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The Influence of corporate failures and foreign law on South African Corporate Governance

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Summary

This dissertation discusses how South African Corporate Governance has been influenced by corporate failures and foreign law, through comparing international jurisdictions. The dissertation comprises of five chapters, beginning with an introductory Chapter One. The introductory chapter provides a background and sets out the research problem and questions to be answered as well as the methodology used in this study. Chapter Two introduces the concept of corporate governance and is divided into two parts. Part one focuses on principles of good corporate governance as set out by the King Report of 2002 and the Organisation of Economic Co-operation and Development principles of corporate governance. Part Two discusses the importance of corporate governance as it applies to organisations. Part Three considers the different models of corporate governance and where South Africa fits. Chapter three provides case study examples of corporate failures and corporate governance development in both the United Kingdom and the United States of America, to provide an understanding of the negative implications of failing to establish and adhere to corporate governance protocols. In Chapter Four examples are provided relating to corporate failures and corporate governance development in the South African context in particular. Finally Chapter Five summarises the research findings and concludes this dissertation. In addition to highlighting how corporate failures have influenced the development of corporate governance and how these together with foreign law have influenced corporate governance in South Africa, the study recommends that an African-centred approach to corporate governance be adopted in South Africa and the continent.

The Influence of corporate failures and foreign law on South African Corporate Governance

By

Chipo Mlambo

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Chapter 1: Introduction

1.1. Background

Corporate governance describes the framework by which companies are directed and controlled[1]. The 2004 Organisation for Economic Co-operation and Development's principles (hereinafter referred to as "OECD principles")[2] define corporate governance as involving a set of relationships between a company's management, board, shareholders and other stakeholders. Corporate governance came under greater scrutiny during the period of 1980 to 2002 following major corporate scandals in the United Kingdom and the United States of America as well as in South Africa[3] as a result of, amongst other reasons, fraudulent dealings as well as a lack of separation of powers. These corporate collapses brought corporate governance to the top of the reform agenda.[4]

This dissertation examines corporate governance as it operates in South Africa and highlights how the development of local South African corporate governance has been influenced by local and foreign corporate failures and foreign law.

The lessons gleaned from the United Kingdom and the United States of America provide useful case studies to understand their responses to corporate scandals and their approaches to corporate governance. Although these two jurisdictions follow the same model of corporate governance, namely the Anglo-American model, they have adopted different approaches of implementation and enforcement. The United Kingdom has adopted a "principle-based" approach to corporate governance through recommendations and combined codes, while the United States has opted to go the legislative approach. Principles, approaches and models of corporate governance

[1] This is the definition subscribed to by the Cadbury Report and King Report on Corporate Governance of 1994. This will further be discussed in Chapter 2.
[2] Organisation for Economic Co-operation and Development. (2004). *OECD principles of corporate governance*. Paris: OECD
[3] Some of these collapses include Enron, WorldCom, Masterbond, Saambou Bank and Fidentia. Bekink, M. "*An Historical Overview of the Director's Duty of Care and Skill: From the Nineteenth Century to the Companies Bill of 2007.*" *SA Mercantile Law Journal 20.1* (2008) 95 – 116 at 95.
[4] Ngum PC (2009) *Using the OECD Principles of Corporate Governance as an International benchmark: A comparative Analysis of Corporate Governance Legislation in the UK, US and South Africa.* LLM Dissertation Angela Ruskin University at 6.

will further be examined in this dissertation. Significant international developments in corporate governance occurred during the period of 1980 to 2002 following major scandals. The period will be the focus of this dissertation.

In the United Kingdom, some of the major collapses that influenced the development of corporate governance were those of Coloroll and Polly Peck, the collapse of the Bank of Credit and Commerce International and the misappropriation of funds from the Maxwell Group of Companies.[5]

In response to such collapses the United Kingdom established Committees that were tasked to review the corporate failures and, thereafter, produce reports and provide recommendations with the aim of developing corporate governance. Some of these committees established were the Committee on the Financial Aspects of Corporate Governance (hereinafter referred to as "the Cadbury Commission")[6] which made recommendations on corporate governance with further committees such as the Greenbury Report of 1998, as well as Hamel's Committee on Corporate Governance[7] being set up to comment on the Cadbury Committee recommendation and further develop principles of corporate governance. Some of the recommendations presented by the committees addressed directors' remuneration, financial reporting, among others and these will be discussed in more detail in Chapter 3.

In the United States of America, the Committee of Sponsoring Organisations sponsored the National Commission on Fraudulent Financial Reporting[8] following the collapse of Drysdale Government Securities and Penn Square National Bank among others. Further and what may be more drastic developments in corporate governance followed the collapse of Enron and Worldcom in 2001 which led to the enactment and implementation of regulatory reform, namely the Sarbanes-Oxley Act of 2002.

[5] Cadbury.cjbs.archios.info/report accessed on 30 December 2015. These corporate collapses will further be discussed in Chapter 3.
[6] ibid.
[7] See Chapter 3. Available at http://www.ecgi.org/codes/documents/hampel_index.htm accessed on 30 December 2015
[8] The Treadway Commission, USA

Following the fall of the Masterbond Group of Companies in 1991 in South Africa, the Commission of inquiry into the affairs of Masterbond Group and Investor protection in South Africa (hereinafter referred to as "the Nel Commission") was set up to consider the failure and make recommendations. This follows the approach in the United Kingdom. Further developments in corporate governance were the drafting of the King Codes on Corporate Governance,[9] and the enactment of legislation that regulates aspects of corporate governance.[10]

1.2. Research problem and questions

This dissertation highlights how foreign law and major corporate scandals in the United States of America and the United Kingdom and the country specific responses have influenced the development of corporate governance principles in South Africa.

This research aims to address the above by answering the following questions:

- How did the United Kingdom respond to corporate scandals?
- How did the United States of America respond to corporate scandals?
- How did corporate governance develop in South Africa?
- What was the influence of international standards and principles of corporate governance on South African corporate governance?

1.3. Research methodology

Through a review of all available literature and documents on corporate governance including applicable legislation this dissertation aims to get a holistic view and determine how South Africa's position compares to selected international positions. This dissertation aims to determine the influence of foreign law on the South African approach to corporate governance, it also necessitates a comparative study of

[9] King Report 1994, King Report 2002 and King Report 2009 further discussed in Chapter 4.
[10] The Companies Act, Act 71 of 2008.

corporative governance regulation in the United Kingdom and the United States of America and the impact and influence this has had on the South African approach and regulation of corporate governance.

1.4. Chapter structure

Chapter 1 provides an introductory overview of the study including a brief description of the various corporate scandals and subsequent responses in the United Kingdom, the United States of America and South Africa respectively. This chapter further sets out the aims, research questions and methodology adopted in this dissertation.

Chapter 2 expands on the first chapter providing a more detailed discussion of corporate governance including considering the various definitions, the principles and the significance of corporate governance in a global context. The chapter also considers various models in corporate governance. In this chapter, principles guiding South African corporate governance are evaluated against principles found in the selected international jurisdictions.

Chapter 3 considers some of the major international corporate scandals and the influence that they have had on the development of the principle of corporate governance, the regulatory response and commission reports. It discusses the collapses of Drysdale Government Securities and Penn Square National Bank, the fall of Coloroll, Polly Peck, BCCI and Maxwell Consortium financial collapses and the resultant creation of the Treadway Commission and the Cadbury Commission and other committees. This chapter also discusses the collapse of Enron and WorldCom and the legislative reform that followed, namely, the Sarbanes-Oxley Act of 2002 (USA).

Chapter 4 considers some of the local South African corporate scandals that have influenced the development of corporate governance as well as some applicable legislation and commissions that have been established to enforce corporate governance protocols, namely, the Masterbond Group of Companies collapse, the

Fidentia and Leisurenet collapses and the responses in the form of the Nel Commission, the King Reports and the Companies Act.

Chapter 5 provides an overview of the dissertation and a summary of the key findings as they address the purpose of this study and the accompanying questions that guided this research.

Chapter 2: The Essence of Corporate Governance

2.1 Introduction

To understand the development of corporate governance, there is a need to first understand what the concept means. While there is no universal consensus on the definition of corporate governance, the King Report of 1994 defines corporate governance as "the system by which companies are directed and controlled".[1] It adopted the definition as set out in the Cadbury report[2] which may, to date, still be the most authoritative description of corporate governance.[3] The King Report and Cadbury Report definitions focus on the internal structure being the company and management.

Alternatively the OECD principles of corporate governance,[4] define it as:

> *"the set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently*".[5]

This definition not only focuses on the internal structures of corporate governance but also considers the fact that there are other stakeholders involved.

[1] Institute of Directors of Southern Africa, The King Report on Corporate Governance I at 1 (1994)
[2] Cadbury A, *Report of the Committee on the Financial aspect of corporate governance* (1992) at par 2.5
[3] Horn RC, The *Legal Regulation of Corporate Governance with reference to International trends*. Published LLM thesis (University of Stellenbosch 2005) at 9
[4] Organisation for Economic Co-operation and Development, OECD P*rinciples of Corporate Governance*. Paris OECD (1999)
[5] OECD P*rinciples of Corporate Governance*. (2004) at 12.

Definitions of corporate governance have progressed from a sole focus on controls to focus being placed on the various relationships involved. Other definitions of corporate governance are as follows:

> "*Corporate governance is the whole system of rights, processes and controls established internally and externally over the management of a business entity with the objective of protecting the interests of all stakeholders*"[6]

> "*Corporate governance refers generally to the legal and organisational framework within which, and the principles by which, corporations are governed. It refers to the process, accountability and relationships of those who participate in the direction and control of a company. Chief among these participants are the board of directors and management. These are aspects of the corporate governance regime that have an impact on the relationship between shareholders and the company*."[7]

> "*Corporate governance system is the combination of mechanisms which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business*."[8]

Definitions of corporate governance can be classed as either narrow or wide definitions. The narrow definition merely focuses on the relationship between shareholders and their company such as the King Report definition, with the wider definition not only focusing on such a relationship but going further to also refer to relationships with a broad range of stakeholders such as the OECD principles definition. Definitions of corporate governance, narrow or wide, do have common

[6] Centre of European Policy Studies, *Corporate Governance in Europe: Report of a CEPS Working Party*. June 1995

[7] HIH Royal Commission, *Background Paper 11: Directors' Duties and other obligations and the Corporations Act* (2001)

[8] Goergen M and Renneboog L *"Corporate Governance and Shareholder value"* Lowe D and Leiringer R (eds) *Commercial Management of Projects: Defining the discipline* (2006) 100 – 131 at 100. Available at (http://www.corpgov.net/library/corporate-governance-defined/ accessed 22 May 2016)

themes they address such as the idea of control. Shareholders have control over company management, who in turn have control over the running of the company itself. Other common themes are the existence of a company and the applicable relationships within a corporation be it the relationship between shareholders and a company or the relationship of different stakeholders with the company.

This Chapter will look at the concept of corporate governance, focusing on the meaning and importance of corporate governance and the applicable principles, as well as the various models of corporate governance that can be found in developed markets.

2.2 Principles of Good Corporate Governance

Good corporate governance helps to assure that corporations are operated and controlled and ensures that they consider the interests of constituencies and communities within which they operate and further that their boards are accountable to the company and shareholders.[9] Cassim in *Contemporary Company Law*[10] states that "good corporate governance is about effective, responsible leadership characterised by ethical values of responsibility, accountability, fairness and transparency".[11] Knowing what constitutes good corporate governance may assist in determining why corporations have failed[12] and how to prevent future corporate failures.

2.2.1 King Report 2002

The King Report 2002, further discussed in Chapter 4, listed seven characteristics of good corporate governance[13], namely:

[9] OECD P*rinciples of Corporate Governance* (1999) at 7
[10] Cassim et al, *Contemporary Company Law* (2011) Chapter 11: Corporate Governance 432 – 458 at 433.
[11] This echoes the principles of corporate governance promoted by the Cadbury Committee in its report at paragraph 3.2
[12] See Chapter 3 and Chapter 4 which will discuss corporate failures in the United Kingdom, the United States of America and South Africa.
[13] King Report 2002 at 11 - 12.

- Discipline: this is a commitment by management to adhere to correct and proper universally accepted behaviour. This involves a commitment to principles of good corporate governance;
- Transparency: this relates to the availability of accurate information to the public which enables investors to have an accurate picture of the company;
- Independence: this involves mechanisms such as board composition, board committees and auditors that are put in place to minimise any potential conflict of interest and prevent undue influence;
- Accountability: those who make decisions should be accountable for the decisions with mechanisms in place to allow investors means to query and assess any actions or decisions;
- Responsibility: the board should act responsively to and with responsibility towards all stakeholders and they should be means for corrective action and for penalising mismanagement;
- Fairness: there should be a balance between interests of the company and the company's future while acknowledging and respecting rights of other various groups; and
- Social responsibility: this involves awareness of social issues and a high priority placed on ethical standards.

2.2.2 OECD Principles of Corporate Governance[14]

A set of standards and guidelines were developed by the OECD which are essential for the development of good corporate governance. They are common elements that underlie good corporate governance. These principles are the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency and the responsibilities of the board.[15] These will be discussed more fully below.

[14] The principles of corporate governance were developed at a response to a growing awareness of good corporate governance and were meant to be utilised as a benchmark for evaluating and improving laws and regulations as well as developing systems for corporate governance and best practice. The principles were first published in 1999 and are non-binding but have however become an international benchmark for policy makers, investors and stakeholders. There are 34 member countries of the OECD including Australia, Germany, the United Kingdom as well as the United States of America. South Africa is not a member of the OECD but obtained observer status as of 2014.

[15] OECD P*rinciples of Corporate Governance* (1999)

2.2.2.1 Ensuring the Basis for an Effective Corporate Governance Framework:

The corporate governance framework should promote transparent and efficient markets and be consistent with the rule of law. It should articulate the division of responsibilities among different authorities with the view to its impact on overall economic performance. The framework should further ensure market integrity and assess the incentive it creates for market participants. It should also be enforceable, and ensure that the public interest is served. Authorities should have the power and resources to fulfil their duties in a professional and objective manner.[16]

2.2.2.2 The rights of shareholders and Key Ownership Functions:

The corporate governance framework should protect and facilitate the exercise of shareholders' rights which basic rights include the right to secure ownership registration, participate, vote and share in profit.[17]

2.2.2.3 The equitable treatment of shareholders:

The corporate governance framework should ensure equitable treatment of all shareholders including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. Insider trading and abusive self-dealing should be prohibited by having members of the board and key executives should disclose any interest that may affect the corporation.[18]

2.2.2.4 The role of stakeholders in corporate governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporation and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. They should have opportunities to obtain effective

[16] Organisation for Economic Co-operation and Development (2004) at 17
[17] Organisation for Economic Co-operation and Development (2004) at 18 - 19
[18] Organisation for Economic Co-operation and Development (2004) at 20

redress for rights violations, access to information, freely communicate concerns to the board and the framework should be complemented by an effective and efficient insolvency framework and effective enforcement of creditors' rights.[19]

2.2.2.5 Disclosure and transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. Disclosure includes material information on financial and operating company results, major share ownership and voting rights and governance structures and policies. Compliance with accounting, financial and audit standards is of great importance.[20]

2.2.2.6 The responsibilities of the board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Board members must act in good faith, with due diligence and care, and in the best interest of the company and shareholders. They should treat shareholders fairly and exercise objective independent judgment on company affairs.[21]

South Africa has incorporated the OECD principles in corporate governance in various ways such as the Code of Corporate Practices and Conduct, JSE Listing requirements as well as legislation. To ensure an effective corporate governance framework, there are repercussions for non-compliance with the JSE listing requirement and the Companies Act. Chapter 2 of the Companies Act[22] deals with both shareholders and directors of the board and this, together with the King Report principles, implement OECD principles. South Africa also has legislation that protects stakeholders such as the Labour Relations Act 66 of 1995 and the Basic

[19] Organisation for Economic Co-operation and Development (2004) at 21
[20] Organisation for Economic Co-operation and Development (2004) at 22 - 23
[21] Organisation for Economic Co-operation and Development (2004) at 24 - 25
[22] In Part F, more specifically discussed at 7.1.1.

Conditions of Employment Act 11 of 2002. Stakeholders may seek redress through the courts as provided by the Bill of Rights.

2.3 Importance of Corporate Governance

> *"The role of corporate governance is to protect and advance the interests of shareholders through setting the strategic direction of a company and appointing and monitoring capable management to achieve this*."[23]

Understanding the importance of corporate governance in an organisation may go a long way in motivating corporations to implement good corporate governance practices. According to Okeahalam and Akinboade,[24] due to the 'principal-agent' problem, the need for corporate governance arose as interests of those controlling the company can differ from the interests of the stakeholder.[25] Corporate Governance increases a company's accountability[26] and ensures that corporations are well run and further that they earn the confidence of investors and lenders.[27] Well implemented and executed corporate governance keeps a company honest, and reduces the risk of corporate scandals. They state that good governance is necessary for four reasons[28], namely:

- To attract local and foreign investors while ensuring the safety of and efficient management of their investments with transparency and accountability;
- To create competitive and efficient companies;
- To enhance accountability and the performance of management; and
- To promote the efficient and effective use of limited company resources.

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[23] Walker D, *A Review of Corporate Governance in UK Banks and other financial industry entities: Final Recommendations*, 26 November 2009. Available at http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf accessed on 5 May 2016.

[24] Okeahalam C and Akinboade P "*A review of Corporate Governance in Africa: Literature, Issues and Challenges*" Corporate Governance Forum (2003).

[25] Ibid at 2. This is reflected in management pursuing activities that may be detrimental to shareholders' interests.

[26] Sun L, "*Why Is Corporate Governance important?"* Business Directory available at www.businessdirectory.com/article/618/why-is-corporate-governance-important/ accessed 17 October 2016.

[27] Okeahalam C and Akinboade P (2003) at 4.

[28] Ibid.

2.4 Models of Corporate Governance

There are various models of corporate governance each with its own characteristics. Countries will adopt a fitting model, depending on socio-economic conditions in the specific country. Models of corporate governance have common elements being those of the role players, the composition of the board of directors, the applicable regulatory framework, applicable disclosure requirements, actions that require shareholder approval and the interaction amongst the role players. Three main models of corporate governance, namely Anglo-US model, the Japanese model and the German model will be briefly discussed below.

2.4.1 Anglo-American Model

This is also known as the unitary model and has been influenced by the systems of governance that are followed in the United Kingdom and the United States as the name suggests. Directors participate in a single board made up of both insiders (also referred to as an executive director) and outsiders (also referred to as a non-executive director). An outside shareholder is one who has no direct relationship with the corporation with an insider being an individual with a vested interest in the corporation. Rights and responsibilities of role players are defined in a legal framework.

The Anglo-American model is a framework that defines the rights and responsibilities of 3 key role-players at three levels[29] forming a "corporate governance triangle" with shareholders appointing directors who then appoint managers allowing for separation of ownership and control. It is characterised by the dominance of independent persons and independent shareholders in the company[30] with concentration of power in a single individual in that the CEO and the Chairman of the Board are a single individual as well as the protection of shareholder interests. The Anglo-American model is considered to have the strictest disclosure requirements.

[29] Shareholders, directors and managers.
[30] Ungureanu M, Models of Corporate Governance Worldwide: CES Working Papers (2012) 625 – 635 at 626 available at http://ceswp.uaic.ro/articles/CESWP2012_IV3a_UNG.pdf accessed 19 October 2016.

The Anglo-US model is followed by countries such as the United Kingdom, the United States of America, Australia and Canada, among others.

2.4.2 Japanese Model

The idea that the activities of a company should not be affected by the relationships between different role players necessitated the need of the Japanese model.[31] This model of corporate governance, like the German model of corporate governance discussed below, is based on internal controls.

Companies have a close relationship with a main bank and/or financial institution, with such bank or institution generally being a major shareholder[32] and being actively involved in the management of the company, which differs from the approach followed in the Anglo-US model.[33] Shareholders and the bank jointly appoint the supervisory board that is made up of board directors, almost completely consisting of executive directors, and a president.

There are four key role-players in this model namely the main bank, the affiliated company, management and government. The government actively influences corporate policies[34] and monitors the supervision and control within the company.

2.4.3 German Model

This is also known as the Continental model. It is considered to be a conservative and socially orientated model.[35] This model has unique elements as it has a two-tiered board structure[36] and individuals cannot serve on both boards simultaneously. The management board is responsible for the daily management of the company and is exclusively made up of insiders (executives) with the supervisory board being

[31] Ungureanu M (2012) at 629.
[32] Eg. Banks. Ungureanu M (2012) at 629
[33] The Anglo-US model prohibits such relationships with anti-trust legislation.
[34] Ungureanu M (2012) at 630.
[35] It is believed this helped Germany endure the world financial crisis. Kseniya L and Denis N (2010) *Characteristics and prospects of the German model of Corporate Governance* at 1.
[36] Management board and supervisory board (set by law).

responsible for the management of the board and is made up of interested parties, being shareholders and employee representatives to the exclusion of insiders.

Decision making can be undertaken by any party that has a vested interest in the activities of the corporation. The key role-players in this model are banks and corporate shareholders which are generally the majority shareholders and, as with the Japanese model, banks have an active role in German corporations.

The structure of corporate governance in South Africa has been influenced by the country's colonial history and "corporate law and corporate practice have been adopted mainly from the UK."[37] The country's approach to corporate governance aligns itself with the Anglo-American model of corporate governance in that (a) there is a single-tiered board structure without stakeholder representation (b) it has the JSE Stock Exchange, being an active stock exchange (c) there is a lack of control of companies by banks. South Africa marginally moves away from the Anglo-American model in that there is legislation that intervenes in the labour market, such as the Broad-Based Black Economic Empowerment Act of 2003 and the Employment Equity Act, amongst others, that does result in firms cooperating with government labour bodies.[38]

2.5 Conclusion

Although the Cadbury Report, and by implication, the King Report of 1996 definition of corporate governance remains the authoritative definition, it falls short of the inclusive approach governance principles are progressively leaning towards. The OECD principle of corporate governance definition, however, better encompasses what corporate governance is all about, the safeguarding of all parties' interest. There are various applicable definitions of corporate governance as a concept, however, it can be seen that there are common threads in the varying definitions. By understanding the importance of corporate governance as a principle, it is then easier to determine and clearly identify the repercussions of failing to achieve the

[37] West A, *Theorising South Africa's Corporate Governance* (2006) Journal of Business Ethics 68 433 - 448 at 435.
[38] West A (2006) at 437.

requisite standard. The next chapter will look at corporate failures in the United Kingdom and the United States of America and the countries responses to their respective failures.

Chapter 3: International Corporate Scandals and the Development of Corporate Governance

3.1. Introduction

This chapter will look at some of the major international corporate scandals, more specifically those that occurred in the UK and the USA during the period of 1980 to 2002. Significant international developments in corporate governance occurred during this period. This chapter will show how these corporate scandals influenced the development of the principles of corporate governance. It will be shown that committees established to investigate the causes of some of these corporate scandals made recommendations which eventually became the accepted principles of corporate governance.

3.2. Chronological summary of corporate governance events

3.2.1. Corporate Scandals in the 1980s

3.2.1.1. Drysdale Government Securities Incorporated

The collapse of Drysdale Government Securities Incorporated (hereinafter referred to as "Drysdale Securities") and Penn Square National Bank, among others[1], which are briefly discussed below, led to the creation of a sponsored committee to look at aspects of corporate governance, more specifically, better audit practices.[2]

[1] Grundfest, JA and Esq Berueffy M "*The Treadway Commission Report: 2 years later*" US Securities and Exchange Commission (1989) at 2. Washington Public Power Supply System, Baldwin-United Corp and ESM Government Securities were other corporate failures that preceded the creation of the sponsored committee. https://www.hbsslaw.com/cases/washington-public-power-supply-system-securities-litigation accessed on 30 August 2016; D'Arista JW, *The Evolution of US Finance: Restructuring Institutions and Markets*, Volume 2 (2015) at 331.

[2] Treadway JC et al, *Report of the National Commission on Fraudulent Financial Reporting* (1987) at 1. The committee's mission was to identify causal factors that can lead to fraudulent financial reporting.

Drysdale Securities, through fraud and misrepresentation,[3] managed to borrow large amounts of money by purchasing bonds and showing the value to be higher than what they could be sold for in the cash market.[4] The company took advantage of a flaw in how bond values were calculated as this did not consider accrued interests. This allowed Drysdale Securities to short-sell[5] US Treasury by selling the securities plus the accrued interests. Drysdale Securities, however, did not have enough money to pay the interest when it became due[6] and lost about $300 million in investor funds when Drysdale Securities collapsed and was forced into bankruptcy.[7]

Warren Essner senior partner at Arthur Andersen & Co, an accounting firm and Drysdale's auditors, was responsible for the preparation of allegedly false and misleading financial statements for Drysdale Securities and was charged together with Drysdale Securities Group and Drysdale Securities.[8] Warren Essner on behalf of Arthur Andersen, prepared a formal document that was a certified statement of Drysdale Securities debts and equity which was accompanied by an unqualified audit opinion that allegedly violated generally accepted auditing standards.[9]

3.2.1.2. Penn Square National Bank

Penn Square failed on 5 July 1982. The bank had minimal board supervision and ineffective oversight committees. Penn Square made loans to directors, their friends

[3] https://www.simplilearn.com/financial-disasters-rrt3co39vd200-video accessed 12 June 2016
[4] Ibid.
[5] This involves the sale of a borrowed security, with the short-seller buying back the borrowed security shortly after to return it to the lender with the possibility of making a profit if the price of the security drops before being bought back. Available at www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/frequently-asked-questions-on-repo/28-what-is-short-selling-and-what-is-the-role-of-repo/ accessed 1 October 2016.
[6] Scott ed. Skyrym, "*The bankruptcies that created the modern repo market*". Available at http://scottskyrm.com/2013/04/two-bankruptcies-that-created-the-modern-repo-market/ Accessed 28 December 2015
[7] *Securities and Exchange Commission v Drysdale Securities 785 F.2d 38* (1986) available at https://www.ravellaw.com/opinions/292fd864330c5fcf64226ff113473acc accessed on 31 October 2016. https://www.simplilearn.com/financial-disasters-rrt3co39vd200-video accessed 12 June 2016
[8] *Securities and Exchange Commission v Drysdale Securities 785 F.2d 38* (1986). Rowe J.L, 3 arrested for fraud in Drysdale Case (1983) The Washington Post available at https://www.washingtonpost.com/archive/business/1983/07/28/3-arrested-for-fraud-in-drysdale-case/edb7550c-8bf2-4e5c-8c52-e17275e4da6a/ accessed 8 October 2016
[9] *Securities and Exchange Commission v Drysdale Securities 785 F.2d 38* (1986)

as well as business associates, thereby breaching federal restrictions.[10] At the time of its collapse, Penn Square's auditors were Peat, Marwick, Mitchell and Co (hereinafter referred to as "Peat Marwick") who issued an unqualified audit shortly before the bank failed, losing millions.[11] All partners at the auditors had loans from Penn Square which created a conflict of interest.[12] Peat Marwick was later sued for fraud and conflict of interest but settlement was made out of court.[13]

3.2.2. National Commission on Fraudulent Financial Reporting

As noted above, corporate scandals involved fraudulent financial reporting and falsifying of financial reports with such instances involving auditors such as the case of Drysdale Government securities. In 1985 The Committee of Sponsoring Organisations, to combat fraudulent financial reporting, sponsored the National Commission on Fraudulent Financial reporting (hereinafter referred to as the "Treadway Commission). The Treadway Commission was an independent private sector initiative that studied the causal factors that can lead to fraudulent financial reporting. The Treadway Commission also developed recommendations to prevent and detect fraudulent financial reporting, for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.[14]

The Treadway Commission defined fraudulent financial reporting as "intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements. Such fraudulent financial reporting can involve many factors such as gross and deliberate distortion of corporate records, falsified transactions or misapplication of accounting principles. If the conduct is intentional, or so reckless that it is the legal equivalent of intentional conduct, and results in fraudulent financial statements, it comes within the Commission's operating definition".[15]

[10] Feris S, *How to Destabilize the Financial System: A Beginners Guide, Variance* Vol 4 Issue 1 (2010) 81-112 at 90 available at http://www.variancejournal.org/issues/04-01/81.pdf accessed on 30 August 201.
[11] Feris S (2010) at 104
[12] Feris S (2010) at 103.
[13] See footnote 11.
[14] Committee of Sponsoring Organisations. Available at http://www.coso.org/aboutus.htm Accessed on 28 December 2015
[15] National Commission on Fraudulent Financial Reporting (1987) at 2

The commission had three major objectives, namely:

- To consider the extent to which acts of fraudulent financial reporting undermine the integrity of financial reporting;
- To examine the role of the independent public accountant in detecting fraud; and
- To identify attributes to corporate structures that may contribute to acts of fraudulent financial reporting or to the failure to detect such acts promptly.[16]

The Treadway Commission made recommendations for public companies. These recommendations dealt with the "tone set by management senior management" in establishing effective internal controls, internal accounting and audit functions, the audit committee and the management of its reports as well as seeking a second opinion from independent accountants and quarterly reporting.[17] As they play an important role in detecting and preventing fraudulent financial reporting, recommendations were also made in respect of Independent Auditors, more specifically with regard to a change in accounting standards, improving the quality of audits and setting of improved auditing standards.[18] Recommendations were also made to improve the regulatory and legal environment.

The committee, in its report and recommendations, aimed to reduce fraudulent financial reporting. However, as will be seen further in this chapter, future corporate scandals still involved fraud and fraudulent financial reporting.

3.2.3. Corporate scandals in the early 1990s

3.2.3.1. Coloroll

Coloroll Group Plc's management style was a contributing factor to its problems. Because of greed and in order to win market share, the company invested largely, while at the same time undercutting their competition with the company's losses being covered up by creative accounting.[19] Coloroll collapsed due to an acquisition

[16] See footnote 9.
[17] National Commission on Fraudulent Financial Reporting (1987) at 11
[18] National Commission on Fraudulent Financial Reporting (1987) at 12
[19] Bowen D, *Rolling over the past: Three years after the demise of Coloroll, David Bowen picks through the rubble and finds strength among the survivors. A*vailable at http://www.independent.co.uk/news/uk/rolling-

programme that left the company deep in debt running into millions of dollars.[20] Coloroll went into receivership[21] in June 1990.

3.2.3.2. Bank of Credit and Commerce International

The Bank of Credit and Commerce International, (hereinafter referred to as "BCCI") was set out in an elaborate structure that was allegedly, specifically set up to evade regulations and controls of different governments.[22] There was systematic fraud by BCCI involving senior management[23] and its customers that involved millions of dollars. This involved fictitious lending, bad loans, stolen deposits and unrecorded deposits.[24] However, the level of criminality also extended to money laundering in Europe, Africa, Asia and the Americas.[25] BCCI was also involved in bribery of officials in different countries, terrorism, arms trafficking, prostitution, tax evasion and financial crimes.[26] Following the discovery of accounting fraud of loss of fictitious assets,[27] BCCI closed its doors in 1991 as it was not able to continue operating.

The company's problems came about because of one of their customers, Gulf Group being unable to repay its loans. Management took the decision to falsify company accounts to hide the resulting losses.[28] They went on to secure additional deposits from customers to settle Gulf Group's debts and, by such actions, they deceived the regulators into believing Gulf Group could meet its repayments.[29] BCCI was effectively operating a Ponzi scheme.

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over-the-past-three-years-after-the-demise-of-coloroll-david-bowen-picks-through-the-rubble-1505777.html accessed on 30 August 2016.

[20] Simpson J and Taylor JR, *Corporate Governance ethics and CSR* (2013) at 107

[21] Receivership is a type of corporate bankruptcy in which a receiver is appointed by bankruptcy courts or creditors to run the company. http://www.investopedia.com/terms/r/receivership.asp Accessed on 31 October 2016.

[22] Federation of American Scientist, Kerry J and Brown H, *The BCCI Affair: A Report to the Committee on Foreign Relations United States Senate*, 102d Congress 2d Session Senate, December 1992 available at http://fas.org/irp/congress/1992_rpt/bcci/01exec.htm accessed on 31 October 2016.

[23] Weaning R, *Cases in Corporate Governance* (2005).

[24] Bank of International Settlements (2004) at 50. BCCI used depositors' money to fund trading activities and any losses were concealed fictitious loans.

[25] Ibid.

[26] See footnote 18.

[27] Bank of International Settlements, v. Westernhagen et at "*Basel Committee on Banking Supervision: Bank Failures in Mature Economies*, Working Paper 13 (2004) at 50. BCCI failed because of widespread fraud.

[28] Weaning (2005) at 57

[29] Ibid.

BCCI created a conflict of interest with its auditors by providing loans and financial benefits.[30]Auditors were accused of failing to protect company creditors and deposits when it had in fact been aware of BCCI's accounting practices.[31] Legal proceedings were later withdrawn against the auditors for an out-of-court settlement of £75 million.[32]

3.2.3.3. Maxwell Consortium

Maxwell Communication Corporation was formerly one of the largest media groups, incorporated in 1964. On 5 November 1991, Robert Maxwell was found dead. His death triggered an examination into the company finances which were found to be in a disastrous state.[33] The extent of Maxwell Corporations fraud involved misappropriation of funds, diversion of shares and cash between companies under his control[34] and false financial reporting. Maxwell also used company pension funds to fund other businesses. The fraud was achieved through complex private ownership of more than 400 Maxwell companies[35] and a lack of separation of powers, as Maxwell was both the CEO and chairman.

Its collapse was a direct catalyst for the publication of the Cadbury Report of 1992 on corporate governance briefly discussed below. Collapses of companies such as Coloroll and Polly Peck, as discussed above, raised concerns about the working of the corporate system and the perceived low levels of confidence in financial reporting. There were also concerns regarding whether auditors could provide safeguards shareholders sought and expected. Loose accounting standards and the

[30] See footnote 18.
[31] Lohr S, "*Auditing the Auditors – A Special Report: How BCCI's Accounts Won Stamp of Approval*", The New York Times (1991) http://www.nytimes.com/1991/09/16/business/auditing-the-auditors-a-special-report-how-bcci-s-accounts-won-stamp-of-approval.html?pagewanted=all accessed on 18 June 2016.
[32] BBC Online Network, *Business: The Company file BCCI auditors to pay up to stop legal dispute* http://news.bbc.co.uk/2/hi/business/177833.stm
[33] http://deepinthemoney.wordpress.com/tag accessed on 18 June 2016.
[34] Commer P J, "*Failing in Corporate Governance and Warning Signs of a Corporate Collapse*" (2014) Vol 8 (3) Pakistan Journal of Commerce and Social Sciences 846 at 847
[35] Lee T.A, *Financial Reporting and Corporate Governance* (2007) at 30

lack of a clear framework for directors were some of the underlying factors for these concerns.[36]

3.2.4. Committee on the Financial Aspects of Corporate Governances

This committee, also referred to as the Cadbury Committee, was set up by the Financial Council, the London Stock Exchange and the accountancy profession. They were tasked with addressing financial aspects of corporate governance. The committee provided recommendations focused on board function, of control and reporting, as well as the role of auditors.[37]

3.2.5. Other Committees

3.2.5.1. Greenbury Committee[38]

This committee set out to review director remuneration as there was concern over the levels of senior executives' salaries and bonuses. It was established by the Confederation of British Industry in 1995. The group was tasked with identifying good practices to determine directors' remuneration as well as prepare an applicable code of practice.[39]

The key themes in the report were accountability, responsibility, full disclosure, alignment of Director and shareholder interests and improved company performance[40] with its key findings being that a remuneration committee must be set up and have the responsibility of determining the level of compensation packages and that there be full disclosure of such packages. These would then need to be approved by shareholders. The remuneration packages, linked to performance, should be sufficient to 'attract, retain and motivate' talent.

[36] Report of the Committee on the Financial aspects of corporate governance (1992) at 14
[37] Cadbury A (1992) at 11
[38] Greenbury J, *Directors' Remuneration: Report of a Study Group*, 17 July 1995 available at http://www.ecgi.org/codes/documents/greenbury_less_recommendations.pdf Accessed 28 December 2015.
[39] The Institute of Charted Accountants in England and Wales: www.icaew.com/en/library/subject-gateways/corporate-governance/codes-and-reports/greenbury-report Accessed 30 August 2016.
[40] Greenbury J (1995) at 7.

3.2.5.2. Hampel Committee[41]

The Hampel Committee on Corporate Governance was established in November 1995, following recommendations that a committee be established to review the implementation of the Cadbury and Greenbury committee findings.[42] The committee outlined principles pertaining to good corporate governance. These are set out briefly below. [43]

Principles of corporate governance regarding Directors:

- Every listed company should be headed by an effective board which should lead and control the company;
- A decision to combine the role of the Chairman and the Chief Executive Officer in one individual should be publicly explained;
- The board should include a balance of executive directors and non-executive directors, including independent non-executive directors;
- The board should be supplied in a timely fashion with information in form and of a quality appropriate to enable it to discharge its duties,
- There should be a formal and transparent procedure for the appointment of new directors to the board
- All directors should be required to submit themselves for re-election at regular intervals and at least every three years.

Principles of corporate governance relating to director's remuneration:

- Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully linking rewards to corporate and individual performance;

[41] Hampel R, *Committee on Corporate Governance Final Report*, January 1998 available at http://www.ecgi.org/codes/documents/hampel.pdf accessed on 28 December 2015.
[42] See footnote 27 at 5
[43] See footnote 27 at 16 – 22.

- Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration package of individual executive directors;
- The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

Principles of corporate governance relating to shareholders applying to both listed companies and shareholders:

- Institutional shareholders have responsibility to make considered use of their votes;
- Companies and institutional shareholders should each be ready to enter into dialogue based on mutual understanding of objectives;
- Institutional investors and their advisers should give due consideration to all relevant factors drawn to their attention when evaluating governance arrangements;
- Companies should use the AGM to communicate with private investors and encourage their participation.

Principles of corporate governance relating to accountability and audit:

- The board should present a balanced and understandable assessment of the company's position and prospects;
- The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets;
- The board should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors;
- The external auditors should independently report to shareholders in accordance with statutory and professional requirements and independently assure the board on the discharge of its responsibilities.

3.2.5.3. Higgs Committee[44]

Derek Higgs was appointed to lead an independent review of the role and effectiveness of non-executive directors. The report made various recommendations for proposed revisions to the Combined Code, namely:[45]

- The Board:

The board, which should be of an appropriate size, is collectively responsible for promoting the success of the company by leading and directing the company's affairs.

- The Chairman:

The roles of chairman and chief executive should be separated with division of responsibilities set out in writing and agreed by the board. The chief executive should not become chairman of the same company with the chairman meeting the test of independence at appointment.

- The role of the non-executive director:

A description of their role is proposed for incorporation into the code. Potential new non-executive directors should carry out due diligence on the board and company to satisfy themselves that they have the knowledge, skills, experience and time to make a positive contribution to the board.

- The senior independent director:

One who meets the test of independence should be identified and should be available to shareholders in the event they have concerns not resolved through the normal channels of contact.

- Independence

Decisions should be taken objectively in the interest of the company.

[44] Higgs D, *The Review of the role and effectiveness of non-executive Directors* (January 2003)
[45] Higgs, D (2003) 5 – 10.

- Recruitment and appointment

A nomination committee, consisting mostly of independent non-executive directors, should conduct the process for board appointments and they should evaluate the balance of skills, knowledge and experience on the board.

- Induction and professional development

A comprehensive induction programme, which is the responsibility of the chairman should be provided to new non-executive directors. This programme should address the developmental needs of the board with the boards performance being evaluated at least once a year. The company secretary should be accountable to the board on all governance matters.

- Tenure and time commitment

They should normally be expected to serve two three-year terms and should undertake, on appointment, that they will have sufficient time to meet what is expected of them. No individual should chair the board of more than one major company.

- Remuneration

This should be sufficient to attract and fairly compensate high quality individuals with non-executive directors having the opportunity to take part of their remuneration in the form of shares. They should not hold options in the company unless approved by shareholders with such approval being sought a year in advance.

- Resignation

The chairman should be informed by a non-executive director on resignation, in writing of the reasons for the resignation.

- Audit and remuneration

Smith Committee recommendations on audit committees[46] briefly discussed below, are endorsed. The remuneration committee should comprise at least three

[46] Smith R, *Audit Committees Combined Code Guidance: A report and proposed guidance by and FRC-appointed group*, 2003 available at http://www.ecgi.org/codes/documents/ac_report.pdf accessed on 28 December 2015.

members, all of whom should be independent non-executive directors and should have delegated responsibility for setting remuneration for all executive directors and the chairman.

- Liability

A company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself. Companies should provide appropriate directors' and officers' insurance and provide such details to non-executive directors before appointment.

- Relationships with shareholders

All non-executive directors should attend the Annual General Meeting and the senior independent director should attend sufficient of the regular meetings with a range of major shareholders and revert to the non-executive directors and the board regarding these meetings.

- Smaller listed companies

The recommendation that no one individual should sit on all three principal board committees at the same time should not apply to smaller listed companies.

The Higgs Report guidance was replaced by "Good Practice Suggestions from the Higgs Report, Guidance on Board Effectiveness" published by The Financial Reporting in 2006.

3.2.5.4. Smith Committee[47]

The committee, chaired by Sir Robert Smith, was established in 2002, following the dramatic corporate failures in the United States in early 2002, discussed briefly below. The committee provided a combined code of guidance, designed to assist with making suitable arrangements for the audit committee and includes essential requirements that should be met. Listed companies failing to comply should explain why they have failed to do so.

[47] Smith R et al (2003) *Audit Committee Combined Code Guidance*.

The audit committee's primary role is to ensure the integrity of financial reporting and the audit process by ensuring that the external auditor is independent and objective[48] while also ensuring that the interests of shareholders are properly protected in relation to financial reporting while acting independently from the executive. They must intervene if there are signs that something may be seriously amiss, monitor the integrity of the company's financial statements as well as review the internal financial control system and review the clarity and completeness of disclosures in the financial statements.

The guidelines also provide that the chairman of the company should not be in the audit committee and no one other than the members are entitled to be present in the committee meetings.

3.2.6. Corporate scandals in the early 2000s

2002 saw an unprecedented number of major corporate scandals.[49] However, two of these scandals summarised briefly below, influenced the development of corporate governance, not only in the United States but also in the United Kingdom.

3.2.6.1. Enron Corporation

Shortly before its collapse Enron Corporation, a publicly traded company, was considered as one of the most innovative and best managed businesses worldwide. The CEO, Jeffrey Skilling, resigned for undisclosed reasons in August 2001[50] and shortly thereafter the company reported its first loss, restated its earnings and filed for bankruptcy on 2nd December 2001.

The company used manipulative accounting techniques to manipulate its financial statements and conceal the extent of its indebtedness[51] to keep its share price high

[48] See footnote 26 at 22
[49] Enron, Tyco and Global Crossing.
[50] Jickling M, *The Enron Collapse: An overview of Financial Issues* (2002) *at* 2 available at http://fpc.state.gov/documents/organization/9267.pdf *accessed 18 June 2016.*
[51] Jickling M (2002) at 1.

and maintain the impression of a highly successful company.[52] The company set up independent partnerships that enabled it to legally remove losses from its books by passing them off to these partnerships. It came to light that the company had grossly overinflated its profits and concealed excessive debts and their auditors admitted to "errors of judgment"[53] in its auditing practices as they appeared to ignore warnings about the accounting irregularities. A partner at the auditing firm ordered the disposal of documents subpoenaed by the SEC which resulted in the firm being found guilty of obstruction of justice, later overturned on appeal.

The Permanent Subcommittee on Investigations conducted an in-depth investigation. The subcommittee considered the role of the Enron Board of Directors in Enron's collapse and bankruptcy. They made the following findings:

- Fiduciary failures:

The board failed to safeguard the shareholder's and contributed to the collapse by allowing the company to engage in high risk accounting, inappropriate conflict of interest transactions. The board chose to ignore numerous questionable practices by Enron's management.

- High risk accounting

The board knowingly allowed the company to engage in high risk accounting practices.

- Inappropriate conflict of interest:

The board approved an unprecedented arrangement to allow the Chief Financial Officer to establish a company that conducted business with Enron with inadequate oversight.

- Extensive undisclosed off the books activities:

The board failed to ensure adequate public disclosure of material off the books liabilities.

[52] Enron: The Fall from Grace/The World's biggest Fraud at 9 available at http://www.efham.net/uploads/efhamelborsa/enron.pdf accessed on 18 June 2016.
[53] Investopedia, *Enron Scandal: The Fall of a Wall Street Darling* (August 2008) http://www.investopedia.com/updates/enron-scandal-summary/ accessed 6 October 2016. (see also http://www.economist.com/node/917422/print)

- Excessive compensation:

The board failed to monitor the cumulative cash drain caused by bonus and performance plans and they further failed to stop Chairman and Chief Executive Officer personal credit from the company.

- Lack of independence:

There were financial ties between the board and the company. The board failed to ensure auditor independence as the auditing firm, Andersen, provided Enron with internal audit and consulting services while being the external auditors as well.

The cause of Enron's collapse appears to stem from failure of the company's leadership with executives being charged with criminal acts including wire and securities fraud, money laundering, conspiracy and making of false statements on financial reports.[54] Among these executives was the company CEO and chairman, Kenneth Lay. The collapse of Enron also stemmed from unethical behaviour which was aggravated by the corporate culture of greed. The collapse of Enron and WorldCom[55] were catalysts in the enactment of the Sarbanes-Oxley Act of 2002.[56]

3.2.6.2. WorldCom

Worldcom was built through rapid acquisitions to become the nation's second largest long distance phone company[57] and handler of internet data. The company accumulated $41 billion in debts. Accounting irregularities involving expenses and capital expenditures inflated the company's cash flow[58] with the assets overinflated by as much as $11 billion. These irregularities did not conform to generally accepted accounting principles.

[54] *Ibid.*
[55] Further discussed at paragraph 7.2
[56] Further discussed at paragraph 8.
[57] A long-distance telephone call is when a call is made outside a defined local area, usually to another city.
[58] Hanock D, *World Class Scandal at Worldcom*. Available at www.cbsnews.com/news/world-class-scandal-at-worldocm/ accessed 20 June 2016.

The Chief Executive Officer Bernie Ebbers underreported line costs by capitalising rather than expensing, and inflated revenues with fake accounting entries.[59] The accounting practices by the head of the internal audit were called into question. This resulted in WorldCom admitting to overstating its profits. Ebbers was sentenced to 25 years for fraud, conspiracy and filing false documents with regulators.

The collapse of Worldcom was another case of failed corporate governance, accounting abuses and outright greed.[60]

Following this scandal, Congress passed the Sarbanes-Oxley Act of 2002 introducing the most sweeping set of new business regulations since the 1930's.[61]

3.2.7. Sarbanes-Oxley Act of 2002

The Act was passed by United States Congress to protect investors from the possibility of fraudulent accounting activities by companies.[62] It was a reaction to the collapses of Enron and WorldCom and the Act is mandatory, to which all organisations must comply. It introduced major changes to financial practice and corporate governance regulation.[63] The key sections of the Act are:

- Section 302:

This section pertains to Corporate Responsibility for Financial Reports. It requires periodic statutory financial reports to include certification that signing officers have reviewed the report and it does not contain any material untrue statements, omissions or be considered misleading. The financial statements and related information must fairly present the financial condition. Internal controls must be evaluated within the previous ninety days with deficiencies in such controls being listed and include information on any fraud involving employees.

[59] www.accounting-degree.org/scandals/ accessed 20 June 2016.
[60] Moberg D and Remar E, *Worldcom Case Study*, available at www.scu.edu/ethics/focus-area/business-ethics/resources/worldcom accessed 30 October 2016.
[61] The 10 worst Corporate Accounting Scandals of all time. Available at http://www.accounting-degree.org/scandals/ accessed on 30 October 2016.
[62] The aim of the act can be found in its preamble which states "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, for other purposes".
[63] A guide to the Sarbanes-Oxley Act available at www.soxlaw.com/ accessed 30 August 2016.

- Section 401

This section pertains to Disclosures[64] in Periodic Reports. Published financial reports are required to be accurate and not containing incorrect statements.

- Section 404

This section pertains to Management Assessment of Internal Controls. Annual reports should include information regarding the scope and adequacy of the internal control structure and procedure for financial reporting and assess the effectiveness of same.

- Section 409

This section applies to Real Time Issuer Disclosures which requires urgent disclosure to the public, in easy to understand terms, of information on material changes in the financial condition or operations.

- Section 802

This section pertains to Criminal Penalties for Altering Documents which imposes penalties of fines and/or imprisonment. These may be imposed because of altering, destroying, manipulating, concealing, falsifying records, documents or tangible objects with intent to obstruct, impede or influence a legal investigation. Penalties are also imposed for accountants who knowingly and wilfully violate the requirement of a 5-year period of maintenance of papers.

Common through corporate scandals was fraudulent financial reporting. Section 302 of the Act ensures that there are sufficient audit controls such as an audit committee that is separate from management that ensures that financial reports are a true reflection of the company's position and have passed the necessary checks and balances. Enron's board was found to have failed to ensure public disclosure of off the book activities as it had Special Purpose entities and off balance sheet entities that presented an unrealistic picture of the finances of the company. Section 401 of the Act ensures full disclosure by a company of such off-balance sheet transactions.

[64] Section 401 requires the disclosure of off-balance sheet items. Subsection (j) provides that all material off-balance transactions, arrangements or obligations that may affect the financial condition shall be disclosed.

The Act effectively gives audit committees powers and responsibilities and it also places strict penalties in section 802 if senior management fails to verify and certify the accuracy of their financial reports.

The Sarbanes-Oxley Act has five main objectives:[65]

- To strengthen the independence of auditing firms;
- To improve the quality and transparency of financial statements and corporate disclosure;
- To enhance corporate governance;
- To improve the objectivity or research; and
- To strengthen the enforcement of the federal securities laws, including the use of criminal penalties.

3.3. Conclusion

Following the various corporate scandals and collapses, the United Kingdom's approach was to establish committees and groups that provided reports, recommendations, guidelines and Combined Codes. The consistent approach in these reports is that they adopted a "principle-based" approach to enforcement of corporate governance codes referred to as the principle of 'Comply or Explain' in that listed companies that fail to comply with requirements set out in the Combined Code need to explain the ways in which they have failed as well as why they have failed to comply in a statement required by Listing Rules. This allows for a more flexible approach to code provisions as the application can be tailor made to individual companies.

In the United States of America however, Congress by passing the Sarbanes-Oxley Act, chose to make compliance a matter of law and companies are therefore required to, in detail, comply with the Acts' provisions. Regulation relies predominantly on legislation that, as consequences of violating the legislated requirements, imposes fines and penalties.

[65] Jackson G, *Understanding Corporate Governance in the United States* (2010) at 39

The next chapter will focus on corporate scandals and corporate governance in South Africa and the impact of the King Reports on Corporate Governance which are comparable to the above-mentioned reports.

Chapter 4: South African Corporate Scandals and the development of Corporate Governance in South Africa

4.1. Introduction

South Africa has had its fair share of major corporate scandals. Some have directly resulted in a commission of inquiry to investigate the causes of the specific collapses. Reports on corporate governance incorporating recommendations were also published due to the changing political situation in the country. This chapter will look at some of the major corporate failures in South Africa as well as how the principle of corporate governance has developed in the country. This chapter will further look at legislation that has incorporated reports on Corporate Governance.

4.2. Masterbond Group of Companies collapse

The Masterbond group was incorporated to do business as a participation bond manager.[1] Company funds were sourced through debenture investments, for periods of 6 to 60 months and at attractive rates.[2] Another source of funding was the pooling of available monies in so called 'money-markets' thereby allowing for higher interests for Masterbond.[3] The rapid growth of the group was due to (a) dishonesty of the executive directors of the group, (b) dishonesty and negligence of auditors, (c) aggressive and successful marketing, (d) inefficiency of regulating authorities, (e) inefficiency of prosecuting authorities and (f) the lack of effective investor protection in South Africa.[4]

Section 300 of the Companies Act 62 of 1973 related to auditors' duties as to financial statements and other matters and effectively required the auditor of a company to examine annual financial statements and be satisfied that proper accounting records were kept. The auditor further had to be satisfied that such financial statements not only complied with the Act itself and truly and fairly reflected

[1] Nel H et al, *The First Report of the Commission of Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa,* Volume 1 (1997) part 2 at 1
[2] Nel et al (1997) at 2.
[3] Nel et al (1997) at 3.
[4] Nel H et al (1997) at 16.

the financial position of the company but also conformed to the generally accepted accounting standards. This section operated in conjunction with section 26(3) of the Public Accountants' and Auditors' Act 51 of 1951 which required an auditor to investigate and report on any irregularities. It was concluded that Masterbonds' auditors failed to act in terms of both section 300 of the Companies Act 1973 and section 26(3) of the Public Accountants' and Auditors' Act, despite the evidence of theft of investor monies.[5]

By March 1991, Masterbond was struggling to meet interest payments and within 6 months thereafter, the group was unable to generate sufficient income to pay interest to investors and were further unable to generate sufficient funds, via investments, to repay matured debentures.[6] Masterbond became nothing more than a Ponzi scheme.[7] This scandal involved millions in investor funds that were amassed by promising what appeared to be secure and safe investments.

The scale of the Masterbond scandal and the collapse in October 1991, was a direct catalyst for the appointment of the Nel Commission of Inquiry in to the affairs of Masterbond[8] to consider the causes of the collapse as well as make recommendations for amendments to legislation that impacted on corporate governance aspects.

4.3. Commission of inquiry into the affairs of Masterbond Group and Investor protection in South Africa (The Nel Commission)

The Commission was appointed by the State President, Nelson Mandela, to inquire into and report on circumstances that gave rise to the financial difficulties of the Masterbond Group of Companies, to report on any legal person which issued debentures and/or registered mortgage bonds in favour of the Masterbond group and

[5] Nel H et al (1997) at 45.
[6] Nel H et al (1997) at 111.
[7] Nel H et al, *The Final Report of the Commission of Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa*, Volume 1 (2001) at 1. A Ponzi scheme is defined as a fraudulent investment scam that promises low risk and high returns for investors and involves new investors funds being used as returns for older investors. Ponzi schemes rely on a constant flow of new investment. Available at www.investopedia.com/terms/p/ponzischeme.asp accessed 8 September 2016).
[8] Discussed further below.

to report on whether individuals entrusted with professional duties, neglected their duties towards the Masterbond group and its investors.[9] The commission was also tasked to make recommendations regarding amendments to be affected to legislation regarding deposit taking institutions, other financial institutions, companies, share-block and times share schemes as well as to any other legislation and the common law.

The Commissions' investigation revealed "deficiencies in the South African supervisory system as well as sections in the Companies Act" of 1973 and further revealed the "degree of dishonesty, inefficiency, lack of professional integrity and the lack of independence of some of the involved auditors".[10] The Commission recommended the creation of an independent Public Oversight Body, to oversee and regulate the activities of the accounting and auditing profession.[11] The recommendation was that this body be given sufficient statutory powers to encourage adherence to high professional standards in the profession, to undertake effective supervision of the accountancy bodies in the discharge of their delegated regulator function and to intervene where accountancy bodies are not carrying out their delegated regulatory functions to a sufficiently high standard.[12]

4.4. Fidentia Group collapse

The Fidentia Group consists of Brown Brothers, Fidentia Holdings (Pty) Ltd, Fidentia Asset Management (Pty) Ltd (hereinafter referred to as "FAM") and other subsidiary companies.[13] As a result of aggressive takeovers, Fidentia was an active player in the financial industry by 2005.[14] The Mine Workers' Provident Fund (hereinafter referred to as "MWPF") was the single biggest trust Fidentia administered via Mercantile Asset Trust Company, an entity of FAM. MPWF was for the benefit of

[9] Nel H et al (1997) Volume 1 Part 1 at 2.
[10] Net et al (1997) at 9.
[11] Nel at al (2001) Volume 3 at 344.
[12] Nel at al (2001) at 342.
[13] Dini T, *All that Glitters: an exploration of the Pyramid Scheme and Ponzi scheme Phenomena and what the law is doing to protect consumers* 15 July 2015, available at http://documents.lexology.com/e8d81314-6bb6-47f9-9248-9c9fd8fffdb3.pdf accessed 24 October 2016.
[14] USB Leaders' Lab, Steenkamp P and Malan D, *How Safe is Safe* (February 2009) 26 – 29 at 26 available at http://www.usb.ac.za/thoughtprint/Leaders%20Lab%20PDFs/How_safe_is_safe.pdf accessed on 2 November 2016.

dependants of deceased members. Fidentia also procured funds from the Transport and Education Authority (hereinafter referred to as "TETA"). This was achieved through financial inducements to TETA's CEO.[15] Brown Fraudulently misrepresented that TETA's investments would be secured and invested safely[16] however, such funds were instead used for personal gain.

Fidentia showed a disregard for corporate governance principles by having concentrated and unlimited powers with the CEO, with the CEO also being the Chairman, the directors failed to uphold their fiduciary duties[17] and there was a conflict of interest between Fidentia and their auditors as the auditor, Graham Maddock was also a director.[18]

Following an inspection in terms of section 2 of the Inspection of Financial Institutions Act[19] of the affairs of FAM some of the findings[20] were as follows:

- FAM failed to maintain proper accounting records and further failed to lodge audited financial statements;
- R689 million in client funds were unaccounted for and were likely utilised for disbursements/misappropriation by the Fidentia group;
- There was conflict of interest between the interests of clients and those of FAM;
- Client funds for investment were instead used to pay business expenses as well as acquire property and private equity for the group;
- FAM failed to observe the utmost good faith and did not exercise proper care and diligence; and

[15] Steenkamp P and Malan D (2009) at 27.
[16] *S v Brown* [2015] 1 All SA 452 (SCA).
[17] These include the duty of good faith and honesty, the duty to ensure no conflict of interest between director's personal interests and the company's and the duty not to exercise their power for improper use.
[18] Benjamin C, *Fidentia Curators look for top dollar as assets go on sale* available at http://journalism.co.za/wp-content/uploads/fidentia%202.doc accessed on 2 October 2016.
[19] No 80 of 1998
[20] Financial Services Board, Seedat D and Topham B, *Inspection report issued to the Register of Financial Services Providers: Fidentia Asset Management (Pty) Ltd*, 16 January 2007 [online] at 12 – 14. Available at http://www.itinews.co.za/content/media/companydocs/ac8554e3-473e-4773-b1d8-eb9c5b5d1202.pdf accessed on 2 October 2016.

- FAM and its key individuals, Joseph Brown and Graham Maddock, did not act honestly, fairly, with due skill, care and diligence and in the best interest of the clients and the integrity of the financial services industry.

The findings of the investigation prompted the Financial Services Board to make an application for the appointment of a curator.

In the Financial Services Board media release[21] the salient findings of the curators were:

- Evidence of dishonesty, misrepresentation and reckless dealings of Mr Arthur Brown, Mr Graham Maddock and other senior officials of Fidentia;
- Almost non-existent record-keeping and inadequate book and accounts hampered a forensic investigation into Fidentia's affairs;
- The findings of the Financial Services Board inspectors as recorded in the earlier inspection report were confirmed;
- A substantial shortfall in Fidentia's holding of trust assets is likely to be found once the available assets have been realised; and
- Certain businesses within the group are still operational and profitable and have been ring-fenced.

A reasonable conclusion following an interrogation was that FAM was operated as a Ponzi scheme as investors' funds were used to repay capital and profit payments to other investors.[22] In 2007, Joseph Brown and Graham Maddock were arrested and charged with theft and fraud[23] and Joseph Brown was found guilty on two counts of fraud and sentenced to 15 years' imprisonment.[24]

[21] Financial Services Board, Media Release: *Curatorship of financial services business of Fidentia Asset Management (Pty) Ltd Associated Companies*, 27 March 2007, available at http://www.fsb.co.za/Departments/communications/Documents/02042007.pdf accessed 2 October 2016.
[22] Papadakis GN, *Supplementary Curators' Financial Report on the status of Fidentia Group*, 7 May 2013 at 38 par 8.1 available at https://www.fsb.co.za/CuratorshipReports/Fidentia%20Supplementary%20curators'%20report%20of%2007%20May%202013.pdf accessed on 20 October 2016.
[23] Steenkamp P, *Fidentia: a strategic and Corporate Governance Analysis,* Study Project (University of Stellenbosch Graduate School of Business (2007) at 27.
[24] *S v Brown* [2015] 1 All SA 452 (SCA).

4.5. Leisurenet collapse

Leisurenet was a public company listed on the Johannesburg Stock Exchange. To raise finances, the company marketed debentures associated with long term membership and these were interest free and the capital was repayable after 40 years.[25] The company later moved away from debentures to membership contracts as a source of finance.

Leisurenet held 57,8% ordinary shares in Heathland International Limited and supported the company with funding and guarantees.[26] The Joint Chief Executive Officers chose to take on 100% of the liabilities of Heathland's various debts.[27] Later, Leisurenet could no longer support Heathland's further development or sustain its operation.[28] Leisurenet's position was materially misrepresented to stakeholders[29] in financial statements due to questionable accounting standards that grossly exaggerated debtors and the non-disclosure of their financial obligations.[30]

Both executives, Peter Gardener and Rob Mitchell, were found guilty on charges of fraud involving a total of R12 million as they had concealed their interests in a German company and in June 2005, Gardner was fined R2,9 million on counts of tax fraud and insider trading.[31] The collapse of the group is said to be the largest corporate collapse in South African history.[32]

Both the Fidentia collapse and the Leisurenet collapse highlighted weaknesses in corporate governance practices despite the existence of the King Report 2002 and made the problems with corporate governance in South Africa more evident. They showed that the framework in place at the time was not capable of effectively

[25] Cilliers A, *Leisurenet: A Strategic Analysis with reference to Corporate as part of company strategy*, Study Project (University of Stellenbosch Graduate School of Business (2002) at 13.
[26] *Gardener and Another v Walters NO and Another [2002] 3 All SA 702 (C).*
[27] Cilliers A (2002) at 53.
[28] Cilliers A (2002) at 54.
[29] Banks, creditors and shareholders. Gardener and Another v Walters NO and Another [2002] 3 All SA 702 (C).
[30] *Gardener and Another v Walters NO and Another [2002] 3 All SA 702 (C).*
[31] McLachlan T, *Ex-chief executives of Leisurenet found guilty of fraud to the tune of R12 million*, The Sowetan 14 Feb 2007 available at http://www.sowetanlive.co.za/sowetan/archive/2007/02/14/ex-chief-executives-of-leisurenet-found-guilty-of-fraud-to-the-tune-of-r12-million accessed on 30 August 2016.
[32] *Gardener and Another v Walters NO and Another [2002] 3 All SA 702 (C).*

controlling management of corporations and were incapable of effectively holding auditors and boards accountable. A further review of corporate practices was needed in South Africa. As a result, the King Report 2009, briefly discussed below, moved from the 'comply or explain' approach in the King Report 2004[33] to the 'apply or explain' approach, which requires the application of the mind and effectively discourages a mere 'tick-box' approach to corporate governance implementation.[34] The various King Reports are briefly discussed below.

4.6. The King Reports on corporate governance

4.6.1. The King Report on Corporate Governance 1994[35]

Corporate governance was institutionalised in South Africa by the publication of the King Report on Corporate Governances which went further than the financial and regulatory aspects of corporate governance as it advocated an integrated approach to good governance.[36]

The committee, commonly referred to as the King Committee, was established in 1992, convened by the Institute of Directors of Southern Africa and chaired by Mervyn King, an attorney. The committee produced a report[37], released in 1994 which was innovative and one of the earliest in an emerging economy[38] as South Africa had recently re-entered the global economy.

The committee's terms of reference went further than those of the Cadbury Committee[39] in that they included a Code of Ethical Practice for business enterprises in South Africa. The situation in South Africa at the time had to be considered by the

[33] See 4.6.2
[34] Cassim et al (2011) at 434.
[35] Institute of Directors in Southern Africa, 29 November 1994
[36] Singh S "*Balancing the Interests of Shareholders and Stakeholders through Corporate Governance",* Blanpain R (ed) 2011, *Rethinking Corporate Governance: From Shareholder Value to Stakeholder Value () at 343.*
[37] King Report 1994
[38] Malherbe S and Segal N (2001), *Corporate Governance in South Africa* at 56
[39] Financial reporting and accountability, good practice concerning the responsibilities of executive and non-executive directors, the case for audit committees, the principal responsibilities of auditors and the links between shareholders, boards and auditors

committee in that they had to consider those from previously disadvantaged communities.

Five task groups were created to consider five specific areas of corporate governance[40] namely:

- Director task group dealt with executive and non-executive directors' responsibilities and information availability to stakeholders. It kept in line with the Anglo-American approach[41] of disclosure as the main means of company regulation;
- The Audit task group focused on the role of the auditors and the appointment of the related committees[42] as well as the interim report;
- The Stakeholder Links task group explored the links between various stakeholders;
- The Ethics task group developed the Code of Conduct which set out the requisite ethical practices in business; and
- The Compliance task group considered the acceptance and implementation by affected parties.

In compiling its report, the committee relied heavily on the Cadbury Code as a guideline for structure and content. Regarding contact, a governance ideal would be determined in terms of the Cadbury Code and where necessary, considering circumstances prevailing in South Africa as required by their terms of reference, adapt or deviate from the approach.[43]

The purpose of the King Report 1994 was to promote the highest standard of corporate governance in South Africa[44] and successfully raise public awareness of

[40] King Report 1994 at 3
[41] See chapter 2
[42] Audit, remuneration and nomination committees.
[43] Corporate Governance in South Africa at 57 – 58: "The two major deviations from the Cadbury Code…the requirement that non-executive directors be independent of management is abandoned and the requirement that the chairman be non-executive is watered down.
[44] King Report 1994

corporate governance.[45] Some recommendations contained in the report have been surpassed by legislation[46] and some applicable sections in such legislation are briefly set out below.

4.6.2. King Report on Corporate Governance for South Africa 2002

Following changes in South Africa, including democratic elections and becoming a fully-fledged member of the international economic community, there was a need to review corporate governance in the country.

Task teams were once again set up to review specific areas of corporate governance[47] namely:

- The Boards and Directors task team that considered board practices, status and responsibilities relating to executives, non-executive and independent directors and remuneration;
- The Accounting and Auditing team considered developing auditing practices, accounting standards and the requisite auditors' skills for reporting non-financial aspects;
- The Internal Audit, Control and Risk Management task team reconsidered roles, functions, scope and status of internal auditors in relation to international best practice and further considered risk management for boards and companies;
- The integrated Sustainability Reporting task team had to consider non-financial reporting including stakeholder engagement, ethics and ethical reporting as well as social transformation; and lastly
- The Compliance and Enforcement task teams considered supervision and enforcement of statutory and regulatory provisions and improve, through recommendations, compliance with guidelines relating to corporate governance.

[45] Corporate Governance in South Africa at 59
[46] Some of these include the Labour Relations Act, the Companies Act, the Banks Act and the Employment Equity Act.
[47] King Report 2002 at 17

4.6.3. King Report on Corporate Governance in South Africa 2009

The need for a new report followed the promulgation of the new Companies Act 71 of 2008 as well as transformation in international governance.[48] The Report applies to all entities incorporated in South Africa whereas the previous reports were mandatory for JSE listed companies.[49] This time around, 11 subcommittees were established.[50]

Compliance with the statutory 'one size fits all' approach as followed in the United States which requires companies to 'comply or else' is a costly exercise. For this reason, South Africa and other Commonwealth countries opted on a 'comply or explain' approach through a combination of codes of principles and practice and legislation of some aspects.[51]This is the hybrid system. This comply or explain approach has further morphed into different approaches, with South Africa evolving into 'apply or explain' which requires consideration of the application of such principles and recommendations.

4.7. Legislation

4.7.1. The Companies Act[52]

The King Report 2002[53] set out the Code of Corporate Practices and Conduct[54] as well as Recommendations requiring Statutory Amendment amongst other actions.[55] The Companies Act incorporated many of these recommendations, some of which will be discussed below. Although the new Companies Act deals with other aspects of corporate governance such as transparency and accountability this section is

[48] King Report 3 at 4; Cassim et al (2011) at 433.
[49] Cassim et al (2011) at 434
[50] Boards and directors, accounting and auditing, risk management, internal audit, integrated sustainability reporting, compliance and stakeholder relationships, business rescue, fundamental and affected transactions, IT governance; alternatively dispute resolution and editing.
[51] King Report 2009 at 5. Cassim et al (2011) at 434 Corporate governance practices in South Africa are voluntary, similar to the Commonwealth Countries and the European Union.
[52] Act 71 of 2008
[53] Discussed at 4.6.2
[54] King Report 2002 21 – 45.
[55] King Report 2002 46 – 153.

limited to dealing with specific aspects of corporate governance namely, the governance of companies, company secretaries and auditors

4.7.1.1. Governance of companies

The governance of companies is dealt with by Part F of Chapter 2 in the Companies Act. Chapter 2 deals with the 'Formation, administration and dissolution of companies'.

Sections 58 to 65 deal with shareholders, more specifically regarding their rights at meetings while Sections 66 to 78 deal with directors[56], their appointment, removal and board meetings. Section 75 deals with potential conflict of interests as it requires a director to disclose any personal financial interests, in advance, where possible.

The above sections of the Act deal with clause 2 of the Code as well as Section 1 of the recommendations requiring statutory amendment.

4.7.1.2. Company secretary

Chapter 3 of the Companies Act deals with 'Enhanced Accountability and Transparency' with Part B the applicable section relating to company secretaries. The appointment of a company secretary is mandatory for a public company or state owned company.[57]

Their duties are laid out in Section 88(2) of the Act and include providing guidance regarding directors' duties, responsibilities and powers as well as reporting to the board regarding any failure of compliance with the Memorandum of Incorporation, rules of the company or the Companies Act.

These sections incorporate clause 2.10 of the Code.

[56] Defined in section 1 of the Act as "a member of the board of a company as contemplated in Section 66, or an alternate director of company and includes any person occupying the position of a director or alternate director, by whatever name designated."
[57] Section 86.

4.7.1.3. Auditors and audit committee

These sections also fall under Chapter 3 of the Act with Part C and Part D dealing with Auditors and Audit Committees.

Section 90 to section 93 deal with the appointment, resignation, rotations, rights and restricted functions of auditors. Section 94 deals with the audit committee and applies concurrently with section 64 of the Banks Act.[58] Members of the audit committee are required to be directors[59] not involved in the day to day management of the company's business.[60] They must, among their other duties, nominate for appointment as auditors of the company, a registered auditor who, in their opinion is independent of the company.[61]

These sections deal with clauses 4 and 6 of the code as well as section 3 and section 5 of the recommendations requiring statutory amendment.

4.8. Present status

Despite major strides in the development of corporate governance in South Africa, the application of principles remains largely voluntary. As it may be difficult and expensive for companies to comply with different legislation, standards and codes this may encourage companies to do the bear minimum in implementing corporate governance principles and follow the "tick-box" approach instead of making corporate governance part of their company culture. Recent difficulties at some companies show that despite how far corporate governances has come, there is still a long way to go.

[58] 94 of 1990. Section 64 deals with the Audit Committee of a bank. S64(1) …the board of directors of a bank and controlling company shall appoint at least three of its members to form and serve on an audit committee. S64(2) the audit committee shall (a) assist the board of directors (i) in its evaluation of the adequacy and efficiency of internal control systems, accounting practices…(aA) in accordance with section 90 of the Companies Act, nominate a registered auditor who is independent of the bank or controlling company, for appointment as an auditor of the bank or controlling company.
[59] Section 94(4)(a) of the Companies Act.
[60] Section 94(4)(b)(i) of the Companies Act.
[61] Section 94(7)(a) of the Companies Act.

The recent events at South African Airways such as the failure to release financial records for a protracted period and financial mismanagement are an example of a corporation exhibiting poor governance. There were calls by the Finance Minister, for an all new Board of Directors at South African Airways. Another recent example is the event at the South African Broadcasting Corporation (hereinafter referred to as "the SABC"). Some examples of poor governance at the SABC were seen to be financial mismanagement and an unqualified board.

Having regard to some examples above, it does not appear corporate governance has reached a point where it can adequately prevent further collapses without intervention. Aside from poor implementation of corporate governance principles, other factors such as nepotism, fraud, preferential treatment in allocating tenders and increased levels of corruption means there is still a great risk of future corporate failures unless such situations are addressed.

4.9. Conclusion

As with the Cadbury Regulations, the King Report follows the "comply and explain" approach in that companies on the Johannesburg Stock Exchange in South Africa are mandated to include the extent of compliance with the code in their annual reports. Certain non-compliance is criminalised through legislation and other non-compliance issues are required to be explained by the non-complying institution with regards to aspects of the King report. As can be seen, South Africa has taken a proactive approach in the governance of corporate entities in that government initiated a commission to consider the major corporate collapse and thereafter present their findings and make recommendations. The King Report of 1994 seems to be pivotal in South Africa's corporate governance implementation and growth throughout the years. The effectiveness of this report in corporate governance can be seen by the subsequent King Reports which have been published since the initial King Report following the significant economic strides South Africa has made since 1994.

Although South Africa has adopted a principle based, apply or explain approach to corporate governance, many principles have been codified in law. The development of corporate governance in South Africa showed deficiencies in the existing company law regime and how same could be addressed. The new Companies Act codifies various aspects of corporate governances with a great emphasis being placed on the Board of Directors, other stakeholders and financial statements released by the company among others and strengthened corporate governance principles for private sector entities.

The following chapter will set out a summary of the dissertation, conclusions and recommendations.

Chapter 5: Summaries and Conclusion

5.1. Introduction

This dissertation sought to determine how the development of corporate governance in South Africa has been influenced by corporate failures as well as foreign law. This was done by looking at international jurisdictions, their corporate failures and their response to such failures as well as by looking at corporate failures in South Africa and the countries approach to corporate governance. This dissertation addressed how both the United Kingdom and the United States of America responded to corporate failures and how corporate governance has developed in South Africa. This chapter will review and summarise the dissertation and make recommendations.

5.2. Summary of findings

Chapter 1 provided a general overview and contextual background, set out the aims of the dissertation as well as the research questions to be addressed and the methodology to be followed.

In chapter 2, various definitions of the principle of corporate governance were set out and discussed.[1] The definition set out in the Cadbury Report and the King Report, the system by which companies are directed and controlled, was seen to be the authoritative definition.[2] However, the wider and more encompassing definition contained in the OECD principles better describes the trend of corporate governance. The principles of good corporate governance as set out in the King Report and OECD principles were briefly set out and discussed[3] and further, how South Africa has endeavoured to incorporate and implement these principles. It was also highlighted that good governance assures that corporations are operated and controlled while ensuring the

[1] Chapter 2 at 2.1
[2] Chapter 2 at 2.1
[3] Chapter 2 at 2.2

consideration of stakeholder interest. The chapter also addressed the importance of corporate governance[4] and discussed the main applicable models and how South Africa has adopted a modified Anglo-American model of corporate governance due to the country's colonial history.[5]

In Chapter 3, the development of corporate governance in the United Kingdom and the United States of America was discussed. A chronological summary of the corporate governance events in these two jurisdictions was set out.[6] A brief discussion of the corporate failures these jurisdictions experienced and the governments responses to such failures such as the establishment of committees to review the causes and make recommendations that soon became accepted principles as well as legal reform[7] were set out. The chapter briefly discussed the Sarbanes-Oxley Act and linked the important provisions to scandals that necessitated the drastic approach to corporate governance. The principle-based comply or explain approach in the United Kingdom was compared against the "comply or else" legislative approach in the United State of America.

In Chapter 4, the position in South Africa was briefly discussed. Major corporate failures were also briefly discussed.[8] Some, such as the Masterbond group of Companies,[9] had a direct result of the setting up of a commission of inquiry to investigate the causes of the collapse and make recommendations on a way forward to ensure the same event did not occur again.[10] The various King Reports that greatly developed corporate governance in South Africa were discussed and the approach of "comply or explain" was introduced and applied.[11] Applicable sections in the new Companies Act were briefly set out and how these have incorporated aspects of the King Reports.

[4] Chapter 2 at 2.3
[5] Chapter 2 at 2.4
[6] Chapter 3 at 3.2
[7] Chapter 3 at 3.8
[8] Chapter 4 at 4.2, 4.5 and 4.5
[9] Chapter 4 at 4.2
[10] Chapter 4 at 4.3 the Commission if inquiry into the affairs of Masterbond Group and Investor protection in South Africa.
[11] Chapter 4 at 4.6

5.3. Conclusion

The development of corporate governance in South Africa has been greatly influenced by foreign law. In the United Kingdom, major changes in corporate governance followed dramatic corporate failures. This was also the case in the United States of America. In contrast, in South Africa the development was not necessitated by major corporate scandals save for the setting up of the Nel Commission that followed the collapse of the Masterbond Group of Companies. The need for corporate governance in South Africa was necessitated by the changing socio-economic status in the country as well as the country re-entering the international economic space after apartheid.

The King Reports sought their inspiration from the Cadbury Report and relied on it for its structure and has, in developing corporate governance principles, incorporated internationally recognised principles such as those contained in the OECD principle and has also taken lessons from jurisdictions that have developed corporate governance over a longer period and further learnt from their corporate failures. The applicable model of corporate governance applied in South Africa, although slightly modified, is like that applied in the United Kingdom and the United States of America. Where the United Kingdom is predominantly principle-based and the United States of America is predominantly legislative in nature, South Africa has opted to adopt a hybrid approach to corporate governance with many aspects being codified in legislation while leaving some aspects as contained in the King Report for self-regulation.

Although South Africa has drawn great inspiration from more experienced jurisdictions, an African approach to corporate governance is recommended that considers the continents' history and culture. An African model would be one that aligns itself with "African" social norms and further, successfully balances the interests of shareholders and stakeholders with a country's cultural background.

In many developing African countries, businesses may not necessarily have developed to an extent to adequately implement international standards of corporate governance as many may still be relatively informal and largely based on personal relationships with individuals and not with banks or financial institutions. An African approach should be able to acknowledge and appreciate such businesses and enable them to, albeit at an entry level, implement basic standards of corporate governance and allow them to shift towards international standards as they progress without being forced to follow a 'tick-box' approach to governance as it stands.

Within a South African context, to address historical inequalities legislation that is largely voluntary in its application has been enacted, the most recent being the Broad Based Black Economic Empowerment Act, 53 of 2003. An African model would ideally incorporate the principles of similar legislation. South Africa, as a major economy and a leader in corporate governance reform, should move away from the colonial influence and lead in the development of a unique model of corporate governance. It is hoped the new King Report will move towards incorporating the concept of 'Ubuntu' into corporate governance.

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