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Transgression of Corporate Governance in South Africa's State-Owned Enterprises

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Abstract: State-owned enterprises (SOEs) play a very important role in South Africa's socio-economic development trajectory, and a strong, transparent and accountable government is central to such course. Accordingly, the immediate attention for the post-apartheid government was to lay the basic foundation for democracy and good governance. SOEs are critical mechanisms to assist government to achieve economic growth, service delivery, poverty reduction, employment creation and in the development of the country's strategic sectors such as finance, energy, transport, telecommunications, manufacturing and natural resources. However, most of these important SOEs in South Africa are characterised by poor leadership, maladministration, corruption, antagonism, animosity, impunity, weak financial reporting, chronic under-performance, debt burdens, insufficient performance monitoring and accountability systems. Some of these setbacks are associated with corporate governance failures including weak managerial accountability, excessive politicisation and unclear objectives. As a result, SOEs no longer contribute strongly to development or perform their public service role effectively and efficiently thereby undermining government's intentions to achieve growth and development objectives. The paper therefore argues that the absence of effective good corporate governance is the one of the major reasons of failures of most SOEs to fulfil the mandate which they were created for. Basis of the paper is that, the success of SOEs is dependent on whether the governance systems are placed towards responsiveness to the needs of individuals, communities and society in general. This paper therefore strives to explore the corporate governance quagmires in the SOE sector which impede socio-economic development efforts of government. The paper concludes that SOEs are muddled with governance problems which are the nemeses of good corporate governance, therefore, governance transformation in the SOE sector in is essential.

Keywords: Accountability, Corporate Governance, Good Governance, State-Owned Enterprises

1. Introduction

State-owned enterprises (SOEs) are a significant element of most African economies such as South Africa. As such, their participation in the corporate governance regime is important (Corrigan, 2014). These are public enterprises owned by governments, in full or in part and provide essential public services such as water, electricity, energy, communication and transportation among others. SOEs in South Africa play a very significant role in socio-economic development trajectory, thus a strong, transparent and accountable government is central to such course. Building strong and accountable government has been a critical component of South Africa's transformation agenda since 1994 and the immediate primary focus was therefore on laying the basic foundation for democracy and good governance (White, Heymans, Favis & Hargovan, 2000). Therefore, SOEs should structure their systems on the basis of good corporate governance principles (Corrigan, 2014:1). Corrigan (2014:1) further states that SOEs are potentially powerful tools in states' developmental inventories, and the manner in which they operate has considerable influence on the wider business and corporate governance landscape.

Although SOEs can play a critical role in the achievement of developmental mandate in strategic sectors such as finance, energy, transport, telecommunications, manufacturing and natural resources, SOEs in South Africa face distinct corporate governance challenges. These common challenges include unformed regulatory systems, politicised board appointments, unclear mandates and objectives, excessive politicisation, weak managerial accountability, poor leadership, maladministration, corruption, antagonism, animosity, impunity, weak financial reporting, chronic under-performance, debt burdens, insufficient performance monitoring and accountability systems (Corrigan, 2014). These

setbacks impede strongly on SOEs from contributing towards their developmental mandate or performing public service role effectively and efficiently thereby undermining government's intentions to achieve growth and development objectives. The paper therefore, seeks to explore corporate governance challenges facing the SOE sector, and their prospects in South Africa. The paper is conceptual in nature and uses desktop analysis of literature. The paper start, firstly, by understanding the transversal legislative prescripts on corporate governance, and secondly why good corporate governance is so significant in the SOE sector. Thirdly, the paper examines the role that SOEs play towards the attainment of developmental objectives. Section four of the paper explores corporate governance challenges and prospects in the SOE sector. The oversight role of government in the SOE sector is assessed in section five of the paper. Lastly, the paper provides conclusion and recommendations from the argumentative discussion.

2. Transversal Precepts for Corporate Governance in South Africa

In recent years, South Africa experienced unprecedented corporate governance challenges and failures of many companies which propelled the government to establish systems that promote higher standards of ethical conduct, accountability and transparency in companies and by directors (Moyo, 2010). As such, government developed legislative and regulatory corporate governance framework to enhance corporate transparency and accountability. The main legislative and regulatory corporate governance framework in South Africa include among others the Constitution of the Republic of South Africa of 1996, the King Reports on Corporate Governance, the Companies Act 71 of 2008, Public Finance Management Act 1 of 1999 and Local Government: Municipal Finance Management Act 56 of 2003.

In terms of the Constitution of the Republic of South Africa Section 1(c) and (d), South Africa is founded on the principles and values of the rule of law, accountability, responsiveness and openness. Section 41(1)(c) of the Constitution further states that all spheres of government and all organs of state within each sphere must provide effective, transparent, accountable and coherent government for the Republic as a whole, while Section 152(a) and (e) require local governments to provide democratic and accountable government for local communities and encourage involvement of communities in matters of local government. Public administration must as well be governed by the democratic values and principles enshrined in Section 195 which include promoting a high standard of professional ethics, efficient, economical and effective use of resources, encouraging public participation in decision making, accountable and transparent public administration. These principles, as enshrined in the Constitution, apply to all administration in every sphere of government, organs of state and public enterprises. The latter also suggests that, these principles and values have an inherent influence on legislation and policies that impact SOEs (Kanyane & Sausi, 2015:31).

Corporate governance in South Africa became well-established since the establishment of the King Committee on Corporate Governance in 1992 (Armstrong, Segal & Davis, 2005; Moyo; 2010). The King Reports on Corporate Governance forms the basis for the debate on corporate governance in South Africa. It is therefore, important to note that all these reports, King I, King II, King III and King IV are aimed at promoting good corporate governance in South Africa (Nevondwe, Odeku & Raliglilia, 2014:663). The King I represented a significant milestone in the evolution of corporate governance and served as a point of reference for policy makers in the development of legal and regulatory frameworks for corporate governance aimed at encouraging highest standard of corporate governance (Moyo, 2010). The main aim of the King I Report was to encourage the highest standard of corporate governance in South Africa by recommending standards of conduct for directors and emphasizing the need for responsible corporate conduct (Moyo, 2010:42).

The King Report was distinguished by its integrated approach to good governance with regard to financial, social, ethical and environmental practice, to serve the interests of a wide range of stakeholders (Armstrong, Segal & Davis, 2005:9). Accordingly, the first King Report was instrumental in raising awareness of what constitutes good governance, both in the private and public sectors. It offered to companies, and state-owned enterprises, for the first time, a coherent and disciplined governance framework that was relevant to local circumstances and offered practical guidance (Armstrong, Segal & Davis, 2005:9). However, King III report on corporate

governance became necessary because of the new Companies Act no. 71 of 2008 and changes made in international governance trends (Institute of Directors in Southern Africa (IDSA), 2009:4; Nevondwe *et al*., 2014:663). According to Nevondwe *et al.* (2014:663), King III applies to all entities regardless of the manner and form of incorporation or establishment, whether in the public, private sectors or non-profit sectors. The fourth report is the draft King IV of 2016. King IV Report sets out the philosophy, principles, practices and outcomes which serve as the benchmark for corporate governance in South Africa. The King IV aims to promote good corporate governance as integral to running a business or enterprise and delivering benefits such as ethical culture, enhancing performance and value creation, enabling governing body to exercise adequate and effective control, to reinforce good corporate governance as a holistic and interrelated set of arrangements to be understood and implemented in an integrated manner and to present good corporate governance as concerned with not only structure and process but also an ethical consciousness and behaviour (IDSA, 2016:2).

Currently State-owned companies (SOCs), also known as SOEs, are regulated by the Companies Act 71 of 2008 which replaced the Companies Act 61 of 1973 as the driver of good corporate governance in South Africa (Nevondwe *et al.*, 2015). The Act was signed by the President on 8 April 2009 and gazetted in Gazette No. 32121 (Notice No. 421) and came into effect on 1 May 2011 (Nevondwe *et al*., 2015:663). Part C of Chapter 2 which deals with transparency, accountability and integrity of companies provides in Section 34(1) that 'in addition to complying with the requirements of this Part, a public company or SOC must also comply with the extended accountability requirements set out in Chapter 3'. Chapter 3 of the Companies Act deals with enhanced accountability and transparency of companies including SOCs or SOEs.

Running parallel with these developments was the introduction of the Public Finance Management Act (PFMA) in 1999, which introduced much more rigorous standards for reporting and accountability by adopting an approach to financial management in public sector institutions that focuses on performance in service delivery, and economic and efficient deployment of state assets and resources (Armstrong *et al*., 2005:9). The PFMA gives effect to financial management that places a greater implementation responsibility with managers and makes them more accountable for their performance. However, without strong vision and committed leadership; an enabling legal environment; effective performance evaluation; and appropriate competencies and capacities effective and sustainable change will not occur in the SOE sector (Presidential Review Committee (PRC), 2013:13). As in government, good corporate governance standards demand leadership with integrity and authority working together at the highest levels to make successful decisions for the greater good (McGregor, 2014:7).

3. Why Corporate Governance in SOEs?

The concept of governance is in recent years being used as an interdisciplinary concept which has fast become critical in the field of development studies (Edoun, 2015). The concept has since generated much debate as far as what governance means and entails. As result, there is a wide range of definitions which indicate that governance means different things to different people depending on the context in which the concept is being used. Governance refers to how government exercises its power and authority to manage state's affairs, goods and services (White, Heymans, Favis & Hargovan, 2000). Kanyane and Sausi (2015:29) affirm that governance means constitutional, legal and administrative arrangements by which governments exercise their power as well as the related mechanisms for public accountability, rule of law, responsibility, effectiveness, transparency, ethics, integrity and citizen participation. Furthermore, International Federation of Accountants (IFAC) and Chartered Institute of Public Finance and Accountancy (CIPFA) (2014:8) state that governance comprises of the arrangements put in place to ensure that the intended outcomes for stakeholders are defined and achieved.

Edoun (2015) sees governance as a paradigm which represents something more than government and considers governance as a system of values, policies and institutions by which a society manages its economic, political and social affairs through interaction within and among state, civil society and private sector. White *et al*. (2000:10) further posits that governance encompasses the state's institutional and structural arrangements, decision making processes and implementation capacity and the relationship between government official and

the public. Kanyane and Sausi (2015:29) argue that without governance, government remains an empty shell. In this regard, governance implies the creation of state institutions and structures of government to enable the former to effectively deliver services in line with the mandate entrusted to it by the people (Edoun, 2015:353).

Corporate governance, on the other hand, refers to the set of systems, principles and processes by which a company is governed (Nevondwe *et al*., 2014:664). Corporate governance is understood to be how a company is directed and controlled. Therefore, corporate governance is important for ensuring that certain individuals in an organisation are held accountable and that organisations are properly directed and controlled (Moyo, 2010:1). Corporate governance is defined as the building of a balance between the economic and social goals, and between individuals and communal goals with the aim of aligning as closely the interests of individuals, organisations and society (King Report, 2002:7). According to Nevondwe *et al*. (2014:664), corporate governance is based on the principles such as conducting the business with integrity and fairness, being transparent with regard to all transactions, making all the necessary disclosures and decisions, complying with all laws of the land, accountability and responsibility towards the stakeholders and commitment to conducting business in an ethical manner. This argument suggests that corporate governance is based on relationships and networks between individuals, corporations and society. Kanyane and Sausi (2015) are of the view that good governance is about steering society through networks and relationships between governments' entities and civil society organisations.

Edoun (2015) suggests that good governance should embody transparency in decision making informed by an enlightened professional bureaucracy, an accountable executive and a strong civil society participation, all functioning under the ambit of the rule of law. The function of good governance is to ensure that entities act in the public interest at all times. This require strong commitment to integrity, ethical values and the rule of law, openness and comprehensive stakeholder engagements (IFAC, 2013). In other words, governance is the manifestation of aspects such as accountability, openness and transparency, independence, responsibility, discipline, fairness and social responsibility as well as engagement between government and the governed (King Report, 2002; Edoun, 2015). IFAC (2013:20) argues that achieving good governance requires, firstly, defining outcomes in terms of sustainable economic, social and environmental benefits and determining the interventions necessary to optimize the intended outcomes; secondly, developing capacity of the entity including capability of its leadership and individuals; thirdly, managing risks and performance through robust internal control and strong public financial management; and lastly, implement good practices in transparency and reporting to ensure effective accountability. These preceding aspects of governance are critical in understanding why corporate governance is so important in the SOE sector. The World Bank (2014:16) outlines several positive outcomes of good corporate governance, namely:

- Better access to external finance by firms, which in turn can lead to larger investments, higher growth, and greater employment creation.
- Lower costs of capital and higher firm valuation, which make investments more attractive to investors and thus also lead to growth and more employment.
- Improved strategic decision making and operational performance, through better allocation of resources and more efficient management, which create wealth more generally.
- Reduced risk of corporate crises and scandals, a particularly important outcome given the potentially large economic and social costs of financial crises and
- Better relationships with stakeholders, which improve social and labour relationships, help address such issues as environmental protection, and can help further reduce poverty and inequality.

Furthermore, many, if not all, of the above benefits apply to SOEs, and while few empirical studies specifically analysed the direct impacts of corporate governance on SOE performance, anecdotal evidence shows that better governance benefits both individual companies and the economy as a whole (World Bank, 2014:16). These are:

- Improved operational performance of SOEs.

- Increased access to alternative sources of financing through domestic and international capital markets, while helping develop markets. As governments face continued budget constraints, better-governed SOEs are more easily able to raise financing for infrastructure and other critical services through the capital markets. In turn, SOE issuances can help develop capital markets.

- Financing for infrastructure development.

- Reduced fiscal burden of SOEs and increased net contribution to the budget through higher dividend payments. Improved governance also increases transparency of the contingent liabilities associated with SOEs, thereby reducing fiscal risk.

- Reduced corruption and improved transparency. Corruption remains a serious problem in SOEs and can influence the financial strength and valuations of the companies, negatively affect investor perceptions, lead to the misallocation of scarce government resources, and constrain overall economic and financial growth. Better-governed companies with integrity and accountability mechanisms are likely to be less corrupt and more transparent.

Good corporate governance ensures proper accountability and transparency in the conduct of a business or entity creating a business environment that is fair and transparent where companies can be held accountable for their actions (Zinkin, 2010; Youssef, n.d). In other words, a company that is well-governed is one that is accountable and transparent to its shareholders and other stakeholders.

4. The Role of State-Owned Enterprises

In most countries, including South Africa, SOEs in strategic sectors such as finance, infrastructure, manufacturing, energy and natural resources are increasingly viewed as tools for accelerated development and global expansion (World Bank, 2014). Additionally, SOEs are critical mechanisms to assist governments to achieve economic growth and service delivery, but also to reduce a country's tax burden (Fourie, 2014:30). Fourie (2014) argues that SOEs are vital for the growth of the economy and in the development of the country's strategic sectors such as energy, transport, telecommunications and manufacturing. According to the World Bank (2014), SOEs continue to play an important economic role and are especially prominent in key sectors of the economy that provide critical services for businesses and consumers which contribute directly to economic growth and poverty reduction. Most of these SOEs are established by most countries to develop strategic industries in order to compete in an increasingly globalized economy becoming global players (World Bank, 2014).

In South Africa, the government mandate for SOEs, as articulated in the National Development Plan and other policy statements, is to provide infrastructure services and to help improve social and economic conditions (McGregor, 2014:6). As South Africa aspires to be a developmental state, SOEs are expected to assist the State in addressing issues of social and economic transformation and in bridging the gap between rich and poor; black and white; rural and urban and other divisions in our society (Presidential Review Committee (PRC), 2013:7). The PRC, however, argues that SOEs are not regarded as a panacea for solving all challenges of South Africa but are an added strategic and catalytic State instrument for transformation, growth, development, service delivery and employment creation. Therefore, they can play a significant role towards attainment of a developmental state. While SOEs have an indispensable role to play in service delivery and have crucial performance and transformation potential, they are nevertheless faced with significant weaknesses and threats that might become grave impediments to their optimum contribution (PRC, 2013:7).

5. Corporate Governance Challenges of SOEs in South Africa

Although SOEs play a crucial role in providing critical services for urban development, there is concern around the poor performance of some South Africa's SOEs (Wendy Ovens and Associates, 2013:9). The current state of SOEs in the country paints a bleak picture about the performance and future of these SOEs. Recently, the performance of and challenges associated with SOEs in South Africa has put these entities under severe pressure and public scrutiny. Chilenga (2016:40) states that SOEs tend to face lots of scrutiny and are pressured into providing better results mainly because of their level of strategic importance. According to Youssef (n.d), weak corporate governance may lead to waste, mismanagement, and corruption. Similarly, SOEs have also

become increasingly ineffective and inefficient in achieving their strategic and developmental mandates as a result of poor governance and mismanagement. This is because these SOEs are faced with challenges ranging from administrative, institutional, and technical to financial mismanagement.

Compared to private sector companies, SOEs face distinct governance challenges that directly affect their performance (World Bank, 2014). Most of these important SOEs in South Africa are characterised by poor leadership, politicised board appointments, maladministration, unformed regulatory systems, corruption, antagonism, animosity, impunity, weak financial reporting, chronic under-performance, debt burdens, insufficient performance monitoring and accountability systems. Some of these setbacks are associated with corporate governance failures including weak managerial accountability and lack of transparency, excessive politicisation (political interference) and unclear mandates and objectives (Links & Haimbodi, 2011; Corrigan, 2014; OECD, 2015b). All these challenges are a function of poor corporate governance of SOEs. Accordingly, SOEs no longer contribute strongly to development or perform their public service role effectively and efficiently thereby undermining government's intentions to achieve growth and development objectives.

Kane-Berman (2016) makes several observations with regard to financial problems in SOEs, firstly, SOEs are faced with three financial burdens of i) negative overall return on equity; ii) their losses are a risk to public finance and iii) SOEs with fragile balance sheets have difficulty raising the money to invest in the economic infrastructure the country needs. Compared with private companies competing in the sector, overall financial situation of the country's SOEs is worrying. Most SOEs are heavily indebted, less profitable and rely on government guarantees (Marrez, 2015). High indebtedness and low rates of return generate payment problems for SOEs. According to OECD (2015b), SOEs are characterised by chronic under-performance with poor returns on government investments and continuous reliance on government support, whether in the form of explicit government guarantees or subsidies which stood at R469.9 billion at the end of 2015/16. In some cases, it is not clear exactly what or whose mandate should or is being implemented in some SOEs (Kane-Berman, 2016). All these problems and challenges depict the volatile nature of the environment SOEs in South Africa finds themselves in.

6. State-Owned Enterprises in South Africa: Governance Oversight

SOEs are known by different names such as government business enterprises, government corporations, parastatals, public enterprises, state-owned companies (SOCs) among others. SOEs have different mandates in relation to some aspects of public service and/or social outcomes and their definition varies across countries with respect to institutions they consider 'SOEs' (PriceWaterhouseCoopers (PWC), 2015; Organisation for Economic Co-operation and Development (OECD), 2015a). SOEs (or public entities) are defined as independent bodies partially or wholly owned by government and perform specific functions and operate in accordance with a particular Act (Pillay, 2011; Wendy Ovens and Associates, 2013). In South Africa, Section 1 of the Public Finance Management Act (PFMA) (No.1 of 1999) introduces the term national government business enterprise which means an entity which, a) is a juristic person under the ownership control of the national executive; b) has been assigned financial and operational authority to carry on a business activity; c) as its principal business, provide goods or services in accordance with ordinary business principles; and d) is financed fully or substantially from sources other than, i) the National Revenue Fund, and ii) by way of tax, levy or other statutory money.

All national government business enterprises are by definition 'national public enterprises' as described and referred to in the PFMA (No. 1 of 1999), of which some are companies and some are not (PWC, 2012:3). On the other hand, Section 1 of the Companies Act (No. 71 of 2008) introduces the term 'state-owned company' which means an enterprise that is registered in terms of this Act as a company which either, a) is listed as a public entity in Schedule 2 or 3 of the PFMA (No. 1 of 1999), or b) is owned by a municipality, as contemplated in the Local Government: Municipal Systems Act (No. 32 of 2000), and is otherwise similar to an enterprise referred to in paragraph a). According to PWC (2012:4), SOCs fall within the ambit of the PFMA (No.1 of 1999) which means that they need to comply with additional provisions over and above of the Companies Act.

The Presidential Review Committee on SOEs established in 2010 reported that there were 715 such entities listed in the PFMA in the country

(Kane-Berman, 2016). The PFMA lists approximately 300 public organisations consisting of nine constitutional institutions, 21 major public entities, 153 national public entities, 26 national government business enterprises, 72 provincial public entities, and 18 provincial government business enterprises. Constitutional institutions are listed as Schedule 1 organisations, major public entities as Schedule 2 organisations, and the remainder as Schedule 3 organisations (Fourie, 2014). Some of the largest state entities in South Africa include among others; Eskom, Central Energy Fund, Transnet, South African Airways (SAA), South African Post Office (SAPO), Passenger Rail Agency of South Africa (Prasa), South African National Roads Agency (Sanral), Trans-Caledon Tunnel Authority, Denel, Telkom, SABC, Industrial Development Corporation (IDC), Airports Company of South Africa (ACSA) and Alexkor (Kane-Berman, 2016). Some of these entities are listed as one of the 21 'major public entities' in the PFMA. Respective government departments, either jointly or individually as shareholder representative on behalf of government, are entrusted with the oversight responsibility of SOEs, provide strategic direction, align their priorities to national growth, create efficient, competitive and responsive economic infrastructure network and ensure that SOEs are implementing their mandates and are delivering the intended outputs (McGregor, 2014).

According to McGregor (2014), the Department of Public Enterprises (DPE) is the largest department responsible for Energy and Mining, Manufacturing and Transport, together with the specific functional departments, while other departments such as Communications, Defence, the Trade and Industry, and Agriculture, Forestry and Fisheries are responsible for other specific SOEs. As its primary mandate, the DPE provides oversight and strategic direction for the SOEs (DPE, n.d). As shareholder representative, the departments have responsibility for providing strategic direction, the alignment of priorities to national growth and creating an efficient, competitive and responsive economic infrastructure network. Part of their role is to ensure that SOCs are implementing their mandates and are delivering the intended outputs. This involves the analysis of the operations and performance, improving the delivery and maintenance of infrastructure, achieving policy and regulatory clarity, improving operational efficiencies and providing operational indicators of each of the required outputs. (McGregor, 2014:6; DPE, n.d.).

This clearly shows that the management of SOEs is currently dispersed across different shareholder departments on behalf of government. Some SOEs are managed by line ministries or entities in central government and some are managed by local government which have the ownership rights (Marrez, 2015). Each ministry has a shareholder department overseeing the SOEs under its responsibility. The Board of Directors of SOEs is the governing body of the SOE with absolute responsibility for the performance of the SOE and is fully accountable for the performance of the SOE (National Treasury, n.d.). According to Marrez (2015:6), such a governance structure is not an ideal setup for avoiding political interference in the day-to-day management of the companies, or guaranteeing a separation between the authorities' ownership and policy-making functions. Adherence to sound corporate governance principles is therefore utmost significant to ensure that SOEs perform the role they were created for.

7. Conclusion and Recommendations

Governance, in particular of SOEs, is central to comprehending how well a country is performing, as it is one of the indicators used in sovereign rating of a State. Governance is the way in which organisations are directed and controlled. It focuses on performance and conformance, and is different from management. This applies to corporations in the realm of corporate governance, and to governments in the realm of public sector governance. However, the performance of many SOEs in South Africa remains in distress as a result of poor corporate governance. Good corporate governance systems ensure that the business environment is fair and transparent, that company directors are held accountable for their actions, and that all business contracts made by the company can be enforced. Similarly, company committed to good corporate governance has strong board practices and commitment, effective internal controls, transparent disclosure, and well-defined shareholder rights. Therefore, the critical role of SOEs in the economy and in advancing the agenda of a developmental state is pivotal to exploring and understanding the need for transformation in the SOE sector's corporate governance challenges. Accordingly, addressing corporate governance challenges can contribute to improved performance of SOEs as part of a comprehensive and contextually relevant approach that also includes policy reforms, restructuring, external incentives, such as increased competition, and more

private sector participation, as well as fiscal discipline. The complex nature of the SOE environment required a review of the legislative environment in order to clarify their mandates and funding issues.

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