

Factors influencing corporate governance disclosure of companies listed on the Alternative Exchange (AltX) in South Africa

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Abstract

This article examines the various factors that influence the level of conformance with corporate governance recommendations for companies listed on the Alternative Exchange (AltX) in South Africa. To achieve this objective, a corporate governance disclosure index was developed by examining the extent to which AltX companies apply the corporate governance recommendations as set out in King II and King III. The corporate governance disclosure index was then regressed on a number of corporate governance and firm characteristics to determine the influence of various factors on the level of conformance with corporate governance recommendations. It was found that larger companies, where the CEO and chairman of the board are separate, companies with an independent audit committee and companies with higher debt levels are more likely to conform to corporate governance recommendations. There is no evidence that levels of corporate governance conformance are influenced by the growth and profitability of companies, or by corporate governance characteristics, such as the independence of the board.

Keywords: Corporate Governance, Agency Theory, Small Companies, Boards of Directors, Independence of the Board.

Introduction

Corporate governance involves the coordination of the processes, practices and rules by which a company is directed and controlled (Ayuso & Argandoña, 2007) and aims at balancing the interests of the many stakeholders in a company (Huyghebaert & Wang, 2012). It involves practically every aspect of management, including performance measurement, corporate disclosure, relationships, transparency and internal controls (Aytakin, Miles, & Esen, 2013).

The quality of corporate governance compliance is considered to be one of the most important factors behind the success of companies (Ramly, 2012). It has been suggested by many researchers (Allen, 2005; Ananchotikul & Eichengreen, 2009; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008) that corporate governance capacity is growing increasingly and rapidly, particularly in developing countries. Thus, developing countries, for example South Africa, are closing the gap between themselves and developed countries in terms of corporate governance (Samaha, Dahawy, Hussainey, & Stapleton, 2012).

As set out below, for some twenty-five years corporate governance has received a considerable amount of attention from policymakers, researchers and the public. This has been driven by factors such as globalisation, transformations in the ownership structure of firms and, more recently, by an increase in corporate collapses and earning restatements. These factors resulted in a call for more effective monitoring mechanisms and the improvement of corporate governance systems (Aguilera & Cuervo-Cazurra, 2004; Grant & Visconti, 2006; Hamilton & Micklethwait, 2006).

Company failures in the UK during the late 1980s and early 1990s led to a decline in investor confidence and led to a call for corporate governance reform (Scholtz, 2009). As a result the Cadbury Committee was established in May 1991 to investigate corporate governance concerns, including the accountability of the board of directors to shareholders and to society. In South Africa, the King Committee on Corporate Governance was established in 1993 to promote good corporate governance. The first King report was issued in 1994, followed by King II in 2002 and King III in 2009.

The King Commission describes corporate governance simply as the system by which companies are directed and controlled (IoDSA, 2009). A corporate governance code is generally a voluntary set of principles, recommendations, standards, or “best practices”, issued by a collective body and relating to the internal governance of corporations, including the behaviour and structure of the board of directors (Aguilera & Cuervo-Cazurra, 2004). Assuming that companies are different in activity, structure and size, corporate governance codes are usually based upon the “comply-or-explain” principle. This allows companies to comply with those provisions that best suit their contingencies, or explain their reasons for deviations (Aguilera & Cuervo-Cazurra, 2004).

The AltX is a division of the Johannesburg Securities Exchange (JSE). Companies listed on the AltX are generally good quality, small- and medium-sized high-growth companies. The AltX provides smaller companies, not yet qualified to list on the JSE Main Board, with a clear growth path and access to capital (JSE, 2012). The listing requirements for AltX companies are a share capital of R2 million, compared to the R25 million for main board listings (JSE, 2012). *Where* executive management of these corporations needs to raise funds externally, corporate governance may be viewed as a set of mechanisms which serve to ensure that potential providers of capital receive a fair rate of return on their investment. Corporate governance could provide investor protection, thereby enabling executive management to raise funds in the external capital markets (Shleifer & Vischny, 1997). Without corporate governance, executive management would probably have to pay more for these funds to compensate investors for the increased risk. This would increase the company’s cost of capital and reduce competitiveness of the company (Dedman, 2002).

Support for the link between corporate governance and disclosure behaviour is found in agency theory, stakeholder theory and legitimacy theory. Agency theory focuses on the conflict between shareholders and managers that arises when the shareholders delegate decision-making powers to the managers (Jensen & Meckling, 1976). Corporate governance mechanisms are introduced to control the agency problem and provide shareholders with some assurance that managers will strive to achieve outcomes that are in the shareholders’ interests (Shleifer & Vischny, 1997), as opposed to the self-interest of the managers and their opportunistic behaviour (Deegan, 2009). Although there is consensus among researchers that corporate governance stems from agency theory, it is argued by Dalton, Daily, Ellstrand, and Johnson (1999) that corporate governance stems from a wider range of theoretical

perspectives, such as systems-orientated theories. These system-orientated theories, for example stakeholder theory and legitimacy theory, are intended to complement rather than replace agency theory. Stakeholder theory and legitimacy theory focus on the role of information and disclosure in the relationships between the company and other parties in the society with which it interacts (Deegan, 2009; Gray, Owen, & Adams, 1996).

This study contributes to the field of knowledge by enhancing the understanding of factors that influence conformance with corporate governance recommendations for smaller listed companies in South Africa. The findings may be useful for regulators, preparers of annual financial statements and investors. Regulators may use the findings to suggest areas where efforts to improve the disclosure regulatory regime in South Africa should be concentrated. Regulators should be particularly concerned with issues relating to annual reports and disclosure. Regulators may use the findings to suggest areas where efforts to improve the disclosure regulatory regime should be concentrated. Preparers of annual financial statements should match the amount of information in their annual reports with other companies in order to be successful in competing for funds (Al-Sham-mari, 2008). Existing and potential investors (local and foreign) may use the findings to better understand disclosure practices of listed companies on the AltX in South Africa, and thereby make more informed investment decisions.

The remainder of this article is structured as follows. An overview of corporate governance principles applicable to AltX companies is provided next. This is followed by the research objective of the study. Next is a review of prior research and the development of hypotheses. A discussion of the methodology follows, which includes the sample selection, an explanation of the corporate governance disclosure index, and a presentation of the research model. The empirical results are then discussed, followed by the conclusion and suggestions for future research.

Corporate governance and the Alternative Exchange

Background

The AltX was launched after the implementation of the King II report on corporate governance in 2002. King II was issued in 2002 and was replaced by the King III report on corporate governance in 2009 due to the implementation of the new Companies Act, No. 71 of 2008 in South Africa and changes in international governance trends (IoDSA, 2009). The King III report came into effect for financial years commencing on or after 1 March 2010 (IoDSA, 2009).

Ethical leadership

Four ethical values were introduced in the King I report as key components of corporate governance: responsibility, accountability, fairness, and transparency. Social and ethical responsibility gained further prominence with the publication of the King II and King III reports. The chapter on ethics was placed first in King III, indicating that the ethical foundation should underpin good governance (Rossouw, 2011). King III (IoDSA, 2009, p. 20) states that good corporate governance is in essence about effective, responsible leadership. This is a fundamental element of any organisation, regardless of size or structure. King III describes an ethical foundation as the “licence to operate” for those affected by and affecting the company’s operations (p. 19).

Boards and directors

King II included as a preference that the board of directors should be comprised of a majority of independent non-executive directors and that the chairman and CEO should not be the same person (IoDSA, 2002). King III (IoDSA, 2009, p. 25) contained a recommendation that the majority of the directors on the board should be non-executive directors. The JSE listing requirements for AltX companies specify that the board should consist of at least 25% non-executive directors (JSE, 2012). King III (IoDSA, 2009, p. 25) further-more recommends that the majority of the non-executive directors should be independent, hence promoting objectivity of decisions and views. The chairman of the company should be an independent non-executive director and should not be the CEO of the company. A lead independent director should be appointed if the chairman is not independent (p. 24). The JSE listing requirements for AltX companies exclude this as a listing requirement, due to the cost element for smaller listed companies (JSE, 2012).

According to King III (IoDSA, 2009, p. 43) the company secretary has an important role to play in the corporate governance of the company and should ideally not be a director of the company. The cost implication for some smaller companies simply does not justify the appointment of a full-time company secretary. The financial director sometimes acts as the company secretary or the function is outsourced.

The use of board committees is encouraged in King III (IoDSA, 2009, p. 46), but it is important to understand that this delegation of functions does not indemnify the board of its responsibilities and obligations. It remains the responsibility of the board to approve recommendations of the board committee. The scope, objectives and authority of the board committees should be reviewed on an annual basis by the board of directors. Examples of board committees include (but are not limited to): audit, remuneration, nomination, and social and ethics committees. The use of board committees is synonymous with large companies that have well-developed corporate structures in place. This may be applicable to large companies but may be too costly for smaller companies.

Audit committee

Additional and specific recommendations with regard to the audit committee have been included in the King III report as compared to King II to ensure an even more independent and suitably skilled audit committee. The duties of the audit committee are elaborated in King III as compared to King II, including overseeing the internal audit department, external audit, risk management and the effectiveness of the finance function (IoDSA, 2002, 2009). King III recommends that the audit committee should be comprised of at least three independent non-executive directors (IoDSA, 2009, p. 31). It is not always possible for smaller companies to have three members.

The governance of risk

Both King II and King III indicate that the board should be responsible for the governance of risk (IoDSA, 2002, 2009). According to King III (IoDSA, 2009, p. 35), a critical aspect of the board's responsibilities is that of risk management and therefore detailed attention and due consideration is given to this topic. King III recommends that the process of risk management be performed through formal processes and that leadership should reflect efforts aimed at meeting expectations and requirements in this regard. Risk management can be outsourced

to a risk committee (p. 35). For smaller companies it is not always possible to have a separate risk committee; consequently the functions of the risk committee and the audit committee are combined in one committee.

The governance of information technologies (IT)

The governance of IT was not included in King I or II. King III introduces this topic and recommends that IT should be seen to add value by enabling the improvement of the company's performance and sustainability (IoDSA, 2009, pp. 39–41). King III suggests that the IT of a company should be appropriate for the specific organisation and should facilitate and enhance the company's ability to reach its objectives (p. 39). This necessitates that the company should have an IT charter and policy that is aligned with its strategic goals. The basis thereof should reflect ethical values and should be of a common language for all to understand. The board has responsibility for setting the strategic IT direction for the business and therefore should view IT as an integrated business discipline of the organisation. King III states that it is important for the board to ensure that an IT framework is adopted and implemented and that independent assurance on the effectiveness thereof is received. The board should furthermore ensure that the relevant processes are in place to facilitate complete, timely, relevant, accurate and accessible reporting from and to relevant parties (pp. 40–41). It therefore recommends that companies view environmental sustainability to be that of a good corporate citizen and as a result consider any negative impact that IT could have on the environment. This impact should be reviewed on a regular basis to ensure that IT meets the required standards and objectives. These aspects are relevant to all companies, regardless of size. Each company is responsible for determining the size of the IT function (p. 39). A study performed by PricewaterhouseCoopers (PwC, 2011) in Canada, comparing the IT governance of smaller companies and larger companies, reported that smaller firms in Canada showed a lower IT maturity and require more formal structure and improved IT governance.

Compliance with legislation

Both King II and III require the board of directors to ensure that the company complies with relevant legislated rules and regulations (IoDSA, 2002, 2009). Besides which, each individual director has a duty to keep abreast of rules and regulations, and is accountable for the company's compliance with these rules and regulations (IoDSA, 2009, pp. 42–43). Non-compliance with rules and regulations should be reported in the integrated report (p. 39).

Internal audit

The importance of an internal audit division was first introduced in King I (IoDSA, 1994). Companies without an internal audit division were required by King II to review the decision annually, while King III recommends that all companies should ensure that there is a risk-based internal audit division (IoDSA, 2002, 2009). The main functions outlined by King III (IoDSA, 2009, p. 93) for the internal audit function of a company are: firstly, to evaluate the company's governance processes in a complex business environment with many different dynamics; secondly, to perform an objective assessment of the effectiveness of risk management and the internal control framework and to systematically evaluate business processes and associated controls; and thirdly, the function of internal audit includes providing a source of information, with reference to fraud, corruption, unethical behaviour and irregularities.

The recommendation by King III (IoDSA, 2009, p. 93) is that the internal audit processes should be flexible and dynamic in addressing the various needs of a company. Internal auditing should also have a formal internal auditing charter to outline the required mandate set by the board.

In larger AltX companies a formal internal auditing function may be present, although the presence of an internal auditing function within smaller AltX companies is rather rare and not considered to be the norm. The costs associated with an internal auditing function simply outweigh the associated benefits to these companies (Goodwin-Stewart & Kent, 2006).

Stakeholder relationships

Stakeholder relationships are considered to be an important aspect of corporate governance; this aspect was introduced in King I and expanded in King II and King III (IoDSA, 1994, 2002, 2009). King III requires that the board of directors should appreciate that stakeholders' perceptions affect a company's reputation (IoDSA, 2009, p. 46). King III also requires that the board of directors should delegate to management the task of proactively dealing with stakeholder relationships (p. 47). The board should strive to achieve the appropriate balance between its various stakeholder groupings in the best interests of the company (p. 47). Transparent and effective communication with stakeholders is essential for building and maintaining trust (p. 48).

Integrated reporting

The integrated report was only introduced in King III. According to King III (IoDSA, 2009, p. 108) the integrated report represents a holistic and integrated representation of the company's performance in terms of both finance and sustainability factors. The report may take the form of one document or multiple sets of documents and should include the financial statements of the company. This aspect is most relevant to small and medium entities (SMEs) that involve shareholders to whom the board reports, but is of limited relevance to SMEs not functioning with these formal structures. However, the underlying principle of leaders asking fundamental questions regarding financial and sustainability factors of the company remains relevant to any SME.

The integrated report of a company should in essence describe how the company earned its revenue (IoDSA, 2009, p. 109). Both positive and negative financial aspects that may impact on the company's operations should be disclosed. The report should furthermore indicate plans regarding how the positive aspects will be further developed and how negative aspects will be mitigated in future. The report should cover all aspects and operations of the company. The main consideration according to King III (p. 109), is whether the information provided has allowed stakeholders to understand the key issues affecting the company, including the effect the company's operations have had on the economic and the social and environmental well-being of the community it serves. Sustainability reporting is an aspect, especially in listed companies, that is receiving increasing international attention and more companies have come to realise the value thereof. This aspect has also become much more sophisticated and formalised, as pointed out by the Global Reporting Initiative (GRI) guidelines (GRI, 2009).

According to King III (IoDSA, 2009, p. 109) the guidelines of the GRI include a much greater emphasis on the principle of materiality, which links sustainability issues more

closely to company strategy and includes the principle of considering a broader sustainability context.

Internal controls

Both the King II and King III reports require the board of directors to report on the effectiveness of the internal controls of the company, while King III requires that this statement should be included in the integrated report and that the audit committee should evaluate the effectiveness of the company's internal controls (IoDSA, 2002, 2009).

Remuneration of directors

King II required that performance related remuneration should make out a substantial portion of the total executive remuneration and that a formal and transparent remuneration policy should be developed (IoDSA, 2002). King III (IoDSA, 2009, p. 48) requires that a company's remuneration policies should be aligned with its strategy and should create value for the company over the long term. This aspect received renewed international attention recently, as a result of excessive remuneration policies based on short-term goals, evident mainly in American corporate banks (Parsa, Chong, & Isimoya, 2007). The notion is that short-term profits may not necessarily facilitate long-term sustainability of an organisation; hence King III focuses on the alignment of remuneration policies and value creation over the long term. Scholtz (2009) argues that the structure of remuneration policies should consist of a balance between corporate structuring, disclosure and share-holder participation to align the interests of executive management and stakeholders. Furthermore, a study of the relationship between executive remuneration and company performance for companies listed on the AltX between 2009 and 2011 provides evidence that if remuneration policies for executives are linked to performance it is possible to increase stakeholder's value over the long term (Scholtz & Smit, 2012). The use of the remuneration committee is not always applicable to smaller companies and may be too costly to implement. It is important, however, to note that the underlying principles of the remuneration committee are relevant to any business. All businesses should give due consideration to remuneration policies, including policies that are linked to the company's needs and strategic objectives. Attention should also be paid to incentives to ensure that they are not in contradiction with the company's risk management strategy (Huafang & Jianguo, 2007).

Research objective

It is the objective of this study to examine various factors that influence the level of conformance with corporate governance recommendations for smaller listed companies in South Africa. To achieve this objective a corporate governance index was developed by examining the extent to which AltX companies applied the corporate governance recommendations as set out in King II and King III. The corporate governance index was then regressed on a number of corporate governance characteristics and firm characteristics to determine the influence of various factors on the level of conformance with corporate governance recommendations.

Prior research and hypothesis development

This study draws from a wide range of research on corporate governance to identify factors that influence conformance with corporate governance recommendations. Although most of

the studies that are reviewed to form the basis for the hypotheses relate to larger companies, several researchers are of the view that the approach followed could also be applicable to smaller companies.

A number of prior studies have investigated determinants of companies' compliance with corporate governance principles and found that the quality of corporate governance disclosure is associated with certain corporate governance characteristics and firm characteristics. The factors that are identified and examined in the current study include: corporate governance characteristics (proportion of non-executive directors on the board, CEO duality and audit committee composition), firm characteristics (company size, growth, profitability and debt) and some control variables such as director's shareholding and auditing firm size. The relevant studies from which these factors have been drawn are identified in the sections which follow.

Board composition: proportion of non-executive directors on the board

Various reports and codes on corporate governance, as well as legislation across the globe, require a majority of non-executives on the board – for example: the Sarbanes-Oxley Act (SOX, issued in 2002) in the United States (US); the Cadbury Report (issued in 1992) that was subsequently included in the Combined Code (issued in 2010) in the United Kingdom (UK); the Toronto Stock Exchange Corporate Governance Guidelines (issued in 1994) in Canada; the Olivencia Report (issued in 1998) in Spain; the Companies and Financial Reporting Acts (issued in 2004) in New Zealand; and the King Report (first issued in 1994) in South Africa.

Cheung, Connelly, Limpaphayom, and Zhou (2006) studied corporate governance disclosures by 337 Thai firms and 168 Hong Kong firms for 2002 and found that for companies registered in Hong Kong and Thailand, the degree of corporate governance disclosure decreases as the percentage of executive directors on the board increases. Patelli and Prencipe (2007) investigated 199 non-financial companies listed on the Milan stock exchange in 2002 and found that companies disclosed more corporate governance information if there were more non-executive directors on the board. Parsa et al. (2007) reported a positive relationship between the number of non-executive directors and the extent of corporate governance disclosure for 89 non-financial companies listed on the UK Alternative Investment Market (AIM). A study of the 100 largest companies listed on the Egyptian Stock Exchange (EGX) revealed that companies with a higher proportion of non-executive directors on the board have higher levels of voluntary disclosure (Samaha & Dahawy, 2011). Corresponding to governance legislation it is expected that:

- H1: Conformance with corporate governance recommendations will be higher for companies with more non-executive directors on the board.

CEO duality

Dual capacities of a CEO, namely that a person acts both as CEO and the chairman of the board, may lead to conflicts of interest and a lack of independence (Jensen, 1993). Mixed findings were reported for the relationship between CEO duality and disclosure. A negative association between CEO duality and voluntary disclosure was reported for non-financial Italian listed companies in 2007 (Allergrini & Greco, 2013), Chinese listed companies in 2002 (Huafang & Jianguo, 2007) and the 100 most active companies on the EGX in 2009

(Samaha et al., 2012). Parsa et al. (2007) finds no significant relationship between CEO duality and corporate governance disclosure for AIM-listed companies. Khan, Muttakin, and Siddiqui (2013) found no significant impact of CEO duality on corporate social responsibility reporting for 135 manufacturing companies listed on the Dhaka Stock Exchange (DSE) in Bangladesh from 2005 to 2009.

Although contravening the principles of good governance, CEOs of smaller companies often act as the chairman of the board due to resource constraints. However, literature supports the notion that the separation of the CEO and chairman of the board roles could improve the quality of disclosure (Allan & Widman, 2000; Beasley & Salterio, 2001; Forker, 1992). For this reason, it is expected that:

- H2: Conformance with corporate governance recommendations will be higher for companies where the CEO does not hold dual capacities.

Audit committee composition: non-executive chairman and members

The audit committee plays a key role in the monitoring activities of the board by ensuring objective disclosure of management's decisions and performance (Allergrini & Greco, 2013). Empirical studies found a positive association between the presence of audit committees and corporate governance disclosure (Allergrini & Greco, 2013; Cerbioni & Parbonetti, 2007; O'Sullivan, Percy, & Steward, 2008). Researchers have, over the years, also found that the transparency of corporate governance disclosure is determined by the non-executive directors on the audit committee (Parsa et al., 2007; Ho & Shun Wong, 2001; Forker, 1992). Akhtaruddin and Haron (2010) studied the link between the effectiveness of audit committees in terms of the proportion of non-executive directors and expert members on the audit committees and corporate voluntary disclosures for 124 public listed companies in Malaysia. They found that a higher number of non-executive directors on the audit committee increased disclosure levels. Parsa et al. (2007) investigated 89 companies listed on the AIM in the UK. They reported that board and audit committee independence results in better corporate governance disclosure.

Following the King III recommendation that the chairman and the members of the audit committee should be independent non-executive directors, it is expected that:

- H3: Conformance with corporate governance recommendations will be higher for companies where the audit committee consists of a non-executive chairman and non-executive members.

Company size

Prior research has indicated that size is an important predictor of compliance with corporate governance recommendations. Finkelstein and Hambrick (1996) found that directors are more likely to influence corporate governance compliance in smaller firms. Ahmed and Courtis (1999) performed a meta-analysis of 29 previous studies and reported that size has a significant effect on corporate governance disclosure. Dalton et al. (1999) analysed 27 previous studies, with a total of 131 samples drawn from 20,620 companies, and found that firm size may influence the corporate governance compliance of organisations. Depoers (2000) examined the 1995 annual reports of 201 randomly selected French listed companies and reported that voluntary corporate governance disclosure is significantly related to the size

of the company. Davidson, Steward, and Kent (2005) studied 434 listed Australian firms and found that firm size is positively associated with corporate governance compliance. Barako, Hancock, and Izan (2006) investigated the 54 companies listed on the Nairobi Stock Exchange in Kenya for the period 1992 to 2001 years and reported that larger companies voluntarily disclose more corporate governance information. Al-Shammari (2008) studied the annual reports of 82 companies listed on the Kuwait Stock Exchange (KSE) for 2005. It was found that size was important in determining corporate disclosure levels regardless of a company's country of origin and category of disclosure. It is expected that:

- H4: Conformance with corporate governance recommendations will be higher for larger companies.

Growth

A study of companies in Brazil, Russia, India and Korea (BRIC) regarding areas of importance for corporate governance in emerging markets found a positive relationship between governance and high-growth firms in Brazil and low-growth firms in Russia and Korea (Black, de Carvalho, & Gorga, 2012). An investigation by Plastow et al. (2012) into the adoption, between 2004 and 2006, of corporate governance recommendations by the non-top-300 Australian Securities Exchange (ASX) listed companies provided evidence that high-growth firms are not associated with higher governance scores. Evidence from listed companies in China for 2002 showed that companies with growth opportunities were reluctant to disclose voluntary information (Huafang & Jianguo, 2007). There are arguments in the literature that high-growth firms may need a higher proportion of executive directors to take advantage of opportunities (James, 2011; Lehn, Patro, & Zhao, 2009). This may impair the monitoring ability of the board and could have a negative effect on conformance with corporate governance recommendations. Consequently, it is expected that:

- H5: Conformance with corporate governance recommendations will be lower for high-growth companies.

Profitability

Kusumawati (2006) studied the 2002 annual reports of a sample of companies listed on the Jakarta Stock Exchange. It was reported that, after controlling for several variables usually employed in disclosure research, higher levels of profitability were negatively correlated with corporate governance disclosure. In other words, companies tend to give more comprehensive corporate governance disclosure when facing a slowdown in profitability. Barako et al. (2006) investigated 54 companies listed on the Nairobi Stock Exchange, for the period 1992 to 2001, and found that profitability levels do not have a significant influence on the level of corporate governance disclosure. Heenetigala and Armstrong (2011) studied 27 companies listed in Sri Lanka, for the period 2003 to 2007, and found a positive relationship between corporate governance practices and company performance. Klapper and Love (2004) studied the corporate governance ratings of 14 emerging markets and found that better corporate governance is highly correlated with better operating performance of a company. Brown and Caylor (2009) selected 2,363 US firms from the Institutional Shareholder Services database in 2003 and found that corporate governance compliance is positively related to return on assets. It is expected that:

- H6: Conformance with corporate governance recommendations will be higher for more profitable companies.

Leverage (debt)

The efficient market hypothesis (EMH) contends that firms make voluntary disclosures to reduce information asymmetry, similarly the “market for lemons” perspective (which means that capital markets view the lack of information in the same light as bad information) creates an incentive for managers to provide voluntary disclosures to reduce the cost of capital (Deegan, 2009). Barako et al. (2006) studied 54 companies listed on the Nairobi Stock Exchange in Kenya, for the period 1992 to 2001, and found that companies with high debt voluntarily disclose more corporate governance information. Studies of AIM-listed companies, the non-top-300 ASX listed companies, and the top-100 companies listed on the EGX, indicated no association between leverage and disclosure of corporate governance information (Parsa et al., 2007; Plastow et al., 2012; Samaha & Dahawy, 2011).

Aldamen and Duncan (2012) investigated 560 companies listed on the ASX, with a 30 June 2007 year-end, and found that increased compliance with corporate governance lowers the cost of debt. They also found that small companies that adopt superior corporate governance practices do not benefit from this lower cost of debt. Following the EMH and the “market for lemons” problem, it is expected that:

- H7: Conformance with corporate governance recommendations will be higher for companies with high levels of debt.

Ownership structure: directors’ shareholding

It has been documented by a number of researchers that ownership structure plays a role in corporate transparency and the quality of disclosure practices. Prior studies mostly split ownership into “inside ownership” and “outside ownership”. Inside ownership relates to the percentage of shares owned by the board members (executive and non-executive directors) to the total number of shares issued. Chau and Gray (2002) investigated the relationship between ownership structure and voluntary corporate disclosure in 133 Hong Kong and Singapore listed companies. They found that a higher level of outside ownership was positively associated with voluntary disclosures. Eng and Mak (2003) studied 158 companies listed on the Singapore Stock Exchange and found that lower levels of directors’ shareholding is associated with increased corporate governance disclosure. Results from a study performed on data from Malaysian companies in 2001 did not indicate any significant relationship between corporate governance disclosure and the proportion of shares held by executive and non-independent directors (Ghazali, 2010). Matolcsy, Tyler, and Wells (2012) studied 450 companies listed on the ASX for the period 2006 to 2007. They report that the percentage of shares held by non-independent directors is significantly associated with corporate governance disclosure, however there is no significant association between the percentage of shares held by independent directors and corporate governance disclosure. A study on the most active 100 Egyptian companies listed on the EGX in 2009 could not find support for their hypothesis that corporate governance disclosure increases with decreases in director shareholding (Samaha et al., 2012).

Due to mixed results from the literature review and the fact that South African companies demonstrate high levels of corporate transparency, it is expected that:

- H8: Conformance with corporate governance recommendations will be higher for companies with higher levels of director's shareholding,

Auditing firms

Jensen and Meckling (1976) argued that large auditing firms act as a mechanism to reduce agency costs and exert more of a monitoring role by limiting opportunistic behaviour by managers. They also argued that larger auditing firms are less likely to be associated with clients that disclose lower levels of information in their annual reports.

Chau and Gray (2002) did not find any significant relationship for Hong Kong and Singapore listed companies with (at the time) big-five auditors and corporate governance disclosure. Farber (2005) examined 87 US companies, identified by the Securities and Exchange Commission (SEC) as companies which fraudulently manipulated financial statements for the years 1982 and 2000. It was reported that these firms had a smaller percentage of the big-four auditing firms as auditors and that the corporate governance compliance of these firms was also poor. This could suggest a negative relationship between smaller (non-big-four) auditors and corporate governance compliance. Aksu, Onder, and Saatcioglu (2007) investigated the relationship between auditor selection, company characteristics and corporate governance disclosure for companies listed on the Istanbul Stock Exchange. They found that the smaller auditing firms allowed management more discretion regarding the selection of disclosure practices, which may not conform with corporate governance recommendations. A study of the non-top-300 ASX-listed companies provides evidence of a positive relationship between companies with big-four auditors and conformance with corporate governance recommendations (Plastow et al., 2012). It can also be predicted that big-four auditors will perform higher quality audits that will attain corporate governance compliance; as a result, it is expected that:

- H9: Conformance with corporate governance recommendations will be higher for companies with big-four auditors.

Methodology

Sample and data

The sample consists of 47 companies listed on the AltX for the 2009 to 2011 reporting periods. The sample was selected to include only South African companies that had been listed for at least three years and had information available on the McGregor BFA database for the sample period. Table 1 summarises the sample selection process. Corporate governance data were selected from the companies' published annual reports; accounting and price/market data were collected from the McGregor BFA database.

Corporate governance disclosure index (CGDI)

The dependent variable – corporate governance disclosure index (CGDI) – measures the conformance of each company in the sample against the corporate governance recommendations as required by the King II and King III reports. The King reports consist of 71 recommendations, grouped into 11 categories: ethical leadership, board and directors, audit committees, governance of risk, IT governance, compliance with legislation, internal

audit, stakeholders relationships, integrated reporting, internal controls and remuneration of directors.

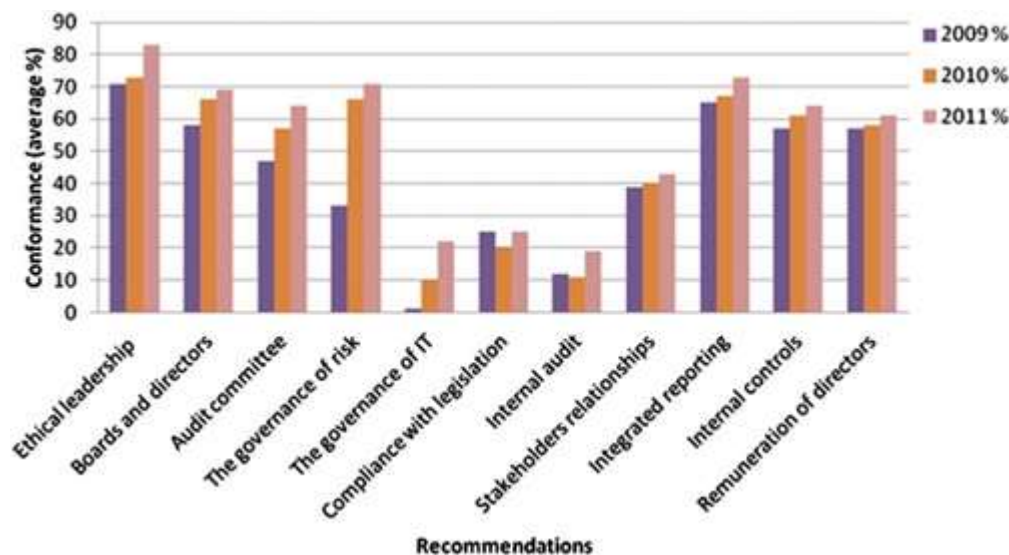
Table 1. Summary of sample selection process.

Total number of companies listed on the AltX on 31 September 2012	64
Less:	
companies primarily listed on other exchanges (non-South-African companies)	(7)
companies listed for less than three years (listing date after 1 January 2009)	(4)
companies where information not available on McGregor BFA for sample period	(6)
Final sample	47

Similar to other studies that use disclosure indices such as Tsipouri and Xanthakis (2004) and Barack and Moloji (2010), this study adopts an item-based approach and assigns a value of 1 when a recommendation has been adopted and a value of 0 otherwise. The recommendations were tested against the information that appeared in the annual reports of each company for the reporting periods in the sample. The disclosure index was based on the number of recommendations adopted divided by the number of required recommendations (the number of required recommendations vary between the King II and King III reports). Furthermore, in the absence of theoretical guidance in the King reports, an unweighted index was used to prevent problems that could arise from the discretionary allocation of different weights.

A summary of conformance with corporate governance recommendations used to determine the corporate governance disclosure index is presented in Figure 1 below.

Figure 1. Summary of conformance with corporate governance recommendations.



Research model

The hypotheses predict that the conformance with corporate governance recommendations is influenced by various governance and firm characteristics. More specifically, higher levels of conformance are expected for companies that demonstrate independence with reference to a higher percentage of non-executive directors on the board and audit committees, larger companies, more profitable companies and leveraged companies. On the other hand a

negative relationship is expected for high-growth companies and companies with CEO duality. With regards to control variables, it is expected that companies with high levels of directors' shareholding and companies with a big-four auditor will have a positive influence on corporate governance disclosures. Taking into account the nature of the data, which included systematic patterns, the Durbin Watson test was performed to test for serial correlation of residuals. A positive correlation of 1.8 was found. Although there is not substantial evidence of positive serial correlation, year dummies were included to control for fixed year effects.

An ordinary least squares (OLS) model was used to test the relationship between the CGDI (dependent variable) and the explanatory variables. The model is estimated as follows:

$$CGDI_{jt}/Pt-1 = \beta_0 + \beta_1 NEX_{jt} + \beta_2 CEO_{jt} + \beta_3 ACOM_{jt} + \beta_4 SHARE_{jt} + \beta_5 SIZE_{jt} + \beta_6 GROWTH_{jt} + \beta_7 PROFIT_{jt} + \beta_8 DEBT_{jt} + \beta_9 AUDIT_{jt} + \beta_{10} 2009_{jt} + \beta_{11} 2010_{jt} + \beta_{12} 2011_{jt} + \varepsilon,$$

where:

- CGDI = corporate governance disclosure index, measured as the number of corporate governance recommendations adopted by a company divided by the number of required recommendations.
- NEX = percentage of non-executive directors on the board, measured as the number of non-executive directors on the board divided by the size of the board (Cheung et al., 2006; Parsa et al., 2007; Patelli & Prencipe, 2007; Samaha & Dahawy, 2011).
- CEO = CEO duality, a dummy variable coded 1 if the CEO does not hold dual positions, 0 otherwise (Allergrini & Greco, 2013; Khan et al., 2013; Parsa et al., 2007).
- ACOM = audit committee composition, a dummy variable coded 1 if the audit committee consists of a non-executive chairman and non-executive directors, 0 otherwise (Allergrini & Greco, 2013; Parsa et al., 2007).
- SHARE = directors' shareholding, measured as the number of shares held by the directors of the company divided by the number of ordinary shares issued at year end (Aksu et al., 2007; Chau & Gray, 2002; Farber, 2005; Plastow et al., 2012).
- SIZE = the size of the company, measured as the natural log of sales for the year (Klapper & Love, 2004).
- GROWTH = the growth of the company, measured by the market-to-book value of equity at year end (Black et al., 2012; Huafang & Jianguo, 2007; Plastow et al., 2012).
- PROFIT = the profitability of the company, measured by the return on capital employed for the year. Although not often used in the studies discussed in the literature review, this measure is useful in comparing the performance of companies in capital-intensive sectors (such as utilities and telecoms) and companies with significant debt. Furthermore return on capital employed measure profits generated in proportion to capital invested rather than the size and volume of transactions (Parsa et al., 2007)
- DEBT = the leverage of the company, measured by the ratio of total debt to total assets at year end (Eng & Mak, 2003; Khan et al., 2013; Parsa et al., 2007).
- AUDIT = dummy variable coded 1 for big-four auditor, 0 otherwise (Eng & Mak, 2003; Farber, 2005; Plastow et al., 2012).
- 2009 = Dummy variable for observations in 2009.
- 2010 = Dummy variable for observations in 2010.
- 2011 = Dummy variable for observations in 2011.

- i and t = company and time subscripts respectively.
- ε = the regression residual.

Empirical results

Descriptive statistics

All independent variables were winsorised at the 1% and 99% percentiles. A value of 2.58 (1% significance level) was used as the cut-off in respect of analysed data for deviations of normality. Square root transformations were performed for the profit and debt variables. The variable for growth has a severe negative-skew distribution and was transformed by ranking the observations. In Table 2, the descriptive statistics for the raw data and the transformed variables and presented in panels A and B respectively.

Table 2. Descriptive statistics (141 observations).

Panel A: descriptive statistics for raw data					
Variables	Minimum	Maximum	Mean	Median	Std. deviation
CGDI	22	70	50.017	50.000	10.600
NEX	0	78	45.250	44.444	14.321
CEO	0	1	0.790	1	0.411
ACOM	0	1	0.560	1	0.498
SIZE	13.684	21.342	18.885	18.753	1.241
GROWTH	-7.63	6.89	0.976	0.827	1.510
PROFIT	-84.760	41.434	-4.651	2.811	32.382
DEBT	0.02	1.46	0.573	0.575	0.270
SHARE	0.42	87.56	41.107	39.870	24.683
AUDIT	0	1	0.400	0	0.491
Panel B: descriptive statistics for transformed variables					
Variables	Minimum	Maximum	Mean	Median	Std. deviation
GROWTH (<i>rank</i>)	1.50	140.50	70.950	71.500	40.782
PROFIT (<i>sqrt</i>)	5.76	13.15	9.866	10.114	1.874
DEBT (<i>sqrt</i>)	0.15	1.21	0.732	0.758	0.191

The corporate governance disclosure among the AltX companies was varied. The minimum CGDI was 22 and the maximum was 70. The mean (45) and median (44) of the proportion of non-executive directors on the board is less than the majority that is required by the King III report. The average debt levels of the AltX companies are almost equal to 57% of their assets. The mean (0.976) and median (0.827) ratio for market-to-book value is positive, indicating that AltX companies are high-growth companies. The negative mean return capital employed (proxy for profitability) of -4.651 demonstrates that on average the companies were unprofitable during the sample period.

The frequencies of the dummy variables are presented in Table 3. There is little variation in CEO duality from 2010 to 2011. There was an increase in the independence (number of non-executive directors) of the audit committee from 51% in 2009 to 62% in 2011. This can be supportive of the increase in the average percentage of conformance with corporate

governance recommendations from 2009 to 2011. Four companies (9%) switched to a big-four auditor during the 2010 reporting period.

Table 3. Frequencies of dummy variables (coded 1 in sample).

Variables	2009		2010		2011	
	No. of firms	% of total firms	No. of firms	% of total firms	No. of firms	% of total firms
CEO	36	77%	36	77%	38	81%
ACOM	24	51%	26	55%	29	62%
AUDIT	16	36%	20	43%	20	43%

Correlations

A correlation matrix and a variance inflation factor (VIF) for each variable was calculated to test the assumptions underlying the regression model for multi-collinearity. The highest correlation (0.396) is between debt and profit. All of the VIFs are below 2. Both of these results are far below the critical values of 0.7 for correlations and 10 for VIFs, suggesting that multi-collinearity is not a problem when interpreting the regression results. In view of the fact that there are no differences between the direction and significance levels of the correlations in respect of the profit, debt and growth variables for the raw data and transformed data, the Pearson correlation coefficients are provided for all the variables using raw data in Table 4.

The analyses show that the CGDI is unrelated to the size and growth of the companies. In addition the fact that the CGDI is not significantly correlated with the SHARE (directors' shareholding) and the NEX (proportion of non-executive directors on the board) variable demonstrates that the boards of the AltX companies are effective and need less monitoring. Consistent with the hypotheses a positive and significant correlation is documented between the CGDI and companies with a CEO who is not the chairman of the board as well as companies with an audit committee that consists of a non-executive chairman and non-executive members. The significant negative correlation of the CGDI with the PROFIT variable is attributable to the fact that on average companies incurred losses during the sample period and did not invest in additional monitoring recommendations such as non-executive directors.

There is also no significant correlation between profitability and any of the other corporate governance characteristics. On the other hand profitability is positive and significantly correlated with all the firm characteristics, except for growth. As predicted a significant and positive correlation was found between companies with higher debt and the CGDI. It is common among AltX firms to have relative high gearing ratios as they are in the process of raising funds to obtain a listing on the JSE. There is a significant positive correlation between AUDIT and ACOM, indicating that companies with independent audit committees have a preference for big-four auditors.

Table 4. Pearson correlation matrix.

	GOV	NEX	CEO	ACOM	SIZE	GROWTH	PROFIT	DEBT	SHARE	AUDIT
GOV	1	.098	.271**	.166**	-.263**	-.102	-.230**	.307**	.115	-.049
NEX		1	.134	.066	-.155	.107	-.050	.076	-.184*	.071
CEO			1	-.007	-.071	-.038	.059	.185*	-.017	-.038
ACOM				1	-.266**	.068	-.088	.043	-.041	-.245**
SIZE					1	-.163	.142	.123	.259**	.095
GROWTH						1	.018	-.029	-.021	.061
PROFIT							1	-.396**	.241**	.008
DEBT								1	-.025	.094
SHARE									1	-.138
AUDIT										1

Notes: *Correlation is significant at the .05 level (2-tailed); **Correlation is significant at the .01 level (2-tailed).

Regression analysis

The results from the OLS regression which examines the relationship between the CGDI and various explanatory variables are reported in Table 5. The adjusted R^2 is 61.4% and the F-value is 19.524 which is highly significant, suggesting that the model shows a good explanatory power. The results indicate that 61% of the variance in the CGDI is explained by the independent variables.

Table 5. Regression results.

Variable	Prediction	Coefficients	p-value
Constant	?	6.564	.549
NEX	+	-.043	.319
CEO	+	5.646	** .000
ACOM	+	2.914	*.018
SIZE	+	1.732	** .002
GROWTH ¹ (<i>rank</i>)	-	-.010	.496
PROFIT ¹ (<i>sqrt</i>)	+	-.425	.238
DEBT ¹ (<i>sqrt</i>)	+	11.231	** .001
SHARE	+	.037	.142
AUDIT	+	-1.500	.217
2009	?	-6.593	.373
2010	?	4.124	.579
2011	?	9.556	.203

Notes: *Significant at the .05 level. **Significant at the .01 level.

¹Transformed variables (*rank* = ranked, *sqrt* = square root).

The corporate governance characteristics that relate to the number of non-executive directors on the board (NEX) are not significantly correlated with the CGDI. H1 is therefore not supported. There is also no support for H5 and H6 as the coefficients for the firm characteristics of growth and profit are insignificant. However the coefficient for size is positive as predicted and significant at the 1% level ($p = .002$). The coefficients of the control variables for directors' shareholding (SHARE) and big-four auditors (AUDIT) are also insignificant. Though the coefficient for AUDIT is negative, and opposite to the expectation that the big-four audit firms will provide higher quality audits. It can be argued that the companies only use big-four auditors for the signalling effect. Consistent with the Pearson correlation, there is a positive and significant association between the CGDI and variables for CEO ($p = .000$), ACOM ($p = .018$) and DEBT ($p = .001$). This provides evidence that companies where the CEO is not the chairman of the board, companies with an independent audit committee and companies with higher debt will be more transparent in their disclosure and have a more robust governance environment.

The independent variables consist of:

1. Corporate governance characteristics: percentage of non-executive directors on the board (NEX), companies where there is no CEO duality (CEO), companies with a non-executive chairman and non-executive members on the audit committee (ACOM), and
2. Company characteristics: SIZE (natural log of sales), GROWTH (market-to-book ratio), PROFIT (return on capital employed), DEBT (debt-to-assets ratio), and
3. Control variables: the percentage of directors' shareholding (SHARE) and companies with big-four auditors (AUDIT).

Additional analysis

Additional analysis was undertaken to test the robustness of the results. First, a stepwise regression was conducted to find the best combination of explanatory variables for the CGDI. The untabulated results of the best combination show an adjusted R^2 of 61.7 and an F-value of 26.029, which is highly significant. This test provides support that all the independent variables are important to explain the variance in the CGDI, except for growth and the 2010 dummy variable. These two variables also have the most insignificant coefficients in the results reported in Table 5. Second, an additional variable to control for the age of the sample firms was introduced, by using a dummy variable, coded 1 if the company had a market listing (number of years listed) above the sample median and 0 otherwise. An insignificant coefficient of the dummy variable was documented. The results in Table 5 remain unchanged for all the other explanatory variables. Third, the continuous variable of the debt-to-asset ratio (proxy for the leverage of the company) was replaced with a dummy variable, coded 1 if the debt-to-asset ratio is above the sample median and 0 otherwise, to differentiate between companies with high debt and low debt. The results remain unchanged from the results reported in Table 5.

Summary and conclusion

The objective of this study was to examine various factors that influence the level of conformance with corporate governance recommendations for smaller listed companies in South Africa. Larger companies, companies where the CEO and chairman of the board are separated, companies with an independent audit committee and companies with higher debt

levels are more likely to conform to corporate governance recommendations. Contrary to the expectations, there is no evidence that the levels of corporate governance conformance are influenced by higher levels of insider ownership, board independence (the proxy for the number of non-executive directors on the board) and big-four auditors. From the results it can be claimed that the growth and profitability of companies are unrelated to levels of corporate governance disclosure.

The literature suggests that the three most important governance attributes are an independent chairman of the board, a majority of non-executive directors on the board, and an audit committee that consists of non-executive members and a non-executive chairman. These recommendations are also the most costly to implement. This study fails to find any significant impact of board independence. This might be attributable to the fact that South Africa demonstrates high levels of corporate transparency and the efficacy of their corporate boards achieved third place in 2011 (sixth place in 2010) among 141 countries in the Global Competitiveness report issued by the World Economic Forum (“South Africa boasts best regulation,” 2011). In addition AltX companies are small to medium in size with high growth opportunities, looking to raise capital, and consequently might not invest in costly alternatives to improve independence of their boards.

Future research may identify more explanatory variables that can influence a company's conformance with corporate governance recommendations. The study can also be expanded by categorising the corporate governance recommendations, and by developing an index for each category, for example: structural, behaviour and disclosure only.

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