifies and exploits its shortcomings. In this case the problem is the standard of conviction. Instead of creating more effective mechanisms for convicting corporate fraudsters, the legislation appears to create more loopholes.

The Board and the SEC play an important role in the punishing of corporate offenders, as civil enforcement of the Act is easier due to a smaller amount of procedural red tape and an easier burden of proof.[955] Nevertheless, some are of the opinion that criminal conviction of white-collar criminals remains the ultimate preventative mechanism for corporate fraud.[956]

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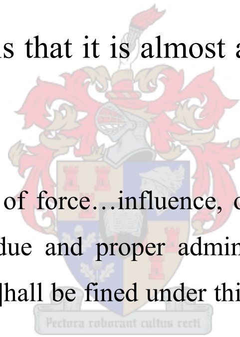
[950] S 906 of the Sarbanes-Oxley Act amends Chapter 63 of Title 18 USC by inserting "S 1350 Failure of corporate officers to certify financial reports".
[951] See also Friedland 2002 *The Company Lawyer* 384 385.
[952] S 1104 (a) (1) of the Sarbanes-Oxley Act.
[953] Editorial 2002 *Harvard LR* 732.
[954] For an alternative view on the effects of s 906 see Friedland 2002 *The Company Lawyer* 384.
[955] Criminal offenders must be proven guilty beyond reasonable doubt while civil liability requires guilt on the balance of probability.
[956] Polinsky & Shavell "Should employees be subject to fines and imprisonment given the existence of corporate liability" 1993 *International Review of Law & Economics* 239 250-251; Walker "The deterrent value of imposing prison sentences for tax crimes" 2000 *New England Journal on Criminal & Civil Confinement* 1 17-18; Editorial 2002 *Harvard LR* 733.

3 Obstruction of justice

As highlighted by the collapse of Enron,[957] one of the major obstacles to enforcement is the destruction of documents. It is therefore not surprising that the Sarbanes-Oxley Act contains a number of provisions addressing obstruction of justice. Title VIII of the Act inserts two new offences under the US Code – and more specifically the federal obstruction of justice chapter. The first offence created by s 802 is s 1519 – "Destruction, alteration, or falsification of records in Federal investigations and bankruptcy". The section reads as follows:

> "[W]hoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department of agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both."[958]

The interesting aspect about s 1519 is that it is almost a carbon copy of the already existing s 1505, which reads as follows:[959]


Pectora roborant cultus recti

> "[W]hoever corruptly, or by threats of force…influence, obstructs, or impedes or endeavours to influence, obstruct, or impede the due and proper administration of the law under which any pending proceeding is being had…[s]hall be fined under this title or imprisoned not more than five years, or both."[960]

It is difficult to see what the aim of the new s 1519 is. Some are of the opinion that it adds little, if anything at all, to the already existing s 1505, which deals with the obstructing "pending proceedings".[961] It should however be noted that the section carries the more severe penalty of a maximum prison sentence of twenty years. According to the Committee of the Judiciary s 1519 should be used in those circumstances where evidence is destroyed "with the specific intent to impede or obstruct a pending or future criminal investigation, a formal administrative proceeding, or bankruptcy case" and not destruction in the ordinary course of business. Furthermore, the new s 1519 is aimed at individuals acting alone with the intent to

[957] See Chapter 3 par 2 1 Enronitis *supra*.
[958] S 802 of the Sarbanes-Oxley Act amends Chapter 73 of Title 18 USC by inserting "S 1519 Destruction, alteration, or falsification of records in Federal investigations and bankruptcy".
[959] The Committee on the Judiciary recognised that s 1519 overlaps with existing obstruction of justice statutes. See Report of the Committee on the Judiciary 27.
[960] See Editorial 2002 *Harvard LR* 730 fn 24.

obstruct future criminal proceedings.[962] This is the situation that occurred at Enron where certain documents were destroyed.

S 802 inserts a additional crime in the US Code in the form of s 1520.[963] The provision is aimed at accountants. Part of the section reads as follows:

> "(a) (1) Any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(a)) applies, shall maintain all audit or review work papers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded..."
>
> "(b) Whoever knowingly and wilfully violates subsection (a)(1), or any rule or regulation promulgated by the Securities and Exchange Commission under subsection (a)(2), shall be fined under this title, imprisoned not more than 10 years, or both."

Section 1520 (b) will most likely only be used in exceptional circumstances where prosecutors are of the opinion that accountants knowingly and wilfully failed to maintain proper audit records. Misbehaviour by accountants is most likely already covered by existing obstruction of justice laws.[964] Section 1520 (b) therefore provides an additional penalty rather than an entirely new crime.

The SEC is furthermore obliged by s 802 to adopt rules and regulations on the retention of audit records for five years.[965] According to s 103 the PCAOB must establish rules requiring accounting firms to maintain their audit working papers for seven years.[966] This differs slightly from the five year-requirement in terms of s 802. On 22 January 2003 the SEC implemented s 802 of the Act by adopting Rule 2-06 of Regulation S-X requiring the retention of certain documents for seven years.[967] This includes the work papers and other documents that form the basis for the audit, memoranda, correspondence, communications and any records pertaining to the audit process.[968] The requirement of seven years, which differs from

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[961] See Editorial 2002 *Harvard LR* 730.
[962] Report of the Committee on the Judiciary 27.
[963] S 802 of the Sarbanes-Oxley Act amends Chapter 73 of Title 18 USC by inserting "S 1520 Destruction of corporate audit reports".
[964] S 1519 of the USC deals extensively with obstruction of justice offence. See Editorial 2002 *Harvard LR* 732.
[965] S 1520 (a) (2) of Chapter 73 of Title 18 USC.
[966] See discussion of the PCAOB Chapter 5 par 3 Accounting and auditing oversight *supra*.
[967] The rules were effective from 3 March 2003 and audits completed on of after 31 October 2003 must comply with the rules. Rule 2-06 (a) of Regulation S-X "Retention of Records Relevant to Audits and Reviews" [17 CFR Part 210]. See also SEC Press Release 2003-11 available at <http://www.sec.gov/news/press/2003-11.htm> (16 July 2003).
[968] Rule 2-06 (a) of Regulation S-X "Retention of Records Relevant to Audits and Reviews" [17 CFR Part 210]. See also SEC Press Release 2003-11 available at <http://www.sec.gov/news/press/2003-11.htm> (16 July 2003).

the five-year period proposed by s 802 of the Sarbanes-Oxley Act, is however in line with the PCAOB's auditing standards that require retention of seven years.[969] The Rule also settles the dissimilarities between ss 103 and 802.

Title XI of the Sarbanes-Oxley Act amends an existing obstruction of justice crime.[970] According to s 1102 of the Act anyone who corruptly and deliberately alters, destroys, damages or conceals any documents used in official proceedings or in any way obstructs an official proceeding shall be fined, imprisoned for not more than twenty years or both.[971] The provision is only applicable to official proceedings and differs from s 802 in that it does not apply to acts performed in "contemplation" of official proceedings.[972]

In South Africa the Companies Act provides for various obstruction of justice provisions. Section 249 (1) of the Act creates an offence for knowingly providing a false statement, financial report, evidence or any document required in terms of the Act. In terms of s 250 (1) of the Act it is also an offence to conceal, destroy, mutilate or falsify any document, book, register and financial record or statement with the intention of defrauding or misleading another. Any director, officer, accountant or auditor in the service of the company is guilty of an offence in terms of s 251 (1) of the Act if he/she makes or circulates any statement or financial statement which is materially false. Furthermore, s 332 of the Criminal Procedure Act 51 of 1997 provides for criminal liability of a director or officer of a company in the exercise of the person's authority. Although these provisions are not as detailed as those contained in the Sarbanes-Oxley Act they nevertheless serve their purpose. To try and close each and every loophole or possible gap in the civil and criminal justice system will not be effective. The only result will be that the legislature will be wasting time on formulating ineffective legislation. The important difference between the corporate culture in the US on the one side and countries like the UK, Australia and SA on the other side must be kept in mind. The US system is an extreme example of capitalism where it is survival of the fittest and profit at all cost. If there is a loophole in legislation or even a hint of some form of ambiguity, it will be exploited to the maximum. This is not the case in the other systems under discussion.

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[969] Rule 2-06 (a) of Regulation S-X "Retention of Records Relevant to Audits and Reviews" [17 CFR Part 210]. See also SEC Press Release 2003-11 available at <http://www.sec.gov/news/press/2003-11.htm> (16 July 2003). See also discussion of the PCAOB Chapter 5 par 3 Accounting and auditing oversight *supra*.
[970] Title XI is also referred to as the "Corporate Fraud Accountability Act of 2002".
[971] S 1102 of the Sarbanes-Oxley Act amends s 1512 of Title 18 USC by inserting subs (c).

4 Recovering losses of defrauded investors

According to the Sarbanes-Oxley Act, if, due to misconduct, there is a need for an accounting restatement, the CEO and CFO must repay any bonuses or incentive-based compensation received in the twelve months after publication of the faulty financial report. In addition, they should also repay any profits realised on the sale of securities during that twelve months.[973] The misconduct does not necessarily have to be the CEOs or CFOs misconduct. It is also not a requirement that the CEO or CFO are aware of the misconduct.[974] The purpose of this provision is to prevent executives from making profits out of incorrect financial statements.[975]

Another provision, which could assist defrauded investors in recovering their losses, is s 308 of the Act. The section creates a fund for victims of securities laws violations. Any civil penalty obtained by the SEC against a person who violates securities laws, rules or regulations will become part of a disgorgement fund to be managed for the benefit of such victims.[976]

These are probably the most positive aspects about the Sarbanes-Oxley Act. Instead of telling people what not to do, the Act is sending a strong message to anyone who wants to defraud investors: if you do it, you will pay back the money you made at the expense of innocent defrauded investors. The provisions will also reassure investors that their money is safe - something the Act aims to do. The Konar Report attempts the same by proposing that the penalty imposed for misrepresentation in financial statements should have a direct link with damages suffered by investors due to the misrepresentation.[977]

5 Whistleblower protection

Another method through which companies can ensure the maintenance of proper corporate governance systems is the development of procedures whereby employees and other individuals can express concerns about corporate practices confidentially and discreetly.

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972 See Recent Legislation 2002 *Harvard LR* 729.
973 S 304 (a) (1) & (2) of the Sarbanes-Oxley Act.
974 "The Sarbanes-Oxley Act of 2002" *Seyfarth Shaw Management Alert* 2 (30 July 2002).
975 Report of the Senate Banking Committee 26; George 2002 *Australian Journal of Corporate Law* 291.
976 S 308 (a) of the Sarbanes-Oxley Act.

Companies should appoint board committees with the sole responsibility of developing procedures whereby employees can not only express their grievances but can also communicate with the board and management on all issues of corporate governance. Whistleblowers should also be protected from the possibility of retaliation. The US and Australia sets a good example of how this can be achieved.

The Sarbanes-Oxley Act provides for whistleblower protection under Title XIII.[978] The aim is to protect employees who provide information on conduct that constitutes fraud against shareholders. According to the provision a company is not allowed to "discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee" who provides information on the violation of securities laws. By affording such people protection the legislature is hoping that more people will come forward with information that will lead to the prosecution of those who commit investor fraud in any way.[979] For the employee to receive protection in terms of s 806 it is not necessary that he/she identify the fraud correctly. The protection is granted if the employee "reasonably believes" that the conduct is a violation of securities laws.[980]

The Sarbanes-Oxley Act includes another provision on whistleblower protection under Title XI:

> "[W]hoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offence, shall be fined under this title or imprisoned not more than 10 years, or both."[981]

The aim of the provision is to broaden the scope of whistleblower protection and extend it outside the scope of the employee-employer-relationship. It differs from s 806 in a number of ways. Firstly, s 806 is limited to the employment situation. S 806 also requires the provision of information for purposes of an investigation or proceedings in terms of securities laws before

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[977] Konar Report par 6.9 43 and see also discussion in Chapter 5 par 10 Enhanced quality of financial statements *supra*.

[978] S 806 of the Sarbanes-Oxley Act amends Chapter 73 of Title 18 USC by inserting "S 1514A Civil action to protect against retaliation in fraud cases".

[979] Similar to the acts of Sherron Watkins, one of the whistleblowers at Enron.

[980] "The Sarbanes-Oxley Act of 2002" *Seyfarth & Shaw Management Alert* (30 July 2002) available at <http://www.seyfarth.com>.

[981] S 1107 of the Sarbanes-Oxley Act amends s 1513 of Title 18 USC by inserting subs (e).

it affords protection to whistleblowers. Furthermore, s 806 allows for more general relief in the form of reinstatement of the employee, back pay and compensation for special damages.

According to CLERP 9 whistleblower protection will be provided in Australia to any employee who reports corporate criminal activity to ASIC in good faith and on reasonable grounds.[982]

Whistleblower protection in SA is regulated by the Protected Disclosure Act.[983] The object of the Act in terms of s 2 is to protect and to provide remedies for employees who provide information on unlawful and irregular conduct and to provide procedures for the disclosure of this information in a responsible manner.[984] If an employee has made a so-called "protected disclosure", s 3 provides that he/she may not be subjected to any "occupational detriment". "Disclosure" is defined by s 1 of the Act as the disclosure of information about the employee's employer or co-employee. Protection will be obtained only if the employee has reason to believe that it is related to the following:

- the commission of a criminal offence;[985]
- non-compliance with a legal duty;[986]
- a miscarriage of justice;[987]
- the endangering of someone's health or safety;[988]
- damaging of the environment;[989]
- unfair discrimination;[990] or
- deliberate concealment of any of the abovementioned matters.[991]

"Occupational detriment" refers to conduct in the working environment and includes disciplinary action, dismissal, suspension, demotion, intimidation or any conduct that could harmfully affect a person's employment, profession or office.[992] The Act deems only certain

[982] CLERP 9 Proposal 35 179.
[983] Act 26 of 2000.
[984] S 2 (1) (a)-(c) of the Protected Disclosures Act 26 of 2000. Although this is the aim of the Act the basic principles underlying the Act are good corporate governance in private institutions together with effective, transparent and accountable governance in the public sector. See the preamble to the Act.
[985] S 1 (i) (a) of the Protected Disclosures Act 26 of 2000.
[986] S 1 (i) (b) of the Protected Disclosures Act 26 of 2000.
[987] S 1 (i) (c) of the Protected Disclosures Act 26 of 2000.
[988] S 1 (i) (d) of the Protected Disclosures Act 26 of 2000.
[989] S 1 (i) (e) of the Protected Disclosures Act 26 of 2000.
[990] S 1 (i) (f) of the Protected Disclosures Act 26 of 2000.
[991] S 1 (i) (g) of the Protected Disclosures Act 26 of 2000.
[992] S 1 (vii) (a)-(i) of the Protected Disclosures Act 26 of 2000.

disclosures as protected disclosures for purposes of the Act. This includes disclosures to a legal adviser, an employer, the Public Protector, the Auditor-General or a member of the Cabinet.[993] The main shortcoming of the Act is that it does not extend beyond the scope of employment. The Act also differs from s 806 of the Sarbanes-Oxley Act in that it affords general whistleblower protection beyond the context of securities laws.

6 Miscellaneous statutory provisions on enforcement

Various acts also provide for enforcement of rules in the jurisdictions under discussion. Lack of space obliges only a cursory discussion of some salient features of enforcement legislation. In Australia, for example, offences in terms of the Corporations Act include directors breaching their duties in terms of ss 180 - 184 of the Act[994] and the common law, breaching of the procedure when giving a financial benefit,[995] not compliance with continuous disclosure requirements,[996] engaging in market manipulation,[997] insider trading[998] and misleading an auditor.[999] Section 1317E, read with s 1317G, of the Corporations Act provides for a fine of up to AUS$200 000 for contravention of the Act. CLERP 9 recommended that the maximum civil penalty for corporate offenders in terms of the Act should be increased to AUS$1 000 000.[1000] ASIC should also be given the power to impose penalties for continuous disclosure breaches.[1001]

Currently s 441 of the Companies Act contains penalties for violations of the Companies Act. The penalties range from ten years imprisonment for forgery of share certificates;[1002] through five years for disqualified persons who are appointed as directors;[1003] to three months for refusing to take minutes at board meetings.[1004] These provisions should be subjected to scrutiny with the aim of establishing more robust fines for misconduct. In addition the courts should seek to enforce these provisions. The Guidelines for Corporate Reform proposes wide-

[993] Ss 5-8 of the Protected Disclosures Act 26 of 2000.
[994] Sections 180 - 184 of the Corporations Act and the common law requires Australian directors to act honestly, exercise care and diligence, not to make improper use of their positions and of information obtained in connection with their position as directors.
[995] S 209 (2) of the Corporations Act.
[996] S 674 (2) of the Corporations Act.
[997] S 1041A-1041G of the Corporations Act.
[998] S 1043A (1) of the Corporations Act.
[999] S 1309 of the Corporations Act.
[1000] CLERP 9 Proposal 21 156.
[1001] CLERP 9 Proposal 23 156.
[1002] S 441 (b) of the Companies Act.
[1003] S 441 (d) of the Companies Act.

spread amendments to company law enforcement and administration. These measures include decriminalisation of company law in conjunction with empowering a new body called the Companies and Intellectual Property Commission to act as an enforcement body.[1005] The possibility of creating a Companies Tribunal to adjudicate any matter falling under the Companies Act was also raised by the DTI. This body will be assisted by an Arbitration Council and an Advisory Panel.[1006] Section 75 of the recently enacted Securities Services Act prohibits manipulative trading practices which creates or might create a false impression of the trading activity of or an artificial price for the particular share. The Securities Services Act defines certain acts as manipulative trading practices. Furthermore, provision is made for a civil as well as criminal liability.[1007]

In the US the SEC, assisted by the PCAOB, serves as watchdog to ensure companies and accountants comply with the various securities laws and regulations. If there is no independent body to ensure that companies comply with these rules they will be worthless. Although South Africa has the FSB, the country lacks a body with similar powers to that of the SEC. The FSB, JSE, Registrar of Companies and the Auditor-General are all responsible for the enforcement of securities laws and regulation. The FSB is also responsible for financial markets and its tasks include supervision of the insurance industry, retirement funds, collective investments schemes, financial advisors and capital markets.[1008] With so many duties it is debatable whether the FSB has the time or resources to perform this difficult task effectively. What is therefore needed is a body that has as its only function that of ensuring that public companies comply with securities laws.

7 Code of conduct and ethics

The value of good company ethics and conduct is often underestimated. Very seldom do business people realise that when they contract with others, the resulting rights and obligations go hand-in-hand with trust. This is also the case with companies. By adopting codes of conduct and ethics companies can address many issues surrounding corporate governance,

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[1004] S 441 (g) of the Companies Act.
[1005] This should however not be confused with the already existing Companies and Intellectual Property Registration Office (CIPRO) whose task is mainly related to the registration of companies and other administrative matters.
[1006] See Guidelines for Corporate Reform 40-50.
[1007] See the ss 77 and 115 of the Securities Services Act 36 of 2004.

including corporate social responsibility. But this brings us to the issue of substance over form. It is not enough if companies adopt a set of ethical principles but do not abide by it. A box ticking approach is simply not enough. What companies need to do is grow a healthy internal culture of keeping to that set of principles. Management must serve as examples for their peers and employees of the company. Non-executive directors should no longer be seen as the rubberstamp of executive directors and management. They need to actively engage in the scrutiny of the company's governance practices and procedures. They are the investor's allies in averting more corporate disasters. The days of shareholders agreeing with everything management tells them are long gone. Auditors too, must ensure that their behaviour meets good ethical standards. The end result will be the restoration of investors' confidence in the business environment and will draw them back to stock markets.

S 406 of the Sarbanes-Oxley Act directs the SEC to adopt rules requiring all companies to disclose whether or not they have adopted a code of ethics for their senior financial officers and if not, the reason(s) for not adopting such a code. For purposes of this section, a "code of ethics" means:

> "[S]uch standards as are reasonable to promote-
>
> (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
>
> (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports…; and
>
> (3) compliance with applicable governmental rules and regulations."

The provision addresses all senior financial officers. It encourages them to exhibit and promote ethical behaviour in the company. By requiring the company to disclose whether and why it does not adopt such code of ethics the drafters are hoping that it will discourage executives from not adopting codes of ethics.[1009] The SEC has consequently adopted rules requiring a code of ethics which apply to the principle financial officer as well as the principal executive officer.[1010] Although the SEC has not predetermined the exact structure of the code,

[1008] See <http://www.fsb.co.za> (25 November 2005)

[1009] Editorial 2003 *Harvard LR* 2132.

[1010] The SEC adopted rules on 15 January 2003 and were effective on 3 March 2003 but only apply to codes of ethics of annual reports ending on or after 15 July 2003 "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" [17 CFR Parts 228, 229 & 249]. See also SEC Press Release 2003-6 available at <http://www.sec.gov/news/press/2003-6.htm> (16 July 2003)

it has defined the term "code of ethics" as a codification of standards reasonably designed to discourage wrongdoing and to promote:

- ethical handling of conflicts of interests;
- disclosure of all communications with the SEC and public;
- general compliance with regulations;
- internal communication of code-violations; and
- accountability for code-violations.[1011]

The code of ethics can be made public in three ways: as an annexure to the annual report, by posting it on the company's website or by providing copies upon request.[1012]

The amendments to the NYSE Manual will mandate all companies to adopt a code of conduct and ethics applicable to its directors, officers and employees. The code, together with any waivers, must be disclosed.[1013] The board or committee of the board is allowed to make waivers of the code for certain executives or directors. Under such circumstances the code is not applicable to the specific individual. To prevent casual or dubious waivers all waivers must be disclosed to shareholders. Although the policies adopted in the code of ethics differs from company to company, all codes must address at least the following aspects:

- conflicts of interest;
- corporate opportunities for employees, officers and directors;
- company or customer information confidentiality;
- fair dealing with customers, suppliers, competitors and employees;
- proper use of company assets;
- legal compliance by the company, employees, officials and directors; and
- promoting the reporting of illegal or unethical conduct.[1014]

While the UK's Combined Code is silent on the drafting of a code of conduct,[1015] the ASX is very pertinent on the issue. By adopting a code of conduct companies will promote ethical and responsible decision-making by adopting of a code of conduct.[1016] The aim of the code of conduct is to advise directors and executives on procedures that would uphold confidence in

[1011] "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" [17 CFR Parts 228, 229 & 249].
[1012] "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" [17 CFR Parts 228, 229 & 249].
[1013] S 303A (10) of the NYSE Manual.
[1014] Commentary on s 303A (10) of the NYSE Manual.
[1015] This is very surprising in light of the UK's healthy system.
[1016] ASX Principles Recommendation 3.1 25.

the company's integrity. The company must also adopt a policy which deals with trading in company securities by directors and employees.[1017] Companies should not only have a code of conduct for its top financial executives, but it should also develop company policy on trading in shares of the company by employees and officials.[1018] Companies should also develop a code of conduct which recognises and respects the interest of stakeholders.[1019]

According to the King Report of 1994 companies should develop codes of ethics to promote the highest standards of behaviour within the board and the company as a whole and which all stakeholders embrace.[1020] Together with this a culture of mutual trust and respect has to be developed in South African business. Individuals should be able to contract without the fear of being taken for the proverbial ride or being exploited.[1021] King II identifies six core principles which should form the basis of all companies' ethical principles. They are fairness, transparency, honesty, non-discrimination, accountability and responsibility and respect.[1022] In addition the Report provides guidance on how to promote ethical conduct within the corporation.[1023]

8 Conclusion

The reasons why laws and regulations are in place vary. Recent laws in the US was introduced to protect investors from corporate fraud, while other laws, like competition laws and insider trading laws, attempt to level the playing fields. While any proper corporate governance system should impose the strictest penalties possible for misconduct, these penalties will not ensure that laws are obeyed. If businesspeople have no respect for laws, they will find ways of evading it, more commonly described as bending the rules. Businesspeople need to understand and respect the reasons why laws are in place. No civil penalty or prison sentence can instill that respect. As long as you have businesspeople with no respect for the law, no set of enforcement laws will prevent corporate collapse. On the other hand, laws do, to a certain extent, breed good ethics.

[1017] ASX Principles Recommendation 3.2 26.
[1018] See ASX Principles Recommendations 3.1 & 3.2.
[1019] See ASX Principles Recommendation 10.1 59.
[1020] King Report Chapter 18 par 8 25. As Black Economic Empowerment is a whole section on its own, the abovementioned discussion on the topic suffices.
[1021] King Report Chapter 18 par 8 25.
[1022] King II par 7 103.
[1023] King II par 11 104 and Appendix VIII 221.

CHAPTER 7: CONCLUSION

1 Enron and WorldCom: will it repeat itself?

The question many commentators are asking in the wake of the Enron and WorldCom scandals is whether the circumstances surrounding the two collapses are symptomatic of an epidemic that has infected company management in general or whether they are just exceptions to an otherwise healthy corporate environment. Some will point out what has recently happened at Parmalat and Royal Dutch Shell. Others will argue that although the collapse of Enron and WorldCom have exposed shortcomings in corporate governance regulation, one never notices or reads about the hundreds of companies out there that follow ethical practices. But what this argument loses sight of is the fact that regulations are in place not to reward good conduct but rather to prevent misconduct. So whenever situations like Enron or WorldCom occur, it means those regulations have failed in their purpose and therefore they are insufficient. It therefore follows that new measures are needed. These measures should discourage company officials from putting their hands in the cookie jar. And if indeed this occurs, these same measures should prevent investors from suffering loss due to such wrongdoings. Measures such as those contained in the Sarbanes-Oxley Act have gone a long way in addressing this issue. This despite the fact that in certain areas the Act amounts to overkill. The Act is very successful in combining criminal with civil sanctions and in assigning enforcement duties to the PCAOB and the SEC.

Experience has however proven that businesspeople have short memories when it comes to corporate scandals. In five years' time when the dust has finally settled around Enron and WorldCom, everyone will have forgotten the lessons learned and complacency will once again set in. And, in a modern corporate world where the bottom line dominates, businesspeople will again push the boundaries of what is legal – resulting in more scandal. No law can prevent that. But the risk of fraud must be reduced and the necessary safeguards must be put in place to ensure that offenders are prosecuted and the losses suffered by investors are recovered where possible. With a combination of criminal and civil penalties, this is what the Sarbanes-Oxley Act will succeed in achieving, provided that the SEC and the PCAOB exercise the powers they were given to their full extent. These two aspects are the two most critical shortcomings of current South African corporate governance. Add to this the current court system and it is clear why one can refer to directors and company officials as the

"Untouchables". It is therefore crucial that these shortcomings in South African corporate governance are addressed.

2 Corporate governance in South Africa – a brief prospective look

A review of South African company law is currently taking place.[1024] Considering the fact that the current Companies Act was written in 1973, the development could hardly have come at a better time. The Act's provisions have become outdated for a South African economy exposed to the rigours of international trade and competition. This fact alone is however not the only reason why the review should be welcomed. Another reason why the Act has become outdated is the South African socio-economic environment. This fact is also highlighted in the Guidelines for Corporate Law Reform.[1025] The South African government now has the opportunity to implement measures that would prevent corporate scandals similar to Enron and WorldCom from happening in South Africa. The review will however have a wider focus as it will attempt to improve the competitiveness and development of the South African economy in general.[1026] This process will run in conjunction with the improvements to legislation regulating the accounting and auditing profession,[1027] thereby ensuring a co-ordinated effort whereby all aspects of corporate governance are simultaneously addressed.

As point of departure for the review, the Government has decided to follow the stakeholder theory which recognises the interests of the company and the shareholders, but also creditors, employees, consumers, suppliers, the state and Black Economic Empowerment. Although the review will look at company law in general, it will focus on corporate governance as a branch of company law. This part of the review will focus on three key areas, namely (a) shareholder and investor protection, (b) directors and the structure of the board and (c) disclosure and reporting.[1028] The review will also address issues relating to the administration and enforcement of company law.[1029] Although the formulation of the Guidelines is very broad, a number of specific issues for review can already be identified at this early stage. One such issue is the duties of directors. The review will attempt to address the shortcomings in the

[1024] See Guidelines for Corporate Reform.
[1025] See Guidelines for Corporate Reform 14-15.
[1026] See Guidelines for Corporate Reform 10.
[1027] See Chapter 5 *supra*.
[1028] See Guidelines for Corporate Reform 36-41.
[1029] See Guidelines for Corporate Reform 45.

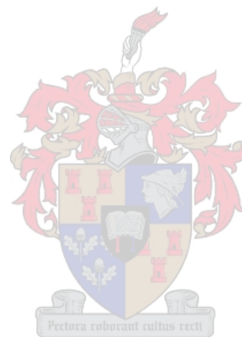
standards regarding directors' duties.[1030] At the moment this facet is governed by the common law. It is generally accepted that this area of company law is due for an overhaul and the thinking is in the direction of implementing statutory duties on directors that would encapsulate existing common law principles. It was already stated in Chapter 4 that current common law principles have developed mainly from English company law. These standards still need to be tested against the requirements and spirit of the Bill of Rights.[1031] Another key aspect of the review is its aim to address the shortcomings in administration and enforcement of company law. Without being very clear on what exactly this involves, the Guidelines mention the decriminalisation of company law together with a new institutional framework consisting of among other bodies a Companies and Intellectual Property Commission.[1032] The creation of this body will definitely reduce the problems associated with the current compartmentalised system of law enforcement in South Africa. The body should have similar powers to those of the SEC and ASIC to ensure effective enforcement of company law.

But, perhaps the promotion of better corporate governance lies not only with companies, directors or bodies such as the Companies and Intellectual Property Commission. Shareholder empowerment is the ultimate mechanism to ensure good corporate governance. To achieve this two things will have to happen. Firstly, the exercise of voting powers needs to be made easier and, secondly, the information provided to shareholders needs to be enhanced. The review mentions possible use of electronic and proxy voting.[1033] Electronic communication has become an everyday part of modern business. There is no reason why it should not be utilised at annual general meetings or in other important areas of company management. This however presupposes that shareholders have sufficient information to exercise their voting rights properly and effectively. This requirement is also mentioned by the Guidelines.[1034] Financial reporting can be enhanced through the use of improved financial statements, more frequent reporting periods and better use of information technology in the compilation and distribution of information. This should be combined with reporting on other issues such as the company's impact on the environment, its employees and society in general.

The easiest solution to the problems surrounding corporate governance is the involvement of shareholders. Individual as well as institutional shareholders must end their apathy towards the management of companies. By becoming more involved with the company, the chances of

[1030] See Guidelines for Corporate Reform 36-41.
[1031] See Chapter 4 par 14 Directors' duties *supra*.
[1032] See Guidelines for Corporate Reform 45-49.
[1033] See Guidelines for Corporate Reform 38.

mismanagement are greatly reduced and, if in fact it does occur, it can be detected at a very early stage. The process of investing in companies does not stop when names are entered in company registers or on share certificates. It is a continuous process through which investors must ensure that their money is applied for the correct purposes. They have a duty to hold company executives accountable for their actions. The easiest solution to the problems surrounding corporate governance is the involvement of shareholders. They must ensure that companies implement good governance policies and create an environment of openness and accountability.



[1034] See Guidelines for Corporate Reform 41.

ADDENDUM: COMPANIES AMENDMENT BILL

1 Introduction

On 13 July 2005 Government published proposed amendments to the Companies Act.[1035] The proposed amendments will take effect before the review of the Companies Act is completed and will, *inter alia*, attempt to strengthen auditor independence. The measures will be implemented in conjunction with the proposed Auditing Profession Bill.

The Companies Amendment Bill distinguishes between limited purpose companies and public interest companies.[1036] A limited purpose company is defined as a company that does not offer its shares to or take deposits from members of the public or a company that operates as a holding company or is a subsidiary of a public interest company. Any company that does not fall within this category is regarded as a public interest company.

The proposals also include a definition of an independent non-executive director, which bears a resemblance to the definition thereof in King II.[1037] An independent non-executive director is defined as a director that:

- is not involved in the day-to-day management of the company and has not been employed as an executive director by the company in the preceding three years;
- does not represent a significant shareholder or an immediate family member of a significant shareholder;
- is not an advisor of the company;
- is not a significant supplier to the company;
- has no significant contractual relationship with the company; and
- has no relationship with the company that could impair the director's independence.

[1035] Companies Amendment Bill (B-2005) GG No. 27784 of 13 July 2005.
[1036] S 2 of the Companies Amendment Bill.
[1037] Clause 10 (c) of the Companies Amendment Bill.

2 Audit committees

All public interest companies must appoint an audit committee consisting of no less than three independent non-executive directors.[1038] The duties of the audit committee include nominating the auditor of the company, determining the auditor's fees, determining the nature and extent of non-audit services to be provided by the auditor and state in the annual financial statements that the financial statements comply with the requirements of the law and that the auditor is independent. Furthermore, the audit committee is responsible for dealing with complaints about the company's accounting practices. A company may appoint an auditor other than the one nominated by the company's audit committee, but such appointment shall be invalid unless the audit committee certifies that the specific auditor is independent.[1039] The appointment of the audit committee shall in no way reduce the board of director's functions and duties, except in respect of the appointment, fees and terms of engagement of the auditor.[1040] The board's duties and functions therefore remain unchanged in all other respects despite the appointment of the audit committee. To determine whether an auditor is independent, the audit committee must:[1041]

- be satisfied that the auditor does not receive any remuneration from the company other than as auditor or providing permitted non-audit services;
- take cognisance of any consultancy, advisory or other work that the auditor is performing for the company; and
- whether the auditor's independence is affected by any previous appointment.

3 Non-audit services

The auditor of a public purpose company may not perform any bookkeeping services to the company for which he/she is appointed as auditor, nor may he/she perform any non-audit services prohibited by the Minister of Finance.[1042]

[1038] Clause 10 (c) of the Companies Amendment Bill. For some reason the clause on audit committees in the Bill contains a different definition of what constitutes a non-executive director. This will most probably be amended before finalisation of the Bill
[1039] Clause 12 of the Companies Amendment Bill.
[1040] Clause 12 of the Companies Amendment Bill.
[1041] Clause 12 of the Companies Amendment Bill.
[1042] Clause 14 of the Companies Amendment Bill.

4 Auditor rotation

The Bill proposes a limit of four consecutive financial years where an individual serves as an auditor of a public interest company. Where someone has served as auditor of a public purpose company for two years and ceases to do so, the person may not be appointed as auditor for a period of two years after ceasing to be the auditor of the company.[1043]

5 Resignation of auditors

Whenever an auditor wishes to resign as auditor of a company, he/she shall deliver to the Registrar of Companies a statement that he/she has no reason to believe that, save for any other such report already made to the IRBA, a reportable irregularity, as defined in the Draft Auditing Profession Bill, has occurred in the conduct of the company's affairs and which is likely to cause financial loss for the company, its members or its creditors.

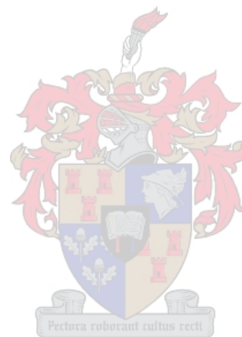
6 Attendance by auditor of certain meetings

The auditor of a public interest company must attend a meeting of the company's audit committee within one month of the meeting at which the annual financial statements of the company will be approved. At this meeting any matter that might, in the opinion of the auditor, be of importance to the financial statements must be discussed with the audit committee. The auditor of a public interest company must also attend the annual general meeting of the company at which the annual financial statements are considered for approval by the shareholders to answer any questions pertaining to the annual financial statements. In the case of a limited purpose company, if the auditor is required, by due notice, to attend the annual general meeting at which the annual financial statements are considered, the auditor must attend such a meeting and respond to any questions regarding the annual financial statements. Failure to comply with these provisions will result in the auditor being guilty of an offence.

[1043] Clause 15 of the Companies Amendment Bill.

7 Incomplete financial statements and false statements

In the event of financial statements containing false of misleading information of a material nature, anyone who is party to the approval, preparation and issue of the financial statements and who knows or ought reasonably to have known of the false or misleading information, is guilty of an offence. The Companies Amendment Bill contains provisions deeming persons as party to the preparation of false and/or misleading financial statements.



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