
The impact of reported corporate governance disclosure on the financial performance of companies listed on the JSE

1. INTRODUCTION

Large scale surveys of UK (CBI, Deloitte and Touche, 1996) and US (Daily and Dalton, 1994) companies a decade ago suggested that the majority of respondents felt that the heightened focus on corporate governance had no positive impact on corporate performance. The general feeling emerged that sound financial performance excuses poor governance (Pic, 1997).

However, interest in corporate governance has grown tremendously in the past decade. Corporate scandals, environmental concerns and globalisation have all played their part in raising shareholder and public awareness of how companies should be governed. The recent international disasters in financial reporting including Enron and Worldcom in the US, Parmalat in Italy, the Maxwell saga in the UK, Daewoo in Korea, Leisurenet and Regal Bank in South Africa demonstrated the growing need for transparency in governing companies.

In many respects, corporate governance should be viewed by investors as a component of equity risk (Deutsche Bank Report, 2004). Furthermore, it can be argued that corporate governance is particularly relevant in developing economies, where the injection of foreign investment is essential to economic growth (Vaughn and Ryan, 2006).

In more recent studies, the McKinsey Consulting Group found that investors in certain emerging market countries would pay a premium of 23 % and 28 % for shares in a company with "good" corporate governance, as opposed to a poorly governed company with similar financial performance (Rose, 2003). Consequently, corporate governance will increasingly affect both a country's economic stability and its growth prospects.

While many academics have stated that sound corporate governance practices will reduce the risk of corporate failure (Collis and Montgomery, 2005), the key question faced by investors is rather the issue of whether an investment in sound corporate governance practices by a company results in an increase in shareholder value.

This study seeks empirical evidence to support the notion that good corporate governance will result in direct financial benefit to shareholders.

2. LITERATURE REVIEW

2.1 Background

The ordinary meaning of the term governance is the manner of directing and controlling the actions and affairs of an entity (King, 2006).

While issues in corporate governance have risen to prominence recently, the origins of corporate governance go back many years to the time when ownership and management of businesses first became separated. It was necessary for owners to implement mechanisms to monitor the performance of managers. Effective corporate governance reduces the control rights shareholders confer on managers, increasing the probability that managers invest in positive net present value projects (Shleifer and Vishny, 1997).

Extensive empirical research has been conducted internationally on the relationship between corporate governance and financial performance within countries (Bauer, Nadja and Otten, 2003; Black, 2001; Chen, Chen and Wei, 2003; Drobetz, Shillhofer and Zimmerman, 2004; Gompers, Ishii and Metrick, 2003; Immik, 2000).

2.2 Governance in South Africa

When foreign financial institutions returned to South Africa in 1994, investors demanded reform in both corporate structures and corporate governance practices in exchange for their infusion of capital (Kakabadse and Korac-Kakabadse, 2002). The period of dramatic political reform, intense market pressure and global scrutiny left South Africans with the understanding that high-quality corporate governance is essential for developing countries and the updated and comprehensive King Committee Report (King II) was issued in 2002.

The primary objective of the King Report is to promote the highest standards of corporate governance in South Africa by advocating an integrated approach to governance in the interest of a wide range of stakeholders (Barrier, 2003).

In 2003, the JSE listing rules were comprehensively updated to require listed companies to comply with the

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recommendations contained in King II or to explain their lack of compliance (Bauer *et al.*, 2004).

2.3 Developing a governance scorecard

The King Committee identified seven primary characteristics of good corporate governance: discipline, transparency, independence, accountability, responsibility, fairness and social responsibility – and further developed and integrated these fundamental principles into tangible guidelines for minimum standards of corporate governance (Barrier, 2003).

Internationally, Standard & Poor's developed a company Corporate Governance Score (CGS) in 1997, reflecting their assessment of a company's corporate governance practices and policies. Standard & Poor's analysed four key components when evaluating a company's corporate governance standards: ownership structure and influence, shareholder rights & stakeholder relations, financial transparency and information disclosure, and board structure and process (Bradley, 2004).

2.4 Corporate governance and shareholder returns

Although there is growing literature linking corporate governance to company performance (Bauer *et al.*, 2003; Black, 2001; Chen *et al.*, 2003; Drobetz *et al.*, 2004; Gompers *et al.*, 2003; Immik, 2000), the diversity of results is also growing. This can be partly explained by widely differing methodologies, the measurement of performance and differences in governance standards throughout the world.

Good corporate governance can serve as a tool for attracting investors as well as influencing what will be paid for a stock. The average premium investors are willing to pay for good governance has been estimated to be between 11% and 16% in the US (Agrawal, Findley, Greene, Huang, Jeddy, Lewis, and Petry, 1996). In Europe Brown and Caylor (2004) showed that better corporate governance is related to better firm performance, and his study concluded that better governed firms perform better than poorly governed firms.

Gompers *et al.* (2003) found a significant association between a corporate governance index built from 24 provisions and stock returns. More specifically, they found that investors who are investing in firms, which are ranked high, based on this index, are on average earning 8,5 % abnormal returns. They also observe that weaker governance measures exhibit lower firm valuations, while in addition they are more engaged in acquisitions and capital investments.

Black (2001) found a significant association between corporate governance behaviour, as developed by Brunswick Warburg (a Russian investment bank), and

the market value for a relatively small sample of 21 Russian firms using data of September 1999. He argued that in USA, there is no effect or an economically small effect between corporate governance and market values, since the difference in corporate governance in US firms is not significant. In contrast, Russian companies, of which corporate governance differences are much larger, have more measurable effects on firm value. The same argument could apply for other developing stock markets as well.

In terms of developing markets, Klapper and Love (2003) found evidence for the relationship between firm's performance and corporate governance. By employing a corporate governance ranking, developed by Credit Lyonnais Securities Asia, and using a sample of 495 companies from 25 developing markets they found that a positive relationship existed between the corporate governance ranking and financial ratios.

In the case of Germany, Drobetz *et al.* (2004) concluded that a corporate governance rating is positively correlated with firm value. They discovered that an investment strategy that bought companies with high corporate governance ratings and sold short companies with a low rating, would have gained 12% annualised abnormal returns for the sample period.

With regard to the effect of corporate governance on the expected rate of return for shareholders, Lombardo and Pagano (2000) suggested that the expected rate of return should compensate investors for expected monitoring, auditing, and other private costs associated with different corporate governance systems. In their model, stronger corporate governance mechanisms in firms reduce the expected return on equity to the extent that it reduces the shareholders' monitoring and auditing costs.

2.5 Corporate governance and firm value

Several studies have examined the separation of CEO and chairman, positing that agency problems are higher when the same person holds both positions. Using a sample of 452 firms in the annual Forbes magazine rankings of the 500 largest U.S. public firms between 1984 and 1991, Yermack (1996) shows that firms are more valuable when the CEO and board chair positions are separate.

Immik (2000) managed also to relate the corporate governance to the performance of various firms in Europe. More specifically, by using a corporate governance ranking developed by a firm called Deminor, he found that this ranking is positively correlated with ratios such as price-to-book value, return on assets, and return on sales. In the case of Switzerland, Beiner *et al.* (2004) found a positive relationship between a measure of corporate governance and valuation ratios.

Effective corporate governance reduces “control rights” shareholders and creditors confer on managers, increasing the probability that managers invest in positive net present value projects, (Shleifer and Vishny, 1997) and suggesting that better-governed firms will have a market premium.

There are a number of possible reasons why good corporate governance could lead to an increase in firm value. Fama and French (1992) documented that increased levels of governance lead to increased investor confidence, as there is a decreased risk of corporate mismanagement, fraud or negligence. La Porta, Lopez-de-Silanes, Shleifer and Vishny (2003) find that better shareholder protection is associated with higher valuation of corporate assets.

Finally, Black *et al.* (2003) concluded that corporate governance is important for explaining the market value of a complete set of Korean public companies. Their results also shed some light on endogeneity, an issue that plagues virtually all empirical studies in the field. They show that even moderate increases in the quality of firm-specific corporate governance causes substantial increases in the market-to-book ratio.

3. RESEARCH METHODOLOGY

3.1 Constructing a governance disclosure scorecard

Corporate governance is difficult to measure because of its subjectivity and intangibility with respect to several key issues, for example the true independence of a director. However, many aspects are factual, including the level of disclosure of compliance with a code of best practice.

A broad measure of corporate governance disclosure, the G-Score, was designed and developed exclusively for this research. The G-Score is based largely on King II principles and the Standard & Poors International CGS index.

The G-Score is a composite measure of 29 governance disclosure factors, encompassing seven corporate governance categories: board effectiveness, remuneration, audit & accounting, internal audit, risk management, sustainability and ethics. These categories and governance disclosure factors were selected after careful analysis of the principles outlined in the King II report, and after considering the practicalities and usefulness of each disclosure factor to a user.

A company's G-Score is calculated by assigning a 3 point discriminate scoring scale to each of the 29 governance disclosure factors. For example, for attributes where there is no evidence or disclosure in the annual report, 0 points are assigned, where the attribute does exist or is disclosed in annual report, 1 point is assigned and for instances where there is comprehensive disclosure and evidence of implementation/monitoring of practices, 2 points are assigned.

A total percentage score is then attained for each category, by taking the companies score divided by the maximum score attainable for that category. Table 1 provides an example of one category in the scorecard. Remuneration of directors, which has 5 governance disclosure factors, has a maximum score of 10 points. Therefore the score for this company of 8 points is translated into an 80% score for remuneration disclosure.

Table 1: G-Score extract – category 2, the remuneration of directors

No	Governance Disclosure Factor	Score	Max	%
1	Existence of remuneration committee	2	2	100%
2	Majority members are non executive	2	2	100%
3	Remuneration philosophy codified and disclosed in annual report	1	2	50%
4	Balance between guaranteed salary and performance element (share options)	1	2	50%
5	Full disclosure of individual director remuneration including benefits	2	2	100%
Governance Disclosure Points		8	10	80%

Table 1 shows an extract from the G-Score template. The disclosure of remuneration of directors is assessed through five independent governance disclosure factors, each with a possible maximum score of 2, depending on the level of disclosure. In this example, the company has scored 8 out of 10 for this category – a score of 80%.

The governance disclosure factors are scored on publicly available information. The annual report for each company was inspected as the first source of data, following which the company website was searched as a secondary source of information. Only information disclosed to the public was considered.

By applying this factual scoring methodology template to companies in South Africa, objective and quantifiable data was obtained. The resultant research provides for a comparable measure of corporate governance disclosure for companies listed on the JSE securities exchange in percentage format.

3.2 Measuring financial performance

The first financial performance measure used was annual average share price returns. Using closing share prices obtained from I-Net Bridge for period 30 June 2003 and 30 June 2006, the actual share price return for the 3 year period was derived for each of the sample companies selected. This was then translated into an average annual return for the period under review.

The second financial performance measure related to firm value. Using the methodology applied by Drobetz *et al.* (2004), the market-to-book value (MTBV) ratio was used as an indicator of firm value. The MTBV ratio is derived by taking the market capitalisation of the company divided by the book value of equity (total assets minus total liabilities) as per the balance sheet. A value of less than 1 could mean that the firm has not been successful in creating value for shareholders, while a higher ratio would indicate the firm has created significant value (Firer, Ross, Westerfield and Jordan, 2004).

The third measure or variable considered is the price/earnings (P/E) ratio. The P/E ratio is simply the share price divided by earnings per share (EPS). Since the P/E ratio measures how much investors are willing to pay per rand of current earnings, higher P/Es are often taken to mean the firm has significant prospects for future growth. It is generally true that firms with high growth rates and lower perceived risk levels trade at high P/E ratios (Firer *et al.*, 2004).

The MTBV and P/E ratios were obtained for each sample company from Standard Bank Online Securities (www.standardbank.co.za, accessed 13 October 2006). All values are taken as at 30 June 2006.

3.3 The population and sample selection

The time period chosen for this investigation was 30 June 2003 to 30 June 2006. This 3 year period, although shorter than most studies of this nature, allows for a significant lag period for companies to have reviewed and implemented King II

recommendations into their financial reports and disclosures.

In order to provide for a cross-section of companies on the JSE, and to avoid selection bias, 9 sectors covering all major industries on the JSE including mining, manufacturing and services were selected. All the companies within each of the 9 sectors on the JSE were chosen for analysis. This methodology allows for an exploration of the relationship between governance disclosure and share returns or firm value within each industry sector. Porter (1998) makes a strong argument that the competitiveness and profitability of companies are directly effected by the industry dynamics in which they operate. Therefore, by assessing the impact of governance disclosure within industry sectors, there is an elimination of the effect of industry competitiveness or dynamics from the analysis.

Companies within each sector were eliminated from the sample if they had initially listed on the JSE after 30 June 2003, or if they had been de-listed during the period under review. The remaining 97 companies from the 9 sectors formed the sample and were scored for governance disclosure using the G-Score framework in two periods, 2003 and 2005. An average G-Score for the period was calculated for each company.

3.4 Research methodology

The following propositions were considered in this study:

- P_{1A} – South African companies with high levels of corporate governance disclosure achieve higher than average returns for shareholders over time.
- P_{1B} – South African companies with low levels of corporate governance disclosure achieve lower than average returns for shareholders over time.
- P_2 – South African companies with high levels of corporate governance disclosure will achieve higher firm valuations than companies with low levels of corporate governance.

Apart from the different governance background in the US, this methodology followed that of Gompers *et al.* (2003), who constructed different investment portfolios, based on the level of governance disclosed by each company.

The companies were grouped into their respective sector on the JSE, and based on their average G-Score for the period under review. The companies were then ranked from highest G-Score to lowest. Portfolios of shares were selected for each sector, High G-Score portfolios (High), consisting of companies with a G-Score above 75% and Low G-

Score portfolios (Low), consisting of companies with a score of less than 50%.

Assuming equally weighted portfolios, the average return for the High and Low portfolios in each sector was derived for the 3-year period. An average return for the sector was obtained by calculating an overall return for the sector from the sector indices for the same time period. The average return for the High and Low portfolios was compared to the sector index and the ALSI40 index to determine whether above average or below average returns were generated.

4. RESULTS

4.1 General findings

The data reveals a wide range of corporate governance disclosures in South Africa. The highest recorded mean score was 91% and the lowest was

20%. Although the mean G-Score over the period under review was 61%, indicating an above average measure of compliance and disclosure, there are definite outliers in terms of companies offering poor disclosure levels overall. 32 of the 97 companies selected had a mean disclosure score of less than the 50%, which translates into less than half of the requirements of the G-Score framework. Figure 1 is a histogram of the range of scores recorded. It shows that the disclosure rating to be skewed to the left. More than 40% of the firms have a rating greater than 60%, and it is encouraging that the highest frequency falls within the 60% to 70% scoring range. It shows that an adequate spread of companies were selected, giving a wide range of G-Scores, mitigating against a possible selection bias in the sample.

The overall G-Score percentages and changes thereof from 2003 to 2005 are disclosed in Table 2.

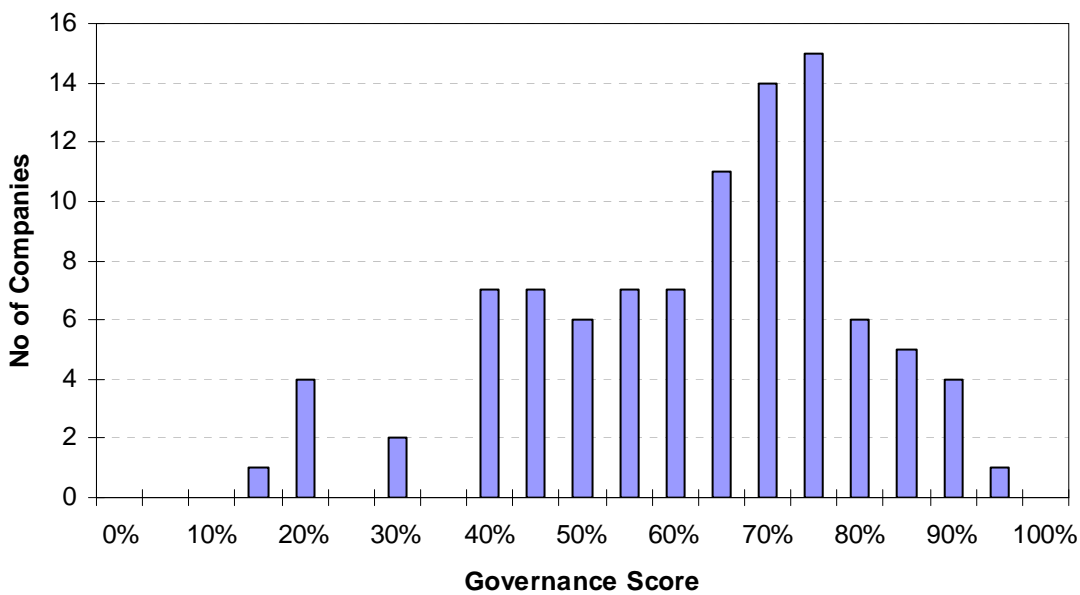


Figure 1: Distribution of governance scores

Figure 1 is a histogram of the governance scores, showing the frequency in each range. The graph is skewed to the left, indicating the majority of companies having a disclosure score in excess of 60%.

Table 2: Governance disclosure categories

Governance Category	2003 Mean	2005 Mean	% Change
Board Effectiveness	66%	70%	7%
Remuneration	69%	73%	5%
Accounting & Auditing	52%	56%	7%
Internal Audit	44%	47%	7%
Risk Management	57%	62%	8%
Sustainability	57%	67%	16%
Ethics	58%	60%	4%
Mean	58%	62%	8%

Table 2 indicates the mean score for each of the 7 categories of governance disclosure. The data indicates the average score for both years of assessment. The final column shows the percentage change from 2003 to 2005. From the table, the best and worst disclosed categories are clearly visible, as is the general trend toward better governance disclosure.

A comparison of scoring from the two assessments shows an improvement of 7% in the level of governance disclosures for the sample. This indicates an increase in the quantity and quality of corporate governance issues disclosed by companies, as they begin to understand and implement many of the requirements of King II. It is a reasonable expectation that companies will continually seek to improve and enhance the level of disclosure and reporting of non financial information over time.

The biggest improvement occurred in the level of sustainability reporting, particularly for mining sectors. The focus of sustainability reporting is the disclosure of the company's commitment to social, environmental and safety responsibilities. This would appear to align to current trends in environmental reporting worldwide. Another plausible reason for the surge in sustainability scores in 2005 is the implementation of BEE policies and initiatives over the 3 year period, as this is also a high scoring opportunity, where disclosure of BEE transactions and plans is comprehensive.

The lowest scoring category in each year of assessment was internal audit, indicating that not all public companies understand the importance and role of their internal audit functions. Certain companies did not have a separate internal audit division, while others did not emphasise the importance of disclosing the internal audit charter and function within the organisation in the annual report. The highest disclosure category was remuneration of directors. This is understandable, given that the JSE listing requirements require disclosure of director's emoluments per director (JSE Listing Requirements, 2003). Further to this is the recent media exposure of director's remuneration in the financial press.

Of concern, is the low score registered for Accounting & Audit disclosure. This category included aspects of governance relating to the independence and powers

of the audit committee, an important vehicle for the monitoring of audit scope and findings (King, 2006). Several recent studies (discussed below) have looked at the role of the audit committee in reviewing key audit findings and ensuring implementation of corrective action, prior to a potential fraud or gross negligence.

There are mixed findings on the importance of these factors. Dulewicz and Herbert (2004) found evidence that the existence of a strong independent audit committee contributed positively to a company's operating performance. They also considered the role and impact of the independent auditor performing non-audit related services. This was one of the reasons cited for various corporate failures in the US, particularly in the case of Enron, where the audit firm concerned performed several management services.

Klein (2002) documents a negative relation between earnings management and audit committee independence, and Anderson, Mansi, and Reeb (2004) find that entirely independent audit committees have lower debt financing costs. Frankel, Johnson and Nelson (2002) show a negative relation between earnings management and auditor independence (based on audit versus non-audit fees), but Ashbaugh and Mayhew (2003) dispute their evidence.

It should also be noted that an equal weighting scheme for the different categories makes no attempt to accurately reflect the relative importance of individual governance practices, but it has the advantage of being transparent and allows easy interpretations. To assess whether an equal weighting scheme is appropriate, Table 3 shows the correlations among the seven corporate governance disclosure categories. All correlations are positive, but not always very high.

Table 3: Correlation matrix for governance disclosure categories

	I	II	III	IV	V	VI	VII
Board Effectiveness (I)	1,00						
Remuneration of Directors (II)	0,54	1,00					
Accounting & Auditing (III)	0,60	0,56	1,00				
Internal Audit (IV)	0,56	0,50	0,57	1,00			
Risk Management (V)	0,66	0,63	0,58	0,58	1,00		
Sustainability (VI)	0,71	0,61	0,57	0,54	0,66	1,00	
Ethics (VII)	0,29	0,28	0,26	0,07	0,32	0,29	1,00

This table represents pairwise correlations for the 7 categories of governance disclosure, board effectiveness (I), remuneration (II), accounting & auditing (III), internal audit (IV), risk management (V), sustainability (VI) and ethics (VII).

Table 3 further indicates that the decision not to weight categories avoids double-counting by not assigning undue weights to some governance practices (while neglecting others), which would lead to biases in the aggregate score.

From the table it appears as though disclosure relating to the companies' code of ethics is least correlated to the other categories, whilst categories are highly correlated to board effectiveness. The aggregate corporate governance score consists of these seven categories: board effectiveness (I), remuneration of directors (II), accounting & auditing (III), internal audit (IV), risk management (V), sustainability (VI) and ethics (VII).

An interesting observation is how the level of reporting differs per category of disclosure. For example, Table 4 reveals the best disclosed category across the sample to be remuneration of directors with a mean of 71%, while in contrast the lowest scoring category is internal audit at 49%, providing a range of 22%. Perhaps the most startling finding is that internal audit, risk management, sustainability and ethics all have a minimum score of 0%, which indicates instances where no disclosure relating to this category was mentioned in the company's annual report.

There is a positive correlation between the average G-Scores of each of the 97 companies and the annual share price return of 0,27. The sustainability (VI) category indicates the highest positive correlation, while internal audit (IV) and risk management (V) have the lowest correlation with share price return.

In terms of a market premium or excess firm value, the market-to-book value (MTBV) ratio has a positive correlation of 0,40 and in terms of expected future value in the form of earnings, the P/E ratio has an overall correlation of 0,23.

Figures 2 and 3 display the scatter plots for ordinary least square regressions of the corporate governance rating (G-Score) against annual share return and the market-to-book ratio, respectively. The correlations are reported in Table 4. The correlation co-efficients are

0,27 and 0,40 for the return and market-to-book value respectively. Supporting the propositions, there appears a positive relationship with the corporate governance rating in both cases. There are definite outliers in the sample, particularly in terms of high returns from certain companies during the period.

Figure 3 suggests that good corporate governance and higher firm valuations are related. As argued by Black *et al.* (2003), an important issue in the analysis above is endogeneity. If corporate governance was endogenously determined, we could not make an assessment of the causal connection. Firms with higher market values could simply be more likely to choose better governance structures.

Specifically, they can do so for two possible reasons. First, firm insiders believe that better governance structures will further raise firm value. Accordingly, there is a causal relationship, but ordinary least square coefficients will overstate the actual connection. Second, firms adopt good governance to signal that insiders behave well. For example, Klapper and Love (2003) argue that a growing firm with large needs for outside financing has more incentives to adopt better governance practices in an attempt to lower its cost of capital.

4.2 Segmenting results by sector

In order to isolate the effects of industry dynamics and competitiveness on financial performance, the 97 companies were sorted into 9 JSE sectors (identical to the JSE index classifications). The sector scores are shown in Table 5. The range between sectors is high, as with the overall population. The bank sector has by far the highest governance score in terms of mean G-Score, while Media and Publishing is the only sector to score below 50%. Most sectors have a mean G-score close to or above 60%, which is a positive sign of a move toward disclosure.

A possible reason for the high scoring banking and life insurance sector is the role of independent regulators such as the South African Reserve Bank (SARB) in fostering a culture of disclosure and transparency.

Banks are required to report financial and non financial information on a regular basis, and the additional reporting requirements result in a strong G-Score for this sector. As expected, the highest scoring category for banks is risk management (V) with a mean of 80 %, closely followed by life insurers in the same category at 77%. Risk management is an important aspect of SARB regulation for banks and furthermore the BIS Basel II Report (2004) makes specific reference to risk management disclosure.

Media and publishing scored a low 28% for internal audit, which contributed to their overall low mean of 47%.

In support of proposition 1A and 1B respectively, and following the methodology applied by Gompers *et al.* (2003), two portfolios were created for each sector, the High portfolio consisting of companies with a G-Score in excess of 75%, and the Low portfolio with companies that have a G-Score below 50%. These ranges were selected based on the mean and range of data collected in Table 5. Following a simple buy and hold strategy over the 3 year period, the annual average return for each portfolio is summarised in Table 7.

The results are remarkably consistent; the High portfolio outperforms both the Low portfolio and more significantly the index for each sector. Two exceptions

occur for media and publishing, and the IT sector, where no companies qualified for the High portfolio.

Table 8 calculates the excess return over the recorded sector index return. The column second from the right reflects the “above average” return achieved for the High portfolio, assuming the index return represents the average return. The above average return is particularly significant in the mining sectors, where large abnormal returns were available from the well governed companies.

An investment of R100 in the High portfolio of the general retail sector on 30 June 2003, would have grown to R170 by 30 June 2004. In contrast, a R100 investment in the Low portfolio of the same sector would have grown to R134 over the same period, a difference of 36 % per year.

What can explain this disparity? One possible explanation is that the performance differences are driven by differences in the riskiness or “style” of the two portfolios. Researchers have identified several equity characteristics that explain differences in realized returns. In addition to differences in exposure to the market factor (“beta”), a firm’s market capitalization (or “size”), book-to-market ratio (or other “value” characteristics), and immediate past returns (“momentum”) have all been shown to significantly forecast future returns (Drobetz *et al.*, 2004).

Table 4: Governance disclosure categories

	Mean	Min	Max	Correlation with Return	Correlation with MTBV Ratio	Correlation with P/E Ratio
Board Effectiveness (I)	68%	25%	95%	0,26	0,36	0,04
Remuneration of Directors (II)	71%	15%	100%	0,27	0,30	0,33
Accounting & Auditing (III)	54%	0%	100%	0,30	0,28	0,16
Internal Audit (IV)	49%	0%	100%	0,08	0,24	0,10
Risk Management (V)	59%	17%	100%	0,08	0,39	0,17
Sustainability (VI)	62%	0%	100%	0,33	0,40	0,12
Ethics (VII)	59%	0%	100%	0,11	0,16	0,26
G-Score	60%	15%	91%	0,27	0,40	0,23

Table 4 indicates the correlation the minimum, maximum and mean disclosure score in each category for the entire 3-year period under review, derived by taking an average score over the two assessments in 2003 and 2006. The table also shows the correlation between each category and the 3 performance measures, return, MTBV and P/E ratio.

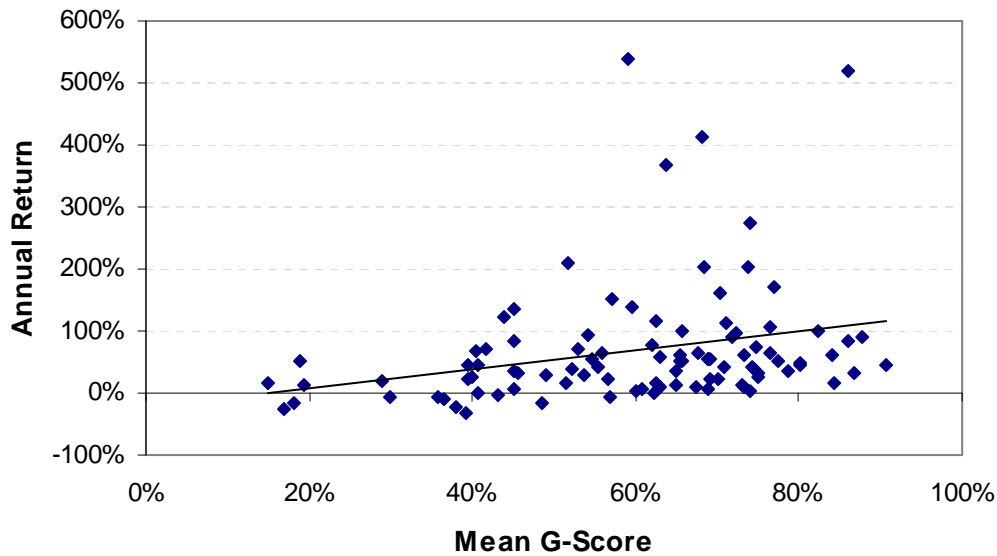


Figure 2: Scatter plot of governance scores and returns

Figure 2 is a scatter plot indicating graphically the relationship between governance disclosure (G-Scores) and the annual average return over the 3 year period under review. The graph reveals a trend line with a positive slope, indicating that higher scores lead to higher returns. There are several outliers, mostly represented by companies with super returns in the period.

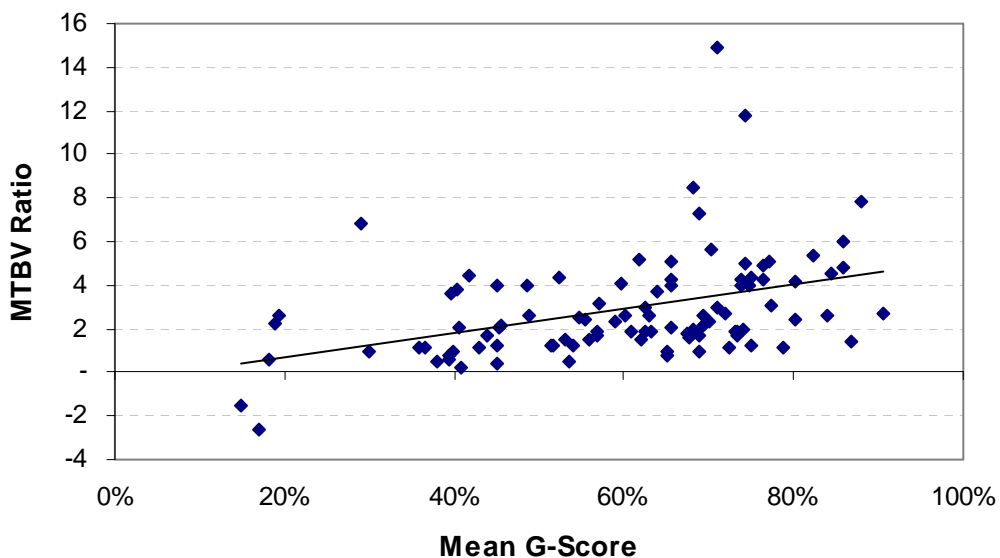


Figure 3: Scatter plot of governance scores and MTBV

Figure 3 is a scatter plot indicating graphically the relationship between governance disclosure (G-Scores) and firm value (MTBV ratio). The graph reveals a trend line with a positive slope, indicating that higher scores lead to higher firm value.

Table 5: Governance score by JSE sector

No	Sector	Firms	I	II	III	IV	V	VI	VII	G-Score	Min Score	Max Score
1	General Mining	13	66%	72%	54%	37%	51%	60%	42%	55%	29%	86%
2	Gold Mining	11	69%	68%	56%	41%	52%	69%	55%	58%	15%	86%
3	Construction	13	69%	75%	46%	46%	57%	69%	62%	61%	30%	88%
4	Food Producers	12	66%	71%	47%	49%	58%	60%	56%	58%	19%	77%
5	General Retail	18	68%	71%	63%	55%	68%	60%	57%	63%	18%	82%
6	Media & Publishing	5	64%	58%	44%	28%	47%	34%	55%	47%	19%	72%
7	Banks	7	77%	75%	59%	63%	80%	66%	71%	70%	41%	91%
8	Life Insurance	7	73%	71%	55%	57%	77%	72%	75%	69%	41%	87%
9	IT	11	63%	76%	55%	27%	49%	59%	73%	57%	43%	73%
Mean		97	68%	71%	53%	45%	60%	61%	61%	60%	28%	82%

This table provides a summary of governance disclosure score by JSE sector for each of the 7 disclosure categories: board effectiveness (I), remuneration (II), accounting & auditing (III), internal audit (IV), risk management (V), sustainability (VI) and ethics (VII). The governance scores are derived by taking a simple average for the 2003 and 2005 assessment periods. The table also indicates the number of companies and the overall governance score for each sector.

It also indicates the minimum, maximum and average governance scores for each sector. Banks and life insurance sectors score the highest, while media & publishing and general mining are the lowest scoring JSE sectors. The minimum score for all sectors is 15% and the highest is 91%, indicative of the broad range of governance disclosure on the JSE.

Table 6: Portfolio returns by sector

No	Sector	Fir-ms	Sector Index Return (A)	High Portfolio Firms	High Portfolio Return (B)	Low Portfolio Firms	Low Portfolio Return (C)
1	General Mining	13	63%	2	95%	6	60%
2	Gold Mining	11	16%	4	184%	4	-13%
3	Construction	13	66%	2	69%	3	20%
4	Food Producers	12	49%	1	51%	3	22%
5	General Retail	18	58%	3	70%	4	34%
6	Media & Publishing	5	37%	0	N/A	3	14%
7	Banks	7	43%	2	54%	1	45%
8	Life Insurance	7	33%	3	33%	1	0%
9	IT	11	50%	0	N/A	2	15%

Table 6 summaries the results of the portfolio analysis. For each JSE sector, all companies with a G-Score of greater than 75% were allocated to a High governance portfolio and all companies with a G-Score of less than 50% were allocated to the "Low" governance portfolio for the 3 year period under review (30 June 2005 to 30 June 2006). An average annual return was calculated for both the High and Low portfolios in each JSE sector. The High and Low portfolio return was then compared to the JSE Sector Index Return as published by the JSE for the same period. The JSE index return served as a proxy for "average" return for each sector. The N/A indicates that no company met the criteria for selection to the portfolio in that sector.

Table 7: Portfolio performance against sector index return

No	Sector	Firms	Sector Index Return (A)	High (B) – Index (A)	Low (C) – Index (A)
1	General Mining	13	63%	32%	-3%
2	Gold Mining	11	16%	168%	-29%
3	Construction	13	66%	3%	-46%
4	Food Producers	12	49%	2%	-27%
5	General Retail	18	58%	12%	-24%
6	Media & Publishing	5	37%	N/A	-23%
7	Banks	7	43%	11%	2%
8	Life Insurance	7	33%	0%	-33%
9	IT	11	50%	N/A	-35%

Table 7 indicates the difference in average annual return for each portfolio and the average index return published by the JSE for the 3 year period under review. The column second from the right derives the "above average" return for the high portfolio over the index (sector portfolio). The last column reveals the "below average" return for the low portfolio in comparison to the index (sector portfolio).

Table 8: Governance and firm value

No	Sector	Firms	Sector MTBV	High Portfolio MTBV	Low Portfolio MTBV
1	General Mining	13	2,85	4,55	3,08
2	Gold Mining	11	3,03	4,99	0,08
3	Construction	13	3,00	5,11	1,60
4	Food Producers	12	2,32	3,11	1,27
5	General Retail	18	3,59	4,80	2,06
6	Media & Publishing	5	2,86	N/A	2,15
7	Banks	7	2,66	2,64	2,08
8	Life Insurance	7	3,34	1,27	0,26
9	IT	11	1,92	N/A	1,67

This table uses the same portfolio model and criteria as Table 6 and 7, but now considers the relationship to firm value. The MTBV (Market to Book Value) ratio is used as a proxy for firm value. A higher MTBV ratio indicates higher firm value (Firer *et al.*, 2004). Again, the High portfolio ratios are compared to the sector average and similarly with the Low portfolio. The data indicates that in all sectors, the high portfolio has higher than average firm value and the low portfolio has below average firm value.

If the High portfolio differs significantly from the Low portfolio in these characteristics, then all these factors could be seen to contribute to this out performance. However, it is unlikely that the high portfolio will differ from the low portfolio in all of these characteristics for all 9 sectors. The results from Table 7 would support this. The column on the far right represents the below average returns from the Low portfolios. In 8 out of the 9 sectors, the Low portfolio has a return below that of the JSE sector index.

The data in Tables 6 and 7 provide support for the proposition that better governed firms will experience above average returns and the converse for poorly governed firms. Following the identical approach for firm value as for returns, Table 8 summarises the results of using the market-to-book value (MTBV) ratio as a proxy for firm value. The results provide support for proposition 2, South African companies with high levels of corporate governance disclosure will achieve higher firm valuations than companies with low levels of corporate governance.

5. DISCUSSION

Although there is growing literature linking corporate governance to company performance, there has been a diversity of results from around the world. Dalton, Daily, Ellstrand, and Johnson (1998) commented that most governance studies are fraught with a variety of limitations, including inconsistent measurement of performance, differing governance standards worldwide and the additional impact of contextual factors.

Contextual factors such as societal, political and economic structures and legal financial systems must have an impact on corporate governance and company performance. Evidence of this is the fact that institutional investors are prepared to pay a premium

of 16% to 18% for good governance in the US and UK, 27% in Venezuela or Indonesia and 22% in Italy (IRB, 2000) suggesting that the geo-political dimension of corporate governance is largely ignored.

This has interesting implications for South Africa. Transitional and developing economies face additional challenges to implementing corporate governance systems. The South African economy is the largest in Africa and generates nearly 40 % of the income in sub-Saharan Africa (Reed, 2003). One reason given for the recent economic success in the context of Africa is leadership in corporate governance (Vaughn and Ryan, 2006). Constitutional and other initiatives such as King II and JSE listing requirements have an underlying theme of corporate governance reform and this is encouraging foreign direct investment (Nkomo, 2003). According to a report published by the Institute of International Finance, South Africa rates among the best performers in corporate governance in emerging markets (Judin, 2003).

However, evidence in this paper suggests that standards of governance among South African companies vary widely. There are challenges facing South African companies wanting to attract foreign investment. The poor governance standards within certain sectors of the JSE, as evidenced by the results of this study, further support the need for continual improvement and transparency in reporting.

Whether the low scores recorded by the mining sectors, the media and publishing and the IT sectors are due to lack of understanding of disclosure requirements or due to intentional withholding of information is unclear.

More importantly, the result of the portfolio creation in each sector clearly illustrated that, whatever the motive or reason for poor governance disclosure, there are

significant implications for share returns and firm value. Were contextual factors the sole reason each of aforementioned sectors having returns below the ALSI40 index return over the last 3 years?

Given the link established in section 4 between governance disclosure and financial performance, the implications and urgency for South African companies are apparent. Companies must seek to understand what governance disclosures are required by the market, investors and potential investors alike. King II provides a framework or starting point for disclosure, but it is not an exhaustive shopping list of requirements. A checklist approach to governance is not what is required. Good governance will not result from a mindless quantitative compliance with a governance code (King, 2006).

While the G-Score is a useful measure of governance disclosure, it is a tool for assessing the minimum requirements companies should disclose as best practice. It is a starting point for disclosure. Clearly there is much work to be done.

Governance is also advocated for reasons aside from firm performance, such as fairness, equity, and appearance of propriety. Some factors that are not found to be related to firm performance may be important for other purposes. Finally, although this research associates corporate governance with firm performance, the results do not necessarily imply causality.

These findings are important to regulators, investors, academics, and others who contend that good corporate governance is important for increasing investor confidence and market liquidity (Donaldson, 2003).

It is also important to note the various limitations of this study. Firstly the short time period reviewed, a 3 year time analysis is fairly short for this type of study and further work can be carried out in future years, once more data is available. Secondly, this research was limited to a cross section of companies and sectors on the JSE. Thirdly there is the issue of endogeneity, as mentioned in section 4. It is difficult to eliminate this from the study and therefore there is a limitation on the conclusions drawn on the causal relationship between governance and financial performance. Fourthly the level of corporate governance disclosure reported by companies in their annual report or on their website may not be an actual reflection of the level of governance employed by the company. It is possible that certain companies may have governance policies in place, but do not disclose them in the annual report. Finally the measurement of financial performance used in this study is a broad limitation as there are a multitude of indicators used in other international studies.

6. CONCLUSION

The power-sharing relationship between investors and managers is governed by the rules of corporate governance. Beginning in the late 2000s, there has been a significant and stable variation in these rules in South Africa. Using 7 distinct corporate-governance categories, for a sample of 97 firms in 9 sectors on the JSE, this research entailed the construction of a governance disclosure scorecard, denoted as G-Score, as a proxy for the level of corporate governance disclosure among companies. These companies were assessed using the G-Score during the period 30 June 2003 and 30 June 2006.

The relationship between governance disclosure and corporate performance in South Africa revealed a striking relationship. Corporate governance was positively correlated with share price returns during the period under review. An investment strategy that purchased shares in the highest G-Score companies (High portfolio) for each JSE sector outperformed the index for the sector. Similarly an investment strategy that purchased shares in the lowest G-Score companies (Low portfolio) underperformed the index in terms of annual average return over the 3 year period.

The analysis suggests that investors place a premium on South African companies with good governance.

These findings have significant implications for companies neglecting corporate governance disclosure. There is sufficient evidence to conclude that corporate governance is a component of equity risk and that there is a positive relationship between the level of disclosure and corporate performance.

Finally, it is proposed that investors include a measure of corporate governance risk with traditional profitability and valuation metrics, as corporate governance appears to offer a further dimension in the search for shareholder value.

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