

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

**ISBN number: 978-0-620-74761-5**



## **REGIONAL SAAA CONFERENCES**

<b>WESTERN CAPE</b>	<b>CPUT, The Cape Town Hotel School, Granger Bay, Cape Town</b>	<b>Friday, 2 September 2016</b>
<b>KWA-ZULU NATAL</b>	<b>Durban University of Technology Faculty of Accounting &amp; Informatics, Elangeni Southern Sun Hotel, Durban</b>	<b>Wednesday, 30 November 2016</b>
<b>GAUTENG</b>	<b>University of the Witwatersrand School of Accountancy Building, West Campus, Johannesburg</b>	<b>Friday, 2 December 2016</b>
<b>NATIONAL TEACHING AND LEARNING</b>	<b>University of the Witwatersrand School of Accountancy Building, West Campus, Johannesburg</b>	<b>Friday, 2 December 2016</b>

**The refereed papers included in the conference proceedings were accepted after a double blind peer reviewed process.**

## Preface

The 2016 SAAA Regional and Teaching & Learning Conferences were presented in partnership with the Southern African Accounting Association.

## Objective of these conferences

The SAAA Regional and Teaching & Learning Conferences aims to contribute towards the achievement of the SAAA vision of promoting excellence in Accountancy Higher Education and Research in Southern Africa. By providing a research and information-sharing platform that focuses on teaching and learning in Accountancy, academics can play an active and leading role in Accounting Education in Southern Africa.

## Review process and comments

All papers submitted for the 'refereed category' were subjected to a rigorous process of blind peer review. The papers were submitted to two experts at an independent South African University for blind review. Comments and suggested amendments from the reviewers were communicated to authors and the reviewers decided on the acceptance of the papers for presentation at the conference and inclusion in the conference proceedings. Experts also declined certain papers and these were not included in these conference proceedings.

## SAAA Executive Scientific Committee

Prof Elmarie Papageorgiou	President: SAAA and convener of the SAAA Gauteng Regional Conference
Prof Ilse Lubbe	Vice President: SAAA, guest editor of Accounting Education and convener of the SAAA Teaching and Learning Conference
Magda Turner	Chairman: SAAA Gauteng Region
Andre Neethling	Chairman: SAAA Western Cape Region
Shelly Herbert	Vice-chairman: SAAA Western Cape Region
Tanya Thompson	Secretary: SAAA and co-ordinator of SAAA KwaZulu-Natal regional conference
Brian Ngiba	SAAA subject representative: Financial Accounting, and co-ordinator of KwaZulu-Natal regional conference
Riley Carpenter	SAAA subject representative: Taxation
Prof Lourens Erasmus	SAAA subject representative: Public Sector
Jack Jonck	SAAA subject representative: Auditing
Jolandi Gevers	SAAA subject representative: Management Accounting and Finance

## LIST OF REVIEWERS

FIRST NAME	UNIVERSITY	EMAIL ADDRESS
Andre Hamel	University of Western Cape	phamel@uwc.ac.za
Andre Neethling	Cape Peninsula University of Technology	NeethlingA@cput.ac.za
Andres Merino	University of Witwatersrand	andres.merino@wits.ac.za
Anthony Jodwana	Nelson Mandela Metropolitan University	anthony.jodwana@nmmu.ac.za
Carol Cairney	University of Western Cape	cairney.carol@gmail.com
Edna Hamel	University of Western Cape	ehamel@uwc.ac.za
Francois Steyn	University of Western Cape	gsteyn@uwc.ac.za
George Goldswain	UNISA	goldsgk@unisa.ac.za
Graham Myers	Durban University of Technology (retired)	myersg52@gmail.com
Heinrich Dixon	Tshwane University of Technology	dixonhj@tut.ac.za
Houdini Fourie	Nelson Mandela Metropolitan University	hfourie@nmmu.ac.za
Ilse Lubbe	University of Cape Town	ilse.lubbe@uct.ac.za
Jack Jonck	North-West University	Jack.Jonck@nwu.ac.za
Jaco Barnard	Nelson Mandela Metropolitan University	Jaco.barnard@nmmu.ac.za
Jacques Siebrits	University of Western Cape	jsiebrits@uwc.ac.za
Jacqui-Lyn McIntyre	North-West University	Jacqui.Mcintyre@nwu.ac.za
James Anthony	University of Cape Town	james.anthony@uct.ac.za
Janine Christian	Nelson Mandela Metropolitan University	janine.christian@nmmu.ac.za
Jobo Dubihlela	Cape Peninsula University of Technology	DUBIHLELAJ@cput.ac.za
Johnathan Dillon	Nelson Mandela Metropolitan University	johnathan.dillon@nmmu.ac.za
Jolandi Gevers	University of Cape Town	jolandi.gevers@uct.ac.za
JP Bruwer	Cape Peninsula University of Technology	bruwerjp@cput.ac.za
Lana Hanner Weldon	University of Fort Hare	lhanner@ufh.ac.za
Leandi Steenkamp	Central University of Technology	llubbe@cut.ac.za
Leon Loxton	University of Western Cape	lloxtan@uwc.ac.za
Liza-Mari Sahd	Stellenbosch University	lsahd@sun.ac.za
Lizel Bester	Nelson Mandela Metropolitan University	lizel.bester@nmmu.ac.za
Lynn Schoemann	Nelson Mandela Metropolitan University	Lynn.schoeman2@nmmu.ac.za
Magda Turner	University of Witwatersrand	Magda.Turner@wits.ac.za
Marina Chalmers	Nelson Mandela Metropolitan University	marina.chalmers@nmmu.ac.za
Minga Negash	University of Witwatersrand	Minga.Negash@wits.ac.za
Mmudi David Shaku	Tshwane University of Technology	shakumd@tut.ac.za
Nebbel Motubatse	Tshwane University of Technology	motubatsekn@tut.ac.za
Nestene Botha	University of Cape Town	nestene.botha@uct.ac.za
Peta Myers	Rhodes University	L.Myers@ru.ac.za
Phillip De Jager	University of Cape Town	phillip.dejager@uct.ac.za
Rayghana Abrahams	Nelson Mandela Metropolitan University	rayghana.abrahams@nmmu.ac.za
Riaan Rudman	Stellenbosch University	rjrudman@sun.ac.za

Rikus De Villiers	North-West University	Rikus.DeVilliers@nwu.ac.za
Riley Carpenter	University of Cape Town	riley.carpenter@uct.ac.za
Ronald Arendse	University of Western Cape	rarendse@uwc.ac.za
Solomon Mayo	Tshwane University of Technology	mayosolomon@gmail.com
Tabitha Grace Mukeredzi	Durban University of Technology	TabithaM@dut.ac.za
Tasneem Joosub	University of Witwatersrand	tasneem.joosub@wits.ac.za
Wayne Van Zijl	University of Witwatersrand	Wayne.VanZijl@wits.ac.za

## CONTENTS

No	TITLE AND AUTHORS	Page
AUD02	<b>An analysis of audit partner perceptions regarding the state of auditor independence in South African audit firms</b> <i>Michael Harber, University of Cape Town</i>	6
AUD 03	<b>An exploration of audit practitioner opinions on mandatory audit firm rotation in South Africa: a specific focus on market concentration and transformation issues</b> <i>Michael Harber &amp; Gizelle Willows, University of Cape Town</i>	25
AUD 06	<b>Effects of Internal Organisational Environments on Preventative, Detective and Directive Internal Controls of SMMEs in Cape Town</b> <i>Luyolo Siwangaza and Job Dubihlela, Cape Peninsula University of Technology</i>	44
AUD 08	<b>The Relationship between Board Size and Company Performance</b> <i>Kyla van der Westhuizen &amp; Gizelle Willows, University of Cape Town</i>	58
AUD 09	<b>The effect of changes in auditor reporting standards on audit quality</b> <i>Faatima Kholvadia, University of the Witwatersrand</i>	77
EDU 02	<b>Mobile Learning (M-Learning) As A Paradigmatic Mechanism To Facilitate Practical Subjects In An Undergraduate Financial Information Systems Course: A Developing Country Perspective</b> <i>Suzaan Le Roux, Cape Peninsula University of Technology</i>	94
EDU 03	<b>An analysis of the reasons contributing to academic exclusion: a case study in the faculty of economic and financial sciences at the University of Johannesburg</b> <i>Ester van Wyk &amp; Marita E Pietersen, University of Johannesburg</i>	109
FAC 02	<b>The Proposed Conceptual Framework and its possible effect on the reporting of Contingent Liabilities</b> <i>Taryn Miller and Guy Wagenvoorde, University of Cape Town</i>	134
MAF 03	<b>Public-Private Partnerships in South Africa: A tale of two prisons</b> <i>Tim Prussing &amp; Carlos Correia, University of Cape Town</i>	149
MAF 04	<b>Dividend Yield as a Model for Value Investing on the JSE</b> <i>Celso Zuccollo &amp; Carlos Correia, University of Cape Town</i>	178
MAF 07	<b>An investigation of the factors to consider for a free higher education system in South Africa</b> <i>Mzikazi Ntintelo &amp; Ilse Lubbe, University of Cape Town</i>	215
MAF 08	<b>Long-term incentives: do shareholders get what they pay for?</b> <i>Francois Steyn &amp; Carol Cairney, University of the Western Cape</i>	244
MAF 10	<b>Are there benefits to diversification across the largest African stock markets?</b> <i>Carlos De Jesus &amp; Professor Phillip De Jager, University of Cape Town</i>	268
TAX 02	<b>The Hand Which Reaches Beyond the Grave: Reasons for and against the abolishment of Estate Duty in South Africa using Australia as a benchmark</b> <i>Patrick Dunton, Riley Carpenter, Riyaan Mabutha, University of Cape Town</i>	286
TAX 03	<b>The effect of electronic commerce on the erosion of tax bases – Developing appropriate taxation laws in South Africa</b> <i>Amy Wilson, Shaun Parsons and Riley Carpenter, University of Cape Town</i>	310
TAX 04	<b>Has the changing research and development taxation legislation affected research and development output in South Africa?</b> <i>Riley Carpenter, University of Cape Town</i>	332

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

**ISBN number: 978-0-620-74761-5**



---

**AUD 02: An analysis of audit partner perceptions  
regarding the state of auditor independence in South  
African audit firms**

**Author:** Michael Harber CA (SA), University of Cape Town  
Email: [michael.harber@uct.ac.za](mailto:michael.harber@uct.ac.za)

**Abstract**

*The provision of assurance services, most notably the audit function, is an activity of public protection that requires a high degree of independence between the auditor and the audit client to ensure audit quality is achieved. In the European Union, there is now a legislated move towards mandatory audit firm rotation (MAFR) to ensure auditor independence. South Africa is currently faced with the decision of whether to change legislation and follow suit. In addition, the 2014/2015 Public Inspections Report was recently released by the Independent Regulatory Board for Auditors (IRBA) and it revealed worrying statistics of ethical practice and disclosure non-compliance by audit firms, again highlighting the concerns around independence between auditor and client.*

*Using a qualitative and descriptive methodology, through the use of semi-structured and open interviews with experienced South African audit partners, the views of the profession around auditor independence is explored.*

*This study will therefore present the opinions of a small group of experienced audit partners, most being regional or national managing partners, from audit firms that perform public interest entity audits. The views of these audit practitioners indicate that the South African audit profession does not believe that any changes to regulations are necessary to address auditor independence as any problem with auditor independence is one of perception, not reality. The partners expressed a concern that the public inspections process needs to be revised by the regulator and the audit committee's role in appointing suitably independent auditors is crucially important and a role that should be strengthened before more regulation is imposed on the audit profession.*

## Introduction and Literature Review

*Though auditors should regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay. Whose bread I eat, his song I sing.* (Buffet and Clark, 2006)

The provision of assurance services, most notably the audit function, is an activity of public protection. In the eyes of the public, especially the investing public and all stakeholders of the company, the audit function provides the much needed stamp of credibility and assurance as to the fair presentation of the company's financial reporting. Auditor independence is important because it has an impact on the quality of the audit. DeAngelo (1981) suggests that audit quality is defined as the probability that:

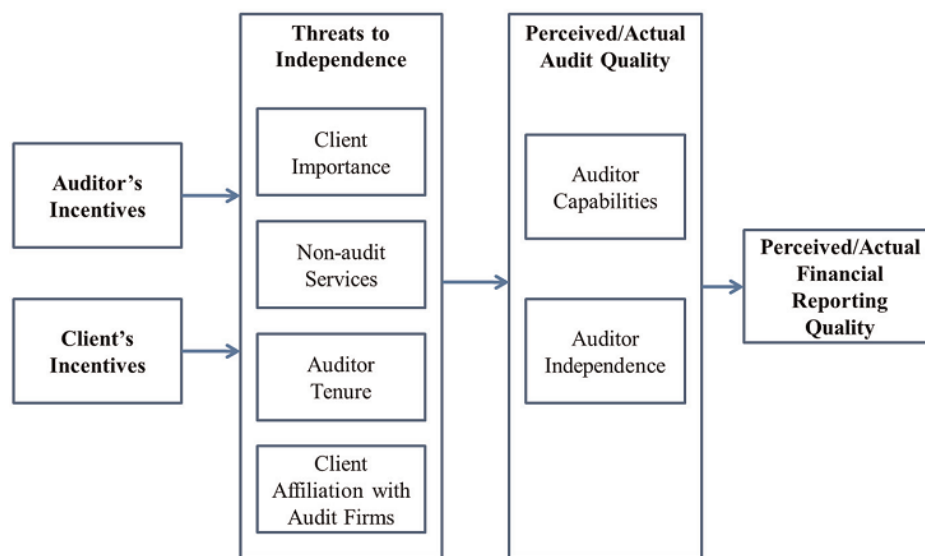
- (a) The auditor will uncover a breach of statutory or regulatory requirement and
- (b) Report the breach to the appropriate parties.

If auditors do not remain independent, they might be less likely to report irregularities or insist that financial statements be prepared to their satisfaction, thus, impairing audit quality (Carey and Simnett, 2006). This potentially lessens the credibility of the financial reporting process and hence why regulations are imposed to ensure the professional standards and the independence of the external audit function. Most countries, including South Africa, have moved away from self-regulation the audit profession, to a system of using an independent regulatory body. In South Africa this regulatory authority is the Independent Regulatory Board for Auditors (IRBA).

Many studies on the topic of auditor independence have been performed to date (Carey and Simnett, 2006; Daniels and Booker, 2011; Tepalagul and Lin, 2015), in significant economic jurisdictions such as the United States and Europe, which is understandable given its importance to the quality of the audit. If auditors do not remain independent, they might be less likely to report irregularities, through the various reporting channels available. The most notable reporting channel is via the audit opinion and audit report, and therefore a lack of independence could impair the quality of the audit report provided to the public and stakeholders of the company. Recent research by Tepalagul and Lin (2015) provides a useful four dimensional approach with which to assess the impact of auditor independence on audit quality, namely, (a) client importance, (b) non-audit services, (c) auditor tenure, and (d) client affiliation with audit firms. This categorisation of the four main threats to auditor independence is useful for further research and theory and will be used in this paper, as shown diagrammatically in Figure 1.

The audit profession in most international jurisdictions is a for-profit and competitive enterprise as well as a public practice (meaning an activity that aims to protect the public from unfair presentation and fraud in financial reporting). Therefore, like any

business, the auditors have profit incentives to yield to client pressure to retain their business, especially the business of their most significant clients, which in turn compromises auditor independence (Tepalagul and Lin, 2015). Added to this potential compromise of independence is the reality that many audit clients require non-audit services from their auditors, which are often more lucrative than the audit fee (Tepalagul and Lin, 2015), possibly resulting again in compromised independence in the audit engagement (Tepalagul and Lin, 2015). These threats to independence are explained at length in the IFAC Code of Professional Conduct in which numerous guidelines are provided to enable the auditor to manage these conflicts of interest. Long auditor-client tenure and client affiliation with audit firms create familiarity between the parties as relationships form (International Federation of Accountants (IFAC), 2006). The profits from non-audit services create self-interest threats to independence. These threats may threaten auditor independence and audit quality.



**Figure 1.** A framework for assessing the impact of auditor independence on audit quality.

Source: Tepalagul and Lin (2015)

As can also be seen from Figure 1, audit quality, which results in quality financial reporting of companies, is a function of the capabilities and the independence of the auditor. However, the threats to auditor independence negatively impact on this quality.

Per discussion with the CEO of the IRBA in December 2015 (the transcript of which is available upon request), the national regulator is concerned with the state of actual and perceived auditor independence in South Africa and is actively considering means of addressing this concern. Part of the reason for this concern is the recently published 2014/2015 IRBA Public Inspections Report.

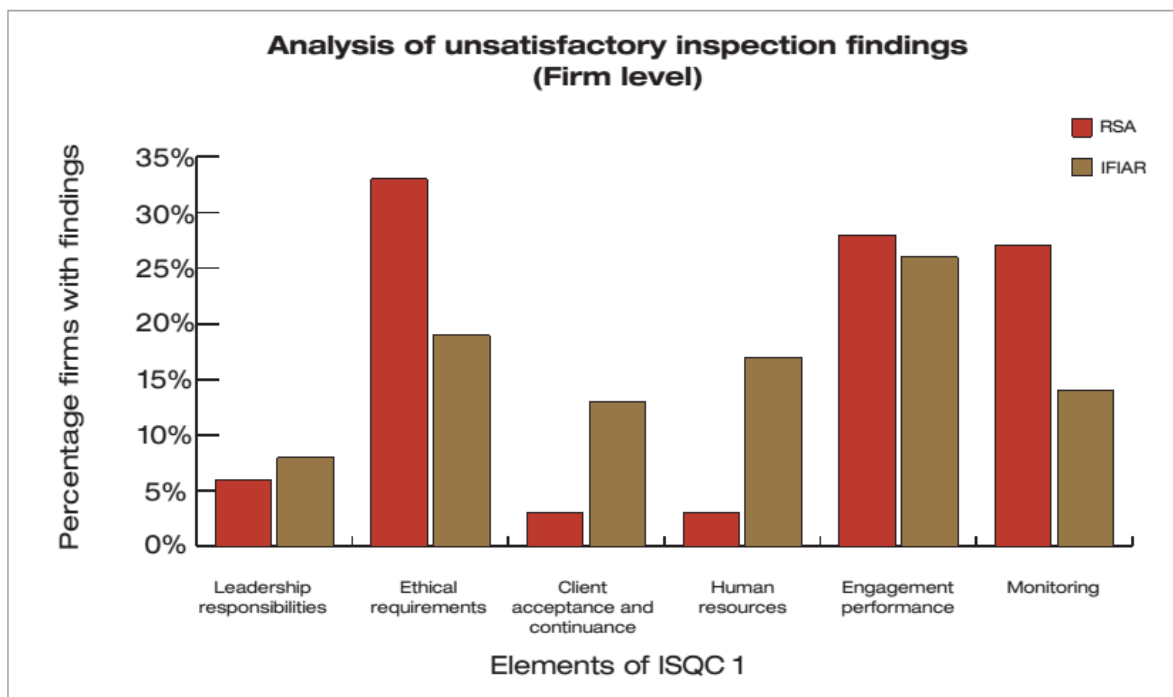
### **The Public Inspections Report**

The IRBA performs inspections on selected firms to evaluate their performance on a selection of audit engagements, as well as the design and effectiveness of their quality



control policies and procedures. The report provides an analysis of key findings arising from firm and engagement inspections performed by the Inspections Department of the IRBA. The latest report was published in December 2015 and covers audits for the year ended 31 March 2015, and also includes an overview of the scope of the IRBA's inspections. (IRBA, 2015c)

The IRBA is concerned that a significant portion of the findings relate to relevant ethical requirements (refer below to Figure 2), and more specifically issues where independence may be considered the root cause. A root cause was identified as "Failure to fortify the importance of professional scepticism and the independence of the engagement team so as to overcome the threats that could develop as a result of their relationship with clients", as well as "Failure to strengthen and maintain independence as an underlying principle for high audit quality." (IRBA, 2015c)



**Figure 2**

**Source:** *IRBA 2014/2015 Public Inspections Report* (IRBA, 2015c)

The above graph (Figure 2) from the latest 2014/2015 Public Inspections Report shows indicates a significant breach by auditors in South Africa of ethical requirements, both relative to other issues, but also in the comparison made to International Forum of Independent Audit Regulators (IFIAR) Inspections Workshop. The IFIAR inspection findings are based on a survey of 29 member countries and present as a percentage the amount of inspected firms with deficiencies found per ISQC1. It should be noted that the IFIAR results represent the largest six global network firms, whereas the results for South Africa span the entire population of large, medium and small auditing firms that were inspected.

Per the IRBA Newsletter 32 – December 2015:

The IRBA Inspection Committee reported on 37 audit firm and 375 audit engagement inspections for the year (IRBA, 2015c, 2015d). Most firms showed one or more deficiencies, including ethics (independence), engagement performance and monitoring, which require urgent improvement. A significant number of individual audit engagement files also showed deficiencies that need urgent attention. A total of 16% of firms and 6% of engagement partners were referred to the Investigating Committee of the IRBA due to fundamental or continued noncompliance with international auditing and financial reporting standards, professional codes and legislative requirements. The report also emphasises the need for audit firms to urgently address ethics and independence matters, as well as engagement quality. (IRBA, 2015c, 2015d)

The IRBA is of the opinion that high-quality auditing and accounting practices are not only essential for reliable financial reporting, but are also critical in protecting the public interest and boosting investor confidence. According to the IRBA, compliance with auditing standards, ethics, financial reporting standards and legislative requirements is fundamental in ensuring a reliable profession that can effectively compete internationally (IRBA, 2015a). Therefore the IRBA is considering advocating a change in South African legislation in order to follow the direction of the European Union in requiring periodic rotation of the audit firm. This system is called mandatory audit firm rotation (MAFR) and its primary purpose is to protect audit quality through promoting the independence of the auditor from the audit client by way of full audit firm rotations every few years. According to the IRBA CEO and 2015 consultation paper issued by the IRBA (entitled “Measures to strengthen auditor independence”), the main reasons that the IRBA Board should consider further measures to strengthen auditor independence are (1) to strengthen auditor independence and so protect the public and investors, (2) address market concentration of audit services and create a more competitive environment; and (3) promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets.

(IRBA, 2015b; SAICA, 2016)

### **Mandating disclosure of audit tenure**

In December 2015, the Regulatory Board (IRBA), in terms of its powers provided by the Auditing Profession Act, Act 26 of 2005, published a Rule in the Government Gazette which makes it mandatory that all auditor's reports on Annual Financial Statements shall disclose the number of years which the audit firm (or sole practitioner) has been the auditor of the entity (audit tenure). The rule (Government Gazette Nr 39475 of 04 December 2015), effective for periods ending on or after 31 December 2015, applies to audit reports issued on the Annual Financial Statements of all public companies, as defined in Section 1 of the Companies Act of 2008, which also meet the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered Auditors (IRBA, 2015e, 2016). The

reason for this requirement was to strengthen auditor independence and was disclosed by the IRBA as follows:

*"The Regulatory Board made the decision to require the mandatory disclosure of audit tenure in the context of strengthening auditor independence which is consistent with measures implemented in other jurisdictions. This disclosure of audit tenure will lead to transparency of association between audit firms and audit clients."* (IRBA, 2015e)

### **International regulatory developments**

According to Hay (2015), current and recent auditing reforms internationally can be classified into those that aim to improve independence, and those intended to increase competence. In recent years, most notably since the collapse of Enron in 2001, regulators have expressed concerns about auditor independence and taken actions to mitigate those concerns (Laurion, Lawrence, & Ryans, 2015). These include the passage of the 2002 Sarbanes–Oxley (SOX) Act, also known as the "Public Company Accounting Reform and Investor Protection Act", which is United States (US) legislation that, among many other requirements, prohibits the auditor (in a US context) from providing most non-audit services to its clients. More specifically, SOX imposes a one-year "cooling-off period" for former auditors taking employment at their previous audit clients and requires audit partners to rotate every five years. In terms of SOX, the US also shifted from a seven-year rotation with a two-year cooling-off period (before SOX), to a stricter five-year rotation and five-year cooling-off period for audit engagements. More specifically the requirement is to rotate (1) the partner having primary responsibility for the audit and (2) the partner responsible for reviewing the audit every five years. The audit committee is required to ensure that the requisite rotation actually takes place (Tepalagul and Lin, 2015).

In the European Union (EU), regulations have also recently changed. The European Parliament in 2014 voted in favour of Directive 2014/56/EU, amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (European Commission, 2015). These new rules force European companies to hire new audit firms at 10- to 24-year intervals, depending on certain criteria, bringing mandatory audit firm rotation into one of the world's most significant economic regions (KPMG, 2014). More specifically, public interest entities have to appoint a new firm of auditors every 10 years. However, member states have the option to extend this maximum period to 20 years (24 if there is a joint audit) provided the audit is subject to a public tender carried out after 10 years. It is expected that the United Kingdom (UK) may also implement mandatory firm rotation in the near future (KPMG, 2014). In 2012, the Financial Reporting Council in the UK introduced a provision in the UK Corporate Governance Code for FTSE 350 companies to consider tendering their audit appointment every 10 years, on a comply or explain basis. The Competition and Markets Authority finished their long running investigation of the UK large company statutory audit market in October 2013, concluding that tendering of the audit appointment should be mandatory for FTSE 350 companies at least every 10 years (PWC, 2014).

As can be seen in the comparison between the US regulations of auditor rotation and the recently adopted EU and the UK audit firm rotation regulations, there is a difference between auditor rotation i.e. audit engagement partner and audit firm rotation (MAFR), although sometimes the terms are used loosely and the distinction is lost. Auditor rotation, as in the US and South Africa, refers to the mandatory rotation of the engagement audit partner after a prescribed five years. Under auditor rotation the audit firm retains the client, providing a different audit partner to the engagement. There is then a “cooling-off” period (five years in the US, two years in South Africa) whereby the rotated audit partner must wait until being allowed to be reappointed as engagement partner on that client. However, audit firm rotation, as is now being adopted in 2016 by the EU, is a step further than this. It requires a change of the audit firm, not simply the audit partner. The audit firm effectively loses the business of the audit client, regardless of the partners in the firm being capable of performing the audit. The EU has adopted this in an attempt to further mitigate the threats (particularly familiarity) to independence (KPMG, 2014). Other than the more significant recent examples of the UK and the EU, other countries such as Brazil, India, Italy, Spain, Singapore and South Korea have required, and some still do require, audit firm rotation (MAFR) after a maximum specified period (Cameran, Vincenzo, Merlotti, and Cameran, 2005). As mentioned, the US is a notable exception against this international trend and the European Union therefore remains the largest economic jurisdiction to apply MAFR rules. Other examples include the UK, Australia and New Zealand (SAICA, 2016).

### **The context in South Africa**

Currently South Africa does not legislate the mandatory audit firm rotation laws as have been implemented in the EU, but rather follows a system similar to the US, with auditor rotation (i.e. individual audit partner) required every five years. This includes a cooling-off period of two years, as prescribed by section 92 of the Companies Act, 2008 (Act No. 71 of 2008). The profession in South Africa also places a large degree of reliance on the ethical standards in order to internally assess (or self-assess) threats to its independence as auditor. These standards are contained in the International Standards on Auditing (ISAs), as well as the Code of Ethics for Professional Accountants issued by the International Federation of Accountants (the IFAC Code). These are internationally recognised auditing standards for which the auditor can use as a guide to self-assess their independence from the audit client.

In South Africa there is also regulation and guidance provided to the audit committee of public interest entities to assess the independence of the auditor. This is legislated in the South African Companies Act, 2008 (Act No. 71 of 2008), as well as the King Report on Governance (King III), which is the South African standard on issues of corporate governance. As an example, the Companies Act requires the audit committee to formally assess the independence of the auditor. However, legislation, standards and regulations of the Johannesburg Stock Exchange (JSE) have all stopped short of requiring mandatory audit firm tendering or audit firm rotation as is now being implemented in the EU and the UK.

According to Hay (2015) the research of the effects of rotation of audit firms, including systems of joint audits, is very much in its infancy and requires significant attention, especially considering the recent international focus.

The purpose of this study is to examine the perceptions of leading and senior audit practitioners about the state of auditor independence in public interest entity audits in South Africa. Is there a problem with auditor independence in reality and/or in perception i.e. in the minds of the public? If so, how could this be best addressed so as to promote high quality financial reporting and therefore the protection of the public interest? These questions must first be addressed before considering whether regulatory change is required in South Africa in order to strengthen auditor independence.

Perception of auditor independence and audit quality is important, as described in the International Federation of Accountants (IFAC) Code of Ethics for auditors (section 290:8), because of the need for the auditor to have independence in both mind and appearance to a third party (International Federation of Accountants (IFAC), 2006). The audit opinion provides assurance to the market and the public of the credibility of the financial statements, as explained in the International Standards on Auditing (ISA 200, paragraph 3), and therefore this independence of the auditor in the eyes of the market is necessary. According to ISA 200, the audit enhances “the degree of confidence of intended users in the financial statements” (ISA 200, paragraph 3).

### **Mixed Results in the Literature**

A study by Tepalagul and Lin (2015) consisted of a comprehensive review of academic research pertaining to auditor independence and audit quality. Through a review of published articles during the period 1976-2013 in nine leading journals related to auditing, most studies concluded that long auditor tenure does not impair independence (Tepalagul & Lin, 2015), although there are some mixed results. According to Tepalagul & Lin (2015), some studies even find that long tenure actually improves audit quality and that short tenure is associated with lower audit quality. In addition, this study concluded that there is limited evidence that auditor independence is compromised in the presence of a high degree of client importance and non-audit services provided.

There is very extensive research on the effects of non-audit services by auditors, as reviewed by Sharma (2014, p.85). Sharma (2014, p.85) analyses 45 research studies on this topic and finds that there is a lack of evidence that auditors lose their independence, but that policy makers often feel an urge to regulate anyway, despite criticism from the accounting profession and corporate executives.

As an example of the mixed results around auditor independence, conflicting results were identified by Johnson et al. (2002) who examined whether the length of the relationship between a company and an audit firm (audit firm tenure) is associated with financial reporting quality. Johnson et al. (2002) categorised auditor-client relationships

into periods of short, medium and long tenures. Using two proxies for financial reporting quality, based on accounting accruals, and a sample of large audit firm clients matched on industry and size, Johnson et al. (2002) found that, relative to medium audit firm tenures of four to eight years, short audit firm tenures of two to three years are associated with lower-quality financial reporting. Again, in contrast to the shorter periods, Johnson et al. (2002) found no evidence of reduced financial reporting quality for longer audit firm tenures of nine or more years.

Bamber and Iyer (2007) used a theory-based measure for the extent to which auditors identify with a client, which was then used to directly measure auditors' attachment to the client and consequently the threat of this attachment to auditors' objectivity. The responses of 252 practicing auditors were obtained, providing support for the predictions of Bamber and Iyer (2007). Specifically, Bamber and Iyer (2007) found that auditors do identify with their clients and that auditors who identify more with a client are more likely to agree with the client preferred position on an audit and financial reporting matter. However, more experienced auditors and auditors who exhibit higher levels of professional identification are less likely to acquiesce to the client's position. Differing incentives were identified for the partner in comparison to the firm. The incentive of the individual audit partner may conflict with that of the audit firm so that long partner tenure increases the likelihood of the auditor acquiescing to the client's preferences, whereas audit firm tenure is associated with the decreased likelihood of auditor concessions (Bamber & Iyer, 2007). By looking at the differing incentives of the firm as a whole, compared to that of the individual partner in the firm, the results imply that, unlike an audit partner, an audit firm may have stronger reputational incentives to remain independent. Therefore, rotating the firm, as opposed to the partner, may not be the best means to achieve independence and audit quality.

The mixed results in the academic literature are clear and it cannot be concluded with certainty that long audit tenures or non-assurance services measurably impair auditor independence and audit quality.

## Research Methodology

This is a descriptive study that employs a qualitative research methodology. Qualitative studies aim to explain the ways in which people come to understand and account for issues, events and behaviours in their lives. Therefore the data gathered covers the perceptions, opinions and reasoning of the participants based on their unique experiences of areas related to the topic studied (DiCicco-Bloom & Crabtree, 2006).

The purpose of this study is to examine the perceptions of senior audit practitioners about the state of auditor independence in public interest entity audits in South Africa. To achieve this semi-structured interviews were performed with experienced partners, ranging between seven and thirty-three years as a practicing registered auditor, across a number of audit firms nationally. A semi-structured interview is a qualitative method of inquiry that combines a pre-determined set of open-ended questions (questions that

prompt discussion), with the opportunity for the researcher to explore particular themes or responses further. This type of interview does not limit respondents to a set of pre-determined answers, unlike a structured questionnaire for example (Dearnley, 2005).

Semi-structured in-depth interviews are the most widely used interviewing format for qualitative research and can occur either with an individual or in groups (DiCicco-Bloom and Crabtree, 2006). The open nature of the questions encourages depth and vitality in the responses by the interviewees and allows new concepts to emerge over the course of the interviews (Dearnley, 2005).

### **The population and the selection**

This study employs a purposive sampling technique, also known as judgemental, selective or subjective sampling. Purposive sampling is a type of non-probability sampling which focuses on sampling techniques where the units that are investigated are based on the judgement of the researcher, rather than on statistical techniques (Lærd Dissertation, 2016). Purposive sampling technique is most effective when one needs to study a certain domain which contains knowledgeable experts. In choosing a sampling method for informant selection, the question the researcher is interested in answering is of utmost importance and it is especially important to be clear on informant qualifications when using purposive sampling (Tongco, 2007).

Fourteen practicing “registered auditors” (audit partners) were selected from nine different audit firms in order to perform the interview (refer to table below). According to the book entitled “The Long Interview” by McCracken (1988), as cited in DiCicco-Bloom and Crabtree (2006), in-depth interviews are used to discover shared understandings of a particular group and the sample of interviewees should be fairly homogenous and share critical similarities related to the research question. This selection of audit partners is therefore a homogenous group that share critical experience related to the research question. The selection is also considered to be fairly representative of the population of registered auditors in South Africa, especially considering that the audit partners selected were involved in the senior leadership of their respective audit practices and were considered sufficiently experienced as audit practitioners, having worked for many years in the capacity of audit partner (ranging between seven and thirty-three years as a practicing registered auditors).

The commonly agreed and recognised distinction between the audit firms (Marx, 2009; Rapoport, 2016) has been used in this study and is as follows:

- “Big four” audit firms refer to the largest four accounting and audit firms globally, namely Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young (EY) and KPMG. These four firms are also referred to as “large-tier” firms (ICAEW, 2016a).
- The non-big four firms are either mid-tier or small-tier firms depending on their respective global size, global presence and capabilities as an audit firm in terms of resources (ICAEW, 2016b; Rapoport, 2016).

The researcher and the participants in this study will use these terms in the interview discussions. The following is a description of the fourteen practitioners interviewed:

- All the partners were considered senior and highly experienced, ranging between seven years as a practicing audit partner and thirty-three years. The average number of years as a practicing registered auditor of all interviewees is 22 years.
- Seven of the partners were either regional or national managing partners in the firms and therefore in key leadership and strategic roles. The remainder were senior partners who also held significant leadership responsibilities and portfolios within their respective firms or network of firms.
- The audit firms were selected from Johannesburg and Cape Town offices of the network firms.
- Of the fourteen partners, two were women.
- The two largest black audit firms in South Africa, namely SizweNtsalubaGobodo Inc. and Nkonki Inc. were represented. These two firms are the largest “black-owned” audit firms in South Africa and have grown to considerable size to rival the traditional “mid-tier” firms.
- Five partners were from the “big four” international audit firms.
- The remaining partners were from the “mid-tier” audit firms (including the “black-owned” medium size firms) who also perform audit services of public interest entities.

The below table shows a further description of the audit partners (participants) interviewed, including the number assigned for the purposes of analysing the results of the interviews, i.e. “Audit Partner 1”, “Audit Partner 2” etc.:

Designation of Participant in Analysis of Results	"Big four" or "Mid-tier" or "Black-owned Mid-tier" firm	Position	Years as Practicing Audit Partner
<i>Audit Partner 1</i>	Big four	Senior partner	25
<i>Audit Partner 2</i>	Big four	Managing Partner	20
<i>Audit Partner 3</i>	Big four	Senior partner	25
<i>Audit Partner 4</i>	Big four	Senior partner	9
<i>Audit Partner 5</i>	Big four	Senior partner	23
<i>Audit Partner 6</i>	Black-owned Mid-tier	Managing Partner	22
<i>Audit Partner 7</i>	Black-owned Mid-tier	Managing Partner	23
<i>Audit Partner 8</i>	Black-owned Mid-tier	Senior partner	29



<i>Audit Partner 9</i>	Mid-tier	Managing Partner	32
<i>Audit Partner 10</i>	Mid-tier	Managing Partner	17
<i>Audit Partner 11</i>	Mid-tier	Senior partner	16
<i>Audit Partner 12</i>	Mid-tier	Managing Partner	33
<i>Audit Partner 13</i>	Mid-tier	Managing Partner	28
<i>Audit Partner 14</i>	Mid-tier	Senior partner	7

### **Interview process and methodology**

Each interview was held in person with the respective participants and lasted between one and two hours, the discussion audio being electronically recorded with the express permission of each participant.

According to Leedy and Ormrod (2010), qualitative data analysis ideally occurs concurrently with data collection so that the researcher can generate an emerging understanding about research questions, which in turn informs both the sampling and the questions being asked. This was certainly the case within this study as while the interviews were being conducted, new opinions were documented which fed into and shaped the subsequent discussions with interviewees. This iterative process of data collection and analysis eventually leads to a point in the data collection where no new categories or themes emerge, referred to as saturation, signalling that data collection is complete (DiCicco-Bloom and Crabtree, 2006). Saturation is believed to have been reached in these interviews in the sense that no new themes or categories surrounding the question of MAFR emerged in the last interviews, indicating that the sample of fourteen practitioners was sufficient for the purpose of the study. The transcribed data was then used in order to identify common, recurrent, or emergent themes around the issue of the role of audit committees in preserving auditor independence and quality financial reporting, rather than pursuing MAFR in South Africa.

## **Presentation and Analysis of Results**

### **The need for improved auditor independence**

There was some degree of mixed response with regard to whether or not South African auditors were appropriately independent, however most (11/14) were of the opinion that independence was not a concern in reality, especially for public interest entities where a partner rotation is mandatory every five years. The three dissenting opinions in this regard all made the point that audit committees are failing to properly and independently assess the independence of external auditors and this was part of the problem. Interestingly, there were no partners, of the fourteen interviewed, who were fully in favour of mandatory audit firm rotation (MAFR) in South Africa. This includes the three partners who expressed concern regarding the state of auditor

independence. Most were against MAFR on the grounds that (1) it would not achieve improved auditor independence and (2) that there were too many significant negative consequences to changing legislation in favour of MAFR.

After expressing that independence in their experience was not a real concern, i.e. that the degree of auditor independence in their audits was sufficient, one partner expressed the following qualification:

**“But then you say on the flipside, you know the counter argument against that, when the client is such a dominant number in your world - you know, four or five percent of your fees - you can never be independent. In reality with any client paying fees to the practitioner you can never be independent, so you get to the heart of it because I’m ultimately coming back to the client for my fee discussion and I can’t be independent. And so whether you do that rotate [MAFR] it’s not going to make a difference.”** (*Audit Partner 12*)

The point being made here was that in a regime of partner rotation or MAFR, the partner and the firm will always be dependent on the client for the audit fee and the audit fees are often significant to the auditor. Therefore MAFR would not be solving the problem entirely in any case. However, this partner agreed with most of the interviewees that independence was not actually a significant problem in reality.

One partner (*Audit Partner 10*) felt that, as a mid-tier firm partner, there are many medium size businesses that are considered public interest entities in South Africa but are relatively small private companies. These businesses are often family owned and management (who are the owners) will often rely on the professional advice of their auditors and over time will develop a good relationship with the partners at the audit firm. This good relationship with the client and the professional advice offered by audit firm should not be automatically considered an independence problem as the firm manages its conflicts of interests as guided by the Code of Professional Conduct and the integrity that comes with being a professional. Too often, in their opinion, the public assumes a lack of independence when in reality there is no such thing.

The partner who expressed this view also made the point that the public interest score, as it is currently contained in the Regulations to the Companies Act 71 of 2008, results in too many smaller businesses being labelled as public interest entities. However, this partner’s point was that regulation like MAFR may force a greater degree of independence but that would lead to other unintended consequences on the profession and on audit quality. Nearly all partners interviewed expressed a strong concern that the implementation of MAFR will not improve audit quality, even if it may improve auditor independence. The concerns expressed were in regard to the unintended consequences and effects of MAFR, which are not discussed for the purposes of this paper.

### **Public perception of independence**

Most audit partners (11/14) agreed that there is a significant difference between the public perception of independence and the reality of auditor independence, with the public's perception being significantly worse (i.e. perception of an independence or audit quality problem) than what was in reality the case (in their opinion). These partners are all in favour of pursuing means of addressing public misconceptions about the audit function and about auditor independence before making a decision on MAFR. In their opinion the regulator (IRBA) should look at means of addressing the perception problem before looking to change legislation in the profession. A number of partners illustrated this point with the example of how, in their experience of discussing their work with company stakeholders and the general public, it is not uncommon for people to express their understanding that it is the auditor's role to guarantee the accuracy of the financial statements and to detect all forms of fraud and mismanagement. These experiences are evidence that the public does indeed misunderstand the role and value added of the auditor. In the opinion of these partners, MAFR should not be adopted in response to public perception per se, but rather other more effective and perhaps less damaging methods (to audit quality and the profession) should be pursued by both the IRBA and the profession to educate public understanding of the limitations of the audit function.

**"If there were let's say, an error. We had, I'm thinking of last year, let's say, we had an error with a set of listed companies [a group of companies]. I think it's an easy scapegoat to say "ah, you guys have been for thirty years the auditors and that's why you missed it!" I think they [the public] missed completely the point. I think there's no correlation between an error and how long you've been their auditor. It's mainly because you just missed something the last year, you must understand, it's not because you've been here for thirty years because the partners are only there five years. That's definitely for me a perception - that is not a reality. If you want a fresh perspective, we do see that where the partner rotates... The partner comes in with new ideas and so I think that gets actually done." (Audit Partner 2)**

Expressing their concern around reacting to the public's perception one partner stated:

**"I'm just a bit concerned that there's a degree of over-reaction around things and that really worries me. I mean, we are professionals at the end of the day. Independence ethics is the cornerstone of what we do... you know, the firms have their policies and procedures in place around ethics and independence and it's taken very seriously. So, I mean we have, ours [referring to the firm] is even narrower than most and likewise what IRBA and the codes have got in place, so it's extremely rigid. I'm just a bit worried that this heightened focus, too much focus on it...by all and sundry, various stakeholders. I'm worried that the regulator's jumping onto something because this is what's happened overseas. We're number one in terms of World Bank Risk Report." (Audit Partner 5)**

A number of partners raised the point that there is a high degree of ethical standards – at a professional level and at a firm level – that the audit

practitioners need to adhere to. And in their opinions they find that the partners take this very seriously. In addition, the fact that South African audit partners are required by local regulations to place their personal name on the audit report and sign, together with the firm name, was raised as a further reason for the partner to guard his or her independence. The international audit standards do not require the name of the engagement partner on the signed audit report.

**“You’re personally invested. It’s my name. I’ve signed. You’re out there in the public... You’re holding yourself out there. It’s me, it’s not [firm name], I’m signing there as well.”**  
(*Audit Partner 5*)

### **The Public Inspections Report**

All the partners interviewed expressed varying degrees of unhappiness and concern regarding the IRBA public inspections process. The common feeling was that the reviews are too harsh on the profession and do not allow for sufficient professional judgment to be exercised by the auditor, as is the allowance and indeed the requirement of the International Standards on Auditing (ISAs). Partners described the IRBA inspections as too much of a tick-boxing exercise that does not properly account for professional judgement exercised by the audit team.

All the audit partners interviewed expressed concern over the degree of regulation in the profession. In fact, the issue of over-regulation resulted in the strongest opinions and even frustration amongst the partners. Many were particularly concerned over the nature of the public inspections process as performed by the IRBA and feared that additional regulation was damaging the ability of the practitioners to make professional judgement calls, something absolutely necessary in performing an audit, and which the International Standards of Auditing (ISAs) strongly require of the auditor. The concern was simply that MAFR would be another unnecessary regulation in an already over-burdened profession.

**“So I’m saying there’s a lot there that’s going to lighten or reduce the expectation gap when it comes to stakeholders and users, because they’ll be able to read each audit report [which] will be specific. It’s not going to be a template. They will be able to understand... And independence and all of that, rather than just coming with a rule if it’s mandatory. We are principles-based at the end of the day. And we’re relying on judgement from the profession and from the Audit Committee. Both sides of the engagement are applying their minds and their skills and they’re qualified to do so... Doesn’t that make us a profession? That fact that we exercise professional judgement? We don’t tick boxes. The more we tick boxes... that will directly affect the quality of what we do. That’s where the regulator needs to get a balance... I hope common sense prevails. I think we’ve got a lot of checks and balances in place. I mean enhancing existing structures and I’m not one in favour of rules. We are principle-based, we must deal with it and the King Codes have done tremendous work over the years with the Institute of Directors.”** (*Audit Partner 5*)

### **The role of the audit committee**

All the audit partners (14/14) agreed that the audit engagement and the choice of the auditor, as well as any non-assurance services required, is a decision of both the audit committee, being those charged with governance by the shareholders, as well as the auditors themselves. The audit committee, whose existence is a legislative requirement in South Africa for a public interest entity (refer to section 94 of the Companies Act 71 of 2008), is ultimately responsible for the recommendation for the nomination and the replacement of the auditor, subject to approval by the shareholders. The decision of whether or not to ask the auditors for non-assurance services and whether or not to put the audit out for tender, is ultimately in the hands of the audit committee, being those charged with governance by the shareholders.

All the partners interviewed (14/14) agreed with the reasoning that the best means of improving auditor independence is actually to improve the quality of corporate governance in the audit clients, rather than through regulation. Improving the quality of the non-executives on the audit committees, possibly through education and promotion of King III Report principles of corporate governance (soon to be replaced by King IV), was believed to be a means of having a greater impact on auditor independence and audit quality.

In the opinion of one partner, **“the Audit Committees that I have served on over the years and continue to serve on now take auditor independence very seriously. Our firm and my experience of the other big firms, I can’t talk for the smaller and medium sized firms... the audit firms themselves take auditor independence extremely seriously... If you just consider that South Africa is the pre-eminent market as far as implementation of corporate governance King III etcetera is concerned, it really is at the top of its game. And those Audit Committees are very diligent and they take all of the issues - not just auditor independence, all of their budgetary duties... very seriously.”** (*Audit Partner 1*)

The pointing to instances of strong audit committees was this partner’s way of explaining that when the opposite is the case, i.e. weak governance by the audit committee, this is when there is the greatest potential for independence of the auditor and audit quality to be compromised exists. Auditor independence is a function of both parties and both sides to the engagement letter need to be independent and professional. The audit committee must remain independent of management and professional in their execution of their role. The auditor must remain independent of the client and professional in their execution of their role.

## **Summary and Conclusion**

Most audit partners do not believe that any changes to regulations are necessary to address auditor independence and the policies and structures in place currently are

sufficient. The profession must be allowed the freedom to exercise its professional judgement and adherence to the ethical codes of conduct. Regulation restricts their ability to do that.

The partners expressed a strong belief that the public inspections process itself needs to be re-looked at by the regulator and moved in a direction that allows professional judgement and less compliance focus.

The audit committee's role in appointing suitably independent auditors and continually assessing any factors such as tenure and non-assurance fees, that may compromise that independence, is crucial.

Most audit partners (11/14) expressed the view that there is no problem with auditor independence in reality, but rather that public perception and public misunderstanding of the audit function, was the issue. Rather than respond with more regulation (such a MAFR), they would have the regulator address public understanding of the role (and the limitations) of the audit function.

### **Areas for further research**

Auditor independence, including public perception thereof, as well as regulatory responses, requires more attention by South African auditing academics. This research will be followed by a national survey of the South African audit profession in order to provide a representative view from the profession on auditor independence, and particularly the IRBA's intention to address it with regulation. The IRBA is currently considering mandatory audit firm rotation legislation (MAFR) as a possible response, similar to that enacted in the European Union. The impact on, and the opinions of, other stakeholders such as audit committee members, management and investment professionals in these matters need to be understood as well. Research also needs to be performed around the effectiveness of the regulator's public inspections. A direct response to the 2014/2015 Public Inspections Report from the profession in this respect is also recommended.

## **Bibliography**

- Bamber, E. M., & Iyer, V. M. (2007). Auditors' identification with their clients and its effect on auditors' objectivity. *Auditing: A Journal of Practice & Theory*, 26(2), 1–24.
- Buffet, M., & Clark, D. (2006). *The Tao of Warren Buffett*. New York, NY: Scribner.
- Cameran, M., Vincenzo, D. Di, & Merlotti, E. (2005). The Audit Firm Rotation Rule : A Review of the Literature. *SDA Bocconi Research Paper*, (September).
- Carey, P., & Simnett, R. (2006). Audit Partner Tenure and Audit Quality. *The Accounting Review*, 81(4), 653–676.
- Daniels, B. W., & Booker, Q. (2011). The effects of audit firm rotation on perceived auditor

- independence and audit quality. *Research in Accounting Regulation*, 23, 78–82.
- DeAngelo, L. E. (1981). Auditor size and audit quality. *Journal of Accounting and Economics*, 3, 183–199.
- Dearnley, C. (2005). A reflection on the use of semi-structured interviews. *Nurse Researcher*, 13.1.
- DiCicco-Bloom, B., & Crabtree, B. F. (2006). The qualitative research interview. *Medical Education*, 40(4), 314–321.
- European Commission. (2015). Directorate-General for Financial Stability. Retrieved May 2, 2016, from <https://www.unodc.org/unodc/en/drug-trafficking/legal-framework.html>
- Hay, D. (2015). The frontiers of auditing research. *Meditari Accountancy Research*, 23(2), 158–174.
- ICAEW. (2016a). Accountancy firms. Retrieved May 24, 2016, from <http://www.icaew.com/en/about-icaew/what-is-chartered-accountancy/accountancy-firms>
- ICAEW. (2016b). Accountancy firms (ICAEW). Retrieved from <http://www.icaew.com/en/membership/regulations-standards-and-guidance/practice-management/use-of-chartered-accountants-regulations>
- International Federation of Accountants (IFAC). (2006). *Code of Ethics for Professional Accountants. IFAC (2006 revised)*. Retrieved from <http://scholar.google.com/scholar?hl=en&btnG=Search&q=intitle:Code+of+Ethics+for+Professional+Accountants#4>
- International Federation of Accountants (IFAC). (2009). *International Standard on Auditing 200. ISA 200*. Retrieved from [http://www.ifac.org/sites/default/files/publications/files/2012 IAASB Handbook Part I\\_Web.pdf](http://www.ifac.org/sites/default/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf)
- IRBA. (2015a). *Consultation Paper: Measures to Strengthen Auditor Independence*.
- IRBA. (2015b). *Consultation paper: Measures to Strengthen Auditor Independence*. Retrieved from <http://www.irba.co.za/news-headlines/press-releases>
- IRBA. (2015c). *IRBA 2014/2015 Public Inspections Report*. Retrieved from [http://www.paab.co.za/dmdocuments/Public Inspections Report 2015.pdf](http://www.paab.co.za/dmdocuments/Public%20Inspections%20Report%202015.pdf)
- IRBA. (2015d). *IRBA Newsletter 32*. Retrieved from <http://www.irba.co.za/index.php/publications-mainmenu-121/newsletters-mainmenu-123?task=section>
- IRBA. (2015e). *IRBA Strengthens Auditor Independence by Mandating Disclosure of Audit Tenure*. Retrieved from <http://www.irba.co.za/guidance-for-ras/general-guidance/audit-tenure>
- IRBA. (2016). *Frequently Asked Questions on Disclosure of Audit Tenure*. Retrieved from <http://www.irba.co.za/guidance-for-ras/general-guidance/audit-tenure>
- ISA 200. (n.d.). *IFAC: International Standard on Auditing 200. ISA 200*.
- Johnson, V. E., Khurana, I. K., & Kenneth Reynolds, J. (2002). Audit- firm tenure and the quality of financial reports. *Contemporary Accounting Research*, 19(4), 637–660.
- KPMG. (2014). *EU Audit Reform*. Retrieved from <https://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Documents/EU-Audit-Reform-Fact-Sheet-MFR.pdf>

- Lærd Dissertation. (2016). Purposive Sampling. <http://doi.org/10.4135/9781412950589.n774>
- Laurion, H., Lawrence, A., & Ryans, J. (2015). U . S . Audit Partner Rotations. *Haas School of Business*.
- Leedy, Paul D; Ormrod, J. E. (2010). *Practical Research: Planning and Design. Practical Research - Planning & Design*.
- Marx, B. (2009). Challenges Facing the Modern Day Auditing Profession. *Accountancy SA*, 16–19.  
Retrieved from <http://search.proquest.com.ezproxy.canterbury.ac.nz/docview/215224897?accountid=14499>
- PWC. (2014). *Audit firm rotation and tendering in the UK: Piecing together the jigsaw puzzle*.  
Retrieved from [http://hb.betterregulation.com/external/Audit firm rotation and tendering in the UK.pdf](http://hb.betterregulation.com/external/Audit%20firm%20rotation%20and%20tendering%20in%20the%20UK.pdf)
- Rapoport, M. (2016). Auditing the Auditors : U.S. Rethinks Approach. *Wall Street Journal*, (May).  
Retrieved from <http://www.wsj.com/articles/u-s-government-rethinks-how-it-audits-auditors-1462440600>
- SAICA. (2016). *Discussion Paper: Considering Mandatory Audit Firm Rotation (MAFR)*. Retrieved from [http://www.saica.co.za/Portals/0/documents/MAFRDiscussionPaper.pdf?Reference\\_ID=45018384](http://www.saica.co.za/Portals/0/documents/MAFRDiscussionPaper.pdf?Reference_ID=45018384)
- Sharma, D. S. (2014). *The Routledge Companion to Auditing*. (K. Hay & J. Willekens, Eds.). Routledge, Abingdon.
- Tepalagul, N., & Lin, L. (2015). Auditor Independence and Audit Quality: A Literature Review. *Journal of Accounting, Auditing & Finance*, 30(1), 101–121.
- Tongco, M. D. C. (2007). Purposive sampling as a tool for informant selection. *Ethnobotany Research and Applications*, 5, 147–158.



# 2016 Southern African Accounting Association (SAAA) National Teaching and Learning and Regional Conference Proceedings

ISBN number: 978-0-620-74761-5



## **AUD 03: An exploration of audit practitioner opinions on mandatory audit firm rotation in South Africa: a specific focus on market concentration and transformation issues**

**Authors:** Michael Harber and Gizelle Willows, University of Cape Town  
Email: [michael.harber@uct.ac.za](mailto:michael.harber@uct.ac.za)

### **Abstract**

*The provision of assurance services, most notably the audit function, is an activity of public protection that requires a high degree of independence between the auditor and the audit client to ensure audit quality is achieved. Internationally, especially in the European Union, there is a legislated move towards mandatory audit firm rotation (MAFR) to ensure auditor independence. South Africa is currently faced with the decision of whether to change legislation and follow suit.*

*The three main reasons why the IRBA are considering further measures, such as MAFR, to strengthen auditor independence are (1) to strengthen auditor independence and so protect the public and investors, (2) address market concentration of audit services and create a more competitive environment; and (3) promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets. Internationally, the primary reason that MAFR is considered is to achieve auditor independence and therefore ensure audit quality.*

*Therefore research is needed to assess the credibility of the IRBA's additional reasons, as well as the impact of MAFR on these factors, namely market competition and transformation in the audit profession. Using a qualitative and descriptive methodology, through the use of semi-structured and open interviews with experienced South African audit partners, two of the three key reasons in favour of MAFR, as provided by the IRBA, were explored.*

*The research objective is to document the opinions of a select group of experienced audit practitioners regarding the credibility of the IRBA's additional reasons, as well as the impact of MAFR on these factors, namely market competition and transformation in the audit profession.*

*The results show that the partners interviewed have mixed opinion regarding the ability of MAFR legislation to achieve these two goals appropriately. There is significant concern as to whether MAFR will not actually reduce market concentration amongst the large company audits. MAFR was generally not regarded as South Africa's best option to achieve IRBA's stated goals of increased competition and transformation in the audit profession. There is some difference of opinion between those partners from big four firms compared to those in mid-tier firms.*

## Introduction and Literature Review

### Introduction

The provision of assurance services, most notably the audit function, is an activity of public protection. In the eyes of the public, especially the investing public and all stakeholders of the company, the audit function provides the much needed stamp of credibility and assurance as to the fair presentation of the company's financial reporting. Auditor independence is important because it has an impact on audit quality. DeAngelo (1981) suggests that audit quality is defined as the probability that:

- (a) The auditor will uncover a breach of statutory or regulatory requirement and
- (b) Report the breach to the appropriate parties.

If auditors do not remain independent, they might be less likely to report irregularities or insist that financial statements be prepared to their satisfaction, thus, impairing audit quality (Carey and Simnett, 2006). This potentially lessens the credibility of the financial reporting process and hence why regulations are imposed to ensure the professional standards and the independence of the external audit function. Most countries, including South Africa, have moved away from self-regulation the audit profession, to a system of using an independent regulatory body. In South Africa this regulatory authority is the Independent Regulatory Board for Auditors (IRBA).

Per discussion with the CEO of the IRBA in December 2015, the transcript of which is available upon request, the national regulator is considering advocating a change in South African legislation in order to follow the direction of the European Union in requiring rotation of the audit firm periodically. This system is called mandatory audit firm rotation (MAFR) and its primary purpose is to protect audit quality through promoting the independence of the auditor from the audit client by way of full audit firm rotations every few years. According to the IRBA CEO and consultation paper issued by the IRBA, the main reasons why the IRBA Board must consider further measures to strengthen auditor independence are (1) to strengthen auditor independence and so protect the public and investors, (2) address market concentration of audit services and create a more competitive environment; and (3) promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets.

(IRBA, 2015)

### International developments

In recent years, most notably since the collapse of Enron in 2001, regulators have expressed concerns about auditor independence and taken actions to mitigate those concerns (Laurion, Lawrence, & Ryans, 2015). These include the passage of the 2002 Sarbanes–Oxley (SOX) Act, also known as the "Public Company Accounting Reform and Investor Protection Act", which is United States (US) legislation that, among many other requirements, prohibits the auditor (in a US context) from providing most non-audit services to its clients.

In the European Union (EU), regulations have also recently changed. The European Parliament in 2014 voted in favour of Directive 2014/56/EU, amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (European Commission,

2015). These new rules force European companies to hire new audit firms at 10- to 24-year intervals, depending on certain criteria, bringing mandatory audit firm rotation into one of the world's most significant economic regions (KPMG, 2014).

Other than the more significant recent examples of the UK and the EU, other countries such as Brazil, India, Italy, Spain, Singapore and South Korea have required, and some still do require, audit firm rotation (MAFR) after a maximum specified period (Cameran, Vincenzo, Merlotti, and Cameran, 2005). The US is a notable exception against this international trend and the European Union therefore remains the largest economic jurisdiction to apply MAFR rules.

### The context in South Africa

Currently South Africa does not legislate the mandatory audit firm rotation laws as have been implemented in the EU, but rather follows a system similar to the US, with auditor rotation (i.e. individual audit partner) required every five years. This includes a cooling-off period of two years, as prescribed by section 92 of the Companies Act, 2008 (Act No. 71 of 2008). The profession in South Africa also places a large degree of reliance on the ethical standards in order to internally assess (or self-assess) threats to its independence as auditor. These standards are contained in the International Standards on Auditing (ISAs), as well as the Code of Ethics for Professional Accountants issued by the International Federation of Accountants (the IFAC Code). These are internationally recognised standards for which the auditor can assess their independence from the audit client.

In South Africa there is also regulation and guidance provided to the audit committee of public interest entities to assess the independence of the auditor. This is legislated in the South African Companies Act, 2008 (Act No. 71 of 2008), as well as the King Report on Governance (King III), which is the South African standard on issues of corporate governance. As an example, the Companies Act requires the audit committee to formally assess the independence of the auditor. However, legislation, standards and regulations of the Johannesburg Stock Exchange (JSE) have all stopped short of requiring mandatory audit firm tendering or audit firm rotation as is now being implemented in the EU and the UK.

According to Hay (2015) the research of the effects of rotation of audit firms, including systems of joint audits, is very much in its infancy and requires significant attention, especially considering the recent international focus.

### The position of the Independent Regulatory Board for Auditors (IRBA)

At the forefront of IRBA's mind in the MAFR debate, is the need to pursue a solution that (1) meets the objective of IRBA, but also (2) to be consistent with the priorities set out in the "four key pillars".

IRBA's objective is to endeavour to protect the financial interests of the South African public and international investors in South Africa through the effective and appropriate regulation of audits conducted by registered auditors, in accordance with internationally recognised standards and processes. Therefore the financial interest of the public is utmost priority in the MAFR decision.

However the four key pillars are also important, namely:

1. Comprehensive regulator

2. Independence. Strengthening both the independence of the IRBA and the independence of registered auditors.
3. Leadership in Africa.
4. Transformed profession. Influencing the advancement of transformation in the profession.

(IRBA, 2015)

As part of IRBA's initiative to strengthen auditor independence in South Africa, the regulator has embarked on a series of national workshops and has issued a consultation paper to specifically consider MAFR. Given the importance of responding to the need to strengthen auditor independence, the IRBA Board had a workshop in July 2015 and received comment from audit firms. IRBA also issued a consultation paper in October 2015, requesting comment from executive and non-executive directors. (IRBA, 2015)

According to the consultation paper, the main reasons why the Board must consider further measures to strengthen auditor independence are the following:

- It will strengthen auditor independence and so protect the public and investors, which is part of the IRBA's strategy;
  - It will address market concentration of audit services and create a more competitive environment, which will positively influence audit quality; and
  - It will promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets, provided they are competent to audit in those markets.
- (IRBA, 2015)

Black economic empowerment (transformation / affirmative action initiatives) is a specific priority in the economy, acknowledged by both business and government as an ethical and urgent national priority. South Africa's history of Apartheid and its impact on the economy and society today has resulted in a widespread desire to "level the playing field" and redress the inequalities of Apartheid by giving previously disadvantaged groups of South African citizens' economic privileges previously not available to them. This has significant impact on the MAFR debate in South Africa.

The purpose of this study is to examine the effects that a system of mandatory audit firm rotation (MAFR), if imposed in South Africa, would have on the South African national priority of transformation as it applies to the audit profession, as well as competition in the audit industry.

## **Literature Review**

The following literature review will examine the impact of audit firm rotation (MAFR) in the few countries that have implemented it through legislation. More studies have been performed on audit tenure in comparison to full audit firm rotation (MAFR), owing to the relatively recent move of jurisdictions such as the European Union and the UK towards MAFR. This review will only focus on mandatory audit firm rotation.

### **The effect of audit firm rotation on audit quality**

A study by Tepalagul and Lin (2015) consisted of a comprehensive review of academic research pertaining to auditor independence and audit quality. Through a review of published articles during the period 1976-2013 in nine leading journals related to auditing, most studies

concluded that long auditor tenure does not impair independence (Tepalagul & Lin, 2015), although there are some mixed results.

As mentioned above, recent studies have mostly concerned themselves with audit partner (auditor) rotation (Bowlín et al., 2014; Daugherty et al., 2012; Laurion et al., 2015; Tepalagul & Lin, 2015), rather than audit firm rotation. According to the South African Independent Regulatory Board for Auditors (IRBA), since the audit failures associated with Enron, larger corporates in South Africa and major financial institutions across the globe, the independence of auditors and regulators have become a focal point for governments and oversight structures (IRBA, 2015). It is for this reason that the recent European Union legislation concentrates on improving independence rotation of audit firms after a fixed period of 20 years; a cap on the amount of fees for non-audit services at 70 per cent of the audit fee; and encouragement for companies to adopt joint audits (Hay, 2015). Investors and the public are also demanding more information and transparency and have become more aware of their rights to be protected (IRBA, 2015). However, there is very little research on the effectiveness and consequences of audit firm rotation specifically. According to Hay (2015) the rotation of audit firms is a difficult area to research because there are so few practical situations where it has been enforced. As a result, “there is no clear evidence about whether it is effective” (Hay, 2015). According to the “The Routledge Companion to Auditing” (2014), as quoted by Hay (2015), “academic research has been unable to provide clear answers about the consequences of mandatory audit firm rotation”.

Two leading studies that have been performed in this area of mandatory audit firm rotation (MAFR), namely 1) Jackson, Moldrich, and Roebuck (2008) and 2) Ruiz-Barbadillo, Gómez-Aguilar, and Carrera (2009) are not in favour of pursuing mandatory audit firm rotation. Jackson et al. (2008) investigated the effect of mandatory audit firm rotation in Australia on audit quality. However, only actual audit quality was examined and while the results suggest that actual audit quality is associated with the length of audit firm tenure, the perception of audit quality by market participants was not addressed. Perception of audit quality is important, as described in the International Federation of Accountants (IFAC) Code of Ethics for auditors (section 290:8), as the need for the auditor to have independence in both mind and in appearance to a third party (International Federation of Accountants (IFAC), 2006). The audit opinion provides assurance to the market and the public of the credibility of the financial statements, as explained in the International Standards on Auditing, ISA 200 (International Federation of Accountants (IFAC), 2009), and therefore this independence of the auditor in the eyes of the market is necessary. According to ISA 200, the audit enhances “the degree of confidence of intended users in the financial statements” (International Federation of Accountants (IFAC), paragraph 3, 2009). Ruiz-Barbadillo et al. (2009) suggested that auditors’ incentives to protect their reputation has a positive impact on the likelihood of them reporting going concern uncertainties. In addition, auditors’ incentives to retain existing clients did not impact on their decisions in both the mandatory rotation (1991-1994) and post-mandatory rotation (1995-2000) periods in Spain.

Therefore the research of Jackson et al. (2008) and Ruiz-Barbadillo et al. (2009), both provide evidence against pursuing mandatory firm rotation. However, no studies have been found that explore the impact mandatory firm rotation on audit market competition nor demographic or employee transformation.

### Competition in the audit industry

Internationally, professional and academic circles acknowledge the fact that there are a dominant set of audit firms, commonly called “the big four”. A large body of academic literature interprets the dominant audit firms in audit markets to be high quality, differentiated suppliers who command higher audit fees (Chu, Simunic, Ye, & Zhang, 2015). According to Gerokos and Syverson (2015), the market’s supply side in the audit industry is highly concentrated. Among publicly traded companies in the United States, for example, the majority of audit engagements and almost all audit fees involve just four audit firms (the “Big four”: Ernst & Young, Deloitte, KPMG, and PricewaterhouseCoopers). In 2010, the Big 4 handled 67% of audit engagements and collected over 94% of audit fees in the US (Gerokos & Syverson, 2015). As discussed by Velte and Stiglbauer (2012), audit markets in many other developed economies exhibit similar concentration, namely an audit market concentration of listed firms which is characterized by an oligopoly of “Big Four” audit firms.

According to Velte and Stiglbauer (2012) this concentration of suppliers on the audit market, is often assessed negatively from the point of view of competition policy, since

- The incentives to ensure cost efficiency and appropriate audit quality are decreasing,
- Higher barriers of entry for small and medium-sized audit firms exist and
- A strong influence from the Big Four on the development of international accounting- and audit standards (IFRS and ISA) must be assumed.

This lack of competition may result in monopolistic pricing, a decline in the quality of audits and of the services provided by audit firms, a decrease in the stability of capital markets and in investor confidence, and the impact on economies of corporate failures.

### Literature review conclusion

There is a move towards mandatory audit firm rotation in many developed economies, with the most significant and recent change in that direction being the European Union in 2014, with the United Kingdom likely to follow suit. The literature reviewed presents mixed results regarding the impact of audit tenure on audit quality and auditor independence, with most studies indicating that independence is not impaired as auditor tenure increases.

Little research has been performed specifically on the link between firm rotation and audit quality, mostly because the move towards firm rotation regulations is very recent and therefore the impact of such regulations is yet to be seen. The studies that have analysed audit firm rotation in countries that have adopted it, such as Australia and Spain, are not in favour of audit firm rotation and do not show clear links to the improvement of auditor independence or audit quality.

The indirect and unintended consequences of a move to mandatory firm rotation has not been studied, nor the perceptions of the various stakeholders involved in the audit process. In addition, no studies appear to have been published in a South African context around mandatory firm rotation. The impact of any proposed system of firm rotation (MAFR) on employment transformation in the audit industry and on competition in the industry, which represent two of IRBA’s three key reasons for pursuing MAFR, must also be researched.

It is generally acknowledged that a lack of market competition is not desirable in any market. However, will MAFR help to decrease this state of dominance by the “big four” audit firms? Will MAFR lower market concentration in the audit industry?



It is generally acknowledged that racial transformation is a specific and urgent ethical and national priority in the South African economy, and therefore the audit industry, like other industries must seek to become more representative of the South African demographic. However, will MAFR help to achieve this goal?

### Problem Statement and Research Objective

The three main reasons why the IRBA are considering further measures, such as MAFR, to strengthen auditor independence are (1) to strengthen auditor independence and so protect the public and investors, (2) address market concentration of audit services and create a more competitive environment; and (3) promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets. Internationally, the primary reason, if not the only reason, that MAFR is considered is to achieve auditor independence and therefore ensure audit quality. Therefore there is a degree of scepticism in reaction to IRBA's announcement to pursue MAFR as a means to also transform the audit industry and increase competition.

Therefore the research objective is to document the opinions of a select group of experienced audit practitioners regarding the credibility of these additional objectives, as well as the impact MAFR will have on these objectives, namely market competition and transformation in the audit profession.

### Research Methodology

This is a descriptive study that employs a qualitative research methodology. Qualitative studies aim to explain the ways in which people come to understand and account for issues, event and behaviours in their lives. Therefore the data gathered covers the perceptions, opinions and reasoning of the participants based on their unique experiences of areas related to the topic studied.

The purpose of this study is to explore the perceptions and opinions of the South African audit practitioners regarding the proposed move towards mandatory audit firm rotation (MAFR), and whether it will achieve the goals intended by the IRBA. To achieve this semi-structured interviews were performed with experienced partners across a number of audit firms nationally. A semi-structured interview is a qualitative method of inquiry that combines a pre-determined set of open-ended questions (questions that prompt discussion), with the opportunity for the researcher to explore particular themes or responses further. This type of interview does not limit respondents to a set of pre-determined answers, unlike a structured questionnaire for example (Dearnley, 2005).

The purpose of the semi-structured interviews is to understand the breadth of issues and opinions around adopting MAFR in South Africa, as well as opinions regarding possible alternatives to, and unintended consequences of, MAFR. Therefore this study aims to document the breadth of the issues and opinions using a small sample of audit partners so as to allow the second natural step in the research, which is produce and implement a comprehensive and appropriate field survey of the audit profession. This survey is to be sent more broadly to the profession where the intention will be to receive responses from a much larger sample of audit practitioners, i.e. audit partners around the country. Note that the second step is not the purpose of this paper, but rather an important area for further research based on this study.

Semi-structured in-depth interviews are the most widely used interviewing format for qualitative research and can occur either with an individual or in groups (DiCicco-Bloom and Crabtree, 2006). The open nature of the questions encourages depth and vitality in the responses by the interviewees and allows new concepts to emerge over the course of the interviews (Dearnley, 2005).

### The population and the selection

This study employs a purposive sampling technique, also known as judgemental, selective or subjective sampling. Purposive sampling is a type of non-probability sampling which focuses on sampling techniques where the units that are investigated are based on the judgement of the researcher, rather than on statistical techniques (Lærd Dissertation, 2016). Purposive sampling technique is most effective when one needs to study a certain domain which contains knowledgeable experts. In choosing a sampling method for informant selection, the question the researcher is interested in answering is of utmost importance and it is especially important to be clear on informant qualifications when using purposive sampling (Tongco, 2007).

Fourteen experienced practicing “registered auditors” (audit partners) were selected from nine different audit firms in order to perform the interview (refer to table below). According to the book entitled “The Long Interview” by McCracken (1988), as cited in DiCicco-Bloom and Crabtree (2006), in-depth interviews are used to discover shared understandings of a particular group and the sample of interviewees should be fairly homogenous and share critical similarities related to the research question. This selection of audit partners is therefore the homogenous group that share critical experience related to the research question. The selection is also considered to be fairly representative of the population of registered auditors in South Africa, especially considering that the audit partners selected were involved in the senior leadership of their respective audit practices and were considered sufficiently experienced as audit practitioners, having worked for many years in the capacity of audit partner.

The commonly agreed and recognised distinction between the audit firms (Marx, 2009; Rapoport, 2016) has been used in this study and is as follows:

- “Big four” audit firms refer to the largest four accounting and audit firms globally, namely Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young (EY) and KPMG. These four firms are also referred to as “large-tier” firms (ICAEW, 2016).
- The non-big four firms are either mid-tier or small-tier firms depending on their respective global size, global presence and capabilities as an audit firm in terms of resources (ICAEW, 2016; Rapoport, 2016).

The researcher and the participants in this study will use these terms in the interview discussions. The following is a description of the fourteen practitioners interviewed:

- All the partners were considered senior and highly experienced, ranging between seven years as a practicing audit partner and thirty-three years. The average number of years as a practicing registered auditor of all interviewees is 22 years.
- Seven of the partners were either a regional or a national managing partner in the firm and therefore in key leadership and strategic roles within their respective firms. The



remainder were senior partners who also held significant leadership responsibilities and portfolios within their respective firms or network of firms.

- The audit firms were selected from Johannesburg and Cape Town offices of the network firms.
- Of the fourteen partners, two were women.
- The two largest black audit firms in South Africa, namely SizweNtsalubaGobodo Inc. and Nkonki Inc. were represented. These two firms are the largest “black-owned” audit firms in South Africa and have grown to considerable size to rival the traditional “mid-tier” firms.
- Five partners were from the “big four” international audit firms.
- The remaining partners were from the “mid-tier” audit firms (including the “black-owned” medium size firms) who also perform audit services of public interest entities.

The below table shows a further description of the audit partners (participants) interviewed, including the number assigned for the purposes of analysing the results of the interviews, i.e. “Audit Partner 1”; “Audit Partner 2” etc.:

<b>Designation of Participant in Analysis of Results</b>	<b>"Big four" or "Mid-tier" or "Black-owned Mid-tier" firm</b>	<b>Position</b>	<b>Years as Practicing Audit Partner</b>
<i>Audit Partner 1</i>	Big four	Senior partner	25
<i>Audit Partner 2</i>	Big four	Managing Partner	20
<i>Audit Partner 3</i>	Big four	Senior partner	25
<i>Audit Partner 4</i>	Big four	Senior partner	9
<i>Audit Partner 5</i>	Big four	Senior partner	23
<i>Audit Partner 6</i>	Black-owned Mid-tier	Managing Partner	22
<i>Audit Partner 7</i>	Black-owned Mid-tier	Managing Partner	23
<i>Audit Partner 8</i>	Black-owned Mid-tier	Senior partner	29
<i>Audit Partner 9</i>	Mid-tier	Managing Partner	32
<i>Audit Partner 10</i>	Mid-tier	Managing Partner	17
<i>Audit Partner 11</i>	Mid-tier	Senior partner	16
<i>Audit Partner 12</i>	Mid-tier	Managing Partner	33
<i>Audit Partner 13</i>	Mid-tier	Managing Partner	28
<i>Audit Partner 14</i>	Mid-tier	Senior partner	7

### Interview process and methodology

Each interview was held in person with the respective participants and lasted between one and two hours, the discussion audio being electronically recorded with the express permission of each participant.

According to Leedy and Ormrod (2010), qualitative data analysis ideally occurs concurrently with data collection so that the researcher can generate an emerging understanding about research questions, which in turn informs both the sampling and the questions being asked. This was certainly the case within this study as the interviews process was being conducted, as new opinions documented fed into and shaped the subsequent discussions with interviewees. This iterative process of data collection and analysis eventually leads to a point in the data collection where no new categories or themes emerge, referred to as saturation, signalling that data collection is complete (DiCicco-Bloom and Crabtree, 2006). Saturation is believed to have been reached in these interviews in the sense that no new themes or categories surrounding the question of MAFR emerged in the last interviews, indicating that the sample of fourteen practitioners was sufficient for the purpose of the study. The transcribed data was then used in order to identify common, recurrent, or emergent themes around the issue of the role of audit committees is preserving auditor independence and quality financial reporting, rather than pursuing MAFR in South Africa.

## Presentation and Analysis of Results

### Competing objectives

It was clear that the mid-tier audit partners, especially the representatives of black-owned emerging audit firms, were mostly of the opinion that MAFR, or maybe an alternative such as combined audits, would improve competition (market concentration) and transformation in the audit industry. In response to this argument other partners, mostly comprising of the big four audit partners, pointed out that the IRBA needs to be clear as to what exactly any change in regulation is trying to achieve. Is the IRBA attempting to improve audit quality or are there other priorities driving the agenda, such as market concentration and transformation objectives? More than one partner was sceptical that the IRBA claims that MAFR or any alternative to MAFR is primarily being considered to improve audit quality in the interest of public protection. IRBA has explicitly stated that there are three reasons for pursuing MAFR, however, the primary reason is to enhance audit quality (IRBA, 2016).

The participants who expressed this sceptical view around the IRBA's priorities, believed that there were better ways to achieve the other objectives, namely healthy market competition and economic transformation, rather than imposing such significant additional regulation on the industry. In their view any discussion on MAFR (or an alternative) should only be considered if it did indeed improve audit quality as the only objective. These partners were adamant that by pursuing other objectives (in addition to audit quality) in the decision around MAFR could actually result in a loss of audit quality.

### Addressing market concentration

All the audit partners expressed concern, despite their other differing opinions on other related matters, that a significant unintended consequence of forcing MAFR on South Africa would be

the likelihood that the audit of large companies (particularly the listed companies) would simply rotate around the big four audit firms and therefore actually reduce competition rather than grow it.

There was significant disagreement as to whether market concentration was a concern. As could perhaps be expected, none of the big four partners believed that market concentration was a problem or that it was the regulator's (IRBA) place to step in to actively address it. Of the partners who agreed that market concentration was a problem, all were in favour of a system of joint (combined) audits rather than MAFR as a means to improve competition. It is fair to say, and a significant observation, that there was no person interviewed who was in favour of a direct move from the current system to one of MAFR, either to improve independence or to improve competition in the audit industry.

In response to being asked whether MAFR will allow mid-tier to compete for the larger company (public interest entity) audits, one big four partner's response was as follows:

**“I think all you're going to do is have ‘the shifting of the deck chairs’. The big four will remain the big four. There might be the transformation angle so maybe the big five. You know I'm saying, given the South African avenue here and you might, let's be fair, call it the big five, that it's going to be a ‘shifting of the deck chairs’. That's all that's going to happen. Is the Audit Committee, given the strength of the Audit Committee, are they honestly going to appoint a firm that clearly hasn't had the experience, doesn't have the resources, the staff, to do a large listed company audit? No disrespect to the second tier firms or let's call it the next tier. I mean, clients expecting us to have the depth and breadth of skill and how these smaller firms going to acquire that skills and also have the ability to deliver seamless service across numerous jurisdictions. Our clients expect us to be in every location where they're located and they want us to speak with one voice. How are these other firms going to do that? If you look at what has gone out to tender, the, from what I understand in the UK and the likes, it's really just shifting it around and there's no major... So when they, and those that have gone out to tender, where has it gone? You'll most probably find that the smaller firms, one of them will get invited to come and tender, but they'll fall out somewhere along the process. [It is not going to address market concentration], it's just going to shift between the big five, put it that way. That's honestly the way I see it.”** (*Audit Partner 5*)

Referring to the larger listed multi-national companies, one partner made the point that in their opinion, having been involved in a few companies of this size and geographic diversity, the mid-tier firms could not possibly perform assurance services on that scale. In that sense MAFR would actually reduce competition as these audits would have to move from the one big four firm to one of the other three.

**“Because there's only going to be three left. There's no way that a mid-tier firm will do the [company name] audit in 130 countries within the next twenty years.”** (*Audit Partner 2*)

This opinion is also shared by some mid-tier audit partners. The concern is simply that the audit committee, when faced with having to choose another audit firm during a mandatory rotation is likely to stay with a big four firm, rather than risk negative stakeholder perception by moving away from the big four.

**“But what I want to come to, is typically when we get an opportunity to make a proposal for a big public company that’s audited by the big four, and you go there and you really... I mean, in this one instance we really went to town with the presentation. And in the meeting you can pick up that people are quite positive, and then you get the letter saying no, they’re staying with the current big four auditor. So on reflection, think about it, you’re an independent, non-executive director on an Audit Committee where you’re at risk. So are you really going to change the incumbent... to ‘Joe Soap’? To a non-big four? Or just change from the big four? Let’s say they do it. Let’s say they’ve got that type of appetite for risk, or perceived risk. And they do it, and it’s a stuff-up. [Then their heads are on the block.] If they had moved from big four firm to big four firm then... nobody could fault that. You would went from the same to another... you’re just going to go in a circle. That’s not going to improve market concentration at all. You may even see a movement up to the bigger firms.”** (*Audit Partner 14*)

In the experience of a big four audit partner:

**“I’ll give you an example... I have just gone through a proposal process. It’s not a large firm. It’s actually mid-market firm. I went to see the chair of the Audit Committee afterwards and he gave me the feedback and one of the things he specifically said was, it was clear to them, the Audit Committee and the panel. It was not just the Audit Committee - management was a part of the panel. That there was a big difference in the quality of the whole process and the documents and the presentations. Between the big four and the next tier. That was clear [to them]. He then immediately said “forget about anything below the big four”.”** (*Audit Partner 3*)

Considering the risk involved and the experience, skills and size of mid-tier firms, why would the audit committees of large companies award the audit to a non-big four firm? Is this a realistic expectation? This was a common question raised by audit partners, of both large and mid-tier firms and it is a serious concern for the ability of MAFR to improve participation of the mid-tier firms in large public interest entity audits, especially JSE listed companies. Audit committees of larger companies would be less inclined in their opinion, for reasons of perceived risk or quality or resources, to award tenders to non-big four firms, regardless of whether MAFR was introduced.

One partner expressed, regarding large listed companies in particular, that the current system of five year partner rotation, together with the audit committee and shareholders having the power to put the audit out for tender, allows all four big four audit firms (or all firms for that matter) to bid for appointment – including the incumbent big four firm. However, the effect of MAFR would change this significantly. Under MAFR regulations the audit committee and shareholders will be required to rotate the incumbent big four firm, but the incumbent will not be allowed to bid for the tender i.e. to bid for reappointment. Therefore, since the audit committee will likely only favour another big four firm (as it is a listed company), this results in only three possible choices for auditor - as opposed to four in the current system. So the thinking is that MAFR in effect will actually reduce competition in practice. Can the audit committee of a large listed company realistically be expected to award the tender to a non-big four audit firm, considering stakeholder perceptions and the size and experience of the mid-tier firms? The majority of the audit partners interviewed agreed with this reasoning as far as it applied to large listed entities. This effect will therefore be to reduce market competition in the audit industry.

Another argument that MAFR would actually reduce competition was expressed by mid-tier audit partners, with the point that the smaller firms do not currently have the skills, experience or resources to service the large complex companies. Many of the big four partners made this point as well. And how could the leadership of the audit firm gear up to responsibly perform such audits if firstly they may not be awarded the tender and secondly they will only have the client for the rotation period, whatever period that may be legislated under MAFR?

**“We don’t have the skillset for the banks and then the insurance companies as well - unless they are really small, so you can pick on a mega insurance company. You know we don’t have the manpower and then to gear up the manpower for five years you know... [from a business perspective] you can’t, commercially...”** (*Audit Partner 12*)

This partner went on to express that because of the problem that the incoming audit firms will need to urgently procure the skills and experience to perform the audit professionally, the firm will be tempted to offer the staff from the outgoing audit firm jobs on their audit team. This was referred to by the partner as “cheating the system” of MAFR.

**“What can happen is you know the guys will cheat like they are cheating on the section 90 [of the Companies Act], they will loan their teams around or a team will come and they will be here for five years and the guy will bring his team along and you will find the same people will do [the audit]... a kind of secondment.”** (*Audit Partner 12*)

An example of this was then given with the internal audit function of a large South African state-owned entity that outsourced this function to one of the big four audit firms. What then happened according to this audit partner was that the audit firm then employed most of the state-owned entity’s internal audit staff, with the effect that they left the company to work for the audit firm but to perform the same services as the internal audit function. In the words of the partner, **“it’s the same team but they had different houses, so the guys have to have the economic necessity to do that. So I really don’t have a warm feeling or a strong recommendation for mandatory audit rotation and I really don’t think that audit independence is such a huge issue in South Africa.”** (*Audit Partner 12*)

The same opinion was expressed by Audit Partner 4:

**“I think it was, it could be Brazil... What happened when they realised that a big team, let’s say a [company name] team will do the audit and then a year before the whole firm has moved to let’s say to [firm name] or another firm, the other firm starts headhunting them and then effectively, that whole team is moving and his partner is moving across to the new firm. Now how’s that for independence? It is just under a different umbrella somewhere and another firm must sign it, but it’s the same team. So to overcome this cost and knowledge and all those things, this team just moves over.”** (*Audit Partner 4*)

Will MAFR rotation result in this kind of “headhunting” and employment relocation? If so, the will it occur to such a degree as to negate the added independence that MAFR is intended to produce. The partners who expressed this concern made the point that it would be an economic necessity and make good strategic sense to source the staff who were involved in the audit before the rotation. In their opinion this has already been happening, albeit in a very limited capacity, under the current partner rotation scheme. MAFR would perhaps incentivise the firms to do it on a larger scale.

### Transformation considerations

All the partners interviewed who were not members of the black emerging audit firms (11/14) expressed serious concern regarding whether the black-owned firms who have been awarded large public tenders have the resources, skills and experience to audit such large public interest entities. The concern was that if a firm is under resourced for the job, or has no prior experience with a specific industry, then a drop in the quality of the audit process and audit outcome is inevitable. Government, in their opinion, has been far too quick to award such large tenders to the black-owned audit firms and should have either sought joint audit arrangements for longer or promoted the ability of existing audit firms to transform from within as a better method of achieving transformation objectives. This concern expressed is very similar to that which all the mid- and large-tier firm partners expressed regarding the upskilling required of non-big four firms before they are sufficiently capable to service the large listed companies. Therefore the opinion expressed was that MAFR poses a significant risk to audit quality if a smaller audit firm, whether black-owned or not, is placed in a position too soon to audit a large company or group of companies. Here we see the possibility of MAFR to either result in reduced audit quality if this situation occurs. Or it could result in the audit committees not awarding the audit to smaller (non-big four) firms and MAFR causing reduced competition as the large company audits rotate around the big four firms only. All these possible consequences would be contrary to the IRBA's intentions of reduced concentration and increased transformation.

So what were the opinions of the black-owned firm audit partners about their ability to service larger and more complex companies? When asked whether non-big four audit firms, including the black-owned firms, had the skills and resources to handle the larger and more complex company audits, the managing director of a black-owned firm (Audit Partner 7) responded that there is a problem with perception rather than with reality. In their opinion the mid-tier firms can audit the larger entities and it is wrong to simply assume that they don't have the skills or resources because they are not big four firms. This partner expressed how difficult it was for them to just be appointed as a service provider to large companies for non-assurance work, because there is such a strong perception that their firm lacks the skills and resources. However, they believed that the perceptions are slowly changing as they prove themselves in the non-assurance work and in joint audit arrangements. This opinion by a black-owned audit firm partner is in contrast to the big four partner and some mid-tier partner opinions, which hold that the smaller firms cannot yet audit the bigger listed entities, many of which are multi-national companies.

Again the concerns expressed in this regard contrasted the differing objectives of improving audit quality so as to achieve sufficient public protection on the one hand, and achieving black economic empowerment (transformation) in the profession. If regulation changes are pursued with too many objectives in mind, or with too little research and stakeholder consultation, then the unintended consequence of a loss of audit quality may result. As many partners pointed out, surely public protection through enhanced audit quality should be the only reason for changing reason in favour of MAFR? And if so, most, if not all partners interviewed, believed that MAFR was not going to achieve improved audit quality.

Of particular interest was the fact that all the non-big four partners were of the opinion that market concentration of the public interest company audits was a problem in South Africa and

needed to be addressed for the good of the profession and the public. Many admitted that this was not a South African specific problem by any means, however South Africa was in a unique position whereby transformation was also a high priority in business, across all industries in the economy. By addressing market concentration appropriately in the profession through whatever means was considered most appropriate, it would also thereby improve transformation, as it would allow the smaller black-owned emerging firms to compete in the private sector, together with the other non-big four firms. The big question that was raised numerous times was the question of whether MAFR was the best means to achieve this transformation. None of the partners, including those from black-owned firms believed it was the best means. As mentioned already, there was one black-owned partner (Audit Partner 7), who was tentatively in favour of MAFR, but only if significant corporate governance weaknesses were addressed first and it was pursued carefully and in a slow staged process, such as via a period of requiring joint audits, to allow the non-big four firms time to gain experience with the larger more complex companies.

A common concern from the mid-tier firms, referred to by one partner as a “chicken before the egg story”, was the constraint around gearing up your audit firm to service large companies. This improved capacity in the mid-tier is one of the IRBA’s clear intentions for MAFR i.e. improve competition in the audit sector, including the ability of black-owned firms to compete, which promotes transformation as well. However, how do mid-tier and black-owned firms upskill and increase their resources so as to responsibly and professionally provide audit services to large private companies? How do they afford to do so without first being appointed as auditors? How, from a pure business perspective, can they justify the cost and the risk of increasing staff and other resources on the hope that their firm will be appointed as the auditor? This was seen as a significant restraint to MAFR achieving improved competition and transformation. One partner from a mid-tier firm (Audit Partner 10) expressed the concern that simply increasing staff numbers in expectation of MAFR and in expectation of receiving more appointments (referring to mid-tier and black-owned firms), is dangerous as you need the right skills and the right experience, not simply the numbers and the technology. Or else the sacrifice will be reduced audit quality. A number of partners expressed that this is perhaps what has already occurred by the appointment of the emerging black-owned audit firms to the large public sector and state-owned enterprise audits. Do they (or did they when first appointed) have sufficient skill, experience and resources for such large, high audit risk, high public risk entities?

Some partners suggested that either promoting transformation within the existing firms or allowing mergers with the black-owned firms was preferable to MAFR in promoting transformation. One partner who was not from one of the emerging black-owned audit firms acknowledged that although many consider mergers of these audit firms with the “more established firms” as a solution to promoting transformation in the audit profession, it may not be wise.

**“We can’t just take a black firm and a traditional western firm and merge them because of transformation and think it would be the right thing to do. There are still certain things that those of us from a privileged background maybe just don’t understand about the way people work and the issues that they’ve had to deal with that we are not used to.”**  
(Audit Partner 10)

This person went on to state that therefore joint audits may be a better solution than pursuing MAFR or a simple mergers of firms. Joint audits better allow for a mentoring process and skills transfer to emerging black firms, while preserving their autonomy and growth as a separate firm in the market.

Perhaps in disagreement over the regulator's (IRBA) thinking around transformation through growth of the emerging black-owned firms, the big four audit partners were quick to point out that their firms, and others, were transforming and this should be recognised by the regulator. One managing partner (Audit Partner 2) of a big four firm stated that their target at the moment in the near future is to reach 70% black staff and they were currently on an actual number of around 50%. This partner went on to state that other big four firms may be doing even better and that would mean that the largest "black firms" in terms of number of staff were actually the big four firms, not the so-called "black-owned firms". The main point being made was that the IRBA needed to recognise these transformation achievements at the firms and therefore no focus on changing legislation to achieve transformation, especially not through MAFR.

Two of the partners interviewed were managing partners of leading South African black-owned firms and so their opinion on MAFR is particularly significant in light of the IRBA's transformation objectives. The one managing partner of a black-owned firm (Audit Partner 7) was of the opinion that MAFR rotation was good for South Africa, and was the only partner of the fourteen interviewed in favour of MAFR, albeit tentatively in favour. They were in favour provided that significant corporate governance weaknesses were addressed first, most importantly being the dominance of management in the appointment and managing of the external auditor, and if MAFR was pursued carefully and in a slow staged process, such as via a period of requiring joint audits, to allow the non-big four firms time to gain experience with the larger more complex companies. In their opinion, if these issues are not addressed, then MAFR will not improve transformation nor auditor independence and audit quality. The other qualification this partner made was that the period of the rotation must be carefully determined so as not to encourage unfamiliarity and lack of institutional knowledge of the client (if too short) or promote familiarity threats (if too long).

The other black-owned firm managing partner (Audit Partner 6) was of the opinion that MAFR was not the right answer for South Africa, mostly because it would result in a loss of institutional knowledge built by the firm. This partner was of the opinion that five year partner rotation was sufficient as it allowed the firm to retain the institutional knowledge and experience and professionally manage any independence threats through its own firm and professional codes and practices.

**"But my personal view is I don't believe in mandatory audit environments and I'll tell you why. To a very large extent, especially in large complex operations, it takes time for one to really fully get to grips with the environment. And I see you've got other subsequent questions around we should rotate the senior, the entire senior leadership or just the, the lead partner as such. And frankly, for one to have proper institutional knowledge of that, which is institutionalised, you would need them to be there... I'm saying I'm not supporting mandatory firm rotation. One, because frankly I don't think it has a bearing on independence. Like I say, I think we've got enough safeguards in the current systems to manage and govern independence."** (Audit Partner 6)



In addition to these concerns expressed above, this partner was also concerned with the likelihood that MAFR will simply become a “game of musical chairs” amongst the big four firms, thereby reducing market competition, as well as promoting low-balling of fees to secure the appointments.

These opinions from the two managing partners of South Africa’s largest black-owned audit firms is significant to the MAFR debate, certainly as far as transformation and market concentration aspects are concerned.

## Summary and Conclusion

There was considerable mixed opinion regarding the effect that MAFR legislation may have on the priorities of increasing market concentration and economic empowerment (transformation) in the audit industry. Significantly, all partners interviewed were in agreement that MAFR is not the best option for South Africa if audit and financial reporting quality is the only objective. Many partners criticised IRBA’s competing objectives of audit quality, improving competition and transformation as they believed that MAFR must be pursued for audit quality reasons or not at all. In their opinions, pursuing competing objectives will likely result in actually reducing audit quality.

Most audit partners believe that MAFR will, counter to the IRBA’s intention, reduce auditor competition for the large public interest entities, rather than improve it. This is mostly because the outgoing big four firm will not be allowed to tender for the appointment and most audit committees will only consider the “big three” firms who tender. There is some disagreement among mid-tier firms as to whether they have the resources and experience to audit the larger companies on the JSE. Some believe they simply do not, other believe that they will easily upskill and it will not result in a sacrifice of audit quality.

None of the big four audit partners believe that MAFR will improve transformation, but rather believe that transformation is best addressed in the existing firms with the existing set of regulations. The managing partners of the two largest black-owned audit firms in South Africa did not believe that MAFR legislation was the best route for South Africa, with one quite firmly against it, and the other tentatively for MAFR if done slowly and only after deficiencies in the functioning of audit committees was addressed first.

These findings show clearly that key leaders of audit firms are against MAFR as a means of addressing any objectives other than audit quality itself. There are better means to address concerns around competition and economic transformation in the audit industry. The unintended consequences of MAFR have the potential to actually cause a reduction in audit quality. It is recommended that the IRBA clearly articulate how, in their view, MAFR is intended to address market concentration and transformation; and respond to the many concerns that the audit practitioners have in this regard. More dialogue with key stakeholders, especially the audit practitioners themselves, as well as research around unintended consequences, is required before a final decision can be made by the regulator.

## Areas for further research

MAFR has not been extensively researched internationally and certainly not in a South African context. This research is not intended to be representative of the population of audit practitioners in South Africa. A national survey of the South African audit profession is necessary in order to provide a representative view from the profession on the issues

surrounding MAFR, especially the likelihood and nature of unintended consequences. The impact on, and the opinions of, other stakeholders such as audit committee members, management and investment professionals needs to be understood as well. The impact of MAFR in other key international jurisdictions such as the European Union also needs to be explored.

## Bibliography

- Bowlin, K. O., Hobson, J. L., & Piercey, M. D. (2014). The Effects of Auditor Rotation, Professional Skepticism, and Interactions with Managers on Audit Quality. *The Accounting Review*, 90(4). <http://doi.org/10.2139/ssrn.1914557>
- Cameran, M., Vincenzo, D. Di, & Merlotti, E. (2005). The Audit Firm Rotation Rule : A Review of the Literature. *SDA Bocconi Research Paper*, (September).
- Carey, P., & Simnett, R. (2006). Audit Partner Tenure and Audit Quality. *The Accounting Review*, 81(4), 653–676.
- Chu, L., Simunic, D. A., Ye, M., & Zhang, P. (2015). Transaction Costs and Competition among Audit Firms in Local Markets. *Social Science Research Network*, 1–54. Retrieved from [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2378039](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2378039)
- Daugherty, B. E., Dickins, D., Hatfield, R. C., & Higgs, J. L. (2012). An Examination of Partner Perceptions of Partner Rotation: Direct and Indirect Consequences to Audit Quality. *Auditing: A Journal of Practice & Theory*, 31(1), 97–114. <http://doi.org/10.2308/ajpt-10193>
- DeAngelo, L. E. (1981). Auditor size and audit quality. *Journal of Accounting and Economics*, 3, 183–199. [http://doi.org/10.1016/0165-4101\(81\)90002-1](http://doi.org/10.1016/0165-4101(81)90002-1)
- Dearnley, C. (2005). A reflection on the use of semi-structured interviews. *Nurse Researcher*, 13.1.
- DiCicco-Bloom, B., & Crabtree, B. F. (2006). The qualitative research interview. *Medical Education*, 40(4), 314–321. <http://doi.org/10.1111/j.1365-2929.2006.02418.x>
- European Commission. (2015). Directorate-General for Financial Stability. Retrieved May 2, 2016, from <https://www.unodc.org/unodc/en/drug-trafficking/legal-framework.html>
- Gerokos, J., & Syverson, C. (2015). Competition in the Audit Market: Policy Implications. *Journal of Accounting Research*, 53(4), 725–775. <http://doi.org/10.1111/1475-679X.12087>
- Hay, D. (2015). The frontiers of auditing research. *Meditari Accountancy Research*, 23(2), 158–174. <http://doi.org/10.1108/MEDAR-12-2014-0062>
- ICAEW. (2016). Accountancy firms. Retrieved May 24, 2016, from <http://www.icaew.com/en/about-icaew/what-is-chartered-accountancy/accountancy-firms>
- International Federation of Accountants (IFAC). (2006). *Code of Ethics for Professional Accountants. IFAC (2006 revised)*. Retrieved from <http://scholar.google.com/scholar?hl=en&btnG=Search&q=intitle:Code+of+Ethics+for+Professional+Accountants#4>
- International Federation of Accountants (IFAC). (2009). *International Standard on Auditing 200. ISA 200*. Retrieved from [http://www.ifac.org/sites/default/files/publications/files/2012 IAASB Handbook Part I\\_Web.pdf](http://www.ifac.org/sites/default/files/publications/files/2012%20IAASB%20Handbook%20Part%20I_Web.pdf)
- IRBA. (2015). *Consultation paper: Measures to Strengthen Auditor Independence*. Retrieved from

<http://www.irba.co.za/news-headlines/press-releases>

IRBA. (2016). *Discussion Paper: Considering Mandatory Audit Firm Rotation (MAFR)*. Retrieved from [http://www.saica.co.za/Portals/0/documents/MAFRDiscussionPaper.pdf?Reference\\_ID=44997007](http://www.saica.co.za/Portals/0/documents/MAFRDiscussionPaper.pdf?Reference_ID=44997007)

Jackson, A. B., Moldrich, M., & Roebuck, P. (2008). Mandatory audit firm rotation and audit quality. *Managerial Auditing Journal*, 23(5), 420–437. <http://doi.org/10.1108/02686900810875271>

KPMG. (2014). *EU Audit Reform*. Retrieved from <https://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Documents/EU-Audit-Reform-Fact-Sheet-MFR.pdf>

Lærd Dissertation. (2016). Purposive Sampling. <http://doi.org/10.4135/9781412950589.n774>

Laurion, H., Lawrence, A., & Ryans, J. (2015). U . S . Audit Partner Rotations. *Haas School of Business*. Retrieved from <http://dx.doi.org/10.2139/ssrn.2515586>

Leedy, Paul D; Ormrod, J. E. (2010). *Practical Research: Planning and Design*. *Practical Research - Planning & Design*.

Marx, B. (2009). Challenges Facing the Modern Day Auditing Profession. *Accountancy SA*, 16–19. Retrieved from <http://search.proquest.com.ezproxy.canterbury.ac.nz/docview/215224897?accountid=14499>

Rapoport, M. (2016). Auditing the Auditors : U.S. Rethinks Approach. *Wall Street Journal*, (May). Retrieved from <http://www.wsj.com/articles/u-s-government-rethinks-how-it-audits-auditors-1462440600>

Ruiz-Barbadillo, E., Gómez-Aguilar, N., & Carrera, N. (2009). Does mandatory audit firm rotation enhance auditor independence? Evidence from Spain. *Auditing: A Journal of Practice and Theory*, 28(1), 113–135. <http://doi.org/10.2308/aud.2009.28.1.113>

Tepalagul, N., & Lin, L. (2015). Auditor Independence and Audit Quality: A Literature Review. *Journal of Accounting, Auditing & Finance*, 30(1), 101–121. <http://doi.org/10.1177/0148558X14544505>

Tongco, M. D. C. (2007). Purposive sampling as a tool for informant selection. *Ethnobotany Research and Applications*, 5, 147–158.

Velte, P., & Stiglbauer, M. (2012). Audit Market Concentration in Europe and its Influence on Audit Quality. *International Business Research*, 5(11), 146–161. <http://doi.org/10.5539/ibr.v5n11p146>

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

**ISBN number: 978-0-620-74761-5**



---

**AUD 06: Effects of Internal Organisational Environments  
on Preventative, Detective and Directive Internal Controls  
of SMMEs in Cape Town**

*Luyolo Siwangaza<sup>1</sup> and Job Dubihlela<sup>2</sup>*

**Luyolo Siwangaza<sup>1</sup>**

School of Accounting Sciences,  
Cape Peninsula University of Technology,  
Cape Town Campus  
Corner of Keizersgracht and Tennant Street,  
Zonnebloem, South Africa, 8000  
Tel: +27 21 460 3477

**Job Dubihlela<sup>2</sup> (Corresponding author)**

School of Accounting Sciences,  
Cape Peninsula University of Technology,  
Cape Town Campus  
Corner of Keizersgracht and Tennant Street,  
Zonnebloem, South Africa, 8000  
Tel: +27 21 460 3477  
Tel: +27 21 460 3266  
Email: [dubihlelaj@cput.ac.za](mailto:dubihlelaj@cput.ac.za)

**ABSTRACT**

In spite of the remarkable contributions made by Small, Medium and Micro Enterprises (SMMEs), particularly in developing economies such as South Africa, sustainability remains a major challenge. One root cause of the failure is the absence of adequate and effective internal controls to mitigate a variety of risks that small businesses face. The implementation of adequate and effective internal controls is dependent on how conducive the internal control environment is, which is believed to be the foundation of any system of internal controls. This study which fell within the ambit of positivistic research paradigm, sought to determine the effect of internal control environment (ICEn) on the implementation of detective (DetC), preventative (PreC) and directive (DirC) internal controls within SMMEs. The study employs an empirical survey approach, conducted with 107 SMMEs located within the Cape Peninsula. Descriptive statistical analysis was conducted to run preliminary data and test for reliability and validity of the scales and regression analysis was used to test the proposed hypotheses. This study confirms that internal control environments (ICEn) of SMMEs are essential for successful implementation of DetC, PreC and DirC, whereas robust internal controls are known to enhance enterprise risk management and reduce operational risk. The paper contributes to research by advancing the understanding of internal control environments for SMMEs in South Africa, possibly providing practitioners with managerial insights. Limitations and directions for future research are also reported in the paper.

**Keywords:** *Internal control environment, SMMEs, Sustainability, Risk control, South Africa.*

## 1. Introduction

In many developing economies SMMEs are touted as ‘the backbone’, ‘the engine’, ‘the fuel’ and ‘the lifeblood’ of the national economy (Cant *et al.*, 2014:566; SBP, 2014; Lekhanya, 2015:412; Chimucheka & Mandipaka, 2015:309; Kemp *et al.*, 2015:2). In South Africa, SMMEs operating within the economy are commended for their remarkable contribution to GDP, creation of employment and reduction of poverty (Chimucheka & Mandipaka, 2015:309). Ramukumba (2014:19) puts the important role played by SMMEs into perspective when reporting that over 90% of African business operations can be ascribed to this sector; which contributes alone over 50% towards the GDP and employment creation. In South Africa, SMMEs account for up to 55% of all jobs (Ramukumba, 2014:19). Despite these notable contributions, prior research (Bruwer, 2010; Cant *et al.*, 2014:565; SBP, 2014; Ngubane, 2015:384; Garg and Makukule, 2015:71) shows that the South African SMME failure rate has frequently been cited as one of the highest in the world.

Lekhanya (2015:412) and Bowler *et al.* (2007) as cited by Ramukumba (2014:19) report the 40% failure rate of new establishments in this sector to lie within the first 12 months of start-up, while 60% cease to exist in their second year of trade and a staggering 90% failing to operate beyond the 10th anniversary. In a more recent study, Garg and Makukule (2015:71) confirm the PwC (2015) report that approximately 75% of newly established SMMEs cannot be salvaged from the risk of business failure. A plethora of previous studies have identified a host of SMME challenges, which are attributed to the weak SMME failure rate. These challenges are grouped by Bruwer (2010) and Siwangaza (2014) into two broad categories, namely macro-economic factors (external forces which the business has little or no control over such as crime, fluctuating interest and inflation rates, etc.) and micro-economic factors (internal forces which the business has full control over such as the circumvention of established internal controls by management, incompetent staff, etc.). One of the micro-economic factors which have been identified and confirmed as a root cause of SMMEs failure rate is the absence of adequate and effective internal controls to mitigate a variety of risks that SMMEs face (Siwangaza *et al.*, 2014:163; Prinsloo *et al.*, 2015:66).

The global institute of internal auditors (IIA, 2012) describes internal control as any action or process executed by those charged with governance of the business and other key stakeholders to manage a variety of risks that threaten the attainment of business objectives. According to formal guidelines (IIA, 2012; COSO, 2013) an effective system of internal control can only provide reasonable (not absolute) assurance regarding the attainment of business objectives. Gordon *et al.* (2014:38) holds the view that a system of internal control can only be effective if it is supplemented by a conducive and robust internal control environment, which is globally accepted to be the foundation of any system of internal control. In essence, the control environment is concerned with the operating style and philosophy of those charged with governance (including management), attitude of those charged with governance (including management) towards risk and control, management’s commitment to ethics, integrity, values, responsibility and accountability, the assignment of authority and the establishment of sound human resources practices (COSO, 2004; COSO, 2013, Reding *et al.*, 2013; Coetzee *et al.*, 2014; Nyakundi *et al.*, 2014:5). The problem which characterizes many small businesses, more

often than not, is that there is an absence of adequate internal controls (Sankoloba & Swami, 2014:87). The probable cause for this is that those charged with governance of these entities often lack a commitment towards internal control, thus not setting an appropriate tone at the top, which is believed to be a key attribute of a robust internal control environment (Nyakundi *et al.*, 2014:11). From the forgoing, a perception was formulated that SMMEs are not as sustainable as they ought to be, due to inadequate use of effective internal controls. The latter is as a result of a weak internal control environment, a problem which characterizes many SMMEs.

## **2. Literature Review**

### **2.1. Overview of South African SMMEs**

Although small businesses have been in existence for many years and their growth being a topic of discussion for a number of years (Maye, 2014), SMMEs, in South Africa, were formally recognised in 1995 through the publication of the Department of Trade and Industry (DTI) National Strategy, which was geared towards the development and promotion of these entities (DTI, 1995). In the following year, the South African Parliament gazetted the National Small Business Act No. 102 of 1996, as amended in 2004. In this piece of legislation, SMMEs are regarded as distinct business entities which are managed by those charged with the governance of their respective businesses. According to the afore-mentioned Act, SMMEs can be operated in any sector or subsector of the South African economy and further be classified in terms of their respective sizes as “micro”, “very small”, “small” and “medium”. The criteria for classification of SMMEs in terms of their sizes vary by industry and take into consideration the total number of full-time salaried employees, total revenue generated during a full financial year and total gross value of the business assets, excluding the value of fixed properties.

Bruwer *et al.* (2013:1005) point out that SMMEs continue to receive considerable amounts of attention from government through the provision of advisory and financial support services. The aforementioned policy documents provided for the establishment of various government institutions and service providers to help SMMEs by providing a plethora of support services, which take on the form of financial and non-financial services (DTI, 1995; South Africa, 2004). In addition, the DTI launched a monthly national newspaper; called the Small Business Connect aimed at providing pertinent information on how these enterprises can access markets, leverage emerging technologies, glean insight on business improvement resources and take advantage of networking opportunities (DTI, 2013). All in all, this newspaper transmits empowering information for those charged with the governance of SMME to enhance their understanding of the business environment, stay ahead of all the latest developments in the sector and improve their business operations as a whole (DTI, 2013). In recent times the support provided by government to SMMEs manifested itself into a newly established Department of Small Business Development which will, among other things, address a plethora of challenges faced by this sector, which includes, but is not limited to difficulties in accessing markets, access to finance, access to information, regulatory red tape, skills shortages, etc. (Maye, 2014; SBP, 2014). The latter confirms government’s efforts in building a sector which is renowned for making valuable contributions in the stimulations of the national economy.

According to prior research (Chimucheka and Mandipaka, 2015:309; Chakabva, 2015; Kemp *et al.* 2015:2; Prinsloo *et al.* 2015:64; Ngubane *et al.* 2015:382; Hendricks *et al.* 2015:87; Cant *et al.* 2014:566; Ramukumba, 2014:19 Cant & Wiid, 2013:707) South African SMMEs are playing an increasingly important role in socio-economic development; significantly contributing to the GDP, employment formation and poverty alleviation. The importance of these entities in a developing economy such as South Africa is affirmed by the Global Entrepreneurship Monitor (2014) when stating that SMMEs are instrumental in providing employment opportunities, driving economic growth and achieving equity. The Bureau for Economic Research (2016) reaffirms the latter when reporting that in the second quarter of the 2015 fiscal year there were approximately over 2,25 million South African SMMEs, making contributions of approximately 42% to the country's GDP. Aigbavboa, *et al.* (2014) as quoted by Mthabela (2015), report that roughly 91% of businesses in this country can be attributed to SMMEs, which account for up to 61% of formal employment. The significant role played by SMMEs is further fortified in the Vision 2030 of the South African National Development plan where it is estimating that 90% of new jobs in 2030 will be provided by this sector (SAICA, 2015; SBP, 2014). However, despite these remarkable contributions, the high failure rate of these entities is a matter of concern.

## **2.2. SMME failure**

Despite a number of government interventions in the form advisory and financial support services procured from various South African institutions to aid in the advancement of SMMEs, the failure of these entities continues to rise in rank (Olawale & Garwe, 2010:731; Cant & Wiid, 2013:707; Lekhanya, 2015:412). The sentiments on the SMME failure rates is supported by SBP (2014) when stating that the growth of SMME in South Africa is very stagnant despite government offering a helping hand to stimulate the growth of this sector; which implies that government's efforts have rendered very limited results. Previous studies (Mahembe, 2013; Maye, 2014; Cant *et al.*, 2014:565; Garg & Makukule, 2015:71) have confirmed that the growth of SMMEs remain a major challenge in South Africa, with the failure of a majority of these businesses reported to be within the first year of trade. Lekhanya (2015:412) and SBP (2014) report that in South Africa the SMME failure rate is in the region of 70% and 80%. A plethora of factors can be ascribed to the remarkably high SMME failure rate (Kemp *et al.*, 2015:3; Chimucheka & Mandipaka, 2015:309; Cant and Wiid, 2013:708 - 709).

## **2.3. Factors affecting SMME Sustainability**

According to Cant *et al.* (2014:570), Garg and Makukule (2015:71) SMMEs are faced with a variety of challenges which can adversely affect the sustainability or cause these entities not to grow and succeed as they ought to. Furthermore, Chimucheka and Mandipaka (2015:309) points out that these challenges obstruct the establishment, survival and growth of SMMEs, thus barricading these businesses from attaining success and achieving the 'going concern' status. Bruwer (2010) and Siwangaza (2014) go on further to state that the challenges faced by SMMEs can be broken down into two broad categories, namely macro-economic factors and micro-economic factors as previously stated in the introduction. Previous authors such as Kunene (2008), Bruwer (2010), Grimsholm and Poblete (2010) and Siwangaza (2014) describe macro-economic factors as external events which the business has little or no control over, while micro economic factors are regarded as internal events which the business has full control over. Against this background, examples of macro-economic factors which affect the

sustainability of SMMEs include, but are not limited to rigid and onerous legislation, licencing and registration, market and economic conditions, crime, inflation, interest and exchange rates, taxation, politics, demand and supply of goods, infrastructure, technology, and competition, while on the other hand examples of micro-economic factors are lack of finance, insufficient managerial skills and experience, staff competency, lack of business acumen and marketing strategies, wasteful spending, lack of risk management, lack of internal control, to mention but a few (Maye, 2014; Kemp *et al.*, 2015:3; Prinsloo *et al.*; 2015:66; Cant *et al.*, 2014:570; Chimucheka & Mandipaka, 2015:309; Cant & Wiid, 2013:708-709; Lekhanya, 2015:417; SAICA, 2015; SBP, 2014; Garg & Makukule, 2015:71-73).

Moreover, Prinsloo *et al.* (2015:66) is of the opinion that the afore-mentioned factors may attract a variety of risks especially if they are not effectively managed, and when these risks are realised, they could threaten the ability of these entities to continue operating as a going concern (Bureau for economic research, 2016). To mitigate such risks, the design and implementation of internal controls is warranted.

## **2.4. The concept of internal control**

According to COSO (2013) the term internal control pertains to a set of measures, which are instituted by those charged with governance, to provide reasonable (but not absolute) assurance regarding the attainment of business objectives. These business objectives are briefly explained below (IIA, 2012; COSO, 2013; Reding *et al.*, 2013; Coetzee *et al.*, 2014):

- Operational objectives: These objectives ensure that business operations are efficient and effective, while also ensuring that business assets are safeguarded.
- Reporting objectives: These objectives are concerned with the integrity, reliability, timeliness and transparency of financial and non-financial reporting (internally and externally).
- Compliance objectives: These objectives have their main intention of ensuring that the business conforms to all applicable laws, rules, regulations, policies and procedures.

The significance of internal control in any business environment is underscored by Coetzee *et al.* (2014) when stating that the non-existence of adequate and effective internal controls will result in the sustainability of a business being negatively impacted upon. The latter is supported by Oseifuah and Gyeke (2013:241) who share the view that the lack of robust internal controls is one of the root causes for a number of business failures. To help businesses in designing, implementing and assessing the adequacy and effectiveness of internal controls, the COSO's (2013) internal control integrated framework is a useful tool with the most comprehensive approach (Protiviti, 2016). The framework comprises of five interrelated elements, that were reviewed by various researchers (Teketel & Berhanu, 2009; Reding *et al.*, 2013; Oseifuah & Gyeke, 2013:244-246; Coetzee *et al.*, 2014; Siwangaza, 2014; Bruwer & Van Den Berg, 2015:54), and are briefly explained as follows:

- Control environment: This element is touted as the foundation upon which any system of internal control is built. The operating effectiveness of any system of internal control is influenced by this element. The key aspects of this element are discussed below in section 2.5.
- Risk assessment: Those charged with governance and/or management should identify risks from internal and external sources (for example, criminal activities). This is because risks threaten the attainment of business objectives and as result these risks should be



identified and assessed in terms of their likelihood of occurring and the potential impact should they occur.

- Control activities: Control activities are put in place by management to mitigate the identified risks down to an acceptable level. These control activities will either prevent (known as preventative internal controls) or detect (known as detective internal controls) the risks identified. In addition, directive controls (e.g. management directives) should also be designed and implemented. Examples of popular control activities are management reviews, authorisations / approvals, segregation of duties, reconciliations, limiting access to authorised personnel only, etc.
- Information and communication: Important information, including risk and control information, should be communicated to all business stakeholders. Communication is critical in any business as it ensures that internal controls are operating effectively.
- Monitoring: The internal control system in its entirety must be monitored and its operating effectiveness (performance) be assessed on an on-going and periodic basis.

## 2.5. Internal control environment

A robust internal control environment is like a solid foundation of a building structure - without the solid foundation, the building will cease to exist. As the control environment forms the basis of any system of internal control (COSO, 2013), it influences the manner in which the entire business is managed and controlled (Oseifuah & Gyeke, 2013:244). Furthermore, the internal control environment is about those charged with governance (including management) setting an appropriate tone at the top, demonstrating their attitude and commitment towards internal controls (COSO, 2013). The attitude of those charged with governance (including management) towards internal controls is fundamental; particularly because employees are likely to observe the attitude of management towards internal controls and if this attitude proves to be lax, employees will in turn, not adhere to established internal controls (Coetzee *et al.* 2014). Jackson and Stent (2007) concur with the latter when stating if management is remiss towards internal control, employees will soon follow suit. Previous research studies and policy documents (Teketel & Berhanu, 2009; Oseifuah & Gyeke, 2013:244; COSO, 2013; Reding *et al.*, 2013; Coetzee *et al.*, 2014; Bruwer & Coetzee, 2016:195) concur that the internal control environment should include, among other things, the following rudiments: The operating style and philosophy of management, the commitment of management to ethics, values, integrity, competency, delegation of authority, responsibility and accountability, reporting structures and development of human resources policies and procedures.

## 3. Problem Statement

Based on the established theoretical scenario, it became apparent that SMMEs are playing a vital part in the realisation of socio-economic objectives. Despite a number of government initiatives and support measures to help these enterprises to grow and succeed a large number of SMMEs continue to fail. Previous studies have identified a host of challenges which can be ascribed to the weak SMME failure rate. These challenges have been grouped by prior research as macro-economic and micro-economic factors. These economic factors, if not well managed, attract a variety of risks which can be detrimental to the success of any business. To mitigate a variety of risks which SMMEs face, an effective internal control system is needed. Of concern, the lack of adequate and effective internal controls, which is regarded as a micro-economic factor, has been cited as one of the root causes to a number of business failures.

The implementation of an adequate and effective system of internal control is greatly influenced by the internal control environment, which is the foundation of any system of internal control.

Fundamentally, the internal control environment is about the attitudes and commitment of those charged with governance issues on risks, controls, ethics, values and integrity. It can then be said that sustainable internal controls of SMMEs are always affected by internal organisational environments which in turn influence the effective utilisation of internal control systems. Against this background, the internal control environments can be 'blamed' for the often defective implementation of internal control constructs within SMMEs.

#### **4. Methodology**

The research study conducted was empirical in nature and fell within the ambit of positivistic research paradigm. The main objective of this study was to determine the effect of the internal organisational control environment (ICEn) on the implementation of detective (DetC), preventative (PreC) and directive (DirC) internal controls within SMMEs. Data collected from 107 SMMEs located within the Cape Peninsula using a structured questionnaire were aggregated and analysed (Saunders et al, 2007). The sampling techniques employed were the non-probability purposive and convenience sampling since the size of the population was unknown. All the survey respondents had to comply with a strict delineation criteria, namely that of 1) respondents had to be classified as SMMEs in conformance with the Small Business Act, No. 102 of 1996, 2) respondents had to be SMME owners and/or managers, 3) these SMMEs had to be non-franchised and in existence not less than one year, 4) respondents had to operate their respective businesses in the fast moving consumer goods industry and, 5) lastly all SMMEs had to be located within the Cape Peninsula. Descriptive statistical analysis was conducted to run preliminary data and test for reliability and validity of the scales, regression analysis was used to test the hypothesised construct relationships.

### **5 Measurement and Data Analysis**

#### **5.1 Correlation analysis**

The first step in the data analysis involved a rigorous data screening process as suggested by Malhotra (2012), whose intention was to ensure clean data before performing both the descriptive and inferential statistical analysis. In accordance with study objectives outlined, it was imperative to examine the component inter-relationships between internal control environment (ICEn), detective internal controls (DetC), preventative internal controls (PreC) and directive internal controls (DirC). Therefore, it was necessary to employ correlations analysis among the mentioned constructs to determine the strength of the underlying relationships. The Pearson correlation coefficient ( $r$ ) was used to measure the degree of linear association between the variables in line with Malhotra (2012). The composite correlation is reported in Table 1.

**Table 1: Correlations: internal control environment (ICEn), detective controls (DetC), preventative controls (PreC) and directive controls (DirC)**

		ICEn	DetC	PreC	DirC
Internal Control Environment (ICEn)	Pearson Correlation	1.000	.8031*	.6913**	.7723**
	Sig. (2-tailed)		.0006	.0013	.0003
Detective Internal Controls (DetC)	Pearson Correlation		1.000	.5997**	.6017**
	Sig. (2-tailed)			.0002	.0041
Preventative Internal Controls (PreC)	Pearson Correlation			1.000	.5391*
	Sig. (2-tailed)				.0002
Directive Internal Controls (DirC)	Pearson Correlation				1.000
	Sig. (2-tailed)				
	N	107	107	107	107

\*\* Correlation is significant at the 0.01 level (2-tailed).

Table 1 shows that the relationships among 'internal control environment (ICEn), detective internal controls (DetC), preventative internal controls (PreC) and directive internal controls (DirC)' are significantly positive. It is evident from the table that the results of the Pearson correlation coefficients suggested a strong positive linear relationship between ICEn and DetC at ( $r=0.8031$ ,  $p<0.01$ ) level of significance, indicating that ICEn influences DetC, the relationship between ICEn and PreC is positive at ( $r=0.6913$ ,  $p<0.01$ ), and the table also shows the positive relationship between ICEn and DirC at ( $r=0.7723$ ,  $p<0.01$ ).

In terms of the effect sizes, Cohen's 1988 measure of effect sizes showed a large practical significance. In assessing the size of the correlation coefficients, Cohen's d-measure of effect sizes was used to measure the significance of an effect. The size of the effect is outline bellow as conquered by Steyn (2008:19):

- $r = 0.10$  (small effect)
- $r = 0.30$  (medium effect)
- $r = 0.50$  (large effect)

Based on the above results, it is evident that there is convergence among the investigated variables, lending support therefore, and supplementing the body of knowledge on the relationships among these constructs.

## 5.2 Regression analysis

This study utilised regression analysis to establish the predictive influence of internal organisational environment on the three annotated constructs under investigation. The independent predictor variable in this case was internal control environment (ICEn), and the dependent variable entered into the prediction model was detective internal controls (DetC) as illustrated in Table 2 (below). The beta coefficient of ICEn ( $\beta=0.789$ ) suggests that there is a strong positive relationship between the dependent and independent variables. The table reports the rating of an examination of the predictive relationship between the two variables, where adjusted  $R^2$  (0.613) indicates that ICEn explained 61.3% of variance on DetC. Thus, internal control environments within SMMEs are more likely to enable effective implementation of detective internal controls.

**Table 2: Regression analysis: ICEn & DetC**

Construct	B	Beta (β)	t	p-level
<b>Dependent:</b> Detective internal controls (DetC)	0.697	0.789	22.913	0.000*
<b>Independent variable:</b> Internal control environment (ICEn)				
R = 0.779   R <sup>2</sup> = 0.607   Adjusted R <sup>2</sup> = 0.613   F = 539.015   p<0.0000				

Table 3 reports the results of the regression analysis between internal control environments (ICEn) and preventative internal controls (PreC). In the model, ICEn is held as the constant (predictor and independent variable), whilst PreC is the dependent variable. The beta coefficient ( $\beta=0.801$ ) suggests that there is a strong positive relationship between the dependent and independent variables. The rating (the adjusted R<sup>2</sup>) of the relationship between these two variables is 0.589, indicating that ICEn explains about 58.9% of the variance of PreC. Thus, internal organisational control environments are more likely to impact the implementation of preventative internal controls.

**Table 3: Regression analysis: ICEn & PreC**

Construct	B	Beta (β)	t	p-level
<b>Dependent variable:</b> Preventative internal control (PreC)	0.723	0.756	22.297	0.000*
<b>Independent variable:</b> Internal control environment (ICEn)				
R = 0.769; R <sup>2</sup> = 0.591      Adjusted R <sup>2</sup> = 0.589      F = 497.153 p<0.0000				

Table 4 shows the regression analysis on the relationship between the internal control environment (ICEn) and the directive internal control (DirC). The beta coefficient of satisfaction ( $\beta=0.811$ ), suggests that there is a strong positive relationship between the two variables. The dependent variable was DirC, and the independent variable was ICEn. On the examination of the relationship between these two constructs, the rating score (adjusted R<sup>2</sup>) was 0.641. Therefore, the results indicate that internal organisational controls are more likely to impact the implementation of directive internal controls.

**Table 4: Regression analysis: ICEn & DirC**

Construct	B	Beta (β)	t	p-level
<b>Dependent variable:</b> Directive internal control (DirC)	0.811	0.813	24.819	0.000*
<b>Independent variable:</b> Internal control environment (ICEn)				
R = 0.799; R <sup>2</sup> = 0.638      Adjusted R <sup>2</sup> = 0.641      F = 615.975p<0.0000				

## 6. Concluding remarks

The study sought to investigate if effective internal control systems of SMMEs are influenced by the internal organisational control environment. The findings of the study show that sustainable internal controls of SMMEs are positively influenced by the effective internal

organisational environments. The significance of the internal control environment is underlined by IIA (2011) when stating that the majority of business failures can be blamed on poor internal control environments. These results are consistent with the findings of a study conducted by Jiang and Li (2010:215) which found that the internal control environments of small businesses, although largely defective, are essential for organisational risk performance. In this study, researchers went further to measure the predictive impact on each of the three outcome components (DetC, PreC and DirC). The results illustrated in the previous sections confirm that ICEn positively influences the outcome variables in a strongly significant way. The observations noted in two recent studies by Bruwer and Van Den Berg (2015:61) as well as Bruwer and Coetzee (2016:197) only concluded that the control environment of South African SMMEs were poor, blaming it on poor implementation of internal control activities. Based on the results in the current study, it can further be argued that the issue is not only on poor implementation but rather on the internal organisational environments of SMMEs which do not support sustainable implementation of any nature on internal controls.

## 7. Limitations of the study

Like many other studies, this study also had limitations. One of the limitations was the fact that the survey was confined to only SMMEs in Cape Town. Further studies should consider the SMMEs in other parts of South Africa. The study employed a quantitative research approach. Future research could consider using triangulation methodology where a qualitative design could be used in generating rich ideas and explanations. Another limitation could be the fact that the method of data collection relied on accurate introspection of responses that are subject to some degree of bias. Despite these limitations, the study advances knowledge regarding effective implementation of internal controls within SMMEs environments, considering that there is a noticeable absence of prior research on this subject within the South African context.

## REFERENCES

- Bureau for Economic Research, 2016. The Small, Medium and Micro Enterprise Sector of South Africa. The Small Enterprise Development Agency Research Note.
- Bruwer, J-P. 2010. Sustainability of South African FMGC Retail businesses in the cape peninsula. A dissertation submitted in full fulfilment of the requirements for the degree of Magister Technologiae: Internal Auditing in the Faculty of Business at the Cape Peninsula University of Technology.
- Bruwer, J-P. & Coetzee, P. 2016. A literature review of the sustainability, the managerial conduct of management and the internal control systems evident in South African Small, Medium and Micro Enterprises. *Problems and Perspectives in Management*, 14(2):190-200.
- Bruwer, J-P, Masama, B., Mgidi, A., Myezo, M., Nqayi, P., Nzuza, N., Phangwa, M., Sibanyoni, S. & Va, N. 2013. The need for a customised risk management framework for small enterprises Southern African Accounting Association: Conference Proceedings. 26 June 2013.

Bruwer, J-P & Van Den Berg, A. 2015. The influence of the control environment on the sustainability of fast food Micro and Very Small Enterprises operating in the Northern suburbs. *Journal of Leadership and Management Studies*, 2(1), pp 50-63.

Cant, M.C. & Wiid, J.A. 2013. Establishing The Challenges Affecting South African SMEs. *International Business & Economics Research Journal*, 12(6), pp. 707 -716.

Cant, M.C., Erdis, C. & Sephapo, C.M. 2014. Business Survival: The Constraints Experienced by South African SMEs in the Financial Sector. *International Journal of Academic Research in Business and Social Sciences*, 4(10), pp. 565 – 579

Chakabva, O. 2015. The Effectiveness of Risk Management Practices of Small, Medium and Micro Enterprises (SMMEs) which Provide Microfinance in the Cape Metropole, South Africa. A dissertation submitted in full fulfilment of the requirements for the degree of Magister Technologiae: Internal Auditing in the Faculty of Business at the Cape Peninsula University of Technology.

Chimucheka, T. & Mandipaka, F. 2014. Challenges Faced By Small, Medium And Micro Enterprises In The Nkonkobe Municipality. *International Business & Economics Research Journal*, 14(2), pp. 309

Coetzee, P., Du Bruyn, R., Fourie, H. & Plant, K. 2014. Internal Auditing: An introduction. Johannesburg: LexisNexis.

COSO, 2004. Enterprise Risk Management – Integrated Framework Executive Summary. [Online]. Available from: [http://www.coso.org/documents/coso\\_erm\\_executivesummary.pdf](http://www.coso.org/documents/coso_erm_executivesummary.pdf) [Accessed on 17/05/2016]

COSO, 2013. Internal Control – Integrated Framework Executive Summary. [Online]. Available from: [http://www.coso.org/documents/990025p\\_executive\\_summary\\_final\\_may20\\_e.pdf](http://www.coso.org/documents/990025p_executive_summary_final_may20_e.pdf) [Accessed on 01/06/2016]

Department of Trade and Industry (DTI), 1995. The White Paper on National Strategy for the Development and Promotion of Small Business in South Africa. Parliament of the Republic of South Africa.

DTI, 2013. Minister Davies Launches New National SMME Newspaper. [Online]. Available from: <http://www.thedti.gov.za/editmedia.jsp?id=2811> [Accessed 20/04/2016]

Garg, A.K. & Makukule, P. 2015. Business risk management – the key success factor: evidence from shebeens and taverns in Soshanguve Township. *Problems and Perspectives in Management*, 13(2), pp. 71-81

Global Entrepreneurship Monitor, 2014. GEM South Africa Report South Africa: The crossroads – a goldmine or a time bomb? [Online]. Available from: <http://www.gemconsortium.org/country-profile/108> (Accessed 20/04/2016)

Gordon, C., Baatjies, V., Johannes, L., Samaai, S., Sonto, J., Smit, Y., Bruwer, J. 2014. The control environment of fast food micro and very small entities in the Cape Metropole. *Topclass Journal of Business Management and Innovations*. 1(2), pp 37-46.

Grimsholm, E., & Poblete, L. 2010. Internal and External factors hampering SME growth - A qualitative case study of SMEs in Thailand. A dissertation submitted in fulfillment of the requirements for the degree of Master in Business Administration: International Management in the Faculty of Social Sciences at the Gotland University.

Hendricks, B., Hendricks, G., Johnson, R., Manuel, A., Maritz, R., Theron, L & Bruwer, J.P. 2015. The Influence of "Sin Tax" on the Economic Sustainability of Small, Medium and Micro Liquor Store Enterprises in the Northern Suburbs of the Cape Metropolis, South Africa. *Journal of Economics*, 6(2), pp.87-101

IIA. 2011. IPPF – Practice Guide Auditing the Control Environment [Online]. Available from: [http://www.iiainl.org/Sitefiles/IIA leden/Auditing the Control Environment\[1\].pdf](http://www.iiainl.org/Sitefiles/IIA%20I%20leden/Auditing%20the%20Control%20Environment%2011.pdf) [Accessed on 15/ 05/ 2016]

IIA. 2012. International Standards For The Professional Practice of Internal Auditing (Standards). [Online]. Available from: <https://na.theiia.org/standards-guidance/Public%20Documents/IPPF%202013%20English.pdf> [Accessed on 16/ 05/ 2016]

Jackson, R., Stent, W. Auditing Notes for South African Students. 2007. Durban:LexisNexis

Jiang, L. & Li, X. 2010. Discussions on the Improvement of the Internal Control in SMEs. *International Journal of Business and Management*. 5(9), pp 214-216.

Kemp, A., Bowman, A., Blom, B., Visser, C., Bergoer, D., Fullard, D., Moses, G., Brown, S.-L., Bornman, J. and Bruwer, J.-P., 2015. The usefulness of cash budgets in micro, very small and small retail enterprises operating in the Cape Metropolis. *Expert Journal of Business and Management*, 3(1), pp.1-12

Kunene, T. R. 2008. *A critical analysis of entrepreneurial and business skills in SMEs in the textile and clothing industry in Johannesburg, South Africa*. A dissertation submitted in full fulfillment of the requirement for the degree of Philosophiae Doctor: Entrepreneurship in the Faculty of Economic and Management Sciences at the University of Pretoria.

Lekhanya, L.M. 2015. Public Outlook on Small and Medium Enterprises as a Strategic Tool for Economic growth and Job Creation in South Africa. *Journal of Governance and Regulation*, 4(4), pp. 412 - 418

Mahembe, E. 2013. Research Study to Identify Needs, Opportunities and Challenges of SMEs in the Chemicals and Plastics and Sector Prepared for Small Enterprises Development Agency (SEDA). Underhill Corporate Solutions (UCS).

Malhotra, N. K. 2012. Basic marketing research: *Integration of social media*. Pearson Publishers.

Maye, M. 2014. Small Business in South Africa: What the Department of Small Business Development Can Do to Stimulate Growth. Southern African Catholic Bishop's Conference. Parliamentary Liaison Office. Occasional Paper 35.

Mthabela, T.E. 2015. Assessing the Causal Failures of Emerging Manufacturing SMEs in Johannesburg. A research report submitted in partial fulfillment of the requirements for the degree of Master of Management specialising in Entrepreneurship and New Venture

Creation: Internal Auditing in the Faculty of Commerce, Law and Management at the University of the Witwatersrand.

Ngubane, N., Mayekiso, S., Sikota, S., Fitshane, S., Matsotso, M & Bruwer, J-P.2015. Inventory Management Systems used by Manufacturing Small Medium and Micro Enterprises in Cape Town. *Mediterranean Journal of Social Sciences*, 6(1), pp. 382-390

Nyakundi, D.O., Nyamita, M.O. \* Tinega, T.M. 2014. Effect of Internal Control Systems on Financial Performance of Small and Medium Scale Business Enterprises in Kisumu City, Kenya. *International Journal of Social Sciences and Entrepreneurship*, 1(11), pp. 1-15

Olawale, F & Garwe, D. 2010. Obstacles to the growth of new SMEs in South Africa: A principal component analysis approach. *African Journal of Business Management*, 4(5), pp. 729 – 738

Oseifuah, E. & Gyekye, B. 2013. Internal control in small and microenterprises in the Vhembe district, Limpopo province, *South Africa. Eur. Sci. J.* 9(4)

PwC. 2015. Focus on South Africa's emerging companies and entrepreneurial landscape 2015 Working together, moving forward Emerging companies and the ecosystem. [Online] Available from: <https://www.pwc.co.za/en/assets/pdf/emerging-companies-and-the-ecosystem.pdf> [Accessed on 21/05/2016]

Prinsloo, S., Walker, C., Botha, L., Bruwer, J-P. & Smit, Y., 2015. The Influence of Combined Assurance Initiatives on the Efficiency of Risk Management in Retail Small and Very Small Enterprises in Bellville, South Africa. *Expert Journal of Business and Management*, 3(2), pp.63-81

Protiviti, 2016. Singapore Quick Guide to the COSO Enterprise Risk Management and Internal Control Frameworks. [Online] Available from: <http://www.protiviti.com/Singapore-en/Documents/SG-Quick-Guide-COSO-ERM-Internal-Control-Frameworks-2016Ed.pdf> [Accessed on 18/05/2016]

Ramukumba, T. 2014. Overcoming SMEs Challenges Through Critical Success Factors: A Case of SMEs in the Western Cape Province, South Africa, *Economic and Business Review*, 16(1), pp. 19-38

Reding, K.F, Sobel, P.J., Andersen, U.L., Head, M.J, Ramamoorti, S., Salamasick, M., Riddle, C. 2013. Internal Auditing: Assurance & Consulting. Florida: The Institute of Internal Auditors Research Foundation

SAICA, 2015. SME Insights Report. [Online]. Available from: [http://www.saica.co.za/portals/0/documents/saica\\_sme.pdf](http://www.saica.co.za/portals/0/documents/saica_sme.pdf) [Accessed on 18/05/2016]

Sankoloba, T. & Swami, B.N., 2014. Impact of Internal Controls in Managing Resources of Small Business: Case Study of Botswana. *Journal of Small Business and Entrepreneurship Development*, 2(2), pp. 87-105

Saunders, M.N.K, Lewis, P & Thornhill, A. 2007. Research Methods for Business Studies.London:Pitman Publishing.



SBP, 2014. Examining the challenges facing small businesses in South Africa. [Online]. Available from: [http://www.sbp.org.za/uploads/media/SBP\\_Alert\\_Examining\\_the\\_challenges\\_facing\\_small\\_businesses\\_in\\_SA\\_01.pdf](http://www.sbp.org.za/uploads/media/SBP_Alert_Examining_the_challenges_facing_small_businesses_in_SA_01.pdf) [Accessed on 19/05/2016]

Siwangaza, L. 2014. *The status of internal controls in fast moving consumer goods SMMEs in the Cape Peninsula. Dissertation submitted for the fulfilment for a MTech: Internal Auditing*. Cape Peninsula University of Technology.

Siwangaza, L., Smit, Y., Bruwer, J-P. & Ukpere, W. 2014. The Status of Internal Controls in Fast Moving Consumer Goods Enterprises within the Cape Peninsula. *Mediterranean Journal of Social Sciences*, 5(10), pp. 163-175

Steyn, G.M. 2008. Continuing professional development for teachers in South Africa and social learning systems: conflicting conceptual frameworks of learning. *Koers*, 73(1), pp.15-31.

South Africa. 1996. Small Business Act No. 102 of 1996. Pretoria: Government Printers

South Africa. 2004. National Small Business Amendment Act, No. 29 of 2004. Pretoria: Government Printer.

Teketel, T. & Berhanu, Z. 2009. Internal Controls in Swedish Small and Medium Size enterprises. A dissertation submitted in full fulfilment of the requirement for the degree of Masters in Business Administration at the University of Umea.

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

**ISBN number: 978-0-620-74761-5**



---

**AUD 08: The Relationship between Board Size and  
Company Performance**

Kyla van der Westhuizen

*University of Cape Town*

Gizelle Willows

*University of Cape Town*

[Gizelle.willows@uct.ac.za](mailto:Gizelle.willows@uct.ac.za)

**A South African Study**

**Abstract**

This paper evaluates the relationship between the size of the board of directors (“the board”) and company performance. Presented in this study are the findings that the size of the board has no significant relationship/effect on the financial performance of the JSE Top 40 companies in South Africa. With Tobin’s Q used as the variable that measures the performance of the companies in 2014, and the independent variables – additional to board size – being company size, return on assets, and non-executive directors, the relationship was analysed using an Ordinary Least Squared Regression. The lack of a relationship is suggested to be due to the high quality of corporate governance in South Africa as well as the inefficiencies of information transfers in emerging markets.

**Introduction**

Corporate governance has been known to have a large impact on the financial performance of a company. Financial performance (“performance”) is defined as the overall financial health of the company at a specific time<sup>1</sup> (Bhunia, Mukhuti & Roy, 2011). In this study, the emphasis will be placed on profitability and efficiency influenced by the board, and it will be further detailed as the ratio of market value of assets to its book value (Kusnadi & Maka, 2005). Notable examples of corporate governance impacting performance are the demise of Enron, where the concerns regarding the composition and size of the board of directors were

---

<sup>1</sup> The use of company performance is in line with prior studies, such as Bulan et al. (2009), Horváth et al. (2012), Kartika et al. (2012), as well as Muchemwa, M (2014).

highlighted (Vinten, 2002) and the more recent failure of African Bank, that could possibly have been prevented through the correct corporate governance structures (Mushangwe, 2014). Therefore, it should be determined how much of an impact the size of the board has on company performance in order to identify its impact on failures such as these.

King III insinuates that the size of the board has a positive relationship with the probability of a company complying with corporate governance. This is because a larger company is more likely to have the required number and proportion of non-executive directors on its board (South African Institute of Chartered Accountants, 2014). This study aims to identify how significant this relationship's effect is on the company's performance. By finding the optimal level of board members (or finding out that there is none) in relation to performance, a company can prioritise their members by quality instead of quantity, which can improve the quality and performance of the company.

## Literature Review

The downfall of Enron in the early 2000's has been believed to be caused by a list of factors, one of which being a lack of corporate governance (Munzig, 2003). This can be considered to be due to issues such as lack of communication on the board, which could be affected by its size, an unclear direction of how to come to a conclusion with regards to the most effective way to make business decisions, as well as intimidation tactics to ensure that the board voted a certain way instead of in a way that was in shareholders' best interests (Munzig, 2003). In a similar light, African Bank was said to have had issues with corporate governance in the banking industry (Mushangwe, 2014). This was caused by, firstly, having a higher board size than other banks, and with that higher size, a larger portion were executive directors (Mushangwe, 2014). This was an issue due to the fact that banks are required to be highly independent, and with a ratio of 36% of executive directors, compared to the norm of 18%, African Bank had the executive directors leading the decisions of the board (Mushangwe, 2014).

Looking at the board in detail, the characteristics of a company's board has been found to be a largely influential factor in such company's performance (Bulan, Snyal, & Zhipeng, 2009). Three main board characteristics have been considered in literature, namely 1) the size of the board 2) the size of the company, and 3) the proportion of non-executive directors (Bulan et al., 2009). According to Bulan et al. (2009), performance has a negative relationship with board size, as well as a negative relationship with company size, whereas the proportion of non-executive directors is directly related to performance (Bulan et al., 2009).

Prior literature, which focuses on each of these three factors, along with other supporting factors, will be reviewed and discussed in more detail to follow. Thereafter, the composition of the board of directors within a South African regulatory framework will be assessed.

## **Board Size**

Although much debate exists around the optimal size of a company's board, it is believed that the smaller the size of the board, the better its monitoring abilities over the company (Coles, Daniel, & Naveen, 2008). Furthermore, Muchemwa (2014) stated that the more directors that sit on a board, the higher the risk that there is less control and structure in a board meeting, which could consequently result in less effective decision-making for the company.

Contrary literature, in support of larger board sizes, has found that a larger board size was better for the CEO, as it meant that he/she would receive more feedback and could obtain more expert advice from outside members rather than just from members of his/her staff (Coles et al., 2008).

A large factor that is believed to be the explanation of the influence of board size on company performance is the 'resource dependency theory' (Muchemwa, 2014). This theory relies on the assumption that when a board appoints a director, it does so with the expectation that the new member will support the company and concern himself with its issues, as well as try and resolve them whenever it is possible (Muchemwa, 2014). Therefore, under this theory, the more directors appointed to the company, the higher improved performance of the company as the directors add their necessary resources (i.e. time, skill, and other capital) to the company (Muchemwa, 2014). However, Muchemwa (2014) and Horváth et al. (2012) state that there is also the risk of 'free-riders' on the board, where directors may not use their resources to increase the performance of the company. This meets the definition of 'free-riding', as it is seen as benefiting from the work of others without partaking in said work (Pasour, 1981).

Finally, Muchemwa (2014) found another alternative, being that although there is a relationship similar to that in the case of Kusnadi et al. (2005), there is no significance between board size and company performance (Muchemwa, 2014). As the study by Muchemwa (2014) was completed in a South African context, it implies that companies in South Africa might not be using its board size advantageously to improve its performance.

## **Company Size**

The size effect anomaly has stated that there is an inverse relationship between the size of the company and its performance (Okada, 2006). The anomaly has also found that the size of the company and the size of the returns (i.e. the performance of the investments) are inversely related (Okada, 2006). The size effect anomaly was opposed by Bulan et al. (2009), who found that company size had a significantly 'U-shaped' impact on the performance of the company. It was evidenced that there are generally smaller boards in smaller companies, which caused an increase in productivity and performance (Bulan et al., 2009). This same outcome was found in the research done by Guest (2009), which strengthened the argument concerning this relationship.

Hawawini et al. (2001) found that the size of the company creates a competitive advantage as larger companies are seen to be more efficient than smaller ones. However, Okada (2006) argued that there is little to no effect of company size on company performance.

### **Non-Executive Directors**

Bulan et al. (2009) believes that one of the main factors that positively influence company performance is the independence of the board. Independence in this case was measured as the proportion of non-executive directors in the company (Bulan et al., 2009).

Owing to the potential independent monitoring that can be achieved by non-executive directors and that these directors have more objective insights into company decisions, having a higher proportion of non-executives could have a direct impact on the performance of the company (Jung & Wook, 2011). However, it could also be argued that the costs of additional non-executive directors could reach the point where they outweigh the benefit (or in smaller companies they may not be affordable) in which case it may have an inverse relationship to performance (Jung & Wook, 2011).

Looking at the relationship between board composition and company performance, Guest (2009) found that the more non-executive directors on a board, the more chance the directors can identify and manage ineffective directors who are not working efficiently. Guest (2009) also stated that the more non-executive directors there are on the board, the higher the chance that those directors can sway the board to act in favour of shareholders interest.

Coles et al. (2008) found that when holding executive directors constant, Tobin's Q (as a proxy for company performance) increased with an increase in non-executive directors. This strengthens the argument that a higher proportion of non-executive directors causes company performance to increase. However, Cole et al. (2008) further noted that the most effective proportion of non-executive directors and size of the board is dependent on the size of the company, complexity, and need for company-specific knowledge. The more complex or large the company, the better it is for it to have non-executive directors that can provide an outsiders perspective and a larger range of skills required for decision making (Coles et al., 2008). The optimal composition of the board would not be a set number for every company, as different complexities and amounts of internal knowledge and skills are required.

### **The South African Context**

According to King III, all South African listed companies *should* follow King III guidance on the structure of the board of directors (South African Institute of Chartered Accountants, 2014). This structure is that the board should consist of at least two executives (being the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO)), with the majority of the board being non-executives, and the majority of the non-executives being independent (South African Institute of Chartered Accountants, 2014). Therefore, to comply with King III, a company should ensure that no matter how big its board is, the majority of the board should

be non-executives. With this guidance, a company should have no less than five members (i.e. executive and non-executive directors) on its board. With the majority being non-executives there is likely to be a great deal of monitoring on company boards and objective decisions being made (Horváth & Spirollari, 2012; South African Institute of Chartered Accountants, 2014). However, according to Klein (1998) there is also the risk that the more non-executives there are, the less company-specific knowledge they have, leading to less effective decision making – and lower company performance.

South African listed companies are labelled as some of the best governed companies in emerging markets (Muchemwa, 2014). The benefits to complying with King III is that good corporate governance increases investor trust in companies, which in turn allows them to perceive the company as less risky and reduce the cost of equity, as they would expect a lower rate of return (Bauer, Gunster, & Otten, 2003). Following a lower cost of equity, would be a lower weighted average cost of equity, which would cause the company valuation to increase (Bauer et al., 2003). Therefore, there appears to be a positive relationship between corporate governance compliance and company performance.

## Methodology

The literature reviewed revealed unclear conclusions regarding the effect of board size on company performance. Furthermore, much of the research is outdated and not in a South African context, allowing this paper to determine the current outcome of this question in South Africa.

The research question for this paper is thus: Does the size of the board of director's impact the performance of the company in South Africa?

The null ( $H_0$ ) and alternative ( $H_1$ ) and ( $H_2$ ) hypotheses for this research question are as follows:

$H_0$ : There is no statistically significant relationship between the size of the board of directors and the performance of the company.

$H_1$ : There is a statistically significant positive relationship between the size of the board of directors and the performance of the company.

$H_2$ : There is a statistically significant negative relationship between the size of the board of directors and the performance of the company.

## Research Approach

In order to assess the relationship (if any) between the size of the board of directors and the performance of the company, a sample of companies was selected for testing. This sample consisted of all 40 companies listed on the JSE Top 40 Index as seen in Appendix A. This sample was chosen as a replication of the Yermack (1996) and Kusnadi et al. (2005) studies, which included the Forbes Top 100 companies. Furthermore, a range of prior studies done in South Africa have shown the JSE Top 40 to be a suitable sampling population (Hearn, 2009; Hindley, 2012; Mare & Wentzel, 2007).

The most recent audited Annual Financial Statements available up until April 2015 were sourced for each company, being the 2014-year-end results. Each company must have been listed for a period of at least three consecutive years prior to the study. This would limit any survivorship bias (Kusnadi & Maka, 2005). All of the JSE Top 40 companies selected had at least three consecutive years on the JSE, thus they were all valid for the sample base.

Relying on prior literature from Kusnadi et al. (2005) and Guest (2009), company performance was measured using Tobin's Q. This measure hypothesises that the market value of the assets should be equivalent to the book value (otherwise referred to as the replacement value). The result of this ratio is used to demonstrate whether the assets are more or less 'expensive' on the market relative to its replacement cost (i.e. a ratio above one indicates it is viewed as more valuable on the market). The ratio is calculated as follows:

$$Tobin's\ Q = \frac{Market\ Value\ Assets}{Book\ Value\ Assets}$$

*Market Value Assets*

*= Market Capitalisation + Book Value Liabilities + Preference Shares*

The market value of assets was calculated by taking the market capitalisation at financial year-end, the book value of the liabilities, and the liquidation value of the preference shares (Kusnadi & Maka, 2005). This is due to a company's assets being funded by equity (i.e. market capitalisation and preference shares) and liabilities – so the total asset value can be calculated by aggregating these factors. The reason for the use of book value liabilities is that prior literature can support that the slight deviation from market value liabilities, which is used in the original Tobin's Q formula, would not be large enough to tamper with the final result (Chung & Pruitt, 1994). This therefore allows an acceptable simplification in using book value (Chung & Pruitt, 1994).

The liquidation value of the preference shares was calculated by taking the par value of the equity preference shares (which was calculated as the number of shares in issue multiplied by the par value of preference shares) from the Annual Financial Statements of each company. This way of calculating the asset market value for Tobin's Q is in line with the method followed by Chung and Pruitt (1994).

The 'Book Value Assets' were taken directly from the Annual Financial Statements at their face value.

It should be noted that the company's market value can be linked to performance due to the fact that when company performance increases, the share price in the market increases, which in turn increases the company's market capitalisation – and, therefore, its company value (Kartika, Puspitasari, & Sudiyatno, 2012). This increases the argument by Kusnadi et al. (2005) of the suitability of Tobin's Q as the measurement for company performance.

## Research Method

An ordinary least squares 'OLS' regression analysis is performed to test for any relationship between the size of the board of directors and the company's performance. The company's performance, as measured by Tobin's Q will be the dependent variable. Owing to the limited sample of 40 companies, a maximum of three independent variables could be selected at any time.

Multiple stage testing will be performed, with the first stage only including the size of the board as the independent variable in order to initially test the  $H_0$ . Following from that, the second and third stage of testing will include two additional control variables. The first control variable will be ROA, as it is often used as a measure for performance (Hawawini, Subramanian, & Verdin, 2001). In stage two, the second control variable will be the size of the company, as it appears to have a large influence on company performance upon reviewing the relevant literature (Coles et al, 2008; Horváth et al., 2012; Kusnadi et al., 2005). In stage three, this control variable will be replaced with the proportion of non-executive directors, which was also found to be influential in the literature reviewed (Coles et al., 2008; Guest, 2009; Horváth et al, 2012; Kusnadi et al., 2005).

The formulae used to the  $H_0$ , whilst controlling for other factors is as follows:

Test One:

*Stage One:*

$$\text{Company Performance} = \text{Board Size} \times A_0 + e_{i,t}$$

*Stage Two:*

$$\text{Company Performance} = \text{Board Size} \times A_0 + \text{ROA} \times A_1 + \text{Company Size} \times A_2 + e_{i,t}$$

*Stage Three:*

$$\text{Company Performance} = \text{Board Size} \times A_0 + \text{ROA} \times A_1 + \text{Non Executive Directors} \times A_3 + e_{i,t}$$

Where ' $A_{0-5}$ ' are the relationships between the control variables and the dependent variable and ' $e_{i,t}$ ' is the residual (which contains random or fixed effects on company performance that are not brought about by either of the three control variables).

Each variable used is measured as follows:

**Company Performance** is measured using Tobin's Q as previously explained. This is in line with prior papers, as discussed in the literature.

**Return on assets 'ROA'** is measured as the operating income over the total assets of each company for each of its year-ends. This ratio represents how efficiently the company generates income through the use of assets.

**Company size** is measured as the market capitalisation of each company at its financial year-end, translated into ZAR if necessary at the ruling exchange rate at the reporting date. The ruling exchange rate was sourced from the Reserve Bank, whilst the share prices at year-end were taken from Bloomberg.



**Board size** is measured as the total number of executive and non-executive directors in each company at year-end.

**Non-Executive Directors** are measured as those directors not involved in the management of the company (i.e. all directors that aren't executives).

As this study is done in a South African context, the analysis will be further split up into the effects of the independent variables on Tobin's Q (i.e. company performance) within the respective sectors in which each company operates (Ruland & Zhou, 2006). From the literature reviewed, it was argued that the complexity of the company, the company size, and the composition of the board can all influence company performance. Therefore, it is possible that in different sectors, companies may be grouped into their level of complexity and structure, etc. With this in mind it could be possible that when the companies are grouped into their sectors, the size of the board could have different effects on the performance of the company. The sectors that will be the focus of this study will be those that are the most common on the JSE. According to the JSE SA Sector categories (2015), the three sectors, based on company revenue, are Resources, Financials, and Industrials (i.e. other) (JSE, 2015).

Test Two:

$$\text{Company Performance} = \text{Board Size} \times A_0 + \text{Sector Type} \times A_4 + e_{i,t}$$

## Results

Before analysing the results from the OLS regression, the average (mean) and range of the boards are calculated to indicate their possible level of King III compliance. It should be noted that a limitation of this study would be that by using the JSE Top 40, there would be a likelihood of companies having similar structure and board size, which would skew the results. However, the results from calculating the mean and range of the board showed that the sizes range from 9 to 21 members, with the average size of a board being 13,98, with a median of 13,5 members (Appendix B). With King III in mind, the minimum number of directors on the board was 9 (above the minimum required of five) showing adherence to King III and thus being an indicator of good corporate governance. This could, again, lead to a limitation of scope, as with the minimum number of directors on the board being 9, it is unlikely that any of these companies would not adhere to King III, whereas if one were to examine smaller companies a lack of adherence may be more likely (as the board size would likely decline).

The impact of board size, and other factors, on company performance in three different stages, is shown in Table 1.

**Table 1:**  
**The Effect of Board Size on Company Performance**

VARIABLES	Stage 1 Company performance	Stage 2 Company performance	Stage 3 Company performance
Size of board	0.0130 (0.0547)	0.0524 (0.0463)	0.0812 (0.0495)
ROA		5.850*** (1.428)	6.316*** (1.452)
Size of company		6.62e-07 (3.98e-07)	
Proportion of non-exec's			1.650 (1.496)
Constant	1.727** (0.786)	0.400 (0.710)	-1.143 (1.554)
Observations	40	40	40
R-squared	0.001	0.377	0.351

Standard errors in parentheses

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

Table 1 shows the relationship between each of the independent variables company performance. The manner in which Table 1 is set out allows for the view of the size of independent variables (such as board size, ROA, etc.) being listed in the first column, whereas the company performance is the dependent variable (i.e. Tobin's Q) throughout the above test.

When looking at the significance levels of the different stages, it is clear that ROA has a highly significant positive relationship with company performance. This supports the findings in prior literature (Coles et al., 2008; Hawawini et al., 2001; Kartika et al., 2012; Kusnadi et al., 2005). However, the results differ from Coles et al. (2008) and Guest (2009) with the remainder of the control/independent variables where, in this study, there is no relationship between the size of the company or the proportion of non-executive directors and company performance.

Although insignificant, there does still appear to be a positive relationship between company performance and the remainder of the variables. The positive relationship between company performance and company size disproves the size-effect theory and is explained by Hawawini et al. (2001) who state that a larger company has a larger competitive advantage. Furthermore, Okada (2006) found no significant relationship between these two variables.

When looking at the relationship between company performance and non-executive directors, the lack of a significant relationship is supported by Bhagat et al. (2000). However, Bulan et al. (2009), Coles et al. (2008), Jung et al. (2011), and Guest (2009) argue that more non-executive directors allow for more monitoring and reduced fraud and errors in companies. This enhances

voting towards decisions in the company that may improve shareholder wealth, which in turn improves overall financial performance.

The relationship between board size and company performance was also found to be insignificant, yet positive. The positive aspect of the relationship could be justified by prior literature, which stated that a larger board would allow for more non-executive directors (and increase monitoring of the company) (Bulan et al., 2009). It can also be justified by having more executive directors with the required company specific knowledge and skills to make the most efficient decisions that would enhance the company performance (Bulan et al., 2009). However, the final result is still insignificant, and this difference to prior literature, such as Kusnadi et al. (2005) and Coles et al. (2008), might be explained by all of the prior studies being performed in developed countries, whereas in South Africa – an emerging market – there may be different factors that cause a different relationship between the two variables.

**Table 2:**  
**The Effect of Board Size on Company Performance per Sector**

VARIABLES	Company performance
Size of board	-0.0112 (0.0519)
Sector: Industrial	1.206*** (0.426)
Sector: Resources	0.0292 (0.506)
Constant	1.423 (0.882)
Observations	40
R-squared	0.272

Standard errors in parentheses

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

In Table 2 the 'Financial sector' is isolated as a reference group for the regression. This is owing to the 'sector' variable being an ordinal variable. Thus, in Table 2, it should be noted that the Financial sector is compared to the Industrial sector, as well as being compared to the Resources sector to determine which sector is better at influencing company performance. The results from Table 2 show that companies in the industrial sector have a statistically significant positive relationship with company performance. However, there is no significant relationship with any of the other independent variables, showing that the size of the board has no effect on company performance – overall or per sector, amongst the sampled companies assessed.

## Discussion

The majority of the literature review that found significant relationships between the board size and company performance were performed in developed economies. This might indicate that the relationship is dependent on the developmental stage of the country, and this study in South Africa would find variant results. Within emerging markets, markets are not as efficient, thus investor information is not often reflected in the share price when it becomes newly available (BlackRock, 2015). To explain the insignificant relationship using this information, it is acknowledged that Tobin's Q is used as one of the measurement variables, and Tobin's Q consists of market capitalisation. Thus, the lack of efficiency in transferring company information into the market value could result in the lack of a statistically significant relationship between the two variables – therefore, it would suggest reasoning's behind the difference in the relationship found between this study and prior literature. With this, emerging markets also appear to have under-developed communication foundations compared to developed markets (Khanna & Palepu, 1997). Therefore, it is inferred that the size of the board may have no relationship with company performance as the size will not impact the ability to communicate and make informed decisions due to emerging markets poor communication skills.

Another possible reason behind this difference is explained by Bauer et al. (2003) who suggest that the constructs relationship is often stronger with companies that have less developed governance standards. This suggests that a weaker relationship exists between company performance and a more highly developed corporate governance standard (Bauer et al., 2003). Thus, this could imply that having a strong corporate governance system could add little increased performance for a company.

Furthermore, Klein (1998) noted that the higher the level of non-executive directors, the less company specific knowledge they have that might be required. Most South African companies are compliant with King III – giving them a higher proportion of non-executive directors. In addition, there is the likelihood of a great deal of the JSE Top 40 companies being complex due to their size and specialised nature (i.e. mining, financial, etc.). Therefore, there is the possibility that the performance added due to the monitoring by non-executive directors could be counteracted by the lack of company specific knowledge these directors have with regards to decision making. This would cause the end result to be that there is no significant relationship in either direction when it comes to board size and company performance. The likelihood of this being the reason is strengthened due to the average proportion of non-executive directors from the JSE Top 40 being 76% (Appendix B).

## Conclusion

The results show that return on assets has a statistically significant positive relationship with company performance, as measured by Tobin's Q, which is in support of prior literature. However, no statistically significant relationship between non-executive directors and company performance, as well as company size and its performance was found, which is contrary to prior literature. This was suggested to be owing to South Africa being an emerging market, as emerging markets lack efficiency in communication and information transfer. Another possible reason given was the high level of corporate governance in South Africa, which increases the

monitoring effectiveness of the non-executive directors whilst counteracting the lack of executives required for company specific skills and knowledge for decision-making. Finally, the relationship between board size and company performance, which was undetermined, appears to also show no statistically significant relationship.

In conclusion, there appears to be no significant relationship between board size and company performance within the JSE Top 40 companies in South Africa. South Africa may have a high level of corporate governance, but this is not linked to the performance of the company when looking at board size in this case. Therefore, although the lack of corporate governance and inefficient board size and composition had a large impact on the downfall of Enron and African Bank, the suggestion in this study is that the incorrect board size may increase the chances of 'unexpected' failure of the company as was seen with these two situations, but the size of the board will not cause a company's performance to change significantly – i.e. a larger board size will not be a factor in the increased profitability of the company.

## Recommendations

The results of this study imply that incurring additional costs to obtain the most efficient and objective board might not positively impact company performance in South Africa. Therefore it is recommended that the size of the board be kept to a minimum but that King III considerations should be complied with to ensure the company meets the standards of corporate governance.

A smaller board not only reduces total director remuneration, but also allows for prudence by appointing only those directors that can increase company performance. The communication between directors would also be more efficient. Therefore, a smaller, but flexible, board with highly qualified staff is recommended whilst maintaining a high level of corporate governance.

## Bibliography

Bauer, R., Gunster, N., & Otten, R. (2003). Empirical Evidence on Corporate Governance in Europe. *Journal of Asset Management*, (October), 1–24. doi:10.2139/ssrn.444543

Bhagat, S., & Black, B. (2000). Board Independence and Long-Term Firm Performance. *Social Science Research Network Electronic Journal*, (February), 1–44. Retrieved from [http://www.researchgate.net/profile/Sanjai\\_Bhagat/publication/228230283\\_The\\_Non-Correlation\\_Between\\_Board\\_Independence\\_and\\_Long-Term\\_Firm\\_Performance/links/004635307445468f0f000000.pdf](http://www.researchgate.net/profile/Sanjai_Bhagat/publication/228230283_The_Non-Correlation_Between_Board_Independence_and_Long-Term_Firm_Performance/links/004635307445468f0f000000.pdf)

BlackRock. (2015). Capitalising on Market Inefficiencies in Global Stock Markets. Retrieved June 5, 2015, from <https://www.blackrock.com/investing/resources/education/alternative-investments-education-center/how-can-i-use-alternative-investments/capitalizing-on-market-inefficiencies-in-global-stock-markets>

Bulan, L., Snyal, P., & Zhipeng, Y. (2009). Directors, Outsiders and Efficiency: An Analysis of How Board Characteristics Influence Firm Productivity. *Journal of Economics and*

- Business*, (August), 1–38. Retrieved from <http://people.brandeis.edu/~lbulan/prodBoard.pdf>
- Chung, K. H., & Pruitt, S. W. (1994). A Simple Approximation of Tobin's q. *Journal of the Financial Management*. Memphis: Wiley. doi:10.2307/3665623
- Coles, J. L., Daniel, N. D., & Naveen, L. (2008). Boards: Does one size fit all? *Journal of Financial Economics*, 87(February), 329–356. doi:10.1016/j.jfineco.2006.08.008
- Guest, P. M. (2009). The Impact of Board Size on Firm Performance: Evidence from the UK. *Journal of Asset Management*, 15(4), 385–404. Retrieved from [https://dspace.lib.cranfield.ac.uk/bitstream/1826/4169/4/The\\_impact\\_of\\_board\\_size\\_on\\_firm\\_performance.pdf](https://dspace.lib.cranfield.ac.uk/bitstream/1826/4169/4/The_impact_of_board_size_on_firm_performance.pdf)
- Hawawini, G., Subramanian, V., & Verdin, P. (2001). Is performance driven by industry - or industry- or firm-specific factors? A new look at the evidence Venkat Subramanian Paul Verdin. *Strategic Management Journal*, 24(January), 1–16. Retrieved from [http://www.readcube.com/articles/10.1002/smj.278?r3\\_referer=wol&tracking\\_action=preview\\_click&show\\_checkout=1&purchase\\_site\\_license=LICENSE\\_DENIED](http://www.readcube.com/articles/10.1002/smj.278?r3_referer=wol&tracking_action=preview_click&show_checkout=1&purchase_site_license=LICENSE_DENIED)
- Hearn, B. (2009). Liquidity estimation in major African equity markets. *Journal of Economic Literature*, 44, 1–36. Retrieved from [http://stage.cassknowledge.com/sites/default/files/article-attachments/173~~173\\_brucehearn\\_liquidity\\_estimation\\_in\\_major\\_african\\_equity\\_markets.pdf](http://stage.cassknowledge.com/sites/default/files/article-attachments/173~~173_brucehearn_liquidity_estimation_in_major_african_equity_markets.pdf)
- Hindley, A. T. (2012). *Integrated reporting compliance with the Global Reporting Initiative framework: An analysis of the South African mining industry*. The International Business & Economics Research Journal. North-West University. Retrieved from [http://dspace.nwu.ac.za/bitstream/handle/10394/8701/Hindley\\_AT.pdf?sequence=1](http://dspace.nwu.ac.za/bitstream/handle/10394/8701/Hindley_AT.pdf?sequence=1)
- JSE. (2015). SA Sector. Retrieved June 5, 2015, from <https://www.jse.co.za/services/market-data/indices/ftse-jse-africa-index-series/sa-sector>
- Horváth, R., & Spirollari, P. (2012). Do the Board of Directors' Characteristics Influence Firm's Performance? The U.S. Evidence. *Journal of Economic Literature*, 4, 470–486. Retrieved from <http://www.vse.cz/polek/download.php?jnl=pep&pdf=435.pdf>
- Jung, J., & Wook, S. (2011). Effects of Independent and Friendly Outside Directors. *Journal of Economic Literature*, 1–42. Retrieved from <http://www.ifc.org/wps/wcm/connect/5b21b30048a7e5bca34fe76060ad5911/Effects+of+Independent+and+Friendly+Outside+Directors.pdf?MOD=AJPERES&CACHEID=5b21b30048a7e5bca34fe76060ad5911>
- Kartika, A., Puspitasari, E., & Sudiyatno, B. (2012). The Company's Policy, Firm Performance, and Firm Value: An Empirical Research on Indonesia Stock Exchange. *American International Journal of Contemporary Research*, 2(12), 30–40. Retrieved from [http://www.aijcrnet.com/journals/Vol\\_2\\_No\\_12\\_December\\_2012/4.pdf](http://www.aijcrnet.com/journals/Vol_2_No_12_December_2012/4.pdf)

- Maka, Y. T., & Kusnadi, Y. (2005). Size really matters: Further evidence on the negative relationship between board size and firm value. *Pacific-Basin Finance Journal*, 13(3). Retrieved from <http://www.sciencedirect.com/science/article/pii/S0927538X04000733>
- Mare, E., & Wentzel, D. C. (2007). Extreme value theory – An application to the South African equity market. *Investment Analysts Journal*, 36(66), 73–77. Retrieved from <http://www.iassa.co.za/wp-content/uploads/2009/06/0615WentzelMare66No5final.pdf>
- Muchemwa, M. R. (2014). *The Relationship between Board Composition and Firm Performance: A Study of South African Public Companies*. University of the Witwatersrand. Retrieved from [http://146.141.12.21/bitstream/handle/10539/15133/Raymond Research Report - Board Composition and Firm Performance Final Report - corrected V1.pdf?sequence=2](http://146.141.12.21/bitstream/handle/10539/15133/Raymond%20Research%20Report%20-%20Board%20Composition%20and%20Firm%20Performance%20Final%20Report%20-%20corrected%20V1.pdf?sequence=2)
- Munzig, P. G. (2003). *Enron and the Economics of Corporate Governance*. Stanford University. Retrieved from [http://economics.stanford.edu/files/Theses/Theses\\_2003/Munzig.pdf](http://economics.stanford.edu/files/Theses/Theses_2003/Munzig.pdf)
- Okada, K. (2006). Size Effect and Firm Size. *Security Analysts Journal*, 44(7), 1–24. Retrieved from <https://www.saa.or.jp/english/publications/kengoOkada.pdf>
- Pasour, E. C. J. (1981). The Free Rider as a Basis for Government Intervention. *Journal of Libertarian Studies*, 5(4), 453–464. Retrieved from <https://mises.org/library/free-rider-basis-government-intervention-0>
- Ruland, W., & Zhou, P. (2006). Dividend Payout and Future Earnings Growth. *Financial Analysts Journal*, 62(3). Retrieved from <http://www.cfapubs.org/doi/abs/10.2469/faj.v62.n3.4157>
- South African Institute of Chartered Accountants. (2014). *King Report of Governance*. LexisNexis (Vol. 2D). South Africa.
- Vinten, G. (2002). The corporate governance lessons of Enron. *Corporate Governance: The International Journal of Business in Society*, 2(4), 4–9. doi:10.1108/14720700210447632
- Yermack, D. (1996). Higher Market Valuation of Companies with a Small Board of Directors. *Journal of Financial Economics*, 40(2), 185–211. Retrieved from [http://www.fdp.hse.ru/data/086/482/1225/Sept 16 Higher market valuation of companies with a small board of directors.pdf](http://www.fdp.hse.ru/data/086/482/1225/Sept%2016%20Higher%20market%20valuation%20of%20companies%20with%20a%20small%20board%20of%20directors.pdf)

## Appendices:

### Appendix A: Top 40 Companies

<b>JSE Top 40 Index</b>				
<b>Name</b>	<b>Year-End</b>	<b>Sector</b>	<b>Ruling Exchange Rate</b>	
1 British American Tobacco	31-Dec	Industrial	R/£: 18,0111	
2 SAB Miller	31-Mar	Industrial	R/\$: 10,54	
3 BHP Billiton	30-Jun	Resources	R/\$: 10,6284	
4 Richemont	31-Mar	Industrial	R/€: 14,5176	
5 Anglo American	31-Dec	Resources	R/\$: 11,5559	
6 MTN	31-Mar	Industrial	N/A <sup>1</sup>	
7 Naspers	31-Mar	Industrial	N/A <sup>1</sup>	
8 Sasol	30-Jun	Resources	N/A <sup>1</sup>	
9 Standard Bank	31-Dec	Financial	N/A <sup>1</sup>	
1 Vodacom	31-Mar	Industrial	N/A <sup>1</sup>	
0				
1 Kumba Iron Ore	31-Dec	Resources	N/A <sup>1</sup>	
1				
1 First Rand	30-Jun	Financial	N/A <sup>1</sup>	
2				
1 Old Mutual	31-Dec	Financial	R/£: 18,0111	
3				
1 Absa	31-Dec	Financial	N/A <sup>1</sup>	
4				
1 Sanlam	31-Dec	Financial	N/A <sup>1</sup>	
5				
1 Shoprite Checkers	30-Jun	Industrial	N/A <sup>1</sup>	
6				
1 Remgro Ltd	30-Jun	Industrial	N/A <sup>1</sup>	
7				
1 Nedbank	31-Dec	Financial	N/A <sup>1</sup>	
8				
1 Aspen Health Care	30-Jun	Industrial	N/A <sup>1</sup>	
9				
2 Anglo American Platinum	31-Dec	Resources	N/A <sup>1</sup>	
0				

<sup>1</sup> Where a ruling exchange rate is listed as “N/A”, that company’s financial statements have been sourced in the Republic of South Africa. Thus, no exchange rates were necessary.



2 1	Bidvest	30-Jun	Industrial	N/A <sup>1</sup>
2 2	AngloGold Ashanti	30-Jun	Resources	R/\$: 10,6284

#### Appendix A: Top 40 Companies (Continued)

2 3	Impala Platinum	30-Jun	Resource s	N/A <sup>1</sup>
2 4	Woolworths	30-Jun	Industrial	N/A <sup>1</sup>
2 5	Tiger Brands	30-Sep	Industrial	N/A <sup>1</sup>
2 6	Mediclinic	31-Mar	Industrial	N/A <sup>1</sup>
2 7	Exxaro	31-Dec	Resource s	N/A <sup>1</sup>
2 8	RMB	30-Jun	Financial	N/A <sup>1</sup>
2 9	Intu Properties PLC	31-Dec	Industrial	R/£: 18,0111
3 0	Growthpoint	30-Jun	Industrial	N/A <sup>1</sup>
3 1	Discovery Ltd	30-Jun	Financial	N/A <sup>1</sup>
3 2	Gold Fields	30-Jun	Resource s	R/\$: 10,6284
3 3	Mondi Plc	31-Dec	Industrial	R/€: 13,9903
3 4	Steinhoff	30-Jun	Industrial	N/A <sup>1</sup>
3 5	Assore	30-Jun	Resource s	N/A <sup>1</sup>
3 6	Investec PLC	31-Mar	Financial	R/£: 17,5649
3 7	Massmart Holdings Ltd	31-Dec	Industrial	N/A <sup>1</sup>
3 8	Imperial Holdings	30-Jun	Industrial	N/A <sup>1</sup>
3 9	Truworths International	30-Jun	Industrial	N/A <sup>1</sup>

<b>4</b>	African Rainbow	30-Jun	Resource	N/A <sup>1</sup>
<b>0</b>	Minerals		s	

## Appendix B: Company Composition

<b>JSE Top 40 Index</b>					
	<b>Name</b>	<b>Board Size</b>	<b>Number of Non-Executives</b>	<b>Number of Executives</b>	<b>% Non executives</b>
<b>1</b>	British American Tobacco	12	9	3	75,00%
<b>2</b>	SAB Miller	15	13	2	86,67%
<b>3</b>	BHP Billiton	19	15	4	78,95%
<b>4</b>	Richemont	13	10	3	76,92%
<b>5</b>	Anglo American	11	9	2	81,82%
<b>6</b>	MTN	12	10	2	83,33%
<b>7</b>	Naspers	13	11	2	84,62%
<b>8</b>	Sasol	10	8	2	80,00%
<b>9</b>	Standard Bank	9	6	3	66,67%
<b>10</b>	Vodacom	14	9	5	64,29%
<b>11</b>	Kumba Iron Ore	9	7	2	77,78%
<b>12</b>	First Rand	13	11	2	84,62%
<b>13</b>	Old Mutual	13	11	2	84,62%
<b>14</b>	Absa	14	13	1	92,86%
<b>15</b>	Sanlam	14	11	3	78,57%
<b>16</b>	Shoprite Checkers	12	10	2	83,33%
<b>17</b>	Remgro Ltd	13	11	2	84,62%
<b>18</b>	Nedbank	16	15	1	93,75%

<sup>1</sup> Where a ruling exchange rate is listed as “N/A”, that company’s financial statements have been sourced in the Republic of South Africa. Thus, no exchange rates were necessary.

1 9	Aspen Health Care	12	10	2	83,33%
2 0	Anglo American Platinum	16	12	4	75,00%
2 1	Bidvest	18	14	4	77,78%
2 2	AngloGold Ashanti	21	18	3	85,71%
2 3	Impala Platinum	17	14	3	82,35%
2 4	Woolworths	14	11	3	78,57%
2 5	Tiger Brands	10	8	2	80,00%
2 6	Mediclinic	11	9	2	81,82%

**Appendix B: Company Composition (Continued)**

2 7	<b>Exxaro</b>	<b>17</b>	<b>14</b>	<b>3</b>	<b>82,35%</b>
2 8	RMB	17	11	6	64,71%
2 9	Intu Properties PLC	12	9	3	75,00%
3 0	Growthpoint	10	8	2	80,00%
3 1	Discovery Ltd	15	8	3	53,33%
3 2	Gold Fields	20	11	9	55,00%
3 3	Mondi Plc	16	11	5	68,75%
3 4	Steinhoff	9	6	3	66,67%
3 5	Assore	11	8	3	72,73%
3 6	Investec PLC	18	10	8	55,56%
3 7	Massmart Holdings Ltd	9	7	2	77,78%
3 8	Imperial Holdings	15	11	4	73,33%

<b>3</b>	Truworths International	21	11	10	52,38%
<b>9</b>					
<b>4</b>	African Rainbow	18	9	9	50,00%
<b>0</b>	Minerals				

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

**ISBN number: 978-0-620-74761-5**



---

**AUD 09: THE EFFECT OF CHANGES IN AUDITOR  
REPORTING STANDARDS ON AUDIT QUALITY**

**Faatima Kholvadia  
University of the Witwatersrand**

**ABSTRACT**

The expectation and information gaps have driven many changes in the auditing profession over the last few decades. These gaps combined with corporate collapses involving auditors and the more recent financial crisis have called for changes to restore credibility to the auditing profession. The response has been a series of changes to the auditing standards. The new *Framework on Audit Quality* issued in 2013 is aimed at addressing performance deficiencies in auditors thereby decreasing the expectation gap. The series of changes to reporting standards issued in 2015 are designed to allow users to gain insights on the company through the eyes of the auditor so as to reduce the expectations of users and bridge the information gap. This paper analyses the impact of the changes in auditing standards on the expectation and information gaps and audit quality. The method used was a literature review on the events that precipitated the issue of the new auditor reporting standards and the *Framework on Audit Quality* and a literature analysis of how these standards have bridged the expectation and information gaps. The analysis found that as the *Framework on Audit Quality* is not prescriptive and is dependent on the auditors' commitment to quality while simultaneously promoting transparency on audit quality, the *Framework* addresses only some components of the expectation gap. The study further found that changes in reporting standards do not reduce components of the expectation gap but reduce the information gap by providing entity-specific information to users of the financial statements in the form of Key Audit Matters.

**Keywords:** *audit quality, information gap, expectation gap, audit report*

## INTRODUCTION

At the start of the millennium the auditing profession underwent global change following the collapse of Enron and with it one of the largest auditing firms, Arthur Andersen (Fisher, 2003). Litigation against Arthur Andersen created the need to restore public confidence in the auditing profession. The result was the globalisation and acceptance of International Standards on Auditing (ISA), specific independence and ethical requirements and greater regulation for auditors (Fisher, 2003). Despite these measures, which bolstered the reputation of the auditing profession, the spate of lawsuits against audit firms since the demise of Arthur Andersen has spiked (Porter, 2009). Lawsuits against auditors most commonly follow corporate collapses or corporate malpractice and arise from the auditors' failure - either through poor quality audits, negligence or fraud - to provide early warning signals to users (Porter, 2009).

The rise in lawsuits against auditors is attributed to the gap between auditors' understanding of their function and the role users and society at large expects auditors to play (Leung & Chau, 2001). This gap, called the 'expectation gap', is particularly prevalent in users' perceptions about the auditors' ability to detect financial statement fraud and the auditors' responsibility regarding fraud under existing standards (IAASB, 2011). Prior academic research suggests that the expectation gap is a consequence of the manner in which audit findings are communicated to users (IAASB, 2011). The only communication from the auditor to the user is the current standardised audit report, which does not explain the full extent of the audit effort (IAASB, 2011). Other academic research indicates that user perceptions of audit quality are also impacted by the communicative value of the audit report (IAASB, 2011). Due to the standardised wording of the current audit report, the current audit report does little to influence or change user perceptions about the extent of audit work performed and the quality of the audit (IAASB, 2011).

Users of audited financial statements identify a gap between the information needed to make investment and fiduciary decisions and the information available to them, creating the 'information gap' (IAASB, 2011). This information gap impacts the efficiency of capital markets and affects the allocation of scarce economic resources (IAASB, 2011). While some research suggests that this relates to deficiencies in the financial reporting framework adopted by the company, there is a perception that more transparency about the audit performed and key areas of audit risk would narrow the gap (IAASB, 2011).

The worldwide financial crisis of 2008 brought into question the role of the auditor (Welch, 2010). While the financial crisis is not generally viewed as being triggered by audit failure nor has deficient auditing standards been identified as a contributing factor; changes in auditing standards and regulations are an inevitable response from auditors to maintain their influence and enhance their credibility (The future of audits –

PwC, 2013). The International Auditing and Assurance Standards Board (IAASB) responded by issuing the Framework on Audit Quality in January 2013, a revised standard on the auditors' report in January 2015 (ISA 700 - Forming an Opinion and Reporting on Financial Statements) (Handbook of international standards on auditing and quality control, 2015) which included a revision of a suite of standards affected by the revision of the auditors' report) and a revised standard on auditors' responsibilities regarding other information in April 2015 (ISA 720 - *The Auditor's Responsibilities Relating to Other Information*) (Handbook of international standards on auditing and quality control, 2015).

### **Problem statement**

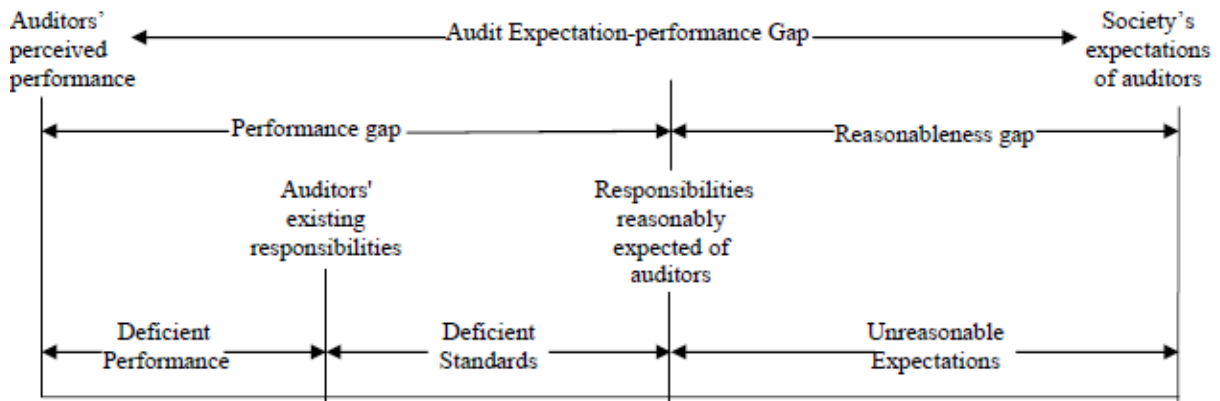
This paper discusses whether the changes in standards - being the Framework on Audit Quality, the revised standard on the auditors' report (*ISA 700 Forming an Opinion and Reporting on Financial Statements*) (Handbook of international standards on auditing and quality control, 2015) including other affected standards, and the revised standard on auditors' responsibilities regarding other information (ISA 720 - *The Auditor's Responsibilities Relating to Other Information*) (Handbook of international standards on auditing and quality control, 2015) – addresses the expectation and information gaps. This paper further explores how these changes will enhance audit.

### **The audit expectation and information gap**

The audit expectation gap can be defined as the difference between what the public and other financial statement users perceive auditors' responsibilities to be and what auditors believe their responsibilities to be (Chye & Woo, 1998). Liggio (1974) was the first to apply the term 'expectation gap' to auditing, even though the concept has been around for over a 100 years (Humphrey, Moizer & Turley, 1992).

Porter (2009) further elaborated on the expectation gap by identifying two distinct components; the reasonableness gap and the performance gap. The reasonableness gap is the difference between the duties financial statement users expects auditors to perform and those duties which are reasonable for the auditor to perform (Porter, 2009). The performance gap is the difference between those duties financial statement users expect auditors to perform and those that auditors actually deliver (Porter, 2009). The performance gap can further be broken down into the deficient standards gap, (which is the difference between auditors' responsibilities in terms of ISAs, statute or regulation and users' perceptions) and the deficient performance gap (which is the difference in the quality of audits performed and users' perceptions) (Porter, 2009). Figure 1 below depicts the expectation gap as:

Figure 1- Expectation gap

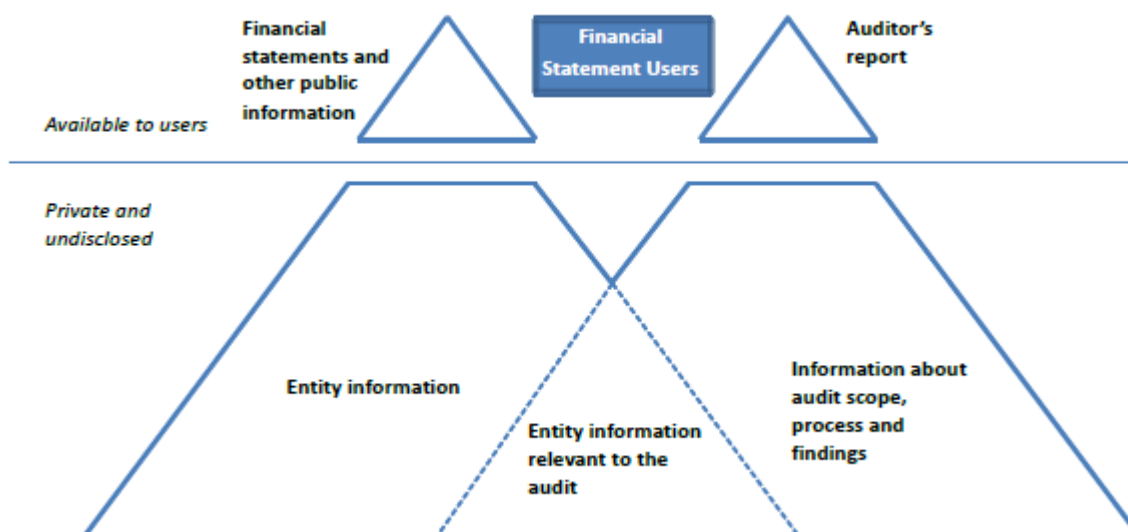


Source: Porter (2009)

The information gap is defined as the gap between the publicly available information provided by companies and the information required by users to make informed investment or fiduciary decisions (IAASB, 2011). The information gap is also seen as the challenge in providing information on the overall picture of a company's financial condition, performance and sustainability through its audited financial statements and other information (IAASB, 2011). Research suggests that the information gap is a result of deficiencies in financial reporting frameworks, particularly disclosures that are vital to a users' understanding of the financial statements (IAASB, 2011). Despite this, there is wide acknowledgement that audited financial statements alone are insufficient to provide the information that users' need (IAASB, 2011).

While users are aware that financial information available to them is only part of a wider set of information available to management and the company's auditors, users point out that the audited financial statements should be a concise summary of information relevant for decision making (IAASB, 2011). Figure 2 below illustrates the information gap:

Figure 2 - Information gap



Source: IAASB (2011)



## Method

The following sections will discuss whether the Framework on Audit Quality as issued by the IAASB in January 2013 addresses the expectation performance gap (deficient performance and deficient standards gap) and whether the revised standard on the auditor's report (ISA 700 - *Forming an Opinion and Reporting on Financial Statements*) (Handbook of international standards on auditing and quality control, 2015) and the revised standard on auditors' responsibilities regarding other information (ISA 720 - *The Auditor's Responsibilities Relating to Other Information*) (Handbook of international standards on auditing and quality control, 2015) addresses the expectation reasonableness gap and the information gap. The discussion is based solely on review of the above literature.

## The Framework on Audit Quality

The Framework on Audit Quality was issued in January 2013 by the IAASB in response to the financial crisis of 2008 which highlighted the critical importance of high-quality and credible financial information (IAASB, 2013). One of the objectives of the Framework on Audit Quality is to challenge auditors on how they can increase audit quality (IAASB, 2013). Another objective is to prompt discussion on whether there are areas in the currently issued ISAs and International Standard on Quality Control (ISQC) 1 which require revision (IAASB, 2013).

This far no globally recognised and accepted definition or analysis of audit quality exists, mostly due to its complexity and multi-faceted nature (IAASB, 2013). The IAASB's definition of audit quality is described as:

*'...a quality audit is likely to be achieved when the auditors' opinion on the financial statements can be relied upon as it was based on sufficient, appropriate audit evidence obtained by an engagement team that: exhibited appropriate values, ethics and attitudes; was sufficiently knowledgeable and experienced and had sufficient time allocated to perform the audit work; applied a rigorous audit process and quality control procedures; provided valuable and timely reports; and interacted appropriately with a variety of stakeholders.'* (IAASB, 2013)

As can be seen from the above definition, many factors contribute to a quality audit being performed (IAASB, 2013). The Framework on Audit Quality describes the input, processes and output factors which affect audit quality and also demonstrate the importance of interactions with stakeholders and contextual factors (IAASB, 2013). These will be discussed in more detail below.

## Inputs

Inputs refer to the qualities an auditor takes into the audit such as the knowledge, skill and experience and includes the values, ethics and attitudes of each auditor (IAASB, 2013). Another input to audit quality is the time available for the audit team to complete the audit and is influenced by the culture in an audit firm (IAASB, 2013).

Deficient audit performance occurs when there is a deterioration of input qualities at an audit engagement, audit firm or national level (IAASB, 2013). For example, poor quality audits would result if audit teams are not adequately staffed in terms of relevant levels of knowledge, skills and experience, and if audit firms incentivise staff based on recoveries (which would result in audit teams compromising quality to achieve targeted recoveries) and if regulators perform infrequent reviews (IAASB, 2013).

### *Processes*

The audit process is fundamental to the quality of the audit but is dependent on the quality of the inputs (IAASB, 2013). Factors that influence audit quality processes at the audit engagement level are compliance with ISAs and ISQC1 and interactions between the audit team and experts (IAASB, 2013). Interactions between the audit team and management are also crucial to a quality audit process as this will determine the efficiency and effectiveness of an audit (IAASB, 2013).

Audit firms promote compliance with auditing standards and quality control standards by ensuring that firm methodology and practices complies with these standards (IAASB, 2013). However, deficient audit performance still occurs even if firm methodology and performance complies with ISAs and ISQC 1, due to the high level of judgement exercised by auditors (IAASB, 2013).

Nationally, standard setters influence audit quality by making clear the minimum audit requirements and the underlying objectives of those requirements (IAASB, 2013). Regulators can influence audit quality by inspecting compliance with standards and also challenging judgements made by auditors (Redmayne & Bradbury, 2010). Disciplinary action meted out by regulators to auditors for poor judgements and non-compliance with ISAs may provide an incentive to audit firms to increase quality (Redmayne & Bradbury, 2010; IAASB, 2014).

### *Outputs*

Outputs at an audit engagement level are the only tangible documents widely available from which audit quality can be deduced (IAASB, 2013). These include outputs from the auditor such as the audit report, reports to Those Charged With Governance, reports to management and reports to financial and prudential regulators; outputs from the entity such as audited financial statements and reports from Those Charged With Governance (like Audit Committees); and outputs from regulators on individual audits (IAASB, 2013).

The audit report is not considered to be an indicator of audit quality due to its generic nature, however, the revision of ISA 700 - *Forming an Opinion and Reporting on Financial Statements* (Handbook of international standards on auditing and quality control, 2015) has seen the inclusion of Key Audit Matters which will provide users with the auditor's insight into matters of audit significance and may enhance audit quality (Redmayne & Bradbury, 2010). The auditors' reports to Those Charged With Governance and management are not widely available but robust and elaborate disclosures in these reports influence perceptions of audit quality (IAASB, 2013).

Users of audited annual financial statements deduce audit quality from the quality of the financial statements (IAASB, 2013). Financial statements which contain arithmetical errors, inconsistencies and vague disclosure may lead users to deduce that a poor quality audit was performed (IAASB, 2103). Financial statements which are restated for changes in estimates or to correct prior period errors are not differentiated and are often perceived by users to be as a result of audit failure (IAASB, 2013). Outputs at an audit firm and national level include transparency reports, annual and other reports and aggregate results of firm inspections (IAASB, 2013). The more widely available these reports, the greater their influence on audit quality (IAASB, 2013).

#### *Key interactions with the financial reporting supply chain*

As part of the audit process, this paper mentioned interactions between the auditor and management as crucial to audit quality (IAASB, 2013). There are several other key interactions, namely interactions between the auditor and Those Charged With Governance, users and regulators; interaction between management and Those Charged With Governance, users and regulators; interactions between Those Charged With Governance and users and regulators; and interactions between users and regulators (IAASB, 2013).

Most of these interactions are already in existence, some in more detailed capacity than others which creates potential for each of these interactions to be improved and to specifically include an agenda of audit quality (IAASB, 2013). Meaningful interactions between all parties listed strengthen the cohesion of the audit process and may be the first step in reducing the information gap (IAASB, 2013).

#### *Contextual factors*

There are several contextual factors affecting audit quality which vary from jurisdiction to jurisdiction depending on the sophistication of the economy and the business culture (Francis, 2011). Contextual factors include business practices and commercial law, laws and regulations relating to financial reporting, the applicable financial reporting framework, corporate governance, information systems, broader cultural factors, financial reporting timelines, attracting talent, litigation environment and audit

regulation (IAASB, 2013). All these factors lead to varied perceptions about audit quality (IAASB, 2013).

The Framework on Audit Quality was not issued as guidance or as a prescriptive standard which should be applied by all auditors, but rather a departure point from where auditors can reflect on the quality of their current audits and use those reflections to engage within the audit firm and with stakeholders outside the audit firm on how to improve the quality of audits (IAASB, 2013). As such The Framework on Audit Quality addresses the expectation performance gap by promoting the transparency of the audit process through formal conceptualisation of the factors which influence both users' perceptions of audit quality and audit quality itself.

### **The revised ISA 700 - Forming an Opinion and Reporting on Financial Statements and affected standards**

Until the 1990's, the auditing profession sought to address expectation reasonableness gap of financial statement users through educating users about the nature and limitations of an audit (Porter, 2009). The standard auditors' report was used as a tool to educate users (Porter, 2009). Before 1988, the 'short form' audit report did little more than identify the financial statements which had been audited and expressed the audit opinion thereon (Porter, 2009).

In 1988, the Cohen Commission sought to educate users and reduce the expectation reasonableness gap and recommended the introduction of the 'long form' audit report which included a paragraph explaining the respective responsibilities of the auditees management and the auditor for the financial statements (Porter, 2009). By the 1990's the long form report was widely adopted and became the international norm (Porter, 2009). Research on whether the long form report met its educational objectives found that users had an increased understanding of the auditors' role and function in financial reporting (Porter, 2009). Critics, however, questioned whether a few sentences in an audit adequately conveyed the essence of the audit process (Porter, 2009).

The long form audit report was expanded further over the years, particularly with regards to the auditors' responsibilities and new requirements by company law and stock exchange listings making the audit report long and complex (Porter, 2009). In 2004, the IAASB issued a revised ISA 700 (Revised) – *The Independent Auditors Report on a Complete Set of Financial Statements* (Handbook of international standards on auditing and quality control, 2015). The revised report had a two-part structure; the first relating to the audit of the financial statements, and the second to the auditors' legal and regulatory responsibilities (Porter, 2009). In addition to the two-part structure the word 'independent' was introduced in the title of the audit report and the description of the audit process was expanded to include that the selection of audit

procedures involved auditor judgement and that the auditor considers internal control relevant to the financial statements when designing audit procedures (Porter, 2009).

Critics of the revised auditors report were mainly concerned about the continued standardised wording which did not differ from year to year or from company to company and made shareholders feel excluded from what they perceived to be the 'real' findings of the audit (Porter, 2009). The audit report had come to be treated as a symbol, rather than read as Porter (2009) quotes one critic:

*'One effect of using a standard report is that as a person becomes familiar with its words, he tends to stop reading it each time he sees it. He relies on his memory of what it says and his impression of what it means and merely glances to see that it is included and that it does not contain a departure from the usual language, that is, an exception. The entire report comes to be interpreted as a single, although complex, symbol that is no longer read.'*

Research conducted on auditor reporting after 2004 found that shareholders believed that they should be provided with much of the information auditors provide to the Audit Committee which included: more information about emphases of matter and references to uncertainties and future risk; discussion of material issues encountered during the audit and how they were resolved; tailored company-specific information rather than standardised reports; discussion of alternative accounting treatments considered and the reasons for selecting the treatments adopted; and more information on material areas of judgement and difficult, sensitive or contentious issues (Porter, 2009). There was also a call for the auditor to make more positive statements in the audit report, such as 'adequate accounting records have been kept' (Porter, 2009). Another research recommendation was to change the format of the auditor report so that important information such as the audit opinion would be displayed first (Porter, 2009).

Further research conducted on the audited report found that detailed explanations in the audit report of auditor and management responsibilities as well as the nature, scope and procedures of the audit did not reduce the expectation gap (Gold, Gronewold & Pott, 2012). This indicated that either explanations need to be more explicitly or clearly formulated or that users' perceptions were not influenced by explanations in the audit report (Gold *et.al*, 2012). The latter indication is supported by Gray, Turner, Coram & Mock (2011) who found that financial statement users only consider the actual opinion and disregard all other information, which suggests wording changes in the audit report is not the solution to reducing the expectation gap.

The new auditors report was issued in January 2015 as a revision to ISA 700 - *Forming an Opinion and Reporting on Financial Statements*, and with it one new standard was issued being ISA - 701 *Communicating Key Audit Matters in the Independent Auditor's Report* in response the call for the auditor's report to be more informative and relevant

(IAASB, 2015a). Four other standards were revised as a result; namely, ISA 705 - *Modifications to the Opinion in the Independent Auditor's Report*, ISA 706 - *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, ISA 720 *The Auditor's Responsibilities Relating to Other Information*, ISA 570 *Going Concern* and ISA 260 *Communication with Those Charged with Governance* (Handbook of international standards on auditing and quality control, 2015; IAASB, 2015a).

Key changes in the new auditors' report are split between those applicable only to listed entities and those applicable to all entities (IAASB, 2015a). Changes pertaining to listed entities are the introduction of a new section to communicate non-standard, Key Audit Matters (KAM) which the auditor judges to be of most significance for the current year audit; and disclosure of the name of the engagement partner responsible for the audit in the signature (IAASB, 2015a). Changes which apply to all entities are: a restructuring of the audit report which allows the audit opinion section to be presented first; followed by the Basis of Opinion section to allow prominence to the opinion; enhanced reporting over going concern; a positive statement confirming the auditors' independence and fulfilment of ethical responsibilities; and enhanced description of the responsibilities of the auditor (IAASB, 2015a).

The introduction of KAM has emphasised the debate of consistency versus relevance as KAM's will differ from entity to entity (IAASB, 2015a). The IAASB has acknowledged that there should be consistency in determining which matters should be reported as KAM, whilst the communication of KAM should be as entity-specific and relevant as possible (IAASB, 2015a). ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* aids this by setting out a decision framework for auditors with the starting point being the communication with those charged with governance (IAASB, 2015a). From the matters communicated to those charged with governance, the auditor should determine those matters which required significant auditor attention, paying particular attention to: areas of higher material misstatement or areas of significant risk as determined using ISA 315 (Revised) - *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*; significant auditor judgement on areas in the financial statements over which management exercised significant judgement, particularly areas of high estimation uncertainty; and significant transactions or events that occurred during the year (IAASB, 2015a). KAM are therefore the most significant matters that required audit attention during the year and the auditors' process at determining a KAM is depicted in Figure 3 below (IAASB, 2015a):

Figure 3 - Determination of Key Audit Matters



Source: IAASB (2015a)

The auditors' description of a KAM in the audit report should include why the matter was determined to be of most significance during the audit and must include how the matter was addressed during the audit (IAASB, 2015a). Wording is not prescribed and allows for auditor flexibility in providing entity-specific information (IAASB, 2015a).

Enhanced reporting over going concern was promulgated as a result of users' requesting explicit disclosure or 'early warning signals' if there is uncertainty about the entity's ability to continue as a going concern (IAASB, 2015a). While going concern is still primarily the responsibility of management, the auditor now has increased responsibilities regarding the evaluation of those disclosures when material uncertainty exists (IAASB, 2015a). The revised ISA 570 – *Going Concern* extends audit procedures on management's disclosures and requires the auditor to refer to those disclosures in the audit report under the heading 'Material Uncertainty Related to Going Concern' (IAASB, 2015a). If management's disclosures are inadequate, the audit report should contain a modified opinion as would be disclosed in the first two paragraphs of the audit report (IAASB, 2015a). Other required going concern disclosures in the audit report include explicit statements about management and the auditors' responsibility regarding going concern.

Auditor disclosure of KAM is not a completely new concept (Bédard, Gonthier-Besacrier & Schatt, 2014). Auditors' in France have been providing commentary, called 'Justification of Assessment' in their audit reports since 2003 (Bédard *et.al*, 2014). The concept of a Justification of Assessment is similar to that of a KAM in that it provides users with additional information as to why the auditor arrived at a specific opinion (Bédard *et.al*, 2014). In a survey conducted in France, the perceived benefits of a Justification of Assessment were requested from financial statement users (Bédard *et.al*, 2014). The perceived benefits varied significantly among users (Bédard *et.al*,

2014). Some of the advantages of Justification of Assessment disclosures included: an increased in the communicative value of the audit report and a complement to the nature of the audit opinion; assisted users in navigating complex and voluminous financial statements; alerted readers to the more judgemental areas in the financial statements; and enabled the auditor to better explain the focus of the audit (Bédard *et.al*, 2014). Among the disadvantages of the Justification of Assessment disclosures were: the technical language of the disclosures made it difficult for users' not schooled in accounting and financial reporting to understand what was being said; were sometimes complex to read; and became standardised over time in relation to an entity. The survey further indicated that auditors should be careful not to provide information already disclosed in the financial statements which means that the auditor would need to engage extensively with management and those charged with governance to clear disclosures in the audit report (Bédard *et.al*, 2014).

By expanding the auditors reporting responsibilities, particularly with regards to KAM and going concern, the auditor may be forced to focus on these issues which are critical to users' understanding of the financial statements, thereby enhancing perceptions of audit quality (IAASB, 2011). Critics have debated the benefit of additional reporting disclosures versus the cost to the auditor and have concluded that even though there are no changes in the scope of the audit, the additional reporting responsibilities increase cost (IAASB, 2011). If these increased costs do not translate to higher fees, it may create pressure to reduce work in other areas thereby negatively impacting audit quality (IAASB, 2011).

The inclusion of KAM in the new audit report is a measure to reduce the information gap and provide transparency in the audit process (IAASB, 2011). Users' are able to make more informed decisions as a result of a better understanding of corporate reporting using specific information about the entity as provided by the auditor (IAASB, 2011). There is, however, concern that additional information may cloud, instead of clear, users' understanding of the entity by adding to the complex and voluminous information already provided (IAASB, 2011). KAM, if disclosed properly, should improve the quality of information received by users rather than just its quantity (IAASB, 2011). Another concern is that the additional disclosures by the auditor in the audit report may widen the expectation gap, however, this may be mitigated by greater transparency about the audit process which would improve perceptions about audit quality as well (IAASB, 2011). For example, if users were informed through a KAM about a significant area of auditor judgement in the financial statements, and the thought process followed by the auditor in arriving at the judgement, the user would have a better understanding of the audit opinion on the financial statements as a whole as well as a better perception on the quality of the audit that was conducted (IAASB, 2011).



## **The revised ISA 720 - The Auditor's Responsibilities Relating to Other Information**

Other information refers to:

*'... information that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity's future development, performance and position'* (IASB, 2005 p.15)

The provision of other information is in response to concerns from financial statement users that financial statements do not provide sufficient information to enable them to understand the performance and position of modern companies (Rowbottom & Lymer, 2010). The most common examples of other information are the Management Discussion and Analysis (MD&A) required by Securities Exchange Commission in the United States and Operating and Financial Review (OFR) required by the London Stock Exchange in the United Kingdom (Rowbottom & Lymer, 2010). The collapse of Enron in the early 2000's prompted regulatory responses from stock exchanges which lead to revisions in narrative reporting guidance in an attempt to strengthen corporate reporting (Rowbottom & Lymer, 2010). The enactment of Sarbanes Oxley legislation in 2002 resulted in an increase in the scope, content and disclosures of the MD&A (Rowbottom & Lymer, 2010).

Over the last few years, there has been significant development in corporate reporting, especially with regards to the extent of other information contained in the annual report (IAASB, 2015b). Other information disclosed ranges from descriptions of the entity's business model to risk exposures and uncertainties (IAASB, 2015b). Other information, through sheer volume, has the ability to undermine the credibility of the financial statements and the auditor's report if not consistent with information disclosed in these documents (IAASB, 2015b). ISA 720 - *The Auditor's Responsibilities Relating to Other Information* was revised so as to reflect the changes in corporate reporting and to align users' expectations and auditors' responsibilities (IAASB, 2015b).

The key changes to ISA 720 - *The Auditor's Responsibilities Relating to Other Information* are the improved scope of the standards clarifying what other information is; providing explicit guidance on the extent of the auditors work effort relating to other information; and providing transparency by requiring reporting on the auditors' work relating to other information (IAASB, 2015b). The scope clarifies other information as financial and non-financial information which accompanies the annual financial statements and the audit report, as either one document or a collection of documents (IAASB, 2015b). The extent of auditor effort is a consideration of material inconsistencies between other information and the financial statements and between

other information and the auditors' knowledge of the entity (IAASB, 2015b). The revised auditor reporting on other information will include a statement that management is responsible for the preparation of other information; identification of other information; a statement that the audit opinion does not cover the other information; a description of the auditors' responsibility to read other information for material inconsistencies with the financial statements and auditors report; and the results of the auditors reading, namely, if material inconsistencies were identified or not (IAASB, 2015b).

The revised ISA 720 - *The Auditor's Responsibilities Relating to Other Information* reduces the information gap as it provides auditors' assessment on the consistency of other information with the financial statements (IAASB, 2015b). Critics have challenged whether the wording of the extent of the work performed by auditors could potentially widen the expectation gap (IAASB, 2015b).

## **Conclusion**

The 'expectation gap' as applied to the auditing profession by Liggio (1974) indicates that the role of the auditor is not in congruence with the expectations of the users (Chye Koh & Woo, 1998). Porter (2009) has identified three main causes of the expectation gap: firstly, the nature of auditing, its various roles and responsibilities and the probabilistic nature of audit practice is not understood by users resulting in users having unrealistic expectations about an audit (called the expectation-reasonableness gap); secondly, there are time lags between the economic conditions and the auditing profession's response in the form of revised standards applicable to the audit process resulting in the deficient standards performance gap; and thirdly, the perception of poor quality audits resulting in corporate collapses (called the deficient performance gap) (Porter, 2009). Another gap was identified and explained by the IAASB, being the information gap (IAASB, 2015a). The information gap is the difference between the information needed by users to make decisions and the information available to them (IAASB, 2015a).

This paper explored to what extent the Framework on Audit Quality as issued by the IAASB addressed the deficient performance gap. The findings indicated that the Framework on Audit Quality is a document that conceptualises the factors that affect audit quality and was issued to challenge auditors to reflect on the factors identified and improve on factors identified to improve overall audit quality. As this Framework on Audit Quality is not prescriptive, the extent to which auditors reflect on their audit quality shortcomings and implement corrective measures will depend on the auditors' commitment to quality. The Framework addresses the deficient performance gap by promoting transparency of the drivers of audit quality which provides users of financial statements and audit committees with information to better engage with auditors on the auditors' responsibility to improve audit quality. The Framework for Audit Quality is

not issued to auditors as guidance and due to its non-prescriptive nature does not address the deficient standards gap.

This paper continued to the assessment of whether the auditors' report addressed the expectation reasonableness gap and the information gap. Findings indicate that the change in auditor reporting from the short-form to the long-form report in 1988 did much to increase the understanding of the auditors' role and function in financial reporting for users of the financial statements, thereby addressing the expectation reasonableness gap (Porter, 2009). Since 1988, there were several revisions to the auditors' report and, in particular, expansion of the auditors' role and responsibility but this did not increase users' understanding of roles and responsibilities, in fact the standardised wording had the effect of the auditor report being treated as a symbol, rather than being read (Porter, 2009). The new ISA 700 - *Forming an Opinion and Reporting on Financial Statements* and the assessment of the introduction of Key Audit Matters in the audit report (ISA - 701 *Communicating Key Audit Matters in the Independent Auditor's Report*) issued in 2015 does not reduce the expectation reasonableness gap but reduces the information gap by providing entity-specific information to users of the financial statements in the form of Key Audit Matters. There is, however, concern that the new auditors' report may widen the expectation gap, however, this may be mitigated by greater transparency about the audit process which would improve perceptions about audit quality as well (IAASB, 2011).

The revision of ISA 720 - *The Auditor's Responsibilities Relating to Other Information* further reduces the information gap, by mandating that the auditor; firstly, identifies other information and secondly, reports on other information in the auditors' report (IAASB, 2015b). This indicates to users that other information is consistent with the financial statements. While reporting on other information may reduce the information gap, there is concern that the extent of the auditors' work on other information may be misinterpreted, thereby widening the expectation reasonableness gap.

The expectation and information gaps have proved resilient against solutions in the past and may reduce for a short period of time before widening again (Humphrey, *et.al*, 1992). The above measures put in place by the IAASB to reduce the expectation and information gaps may prove effective for the short to medium term; however, auditors need to continually be alert for economic, regulatory and political changes which may, again, widen the gap.

Future researchers may wish to obtain empirical evidence from users of audit reports and auditor regulators regarding the effect of the new auditor reporting standards and the *Framework on Audit Quality* on the expectation and information gaps.

## References

- Bédard, J., Gonthier-Besacier, N., & Schatt, A., (2014). *Cost and benefits of reporting key audit matters in the audit report: The French experience*. Working Paper, Laval University.
- Chye Koh, H., & Woo, E. S. (1998). The expectation gap in auditing. *Managerial Auditing Journal*, 13(3), 147-154.
- Fisher, R. W. (2003) The 103th American Assembly, The future of the accounting profession, THE AMERICAN ASSEMBLY COLUMBIA UNIVERSITY
- Firer, S., & Swartz, G. (2006). An empirical analysis of the external audit fee in the “new” South Africa: The basic model. *SA Journal of Accounting Research* Vol, 20(1).
- Fulop, M. T., & Pintea, M. O. (2014). Effects of the new regulation and corporate governance of the audit profession. *SEA-Practical Application of Science*, (4), 545-554.
- Gold, A., Gronewold, U., & Pott, C. (2012). The ISA 700 auditor's report and the audit expectation gap—Do explanations matter? *International Journal of Auditing*, 16(3), 286-307.
- Gray, G. L., Turner, J. L., Coram, P. J., & Mock, T. J. (2011). Perceptions and misperceptions regarding the unqualified auditor's report by financial statement preparers, users, and auditors. *Accounting Horizons*, 25(4), 659-684.
- Humphrey, C., Moizer, P., & Turley, S. (1992). The audit expectations gap—plus ça change, plus c'est la même chose? *Critical perspectives on accounting*, 3(2), 137-161.
- International Accounting Standards Board (2005). *Discussion paper: management commentary*, United Kingdom: International Accounting Standards Committee Foundation.
- International Auditing and Assurance Standards Board (2011). *Consultation Paper: Enhancing the Value of Auditor Reporting: Exploring Options for Change*, New York: International Federation of Accountants.
- International Auditing and Assurance Standards Board (2013). *A framework for audit quality: Key elements that create an environment for audit quality*, New York: International Federation of Accountants.
- International Auditing and Assurance Standards Board (2015a). *At a Glance: New and Revised Auditor Reporting Standards and Related Conforming Amendments*, New York: International Federation of Accountants.
- International Auditing and Assurance Standards Board (2015b). *At a Glance: ISA™ 720 (Revised), The Auditor's Responsibilities Relating to Other Information*, New York: International Federation of Accountants.
- International Standards A 260 *Communication with Those Charged with Governance Handbook of international standards on auditing and quality control* (2015b) New York: Intl Federation Of Accoun.

- Leung, P., & Chau, G. (2001). The problematic relationship between audit reporting and audit expectations: Some evidence from Hong Kong. *Advances in International Accounting*, 14, 181-200.
- Liggio, C. D. (1974). EXPECTATION GAP-ACCOUNTANTS LEGAL WATERLOO. *Journal of Contemporary Business*, 3(3), 27-44.
- Prada, M. (2007), Transcript: Quality of public company audits from a regulatory perspective, International Organisation of Securities Commissions
- Porter, B. (2009). *Report on research conducted in the United Kingdom and New Zealand in 2008: Investigating the audit expectation-performance gap and users' understanding of and desired improvements to, the auditors' report* (Doctoral dissertation, School of Accounting and Commercial Law, Victoria University, Wellington, New Zealand).
- Redmayne, N. B., Bradbury, M. E., & Cahan, S. F. (2010). The effect of political visibility on audit effort and audit pricing. *Accounting & Finance*, 50(4), 921-939.
- Rowbottom, N., & Lymer, A. (2010). Exploring the use and users of narrative reporting in the online annual report. *Journal of Applied Accounting Research*, 11(2), 90-108.
- The Future of Audit." PwC. <http://www.pwc.com/gx/en/audit-services/the-future-of-audit.jhtml>. [Web accessed. 18 Aug. 2015]
- Welch, I., Accountancy Futures (2010), Reshaping the audit for the new global economy, THE ASSOCIATION OF CHARTERED CERTIFIED ACCOUNTANTS

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**EDU 02: Mobile Learning (M-Learning) As A Paradigmatic  
Mechanism To Facilitate Practical Subjects In An Undergraduate  
Financial Information Systems Course: A Developing Country  
Perspective**

Suzaan Le Roux

Cape Peninsula University of Technology, Faculty of Business and Management Sciences  
P.O. Box 652, Cape Town, South Africa, 8000  
+27 21 4603732 (t), +27 21 4603719 (f), LeRouxSu@cput.ac.za

**ABSTRACT**

A plethora of obstacles impede on students' ability to successfully complete practical subjects in an undergraduate Financial Information Systems course (FIS), especially in a developing country such as South Africa. This is mainly attributed to four key encumbrances, namely the limited accessibility of computers on campus, the lack of software needed to complete assignments off campus, the limited availability of Internet access and bandwidth off campus, and its prohibitive cost to students. As the preponderance of these students are from previously disadvantaged communities and can merely not meet the expense of computers, Internet connections, and relatively costly commercial software, they are reliant on campus computer laboratories, whose access are not always practical due to time, distance, and location constraints. It could therefore be argued that current learning mechanisms to facilitate practical subjects in a FIS course do not comply with the demands faced by higher education (HE) institutions in developing countries. In order to ascertain the aforementioned, an action research study was conducted to investigate whether m-learning can serve as a paradigmatic mechanism to bridge existing learning gaps in practical subjects in an undergraduate FIS course in HE institutions of developing countries. Data were collected from 79 students who had to adhere to a set of delineation criteria. Stemming from the results and discussion, key findings indicate that m-learning can broaden educational opportunities for disadvantaged and marginalised students, extend the availability of educators outside the boundaries of the classroom, address student requirements for mobility, flexibility, and ubiquity, assist in bridging existing learning gaps in practical subjects, and increase throughput and success rates in a FIS course.

**KEYWORDS:** Mobile learning, Mobile technology, Mobile device, Practical subject, Developing country, Accounting

## 1. INTRODUCTION

The use of mobile technologies (i.e. mobile/smartphones, tablets, mobile computers and digital media devices that readily fit into ones pocket) is gradually drawing a great deal of attention across all education sectors in both developed and developing countries. These technologies facilitate the connection to a variety of information sources and enable communication almost anywhere, and at any time. M-learning is viewed as “learning across multiple contexts, through social and content interactions, using personal electronic devices” (Crompton, 2013:4). According to Cochrane (2010:134), m-learning distinguishes itself from traditional learning environments by its potential to bridge pedagogically designed learning contexts, facilitate learner-generated contexts, and content (both personal and collaborative) while providing personalisation and ubiquitous social connectedness.

The development of technology has brought a variety of changes to the accounting environment. This has created a need for the services of an accounting person with specialist knowledge of high-technology commercial data processing. The Financial Information Systems (FIS) course offered at the Cape Peninsula University of Technology (CPUT) contains large components of accounting and programming, which leaves open the possibility of specialisation in either field. Students enrolled for practical subjects (subjects that necessitate the use of a computer preloaded with required software) within the FIS course encounter numerous barriers to successfully practice their subject-related skills, as well as to electronically complete and submit assignments. As a result, the formative and summative assessment marks of these students indicate a concerning downward trend year on year. This is primarily attributed to four key encumbrances, namely the limited accessibility of computers on campus, the absence of the required software needed to complete assignments and tasks off campus, the limited availability of Internet access and bandwidth off campus, and its prohibitive cost to students. Since the majority of these students are from previously disadvantaged communities and can simply not afford computers (hardware), Internet connections and relatively expensive commercial software applications, they are dependent on campus computer laboratories, whose access is not always practical due to time, distance and location constraints. In quintessence, a broad base analogy can be drawn that students are not availed the freedom to choose when, where, and how they study, consequently creating the requirement for mobility.

Stemming from the above, the perception was formulated that currently learning mechanisms to facilitate practical subjects in a FIS course do not comply with the demands (providing access to learning while on the move from any location at any time) faced by HE institutions of developing countries which, in turn, have an adverse influence on student performance; the research question which was addressed through this research study reads as follows:

*How effective is mobile learning in bridging the existing learning gap to facilitate practical subjects in a Financial Information Systems course in a Higher Education institution in a developing country?*

For the remainder of this paper, discussion takes place under the following headings: 1) literature review, 2) methodology, results and discussion, 3) benefits and barriers of m-learning in accounting education, and 4) conclusion.

## **2. LITERATURE REVIEW**

### **2.1 The shift from e-learning to m-learning**

M-learning is viewed as an extension of e-learning, where the focus is on the use of mobile devices that allow a greater degree of access to learning resources (Gupta, 2012). One of the primary reasons why m-learning is such a popular alternative compared to e-learning, is that the immobility of personal computers restricts students to the potential of making use of anywhere, anytime learning (Rawlinson & Bartel, 2006). Within an e-learning environment, students are limited to the use of a personal computer and/or Internet at an immobile location (Motiwalla, Tello & Carter, 2006) and as a result cannot access any course-related material or assignments while on the move. Conversely, m-learning allows students to interact with educators and peers and complete course work at their own pace and at any time and location of their choice, thus taking learning away from a fixed location.

### **2.2 M-learning in developing countries**

A worldwide assessment of the use of m-learning in HE has brought into sharp focus the ever increasing use of mobile technologies in HE across the globe. Mobile technology provides more tools to accounting professionals and has forever changed the manner in which data can be accessed and shared by these professionals from any device or location at any time (Drew, 2015). However, the integration of mobile technology into accounting education has not kept pace with the technology-based business environment due to lack of faculty time, knowledge, and resources to implement innovation in accounting courses (Baldwin, 2014<sup>2</sup> cited by Staples *et al.*, 2016).

Although m-learning is moving away from small-scale pilot studies into institution-wide implementation worldwide, it typically does not reflect the current situation in developing countries. The majority of research studies focus on conceptions of m-learning based on the culture and affordances of developed countries. Despite the increasing popularity of m-learning, a review of relevant literature indicates that most educational research focuses on conceptions of m-learning initiatives in especially field work, literacy education, and mathematics education in developed countries, and that

---

<sup>2</sup> Baldwin, A. (2014). Lessons Learned from Integrating iPads into the Accounting Classroom. Paper presented at American Accounting Association 2014 Annual Meeting.



there is little academic support on how mobile technologies can be utilised in practical subjects within accounting education from a developing country perspective.

Gnanasekar, Mieyappan and Rajesh (2016) note that in India, interactive m-learning anywhere and at any time after face-to-face lectures could enhance students' understanding of lectures and improve learning. Similar results were found by Suryaningrum, Wuryani and Purbasari (2015), when they investigated the effectiveness of mobile based learning technology versus face-to-face learning of accounting information systems. Research results indicate that mobile based learning technology is more effective than face-to-face learning for additional learning of accounting information systems. In contrast with the aforementioned findings, Kutluk and Gülmez (2013) conducted research on m-learning perspectives of accounting students at a university in Turkey, and found that though mobile devices have not yet been effectively utilised for accounting lessons, students are interested in using these devices in the case of technological support and as an alternative to access to knowledge anytime and anywhere.

Today there is little doubt that mobile technologies can be utilised as a successful educational medium. Despite the growing demand of mobile technology in the developing world, the potential to address educational challenges through Information and Communication Technologies (ICT) is restricted by the level of technology adoption and resource constraints in the South African education environment. The developing country dispensation is subject to caveats such as, low level of technology penetration, poor infrastructure, lack of reliable and affordable Internet access, narrow bandwidth, limited Wi-Fi availability, logistics and deployment challenges, social, economic and cultural issues (Adam *et al.*, 2011), financial resources and academic preparedness, as well as robbery/crime (Le Roux, 2015). For technology to be used in education, it must be affordable and accessible, but this remains a barrier for many HE institutions, educators and students in especially developing countries. Staples *et al.* (2016) postulate that challenges from integrating mobile devices into accounting education are diverse, and that institutional guidance and technological support are important aspects that must be addressed in order to ensure that m-learning succeed. Despite these barriers, the ubiquity of mobile technology suggests that it could be meaningfully applied in an educational environment of developing countries in order to provide equal access to remote resources while 'on the move', and potential collaboration with educators and peers outside the boundaries of the classroom, and hence broaden educational opportunities for disadvantaged and marginalised students (Mafenya, n.d).

### **2.2.1 M-learning in South African accounting education**

The majority of research available on m-learning use in accounting education was conducted in developed countries. Conversely, there is a dearth of published material on m-learning in South African accounting education, with only one article and a single

conference paper that could be found where learners were exposed to m-learning in an accounting subject. In the aforementioned article, students' views and experiences on the integration of social network sites, mobile messaging applications and podcasts were investigated in a second-year accounting course at the University of South Africa. It was found that students have an enthusiasm for some technologies and a limited interest in others, suggesting that technologies in South Africa is unique when compared to developed countries and need to be taken into consideration by educators if the potential benefits of technologies are to be used effectively in South Africa education (Van Rooyen, 2012). In an earlier study, Van Rooyen (2010) found that the effective use of mobile technology can enrich the learning experience of accounting students and offer them a more satisfying and successful experience. Henceforth, it is imperative to further explore the affordances of m-learning in specifically accounting education.

### **3. METHODOLOGY**

This research study was empirical in nature and combined qualitative and quantitative forms of analysis. Primary quantitative data were obtained from two distinct student groups (undergraduate first-year students enrolled for a FIS course at the CPUT) by means of a combination of quantitative (questionnaires, formative and summative assessments, academic student journals) and qualitative (observation, focus groups, academic student journals, synchronous and asynchronous communication) techniques. Action research (plan, act, observe, reflect) was used to glean data pertaining to m-learning implementation and whether it can bridge the existing learning gap to facilitate practical subjects in a FIS course in HE institutions in developing countries.

True to the characteristics of action research, this research study moved through two cycles over a period of two consecutive years (one cycle during the second semester of each year) using successive groups of undergraduate first-year FIS students (Year 1: Cycle 1,  $n = 33$ ; Year 2: Cycle 2,  $n = 48$ ). Respondents had to adhere to the following delineation criteria:

- Each respondent had to be a full-time undergraduate first-year student enrolled within the Financial Information Systems course at the CPUT.
- Each respondent in Cycle 1 could only utilise mobile devices (tablets) on campus and not outside the boundaries of the institution..

Moreover, relevant ethical considerations were taken into consideration throughout this research study (Collis & Hussey, 2009). Respondents were safeguarded from physical harm and were guaranteed of anonymity and the confidential treatment of information provided. Furthermore, all respondents voluntarily participated in this research study and were informed that they could withdraw from it at any point in time (should they so wish).

Prior to the execution of the two cycles, none of the participants have ever been exposed to any form of m-learning. The first cycle (Cycle 1,  $n = 33$ ) was viewed as exploratory in nature in which the data gathered influenced the approach for the second cycle (Cycle 2). One month after classes commenced during Cycle 1, each student was issued with a high-end Android tablet preloaded with productivity applications that assisted them in completing and submitting practical assignments and interact with educators and peers in a revolutionary way outside the boundaries of the classroom – something that was previously not possible. It is however important to note that these devices were provided to students for exclusive use at the institution. The initial plan was to provide students with mobile devices for utilisation both on and off campus for the duration of the subject, however technical support issues, an increased risk in device loss/theft, and device breakage, made this an unpractical and not a feasible option during the execution of Cycle 1. During the course of Cycle 1, formal reflections by the educator were kept by means of an academic research journal, focusing on the entire m-learning experience from an educator perspective. It was clear that the technology did not work seamlessly, but despite this barrier, student enthusiasm and participation were remarkable and encouraging. In addition, student observations served as a reflective mechanism to identify the benefits and barriers of m-learning, to evaluate the implications of m-learning in an undergraduate accounting subject, as well as to serve as a record for future use. Reflections maintained for the duration of Cycle 1 (a semester) by the educator met the expected outcome and revealed that the teaching and learning experienced of students were enhanced, which in turn resulted in improved student performance.

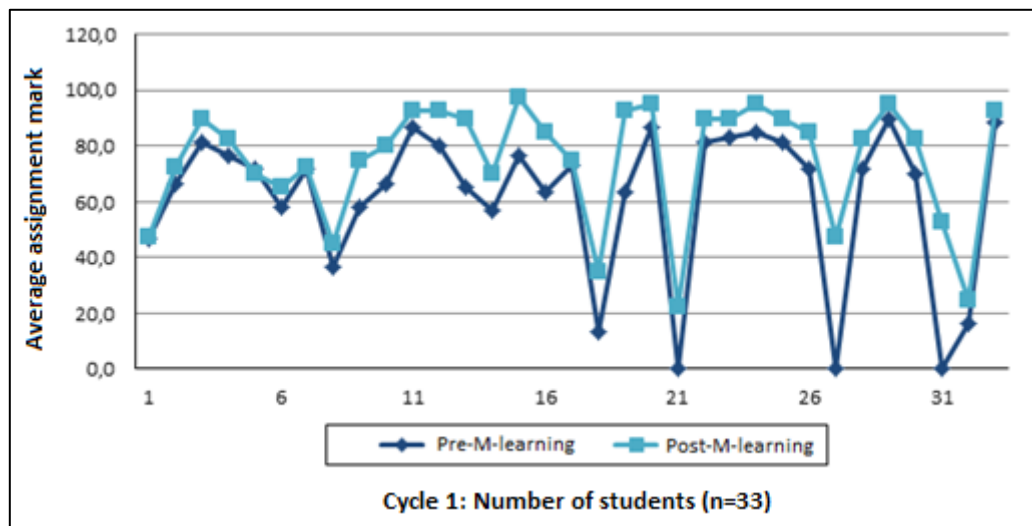
In contrast with Cycle 1, a new intake of students were at the outset exposed to m-learning during Cycle 2 ( $n = 46$ ) the following year. Students were provided with tablets and were allowed to utilise mobile devices off campus, hence allowing students a true m-learning experience. In addition, students in Cycle 2 were also exposed to Mobile Instant Messaging (MIM) discussions via WhatsApp by utilising their own mobile phones to send questions on subject-related assignments/tasks or concerns to the educator. This support service enabled students to complete their work by adding further perspectives to their applications gained through the interaction with the MIM group members and input from the educator and/or their peers. Not only did this initiative assist students in their learning process, but it also provided an attractive and effective learning tool that can enrich the learning environment and experience of students.

#### **4. RESEARCH RESULTS AND DISCUSSION**

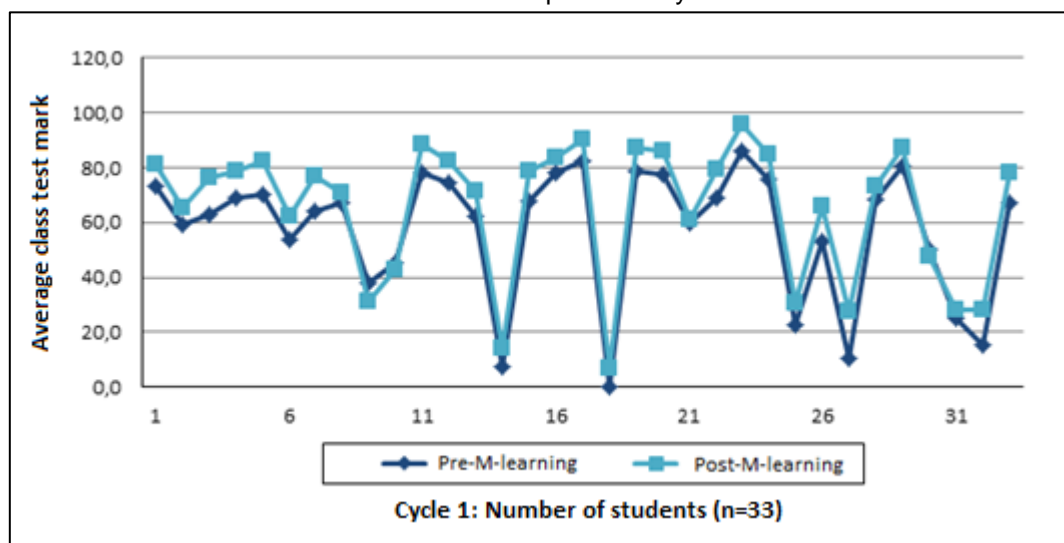
Throughout the remainder of this section, consolidated research findings extrapolated from the data analysis are discussed under the following headings: 1) formative and summative assessment, 2) observation, 3) questionnaires, 4) synchronous and asynchronous communication, 5) focus groups, and 6) academic student journals.

#### 4.1 Formative and summative assessment

The formative and summative assessment marks of undergraduate first-year accounting students at the CPUT consistently decreased over a period of four years prior to m-learning implementation during the second semester of Cycle 1. Formative assessment marks reflect a statistically significant decrease for four years prior to m-learning implementation; however, these marks reveal a statistically significant increase for three consecutive years since m-learning was introduced during the second semester of Cycle 1. Figures 4.1 and 4.2 reflect that there was a statistically significant gain in formative practical assignment marks and formative class test marks respectively, post m-learning implementation in Cycle 1 when students were only allowed to use the provided tablets on campus. A zero mark reflects that the student did not write any formative class tests and/or did not submit any practical assignments.



**Figure 4.1:** Average of Formative Practical Assignment Marks (Pre-M-learning vs. Post-M-learning) over a six-month period in Cycle 1



**Figure 4.2:** Average of Formative Class Test Marks (Pre-M-learning vs. Post-M-learning) over a six-month period in Cycle 1

Similar to the results obtained in Cycle 1 (on campus m-learning only), a significant difference in formative assessment marks were found when compared to that of Cycle 2 (on and off campus m-learning). In both cases students in Cycle 2 scored statistically significant better than their Cycle 1 counterparts. Since no significant difference was found between the summative assessment marks of the two m-learning groups (Cycle 1 and Cycle 2), an analysis of variance was performed to determine whether there are differences between the years (Pre-m-learning vs. Post-m-learning) concerning the formative and summative assessment marks. Results depict that there is a difference between the means of the assessment marks for the different years. With respect to Cycle 1 when m-learning was introduced, there is clear evidence that marks improved after the m-learning experience. More specific, there was an increase in especially formative assessment marks for both Cycle 1 and Cycle 2 after m-learning implementation. Stemming from the aforementioned results, it is evident that m-learning had a positive impact on student throughput and success rates. It is however important to note that since this study was an exploratory research, it did not control for other variables that may influence student performance.

#### 4.2 Observation

Observation of students was conducted by the educator to gather information on student attitudes and how they use and interact with mobile technology. Video material and photos were included as observation examples in order to provide an accurate description of events, as well as to assist in the triangulation of data.

- **Enthusiasm:** Students have shown a substantial amount of enthusiasm when mobile devices were handed out for the first time, and during the course of their studies. Unlike studies that have fell victim to the 'novelty effect' (Kneebone & Brenton, 2005), also referred to as the 'generally positive effect', that results from the enthusiasm for using a new device or tool in learning, students have never appeared to be bored or frustrated (despite several limitations or barriers) when the novelty of using these devices started wearing off over a period of six months. To these students the benefits and use of mobile technology to assist them in practical subjects were clearly outweighing the limitations they faced.
- **General mobile device usage:** Students became effective quickly in executing subject-related assignments/tasks, were found to be less bored in class and became more active and engaged during the learning process. Despite the fact that engagement does not necessarily translate in learning more, this research study proves that student marks (especially formative assessment marks) improved dramatically since the implementation of m-learning. Mobile devices are mainly used to accomplish subject-related tasks such as going online (74.7%), completing and submitting assignments (67.1%), accessing institutional web pages (64.6%), accessing social networking sites to communicate with peers (59.5%), viewing and downloading course material and assignments (59.5%), as well as taking notes in

class (53.2%). This is mainly attributed to the structure of classes, which are based around students utilising mobile devices to aid their classroom-based teaching and learning practices in formal educational settings. It is of interest to note that despite the smaller screen size and onscreen input of tablets and mobile phones (when compared to computers), 35% of the students unexpectedly opted to make use of mobile devices even if they had access to a personal computer in a practical class. Unexpectedly, some students have even gone so far to have never used a computer again since they received the mobile devices. Mobile devices are also used for other teaching and learning purposes such as taking photos (instead of taking notes) of work covered on the whiteboard, recording lectures, downloading and listening to podcasts and vodcasts, assessing library services and communicating with the educator.

- **Collaboration/communication:** Students in general assisted each other when struggling with subject-related aspects, and indicated that they predominantly do not use their mobile devices to communicate with peers and educators outside the classroom (i.e. IM, e-mail), but rather prefer face-to-face discussions on subject-related issues.
- **Context:** Despite the vast possibilities that mobile devices bring to an educational environment, it comes as no surprise that some students still prefer to use conventional mechanisms (i.e. desktop computers, class hand-outs/subject material, paper-based notes) to accomplish their learning activities in formal learning settings. This can be attributed to the fact that students prefer to rather write down notes instead of typing them, since it is a much slower process to type on a mobile device without a keyboard, and also to rather read printed hand-outs as opposed to electronic notes. It could therefore be argued that mobile devices are only used in certain contexts by some students. On the contrary, it is also true that some students prefer to use mobile technology to do subject-related work as opposed to using computers and taking notes, which proved to be mostly the case in practical subjects.

#### 4.3 Questionnaires

Students from both cycles (n=78) were asked to complete pre-questionnaires (that address their current use and perception of mobile technology before being exposed to m-learning), as well as post-questionnaires (that address the usability, use and impact of mobile technology, as well as the experience and attitude of students toward the utilisation of mobile technology) to assess the effectiveness and usefulness of m-learning after being exposed to mobile technology. Findings highlight that the majority of students would like to be able to use mobile technology outside the boundaries of the classroom as a tool to help them with work since nearly 75% found it difficult to access university computer laboratories outside class times, and none of them have access to the required software off campus. The findings furthermore, in no particular order, reveal that the use of mobile devices are perceived to: 1) be useful for teaching

and learning purposes; 2) have mobility and 3) have social interaction value; 4) have an enjoyment factor; 5) be easy to use; 6) improve student attitudes; 7) have certain access barriers; and 8) the behavioural intention to use mobile devices is perceived to be positive. Most of the students use mobile devices on a daily basis for at least 30 minutes at a time for mainly formal subject-related activities, and indicated that it should be mandatory for students to utilise mobile technology within Financial programmes. Students find it acceptable to learn practical subjects with mobile device access only and felt more enthusiastic about the use of mobile devices after being exposed to m-learning.

#### **4.4 Synchronous and asynchronous communication (Cycle 2)**

Synchronous and asynchronous communication was introduced during Cycle 2 and entailed records of comments and thoughts generated by learners by means of MIM (WhatsApp) and e-mail. WhatsApp is a synchronous communication tool where text messages can be sent and delivered instantaneously between users. A major advantage of this type of communication is its minimal cost ranging from 97% - 99% less than text messages or Short Message Service (SMS), thus providing learners the opportunity to interact and collaborate with their peers regarding subject-related issues, and to access professional educator support in an affordable manner. The support service was at students' disposal 7 days a week/24 hours a day (24/7).

Students were initially excited and keen about the idea of using MIM within the FIS course, however it was found that only a few (30.4%) made use of this unique opportunity. Students used this service mainly to: 1) Ask subject content-related questions before formative and summative tests; 2) ask for assistance with assignments/tasks; 3) be assisted with subject administrative queries; and 4) resolve technical difficulties experienced with mobile devices. MIM were received and answered any time during the day and night, with the earliest being at 05:59 am and the latest at 00:59 am. From an educator perspective, MIM proved to be quite a challenge to use when answering student queries, since it is a relatively time-consuming process to answer queries using the different input mechanisms of a mobile phone.

#### **4.5 Focus groups (Cycle 2)**

Focus groups took place during Cycle 2 only, after all the questionnaires have been conducted and were based upon the further exploration of issues that had emerged from questionnaire data. It focused on students' experience with mobile technologies and how they use and interact with these technologies. Student responses were collected for qualitative analysis similar to research conducted by Boone (1995:95), i.e. for "Comments", "What did you like?", "What did you dislike?", etc.

- The majority of the focus groups (89%) indicated that they have found it extremely easy and fair to complete and submit assignments utilising mobile technology anywhere, anytime without the need of a computer and expensive commercial

software. Most students (63%) found it acceptable to exclusively use mobile devices in a practical subject.

- All the groups highlighted the usefulness of mobile devices that could be used anywhere on campus to complete programme-related work, in contrast to the constant unavailability of overpopulated computer laboratories.
- The majority of the groups viewed mobile devices as an educational investment and indicated that they would buy a mobile device if it could aid them in their studies, or if it would be a course requirement.
- It is a harsh reality that theft and robbery in South Africa are severe problems, especially for mobile devices that are carried on a person. Because of the danger of using mobile devices in South African public spaces, most students did not utilise mobile technology while commuting. On the other hand, some students, although by far the minority, indicated that they have used mobile technology while travelling, but that it was dependent on the location, time of day, and travelling time.

#### **4.6 Academic student journals (Cycle 2)**

Academic student journals were kept by students during Cycle 2 to reflect on their m-learning experience, activities and thoughts during mobile technology utilisation. Student journals addressed issues relating to the when, where, for how long, for which event/activity, and by whom the mobile technology was used. In addition, it also provided students with the opportunity to comment on any high or low aspects experienced during mobile technology utilisation. Journal entries were reviewed and assisted in:

- Identifying common trends in mobile technology utilisation amongst students.
- Isolating areas where problems regularly occur.
- Identifying where more work needed to be done or where real strengths have been developed and some obstacles have been overcome.

During educator reflection in the second cycle, the aforementioned observations assisted in identifying the typical potential usage patterns for m-learning learners, and in setting new goals for future research projects and developments. Most students used mobile technology in the mornings and the afternoons for 10 minutes to an hour per session for formal subject-related activities.

### **5. BENEFITS AND BARRIERS OF M-LEARNING IN ACCOUNTING EDUCATION**

The following benefits were identified during the reflection processes of the educator during the two action research cycles, as well as from extensive data gathered with regard to the implementation of m-learning within accounting education:

- All students (regardless of their culture, social- and financial background) could electronically complete and submit assignments/tasks from anywhere, and at any time without the necessity of a computer or being on campus.



- Student marks improved statistically significantly after the implementation of m-learning.
- Students had 24/7 access to their educator via IM to address any subject-related issues.
- Students have rarely subverted formal education by engaging in activities that are not related to the lecture, proving that mobile devices can effectively be used to facilitate learning in formal and informal educational settings, without necessarily distracting the teaching and learning process.

Students expressed and were confronted by several barriers that kept them from enjoying a true m-learning experience:

- **On campus access only (Cycle 1):** Students were only allowed to utilise mobile technology exclusively on campus, therefore not allowing them a true m-learning experience. These students had restricted opportunities compared with other m-learning programmes in which students usually have access to mobile devices 24/7.
- **Uploading assignments onto the Learner Management Systems (LMS):** Students were required to connect (synchronise) their mobile devices to an Internet-enabled computer (via cables) in order to upload their assignments onto the LMS (Blackboard) since the CPUT is not in possession of a mobile LMS (Blackboard Mobile) site license that would allow them to upload assignments directly from a mobile device.
- **Limited or no Wi-Fi availability:** Several Wi-Fi related issues were experienced, which included extremely weak or no Wi-Fi signals on campus and at university residences. These issues had a severe and critical impact on students' ability to access the Internet, and most importantly subject-related work via mobile devices.
- **Lost/stolen devices:** A major concern throughout the duration of the m-learning initiative was the constant anticipation for lost or stolen devices. This was the main and exclusive reason for not allowing students to use mobile devices off campus during the pilot study (Cycle 1). This proved to be successful as all the students returned their devices in working order. On the other hand, during Cycle 2, where the m-learning group was allowed to utilise mobile devices off campus, one student lost a mobile device on an airplane, another provided a police statement indicating that the mobile device was stolen after a car break in, and two students disappeared from all enrolled classes and as a result have never returned the devices.
- **Limited access to computer laboratories:** Despite the fact that students were required to have access to an Internet-enabled computer in order to upload assignments/tasks onto the LMS, several students were also confronted with the fact that they could not access computer laboratories on campus, especially in the morning, when they wanted to upload and submit assignments before the submission deadline. This once again proved that by not affording students a true

m-learning experience by enabling them to complete and electronically submit assignments/tasks outside the boundaries of the classroom before the due date and time, it could potentially have a negative impact on their academic performance.

- **No Wi-Fi enabled printers:** Students could not directly print subject-related material from their mobile devices, as there were no Wi-Fi enabled printers available on campus. Students were therefore forced to use the old-fashioned method of synchronising the mobile device with an Internet-enabled computer in order to print – clearly defeating the objective of providing students with a true m-learning experience.

## 6. CONCLUSION

This research study is concerned with exploring whether m-learning can serve as a paradigmatic mechanism to bridge existing learning gaps to facilitate practical subjects in a FIS course in a developing country. In many respects, the findings of this research study juxtapose and strengthen what the literature in the field of m-learning already suggests. However, this research study has taken earlier notions one step further, by attempting to identify by means of a mixed-method data gathering approach, the effectiveness and usefulness of m-learning, as well as the benefit and barriers related to m-learning in practical subjects within a FIS course. Key findings indicate that mobile devices can be utilised as an acceptable additional technology in practical subjects in a FIS course, and that it can assist in bridging existing learning gaps by extending the availability of educators outside the boundaries of the classroom, addressing student requirements for mobility, flexibility and ubiquity, and improving student throughput and success rates. Results indicate that student marks have improved statistically significant after m-learning implementation, and that student reactions toward these devices are positive and may increase their enthusiasm and motivation to work and learn. Nonetheless, despite the vast number of benefits that mobile technology brings to teaching and learning in accounting education, it is important to recognise that mobile devices still cannot entirely replace traditional methods of instruction and assessment, and thus should be combined with face-to-face education in developing countries. Equally, it is important to ensure that mobile technology is used in a pragmatic way by focusing on the advantages of mobile devices, rather than to endeavour and replicate the functionality of a computer, allowing traditional instruction and the utilisation of mobile technology to complement each other (Le Roux, 2015). The research results of this study contribute to the knowledge base of m-learning in accounting education, especially in a developing country such as South Africa. The author of this paper suggests that further research is conducted on providing a better understanding as to how m-learning in accounting education, work in great detail. By doing so, HE institutions, educators and students, among others, may glean more insight into how m-learning can be effectively implemented to provide sustainable, affordable and reliable accounting education. Not only can this research assist in placing HE institutions at the forefront of pedagogical practice, but it can most

importantly broaden educational opportunities for disadvantaged and marginalised students, extend the availability of educators outside the boundaries of the classroom, address student requirements for mobility, flexibility and ubiquity, and increase throughput and success rates.

## REFERENCES

- Adam, L., Butcher, N., Tusubira, F.F. & Sibthorpe, C. 2011. *Transformation-Ready: The strategic application of information and communication technologies in Africa: Education Sector Study (Final Report)*. African Development Bank, World Bank, ICT Development Associates Ltd. [http://mil.unaoc.org/wp-content/uploads/2012/12/Education\\_Fullreport.pdf](http://mil.unaoc.org/wp-content/uploads/2012/12/Education_Fullreport.pdf) [24 June 2015].
- Cochrane, T.D. 2010. Exploring mobile learning success factors. *ALT-J*, 18(2):133-144.
- Collis, J. & Hussey, R. 2009. *Business research: A practical guide for undergraduate and post graduate students*. Palgrave: Macmillan.
- Crompton, H. 2013. A historical overview of mobile learning: Towards learner-centered education. In Berge, Z.L. & Muilenburg, L.Y. (eds.) *Handbook of mobile learning*, Routledge, Florence: 3-25.
- Drew, J. 2015. Beyond Spreadsheets. *Journal of Accountancy*, 219(4):36-39.
- Gnanasekar, J.M., Mienyappan, D. & Rajesh, M. 2016. Face to face and online mobile learning system. *The Online Journal of Distance Education and e-Learning* 4(3):33-41.
- Kneebone, R. & Brenton, H. 2005. Training Perioperative Specialist Practitioners. In Kukulska-Hulme, A. & Traxler, J. (eds.) *Mobile learning: A Handbook for educators and trainers*, Routledge: London: 106-115.
- Le Roux, S. 2015. Mobile learning (m-learning) as a paradigmatic mechanism to facilitate technology-based learning in a developing country. In Crompton, H. & Traxler, J. (eds.) *Mobile learning and STEM: Case studies in practice*, Routledge, New York: 220-233.
- Mafenya, N.P. n.d. *Increasing Throughput and Success Rate in Open and Distance Learning using Mobile Technology: A Case Study*. <http://www.docstoc.com/docs/100702959/Paper---SAIDE> [7 December 2012].
- Motiwalla, L., Tello, S. & Carter, K. 2006. Outcome Assessment of Learning Objectives: A Case for using e-Learning Software. *Proceedings of the 12th Americas Conference on Information Systems, Acapulco, Mexico, 4-6 August 2006*. [http://faculty.uml.edu/stello/amcis2006\\_final.pdf](http://faculty.uml.edu/stello/amcis2006_final.pdf) [7 July 2011].

Rawlinson, D.R. & Bartel, K. 2006. Implementing Wireless PDA Technology in the IT Curriculum. *Educause Quarterly*, 29(1):41-47.

Staples, J., Collum, T. & McFry, K. 2016. *Mobile devices in the accounting classroom*. [http://blog.cengage.com/wp-content/uploads/2016/05/Spring-2016\\_Staples-Collum-McFry\\_Mobile-Devices-in-the-Accounting-Classroom\\_5.pdf](http://blog.cengage.com/wp-content/uploads/2016/05/Spring-2016_Staples-Collum-McFry_Mobile-Devices-in-the-Accounting-Classroom_5.pdf) [14 September 2016].

Suryaningrum, D.H., Wuryani, E. & Purbasari, I.J. 2015. The effectiveness of mobile based learning technology versus face-to-face learning of accounting information systems. *Business Education & Accreditation*, 7(1):67-76.

Van Rooyen, A. 2010. Effective integration of SMS communication into a distance education accounting module. *Meditari Accountancy Research*, 18(1):47-57.

Van Rooyen, A. 2012. *Student experiences of technology integration in an Accounting course*. [http://uir.unisa.ac.za/bitstream/handle/10500/8610/van%20rooyen\\_a\\_ODL\\_024\\_2012.pdf?sequence=1](http://uir.unisa.ac.za/bitstream/handle/10500/8610/van%20rooyen_a_ODL_024_2012.pdf?sequence=1) [15 September 2016].

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**EDU 03: AN ANALYSIS OF THE REASONS CONTRIBUTING  
TO ACADEMIC EXCLUSION: A CASE STUDY IN THE  
FACULTY OF ECONOMIC AND FINANCIAL SCIENCES AT  
THE UNIVERSITY OF JOHANNESBURG**

Authors: Ester van Wyk; Marita E Pietersen; University of Johannesburg  
Corresponding author; [evanwyk@uj.ac.za](mailto:evanwyk@uj.ac.za)

**ABSTRACT**

The purpose of this research paper is to analyse the reasons academically excluded undergraduate (UG) students provided, as contributing factors, that led to their unsatisfactory academic performance resulting in their academic exclusion from the Faculty of Economic and Financial Sciences (FEFS) at the University of Johannesburg (UJ). The research method used was a case study.

Students can appeal their academic exclusion. Results obtained from the electronic appeals process in June/July 2015 and January 2016 were used to extract the reasons provided by these UG students that led to their academic exclusion. The reasons were categorised, as being academic or non-academic, and were then further divided into seven areas. Overall the main reasons provided by the students that contributed to their academic exclusion was financial difficulty followed by academic difficulty.

The findings from the study could indicate to the Faculty the high risk of allowing students to enter the Faculty without knowing their ability to sustain their studies financially. A practical implication of the findings will allow the Faculty to create a more inclusive environment by supporting the students it accepts. A limitation is that the findings are based on students that appealed their academic exclusion in FEFS at UJ and can therefore not be generalised. This study could, however, contribute value by providing lessons for developing countries in Africa relating to the admission of students.

Keywords: academic exclusion, undergraduate students, unsatisfactory academic performance, on line appeals process, financial difficulty, academic difficulty

## INTRODUCTION

The University of Johannesburg (UJ) is an urban residential comprehensive university in Johannesburg South Africa. UJ has nine faculties of which the Faculty of Economic and Financial Sciences (FEFS) is the largest in terms of student numbers. According to the Academic Rules and Regulations of the University of Johannesburg 2016 (UJ ARR 2016, 6.13), students are allowed to register annually on the condition that they have passed a certain number of modules, as specified by the specific Faculty's Qualifications and Regulations.

The overall undergraduate (UG) enrolment in FEFS for 2015 was 20% of the overall UG enrolment of UJ. The Faculty had 9 361 full time UG students registered in 2015<sup>1</sup>. The overall number of diploma students (inclusive of the advanced diploma students) were 3 360 (36%) and 6 001 (64%)<sup>1</sup> degree (inclusive of extended degree) students. The faculty offers four undergraduate degree programmes, three extended undergraduate degree programmes, two diploma programmes and four advanced diploma programmes. Advanced diploma students were excluded from this study because of relatively small enrolment numbers and those being students enrolled for a second qualification.

In FEFS, every student's academic performance is assessed at the end of each semester. A result code (status) (see Table 1) is allocated to them, based on their academic performance at the end of the semester and subsequent supplementary exam (if relevant). Their academic performance reflects on the Tertiary Software Administrative System (ITS) system, their academic record, the student portal and their result letters.

A FEFS student may register for the following academic year if they have passed at least 60% of their modules in the previous year of study (FEFS) Qualifications and Regulations 2016 (FEFS QR) 2016, EF.5). If a student passes less than 40% of their modules they will receive an academic warning. An E1 (proceed pass all courses November) result code will be awarded after semester one or an E2 (proceed pass all courses June) after semester two.

Despite passing less than 40% of their modules students are given the opportunity to continue with their studies in the following semester, subject to the following conditions. Firstly, they have to attend the Study and Read programme (free of charge), offered by the Academic Development Centre (ADC). Secondly, the student has to pass all modules for which they are enrolled for or allowed to register for in the following semester. These students are often also referred to the Centre for Psychological Services and Career Development (PsyCaD) for personal and career counselling. The Study and Read programme offered by the ADC assist students on

an academic warning with reading strategies, academic skills and academic support such as study guidance, literacy skills and writing skills. Students on an academic warning are not allowed to cancel any module(s) during the semester while they are on an academic warning. If the student fails to meet these mentioned conditions, they are academically excluded from further studies within FEFS. Their academic exclusion is indicated by an F7 (re-admission refused) result code awarded after semester one or a BF (re-admission refused) result code after semester two. Students who have been academically excluded are given the opportunity to appeal their academic exclusion.

In the past students had to manually submit their BF/F7 appeal forms at the Faculty office. The high student numbers in the Faculty led to the development of an online appeal process for students that were academically excluded (awarded a BF/F7 result code). The online pilot project was conducted after the first semester of 2015 and repeated after the second semester of 2015. The online process allowed students to appeal, off campus, from anywhere as long as they had internet access with a smartphone or any other electronic device. This streamlined the appeals process and was subsequently easier to manage, by both students and Faculty alike, than the related paper process.

Once received appeals are reviewed and considered, at Faculty level, by the Faculty Appeals Committee. This committee reviews all appeals and consideration will be given to any mitigating circumstances provided by the students that contributed to their unsatisfactory academic performance and resulted in academic exclusion (BF/F7), as well as investigating their academic records in detail. The Faculty Appeals Committee will either re-admit the student or retain their academic exclusion from the Faculty. The decision of the committee is final and no further appeals are allowed (UJ ARR 2016, 6.13 (e)). All students that had a successful appeal after either the first or second semester of 2015, were placed on an academic warning (FEFS QR 2016, EF. 7). The conditions of the academic warning as explained above needs to be met, in order for the student to be allowed to continue with his/her studies. If re-admitted and the student fails to meet the set conditions, as explained to them when they were re-admitted, the student will be refused continuation of their studies (academically excluded) and no further appeals will be allowed (UJ ARR 2016, 6.9).

## **CLASSIFICATION OF ACADEMIC PERFORMANCE**

A result code is allocated based on a student's academic performance in the relevant semester and/or academic year. This is calculated according to the promotion requirements of the Faculty which are based on the number of registered modules passed for the specific semester.

Table 1 below explains the results codes for the first and second semester respectively for the UG qualification types (summary from FEFS QR 2016, EF.7).

**Table 1: RESULT CODES FOR SEMESTER ONE AND TWO**

MEANING OF RESULT CODES FOR SEMESTER ONE AND TWO FOR ALL UG QUALIFICATION TYPES			
Number of Registered modules passed	Result Code		Meaning
	1 <sup>st</sup> Semester	2 <sup>nd</sup> Semester	
Less than 40%	F7	BF	Re-admission Faculty refused
Between 41% - 49%	E1	E2	Academic warning
Between 50%-59%	P5	P5	May continue with studies
More than 60%	P4	P4	Promoted to next academic year

## CONCEPT CLARIFICATION

This study focused on students who were academically excluded and were all given the opportunity to appeal their academic exclusion. These students were excluded in June/July 2015 after semester one or in November/December 2015 after semester two.

The following key concepts used in this study are clarified below: Student, Academic Exclusion and Faculty Appeals Committee.

For the purpose of this study a **student** is referred to as a person registered for a qualification at the University of Johannesburg (UJ), in the Faculty of Economic and Financial Sciences (FEFS).

**Academic exclusion** means termination of a student's registration on academic grounds resulting in exclusion from the Faculty. This is represented by a BF/F7 result code. Academic exclusion occurs when a student is not allowed to continue with their studies, after not meeting the minimum promotion requirements for the qualification (UJ ARR 2016, 6). For the purpose of this study academic exclusion refers to students who were academically excluded and given the opportunity to submit an appeal in order to be allowed to be re-admitted and consequently to be placed on an academic warning status.

**The Faculty Appeals Committee (as approved on Senate S374/2010(3))** is the committee that considers all appeals. The committee comprises of the following:

- (i) The Executive Dean/Vice Dean/any other Senior Academic staff member given authority by the Executive Dean to act as the Chairperson;



- (ii) The Programme Advisor acts as the secretary noting all the decisions; and
- (iii) A representative from the Student Advisory Council (SAC)/Student Representative Council (SRC). This member only serves in an advisory capacity on the Faculty Appeals Committee meeting.

The decision whether or not to retain the BF/F7 result code is made by the Chairperson; the decision of the committee is final.

## **AIM OF THE STUDY**

The aim of this study is to provide an analysis of the reasons provided by UG students, with a further focus on first year students that contributed to their academic exclusion in FEFS at UJ in 2015. The reasons were categorised into seven areas being academic difficulty, family problems, financial difficulty, health problems, personal problems, transport problems and other problems. Information obtained from the electronic appeal forms, from both the June/July 2015 and January 2016 appeals process, was used to elaborate on certain assumptions.

One certainty in life is that everything is subject to change; this is also the case within the higher education environment in which students find themselves. To be able to address reasons contributing to academic exclusion, it is necessary to understand the type of environment students live in. Certain aspects needs to be taken into consideration such as, how they experience their environment, as well as what their problems are that is making it difficult for them to study, and to progress in their chosen programme. Therefore, these aspects should be considered in order to determine their contribution to the students' difficulties which resulted in academic exclusion.

## **LITERATURE REVIEW**

"High attrition and low graduation rates largely neutralized important gains" (Council on Higher Education (CHE), 2013) in the South African higher education system. Fischer and Scott (2011) as cited by the CHE (2013), describes the South African Higher Education system as a "low participating high attrition system". To proof this fact the CHE then states that roughly only one in four degree students (17% for diploma students) in contact institution graduate in regulation (minimum) time. The CHE continues to say that only 48% of contact students graduate within five years. This leads to a high rate of attrition (40%) by the end of regulation time. This report also indicates that first-year attrition, a longstanding problem in South Africa, is very high – one in every three students whom entered the higher education system in 2006 were lost after their first year of study for various reasons. One of these include bad academic performance.

There are numerous factors such as race, gender, age and socio-economic status that affect a students' academic performance (Shoukat, Haider, Khan & Ahmed, 2013). A large number of factors thus have a causative effect on whether or not a student drops out from university studies (Murry, 2014).

Students' poor academic performance in South Africa's higher education system is well documented. A 2008 study by Letseka and Maile found that the overall graduation rate of South Africa is amongst the lowest in the world (15% across all South African based Universities). Their finding suggests that lack of available funding as well as the articulation gap between secondary education and higher education were the main cause of high dropout rates.

Following Letseka (2009) and Murry (2014), for the purpose of this research, a university dropout is defined as a student who for whatever reason chooses not to re-register for their chosen qualification. A student's academic performance affects whether the student will become a dropout (St John, Gabrera, Nora & Asker, 2000). Poor academic performances thus make it more likely for students to become dropouts (Neethling, 2015). Research by Ishitani and DesJardin (2002), Stratton, O'Toole and Wentzel (2008) as well as Sampaio (2012) indicates that financial aid is an important factor impacting student dropout. Financial aid typically includes loans which students have to repay. Murry's (2014) research findings also indicate that financial aid status is an important determinant of student dropout.

Literature provides definitions for two types of dropouts; the first being a voluntary dropout where a student with a good academic record decides to discontinue their studies and secondly an involuntary dropout, where a students' discontinuation of academic studies is because of academic exclusion (Murry, 2014). A student can be academically excluded from studying further because of unsatisfactory academic performance. Reasons for voluntary dropout may include poor academic performance before any major exams are written, the influence of factors such as family or financial problems or realising that they have registered for a degree that is unsuitable or incompatible. Reasons for involuntary dropout can be because a student failed the same module a number of times, or because the student did not meet the annual progression requirements for their degree (Neethling, 2015).

Poor academic performance could lead to involuntary dropout (academic exclusion). With this context in mind, it is important for FEFS to try and identify the reasons contributing to academic exclusion. These reasons can help FEFS to identify factors that will define a dropout-prone student. Efforts to better support these students can aid FEFS in reducing the academic exclusion (dropout) rate.

## **RESEARCH METHODOLOGY**

This section discusses and justifies the methodology that was used for this paper.

### **Research design**

This case study was done at UJ – an urban residential comprehensive university in Johannesburg, South Africa. FEFS is the largest of the nine faculties of UJ by on average contributing 22% of the overall student number of 48 500 students that are spread across four campuses.

FEFS offers both UG and Post Graduate (PG) programmes. UG programmes offered consists of four undergraduate degree programmes, three extended undergraduate degree programmes, two diploma programmes and four advanced diploma programmes. Advanced diploma students were excluded from this study because of relatively small enrolment numbers and those being students enrolled for a second qualification.

The case study design was used for this study. Godfrey (2012:8) defines a case study design as a design that focuses on a phenomenon to be studied, the case, unit of analysis and the focus of the study. In this paper the phenomenon is the reasons that contribute to academic exclusion and the case is academically excluded students. Academically excluded students that appealed their academic exclusion in FEFS at UJ 2015/2016 were the unit of analysis. The focus of this study is the reasons (phenomenon) that contributed to academic exclusion.

Case studies are widely used in organisational studies and across the social sciences (Kohlbacher, 2006:2). Case studies allow researchers to obtain a holistic and meaningful understanding of real-life events (Yin, 2003:2). A case study research design is thus best suited to gain an understanding of the reasons contributing to academic exclusion. Case studies are often the preferred method when the “how” and “why” questions are being asked, when the researchers have little control over the events, and the focus is on an existing phenomenon within a real life context (Kolhbacher, 2006:4). Therefore, the case study design enabled the researchers to gain an understanding of the reasons that contributed to academic exclusion from the information obtained from the electronic appeal form.

The case study design adopted for this study consisted of both qualitative and quantitative methods of data collection. The quantitative part of the study examined the association between variables such as gender, race, age grouping and previous year's activity. The qualitative part of the research design (reasons listed by students)

attempted to explore why these reasons contributed to their academic exclusion being the dependent variable.

### **Population of the study**

The population for this study consisted of 976 students that appealed their academic exclusion in FEFS at UJ in 2015/2016.

### **Sampling**

Participants for this study were selected using purposive sampling. It was a non-probability sampling procedure in which the researcher purposely decided which participants to select, that would be relevant to the research topic (Godfrey, 2012:9). Table 3 indicates that from the population of 1 423 UG students, 409 students were first year students that were academically excluded in FEFS 2015/2016. The researchers purposively included only the 976 students, of which 167 were first year students, which appealed their academic exclusion. Purposive sampling enabled the researchers to focus the research on the participants who supplied reasons that contributed to their academic exclusion.

### **Method of data collection**

More general/overall data were collected from the ITS system, Management Information System (MIS) and the Higher Educator Data Analyser (HEDA). Detailed data was also collected for this case study from the electronic appeal forms of students academically excluded in the first and second semester of 2015 that completed the appeals process. Data used to develop a more comprehensive picture of an academically excluded student, included demographic information (race, gender and age grouping), number of students academically excluded, number of UG students that appealed their academic exclusion, number of first year students that appealed their academic exclusion, students' previous year activity, the contributing reasons that lead to unsatisfactory academic performance and their NSFAS status.

All students that wanted to appeal their academic exclusion had to complete an online appeal form. The appeal form is of a qualitative nature and it assisted in identifying the reasons that contributed to UG students' academic exclusions.

The online appeal form asked questions about issues not evident from their academic records. This included questions relating to the main reason(s) that contributed to their unsatisfactory academic performance, how these reasons affected their academic performance, their plan(s) to resolve the problem(s) and whether they enrolled for a different qualification previously or studied at a another tertiary institution.

## **Content analysis**

Qualitative content analysis can be viewed as a comprehensive approach to data analysis, which seems to be especially suitable for case study research (Kolbacher, 2006:18). The examination of content recorded information is involved in content analysis (Godfrey, 2012:12). The reasons contributing to academic exclusion were analysed from the information obtained in the electronic appeal form. This made the content analysis very useful for studying reasons contributing to academic exclusion. Content analysis also enables the researchers to compare first and second semester appeals, the students' age grouping and previous year's activity as well as their NSFAS status. The data from the content analysis was used to cross check the trustworthiness of the data. Another advantage of content analysis is that, unlike humans, documents are non-reactive (Godfrey, 2012:12) and as a result, the data that has been gathered is reliable.

## **Ethical clearance**

The researchers obtained consent from the FEFS Ethics committee to execute this study.

## **Limitations of the study**

The disadvantage of this case study is that the findings are based on students that appealed their academic exclusion in FEFS at UJ and therefore cannot be generalised. The findings of this study are therefore generalisable to all academically excluded students in FEFS at UJ. However, the findings illuminate the reasons contributing to academic exclusion which might be similar for students in other Faculties and/or Universities. A limitation of the study was that students that did not appeal their academic exclusion were not included in the study. A second limitation was that these students were not contacted to find out what they would have indicated as the reason(s) that contributed to their unsatisfactory academic performance.

## **DEVELOPMENT OF THE ELECTRONIC APPEAL FORM**

Based on past experience and with reference to the paper based BF/F7 appeals process, an electronic appeal process and related electronic appeals form (template to be completed) was developed whereby students were allowed to follow an online process to appeal against their academic exclusion.

This electronic appeal form, including questions that probed reasons that possibly could have contributed to these students being academically excluded, was made available to all students who received a BF/F7 re-admission refused result code. To assist the students with access to the appeals process the link to the online appeals form was emailed and sms'ed to all students academically excluded. The link to the online appeals form was also placed on the faculty website.

## STUDENTS ACADEMICALLY EXCLUDED

UG students for this study represent students studying toward a three year diploma or are studying for a four year extended degree or a three year degree. Table 2 below indicates the number of students for UG and Postgraduate (PG) that were academically excluded (BF/F7 for UG and DF/7F for PG result code) in 2015's first and second semester.

**Table 2: NUMBER OF UNDERGRADUATE STUDENTS ACADEMICALLY EXCLUDED**

NUMBER OF UNDERGRADUATE STUDENTS ACADEMICALLY EXCLUDED											
After 1 <sup>st</sup> Semester 2015						After 2 <sup>nd</sup> Semester 2015					
UG		PG		Overall		UG		PG		Overall	
500	93%	35	7%	535	100%	966	84%	182	16%	1148	100%

NUMBER OF UNDERGRADUATE STUDENTS ACADEMICALLY EXCLUDED (continue)					
2015					
UG		PG		Overall	
1466	87%	217	13%	1683	100%

The focus of this study will be on the UG students, as well as providing additional detail on first year students, in FEFS that were academically excluded, after the first and second semester of 2015, based on their academic results only. The UG students include students in all study periods. After semester one of 2015, 500 UG students were academically excluded and after semester two 966 UG students. The 1 466 UG students academically excluded represent overall 16% of the 9 361 UG students for 2015. It also represents 87% of the overall UG and PG students academically excluded of the faculty.

Table 3 below indicates the number of UG students that were academically excluded per semester and per qualification type.

**Table 3: DISTRIBUTION OF UNDERGRADUATE STUDENTS ACADEMICALLY EXCLUDED PER SEMESTER AND QUALIFICATION TYPE**

NUMBER AND % OF UNDERGRADUATE STUDENTS ACADEMICALLY EXCLUDED PER SEMESTER AND QUALIFICATION TYPE						
Qualification Type	After 1 <sup>st</sup> Semester 2015		After 2 <sup>nd</sup> Semester 2015		Overall 2015	
	Nr of UG	% of UG	Nr of UG	% of UG	Nr of UG	% of UG
Diploma	169	34%	387	40%	556	38%
Extended Degree	59	12%	114	12%	173	12%
Degree	261	52%	433	45%	694	47%
<b>Overall</b> (excluding Advanced Diploma)	<b>489</b>	<b>98%</b>	<b>934</b>	<b>97%</b>	<b>1 423</b>	<b>97%</b>
Advanced Diploma	11	2%	32	3%	43	3%
<b>Overall</b>	<b>500</b>	<b>100%</b>	<b>966</b>	<b>100%</b>	<b>1 466</b>	<b>100%</b>

From the overall number (1 423) of UG students academically excluded in 2015 694 (47%) were degree students followed by 556 (38%) diploma students. This is in line with the registrations per qualification type. It is noteworthy to mention that the percentage of students academically excluded increased for the diploma students but decreased for degree students in the second semester of 2015, compared to the first semester of 2015. The percentage for the extended degree students remained at 12%. The numbers of advanced diploma students academically excluded are small, and they represent on average only 3% of the overall number of UG students. Because of this small number, the advanced diploma students were excluded from the analysis and discussions to follow.

As stated in the literature review one in every three students that enter the higher education system in 2006 were lost after their first year. Therefore, it is also important to also focus the research on first year students.

Table 3.1 gives a breakdown of the number of first year students academically excluded per semester and per qualification type.

**Table 3.1: DISTRIBUTION OF FIRST YEAR STUDENTS ACADEMICALLY EXCLUDED PER SEMESTER AND QUALIFICATION TYPE**

NUMBER AND % OF FIRST YEAR STUDENTS ACADEMICALLY EXCLUDED PER SEMESTER AND QUALIFICATION TYPE									
Qualification Type	After 1 <sup>st</sup> Semester 2015			After 2 <sup>nd</sup> Semester 2015			Overall 2015		
	Nr of 1 <sup>st</sup> Years	% of 1 <sup>st</sup> Years	% of Overall UG students	Nr of 1 <sup>st</sup> Years	% of 1 <sup>st</sup> Years	% of Overall UG students	Nr of 1 <sup>st</sup> Years	% of 1 <sup>st</sup> Years	% of Overall UG students
Diploma	54	49%	32%	130	44%	34%	184	45%	33%
Extended Degree	3	2%	5%	9	3%	8%	12	3%	7%
Degree	54	49%	20%	159	53%	37%	213	52%	31%
<b>Overall</b>	<b>111</b>	<b>100%</b>	<b>22%</b>	<b>298</b>	<b>100%</b>	<b>31%</b>	<b>409</b>	<b>100%</b>	<b>29%</b>

Of the 489 UG students academically excluded after the first semester of 2015, 22% (111) represented first year students. After the second semester 31% of UG students were first year students. Overall 29% of UG students academically excluded were first year students. Looking at the overall information for 2015 it can be seen that, diploma first year students academically excluded were the highest at 33%, closely followed by first year degree students at 31%.

## THE APPEALS PROCESS

All students that are academically excluded have the opportunity to lodge an appeal against their academic exclusion of the Faculty (UJ ARR 2016, 6.13). All applicants wanting to appeal must follow the prescribed administrative procedure stipulated by the Faculty.

The Faculty Appeals Committee will consider the appeals and may refuse or allow re-admission. Students are informed of the outcome of their appeal via sms and email. The Faculty tries to keep this timeline no longer than 10 working days, in order to give students the opportunity to make the necessary arrangements should their appeal be successful or unsuccessful. The decision of the committee is final (FEFS QR 2016, EF.9).

## ANALYSIS OF APPEALS IN FEFS (First and Second Semester 2015)

Analyses of the undergraduate appeals, in FEFS, for both the first and second semester of 2015 were done. The students' reasons, as provided by them contributing to their academic exclusion, was analysed using the answers they supplied in the



completed electronic appeal form. Biographical detail not available on the completed electronic appeals form (e.g. gender, race and previous year's activity) was extracted from MIS used by the University to supplement the data obtained from the electronic appeal form.

## Number of Appeals

The following table gives a breakdown of the overall number of appeals:

**Table 4: DISTRIBUTION OF APPEALS PER SEMESTER AND QUALIFICATION TYPE**

NUMBER AND % OF UNDERGRADUATE STUDENTS PER QUALIFICATION TYPE THAT APPEALED						
Qualification Type	1 <sup>st</sup> Semester 2015		2 <sup>nd</sup> Semester 2015		Overall 2015	
Diploma	105	29%	259	42%	364	37%
Extended Degree	42	12%	89	14%	131	13%
Degree	208	59%	273	44%	481	50%
<b>Overall</b>	<b>355</b>	<b>100%</b>	<b>621</b>	<b>100%</b>	<b>976</b>	<b>100%</b>

The majority (50%) of the overall number of appeals came from the degree students, followed by the diploma students (37%). This is once again in line with the faculty's enrolment numbers for the respective qualifications.

From Table 3 (overall exclusions) and Table 4 (appeals) above it can be concluded that the appeal rate for UG students was 73% at the end of the first semester and 65% at the end of the second semester. On average the UG students have an overall appeal rate of 68%. It is thus clear that the majority of UG students take the opportunity to appeal their academic exclusion.

From the information above it can be seen that degree students make up the majority (59% and 44% respectively) per semester of the UG students that appealed their BF/F7 re-admission refused status followed by the diploma students. This relates well to the overall number of students registered for a degree or diploma. Interesting to note is that while the percentage of degree students that appealed their BF/F7 status from semester one to semester two increased with only 31% (208 to 273 students) the diploma students increased dramatically by 147% (105 to 259 students).

Table 4.1 gives a breakdown of the number of first year students that appealed. This allows for a comparison between the overall UG number of appeals and first year appeals.

**Table 4.1: DISTRIBUTION OF FIRST YEAR STUDENTS THAT APPEALED PER SEMESTER AND QUALIFICATION TYPE**

Qualification Type	NUMBER AND % FIRST YEAR STUDENTS PER QUALIFICATION TYPE OF UG APPEALS					
	1 <sup>st</sup> Semester 2015		2 <sup>nd</sup> Semester 2015		Overall 2015	
Diploma	15	39%	48	38%	63	38%
Extended Degree	1	2%	8	6%	9	5%
Degree	23	59%	72	56%	95	57%
<b>Overall</b>	<b>39</b>	<b>100%</b>	<b>128</b>	<b>100%</b>	<b>167</b>	<b>100%</b>

The majority (57%) of the overall number of first year appeals came from the degree students followed by the diploma students (38%). This is once again in line with enrolment numbers for the respective qualifications. From the table above, it is clear that, the first year students that appealed follows the same appeals pattern as the overall appeals pattern for all UG students.

From Table 3.1 (first year exclusion) and Table 4.1 (first years appeals) it can be seen that the appeal rate for first year students was 35% at the end of the first semester and increased to 43% at the end of the second semester. On average first year students have an appeal rate of 41%, that is much lower than the 68% appeal rate of the overall UG students. This could be because first year students are still new to university life and might not be aware of the appeals process available to them. It could also be that they did not appeal because they realised that the qualification they were registered for is not meeting the expectations of the career they want to pursue.

### **Undergraduate student profile per qualification type**

The table below presents the profile of the students that appealed their academic exclusion in terms of gender and race.

**Table 5: DISTRIBUTION OF UNDERGRADUATE STUDENT PROFILE FOR THOSE THAT APPEALED PER SEMESTER AND QUALIFICATION TYPE**

<b>UNDERGRADUATE STUDENT PROFILE FOR THOSE THAT APPEALED PER SEMESTER AND QUALIFICATION TYPE</b>						
<b>Qualification Type</b>	<b>1<sup>st</sup> Semester 2015</b>					
	<b>Gender</b>		<b>Race</b>			
	<b>Male</b>	<b>Female</b>	<b>African</b>	<b>Coloured</b>	<b>Indian</b>	<b>White</b>
Diploma	53%	47%	98%	1%	1%	0%
Extended Degree	65%	35%	93%	2%	5%	0%
Degree	52%	48%	86%	2%	7%	5%
<b>Overall semester one</b>	<b>54%</b>	<b>46%</b>	<b>91%</b>	<b>2%</b>	<b>4%</b>	<b>3%</b>
<b>2<sup>nd</sup> Semester 2015</b>						
Diploma	46%	54%	97%	1%	2%	0%
Extended Degree	49%	51%	96%	2%	2%	0%
Degree	53%	47%	88%	3%	7%	2%
<b>Overall semester two</b>	<b>49%</b>	<b>51%</b>	<b>93%</b>	<b>2%</b>	<b>4%</b>	<b>1%</b>
<b>Overall 2015</b>						
Diploma	51%	59%	98%	1%	2%	0%
Extended Degree	57%	43%	95%	2%	3%	0%
Degree	53%	47%	87%	3%	7%	3%
<b>Overall for all qualification types</b>	<b>53%</b>	<b>49%</b>	<b>93%</b>	<b>2%</b>	<b>4%</b>	<b>1%</b>

From the table above the following key observations were made:

- the proportions of male and female students (Male 53% and Female 47%) that appealed are in line with the overall profile of the Faculty for UG students (Male 54% and Female 46%)<sup>1</sup>; and
- the race proportions of students that appealed (African 92%, Coloured 2%, Indian 4% and White 2%) are also in line with the overall profile of the Faculty for UG students (African 92%, Coloured 3%, Indian 3%, White 2%)<sup>1</sup>.

### **Students profile per age grouping and previous year's activity**

The table below provides more information on the students profile per age grouping and previous year's activity, in order to determine whether there is a relationship between a student's age and/or previous year's activity.

**Table 6: AGE GROUPING AND PREVIOUS YEAR'S ACTIVITY PER QUALIFICATION TYPE**

<b>AGE GROUPING AND PREVIOUS YEAR'S ACTIVITY FOR UNDERGRADUATE STUDENTS PER QUALIFICATION TYPE</b>							
<b>Qualification Type</b>	<b>Age grouping</b>				<b>Previous year's activity</b>		
	<b>18-20</b>	<b>21-22</b>	<b>23-24</b>	<b>25-29</b>	<b>Secondary school student</b>	<b>University student</b>	<b>Working</b>
Diploma	6%	55%	32%	7%	4%	88%	8%
Extended Degree	19%	28%	36%	17%	0%	95%	5%
Degree	30%	41%	22%	7%	4%	74%	22%
<b>Overall of all qualifications</b>	<b>21%</b>	<b>44%</b>	<b>27%</b>	<b>8%</b>	<b>3%</b>	<b>82%</b>	<b>15%</b>

The table above indicates that the majority (44%) of UG students that obtained an academic exclusion result code are in the age grouping of 21-22 year old. If this is related to the previous year's activity it indicates that 82% of them were university students in the previous year. This further shows that students in this category are more senior students (students near completion of their qualification) and therefore take the opportunity to appeal their academic exclusion.

The following table gives further insight into the age grouping and previous year's activity of first year students in order to compare it with the overall UG student profile.

### Student profile of first year students per age grouping and previous year's activity

**Table 6.1: AGE GROUPING AND PREVIOUS YEAR'S ACTIVITY OF FIRST YEAR STUDENTS PER QUALIFICATION TYPE**

AGE GROUPING AND PREVIOUS YEAR'S ACTIVITY OF FIRST YEAR STUDENTS PER QUALIFICATION TYPE								
Qualification Type	Age grouping					Previous year's activity		
	18-20	21-22	23-24	25-29	30-34	Secondary School student	University student	Working
Diploma	48%	25%	19%	8%	0%	29%	17%	54%
Extended Degree	25%	25%	38%	13%	0%	13%	13%	74%
Degree	54%	35%	8%	1%	1%	52%	8%	40%
<b>Overall of all qualifications</b>	<b>50%</b>	<b>30%</b>	<b>14%</b>	<b>5%</b>	<b>1%</b>	<b>41%</b>	<b>12%</b>	<b>47%</b>

The table above indicates that the majority of first year students for the diploma and degree that obtained an academic exclusion are in the age grouping of 18-20. But for the extended degree the majority of students were in the age grouping 23-24. The percentage of students that worked in their previous year is high for both the extended degree and the diploma first year students. This could be why 56% of extended degree students list financial difficulties as one of the main reasons contributing to their academic exclusion. It relates back to the fact that these students (75%) were working in the previous year(s) to earn money to pay for their studies and don't have a monthly income anymore. This also corresponds with the high percentage (54%) of diploma students that were working in the previous year. Interesting to note is that the majority (51%) of degree students were secondary school students in the previous year. This is much higher than for the extended degree students (13%) and also the diploma students (29%).

### MAIN REASONS THAT CONTRIBUTED TO UNSATISFACTORY ACADEMIC PERFORMANCE

In the online appeal form students were given the opportunity to select the reason(s), from a drop down list of possibilities, which in their opinion mostly contributed to their unsatisfactory academic performance. The drop down list was created based on years of experience with the manual appeals process. Students then also had to explain how

the reason(s) listed affected their studies and subsequently contributed to their unsatisfactory academic performance.

The table below, listed by undergraduate qualification types, indicates an overall summary of the main reasons listed by the UG students that contributed to their unsatisfactory academic performance and resulting academic exclusion. These reasons were extracted from the online appeal form.

**Table 7: REASONS PROVIDED FOR UNSATISFACTORY ACADEMIC PERFORMANCE BY UNDERGRADUATE STUDENTS PER QUALIFICATION TYPE**

REASONS PROVIDED FOR UNSATISFACTORY ACADEMIC PERFORMANCE PER QUALIFICATION TYPE				
Reasons	Diploma	Extended Degree	Degree	Overall for UG students
Academic difficulty	18%	19%	26%	22%
Family problems	14%	13%	11%	13%
Financial difficulty	47%	55%	45%	47%
Health	11%	8%	9%	9%
Personal	4%	2%	5%	4%
Transport problems	1%	0%	1%	1%
Other	5%	3%	3%	4%
<b>Overall</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

From the information above it is clear that financial difficulty is overall by far (47%) the main reason that contributed to the students' unsatisfactory academic performance. This is also true for each of the UG qualification types individually. Extended degree students seem to be the students that experience the most financial difficulties (55%), followed by diploma students at 47% and degree students at 45%, which is still relatively high.

The reason secondly overall listed by UG students was academic difficulties; overall at 22% ranging from 26% for degree students to 18% for diploma students. Interesting to note is that the degree exit level is on level 7 of the National Qualifications Framework (NQF) while the diploma is on NQF level 6. This could explain why more degree students listed academic difficulties as a contributing reason.

Other and personal problems (both at 4% overall) as well as transport problems (1% overall) seems to be the lowest reasons that contributed to academic exclusion of UG students.

Other key observations, for UG students per qualification type, made from the table above are as follows:

- in terms of family problems the diploma students (14%) were the group with the highest percentage of students claiming that they experienced family problems followed closely by the extended degree students (13%);
- health problems affected 11% of diploma students followed closely by 9% for degree students; and
- personal, transport and other problems affected only a very low percentage overall of UG students per qualification type.

Table 7.1 below provides more detailed information on the reasons provided by first year students per qualification type.

**Table 7.1: REASONS PROVIDED FOR UNSATISFACTORY ACADEMIC PERFORMANCE BY FIRST YEAR STUDENTS PER QUALIFICATION TYPE**

<b>REASONS PROVIDED FOR UNSATISFACTORY ACADEMIC PERFORMANCE BY FIRST YEAR STUDENTS PER QUALIFICATION TYPE</b>				
<b>Reasons</b>	<b>Diploma</b>	<b>Extended Degree</b>	<b>Degree</b>	<b>Overall for first year students</b>
Academic difficulty	15%	22%	27%	22%
Family problems	10%	0%	9%	9%
Financial difficulty	58%	56%	48%	52%
Health	8%	22%	7%	8%
Personal	3%	0%	3%	3%
Transport problems	3%	0%	1%	2%
Other	3%	0%	6%	5%
<b>Overall</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

From the first year information above it is clear that financial difficulty is also by far the overall (52%) main reason that contributed to their unsatisfactory academic performance. This is also true for each of the qualification types individually. This reflects the same overall pattern as seen in Table 7. First year diploma students seem to be the students that experienced the most financial difficulties (58%), followed closely by extended degree students (56%) with first year degree students at 48%, that is still relatively high. A possible explanation of extended degree students' financial difficulty could be because extended students usually only get financial assistance in the form of bursaries or sponsors in their second year of study. This

would be only after they have successfully completed the extended year of the qualification and they start with the first year of the mainstream degree.

The reason secondly listed by first year students was academic difficulties at 22% overall, ranging from 27% for degree students to 15% for diploma students. These reasons, as well as the other reasons listed by first year students also follow the overall UG pattern as seen in Table 7.

As discussed above financial difficulties seem to be the main contributing reasons (factor) leading to being awarded a BF/F7 result code both overall for UG students as well as for first year students. The following table compares the UG students that listed financial difficulties as the main problem with their National Student Financial Aid Scheme (NFSAS) status.

**Table 8: NSFAS STATUS PER QUALIFICATION TYPE**

QUALIFICATION TYPE AND NSFAS STATUS					
Qualification Type	Reason	NSFAS Status Description <sup>1</sup>			
	Financial difficulty	Applied for & eligible but not awarded	Applied for & has NSFAS award	Applied for but was not eligible	Did not apply
Diploma	47%	19%	6%	12%	63%
Extended Degree	55%	29%	0%	7%	64%
Degree	45%	8%	3%	11%	78%
<b>Overall</b>	<b>47%</b>	<b>19%</b>	<b>3%</b>	<b>10%</b>	<b>68%</b>

From the information above it is clear that overall 47% of UG students' listed financial difficulties as a contributing reason to their unsatisfactory performance. While overall 68% did not apply for NSFAS financial aid while only an alarming low 3% was awarded NSFAS financial aid. It could add value to contact the 19% of students that were not awarded financial assistance, even though they were eligible, to try and find out why they were not awarded financial aid. One reason could be that their past academic performance (for senior students) was not seen as satisfactory and therefore they did not qualify for financial aid.

It is interesting to note that while 55% of the extended degree students experienced financial difficulties, 64% of them did not apply for NSFAS financial aid according to the data available<sup>1</sup>. Of the 45% of degree students that experienced financial difficulties 78% of them did not apply for NSFAS.



The large number of students that experience financial difficulties is alarming; it means that the majority of their families are responsible for their financial needs. Research by Fowler (2003), shows that students with financial difficulties not only have to pay for their class fees but they are also liable for books and transport. The parents and community generally assist with the payment of the registration fee. The students then have to make adequate plans for the payment of the bigger amounts of fees still outstanding. Students are then usually strapped for cash and have to manage their finances carefully; they often take up part time jobs to assist them with their financial needs. The part time jobs can cause students to miss classes. Students with financial difficulties often remain on campus all day long in order to avoid paying unnecessary transport fees. Students sometimes make use of the overnight study facility to sleep in just to ensure that they save on transport money and use the money to buy food. It could add value to determine whether adequate study areas and other facilities are available for students that have to stay on campus all day long.

### **WHAT CAN BE DONE TO AVOID POTENTIAL ACADEMIC EXCLUSION?**

Students should only be finally excluded on account of poor academic performance as a last resort, after all other avenues have failed to restore their academic performance to the required level, and provided that the necessary academic support to assist students was given. It is also clear that alternative means of financial support (not only NSFAS) for students' needs to be investigated.

It is the responsibility of both the staff (academic and support) and students of FEFS to ensure that as many students as possible are given the opportunity to be successful in their studies.

Staff have the responsibility of selecting, admitting and orientating students carefully; delivering excellent teaching and fair assessment; ensuring that students have the opportunity and means to assess and monitor their performance on a regular basis; and providing appropriate academic support and feedback to students.

Students have the responsibility of committing themselves fully to their studies; monitoring their performance in their studies; and utilising all the available support resources (academic counselling by PhyCaD, academic support by the ADC as well as career and personal counselling) to successfully complete their studies. This should preferably be done in the minimum time for their qualification but not exceeding the maximum time allowed.

Faculties should implement some initiatives to try and alleviate the academic as well as financial problems that students are experiencing. FEFS already has good measures in place to assist students academically.

To try and assist students with their financial problems it can be useful to consider some of the following:

- the possibility of other types of funding mechanisms available (Fowler, 2003:16);
- investigate the alternatives of more innovative and entrepreneurial ways to guide students to provide their own funding needs;
- provide students with practical budgeting guidelines to assist them in planning their finances; and
- assist students with financial difficulties with a meal a day to ensure they do not have to study or attempt assessment opportunities while being hungry.

## **SUMMARY AND POSSIBLE FUTURE STUDIES**

This paper presented a case study in the form of an analysis of the reasons contributing to academic exclusion in FEFS at UJ. It was shown that after the first semester 93% of the total number of UG and PG students that were academically excluded were UG students and 84% were UG students after the second semester of 2015. Overall for 2015 it was mostly degree students (47%) followed by diploma students (38%) that were academically excluded for 2015. The same can be seen for first year students, where 52% of the first year students that were academically excluded represented degree students followed by diploma students at 45%.

Overall UG students have an appeal rate of 68%; this indicates that the majority of UG students take the opportunity to appeal their academic exclusion. The majority of overall appeals came from degree students (50%) followed by diploma students (37%). This is in line with the faculty's enrolment numbers per qualification type. First year students have an appeal rate of only 41% compared to the overall appeal UG rate of 68%. It could add value to determine why the appeal rates for first year students are lower when compared to the overall UG appeal rate.

The analysis of the reasons contributing to students being academically excluded lead to two important conclusions:

- 47% of UG students listed financial difficulties as the main reason contributing to their unsatisfactory academic performance. Extended degree students seem to be the students that experience the most (55%) financial difficulties. First year students also indicated that financial difficulties were by far overall (52%) the main contributing reason; and

- academically difficulty at 22%, overall ranging from 36% for degree students to 18% for diploma students, was the second highest reason listed by UG academically excluded students. First year students indicated that academic difficulties, also at 22% overall, were the second highest contributing reason.

The results of this study suggest that the Faculty and possibly the University should implement some initiatives to try and alleviate the financial as well as the academic difficulties students are experiencing.

Extracting and analysing the data obtained from the BF/F7 online appeals process should be part of an on-going research project within the Faculty and possibly the University. If more data is obtained relating to the academic exclusion of students the sooner solutions to the problems, being academically or non-academically, could be found and this could possibly positively influence the graduation rate of the Faculty.

Future studies could include the following:

- obtain information from the students that did not appeal their academic exclusion to find out their reasons; and
- track the progress of students, that had their BF/F7 lifted and subsequently received an academic warning, to monitor their academic performance in order to see if the academic warning received and subsequent interventions assisted them in improving their academic performance.

Future studies in these areas could assist the Faculty and University to design and implement strategies and innovations specific to the needs of academically excluded students, based on the data extracted from the online academic appeals process.

## REFERENCES

- Council on Higher Education (CHE). 2013. A proposal for undergraduate curriculum reform in South Africa: The case for a flexible curriculum structure. Council on Higher Education, Pretoria, 2013.
- Fowler, M. 2003. *Student retention problems in Higher Education in a Developing Country*. Pretoria: Strategic Information & Planning.
- Godfrey, J. 2012. *An exploratory study of the interface of child-headed households and academic performance: A Case study of primary school students in Beatrice resettlement area, Zimbabwe*. University of Zimbabwe.
- Higher Education Data Analyser (HEDA), University of Johannesburg, 2016. Data extracted on 19 April 2016.
- Ishitani, TT and DesJardins, SL. 2002. *A Longitudinal Investigation of Dropout from College in the United States*. Paper presented at the 2002 Annual Meeting of the Association for Institutional Research.
- Kohlbacher, F. 2006. *The use of Qualitative Content Analysis in Case study Research*. Forum: Qualitative Social Research. 7(1).
- Letseka, M. 2009 *University dropout and researching (lifelong) learning and work*. Hsrcpress.ac.za 88-105.
- Letseka, M and Maile, S. 2008. High university dropout rates: A threat to South Africa's future. Pretoria: Human Science Research Council; 1–7.
- Murry, M. 2014. *Factors affecting graduation and student dropout rates at the University of KwaZulu-Natal*. South African Journal of Science. 2014: 110-112.
- Neethling, L. 2015. The determinants of academic outcomes: A competing risks approach. Paper presented at the 2015 Conference of the Economic Society of South Africa.
- Qualifications and Regulations of the University of Johannesburg, Faculty of Economic and Financial Sciences (FEFS QR), 2016.
- Sampaio, G. 2012. *Three Essays on the Economics of Education*. PhD Thesis, University of Illinois at Urbana Champaign.

Shoukat A, Haider Z, Khan H and Ahmed A. 2013. *Factors Contributing to the Students' Academic Performance: A Case Study of Islamaia University Sub-Campus*. American Journal of Educational Research 2013: 1(8) 283-289.

St John E, Cabrera A, Nora A and Asker E. (2000). Economic influences on persistence reconsidered: How can finance research inform the reconceptualization of persistence models. In J. Braxton (Ed.), *Reworking the student Departure Puzzle* (29-47). Nashville, TN: Vanderbilt: University Press.

Stratton L, O'Toole D and Wetzel J. 2008. *A multinomial logit model of college stopout and dropout behaviour*. Economics of Education Review, 27, 319-331.

University of Johannesburg. 2016. Academic Rules and Regulations of the University of Johannesburg (UJ ARR).

University of Johannesburg Senate, S374/2010(3), 2010.

Yin, RK. 2003. *Case Study Research Design and Methods*. Thousand Oaks, C.A. SAGE.

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**FAC 02: The Proposed Conceptual Framework and its  
possible effect on the reporting of Contingent Liabilities**

AUTHORS: Taryn Miller and Guy Wagenvoorde,

University of Cape Town; [taryn.miller@uct.ac.za](mailto:taryn.miller@uct.ac.za)

**Abstract**

This paper examines the International Accounting Standards Board's ("IASB's") proposed changes to liabilities within the Exposure Draft of the revised *Conceptual Framework*<sup>3</sup>, and the implications of these changes for the reporting of contingent liabilities, in the event that IAS 37<sup>4</sup> were to be amended to align with the *Draft Framework's* proposals. This paper finds that the *Draft Framework's* liability definition has very few notable changes, yet the *Draft Framework's* recognition criteria will likely impact the number of obligations to be recognised in the future. Specifically, contingent liabilities that are considered to be 'present obligations' but fail the existing recognition criteria, may in future meet both the definition and recognition criteria for liabilities. This will impact key financial statement indicators such as an entity's net asset value and net profit. The results of this paper are therefore useful to a broad array of financial statement users as well as the IASB who are presently engaging various stakeholders on whether to take on an active project to amend IAS 37.

**Keywords:** contingent liability, recognition

---

<sup>3</sup> The revised *Conceptual Framework* is hereinafter referred to as the "*Draft Conceptual Framework*" or the "*Draft Framework*".

<sup>4</sup> International Accounting Standard 37: Provisions, Contingent Liabilities and Contingent Assets

## Introduction

The *Conceptual Framework for Financial Reporting* (the “*Conceptual Framework*” or “the *Framework*”) “describes the objective of, and the concepts for, general purpose financial reporting” (IASB, 2015a, par. IN1). It also forms a basis for the development of International Financial Reporting Standards (“IFRS”). The *Conceptual Framework* has been under extensive review since 2004 and one of the key areas subject to development has been the definitions of assets and liabilities, and the related recognition criteria.

There are numerous issues associated with the existing *Framework* that the IASB has sought to address in their update project. One area of concern is the existing recognition principles that potentially result in the inappropriate reporting of an entity’s obligations. In particular, *contingent liabilities* as defined in IAS 37 are never recognised on the statement of financial position. This research paper investigates whether or not contingent liabilities would be reported any differently, in the event that the proposed definition and recognition principles for liabilities within the *Draft Framework* were to be incorporated into IAS 37. A direct implication of this would result in entities reflecting a lower (or higher) net asset value.

This research paper may be of benefit to the IASB as they currently deliberate on the direction of the *Conceptual Framework* project and whether or not IAS 37 merits being added to their active project agenda (IASB, 2015c, par. 8).

## 1. Background: The *Conceptual Framework*

The IASB and the Financial Accounting Standards Board<sup>5</sup> initiated a joint project in 2004 to overhaul their existing *Conceptual Frameworks*. Since the project’s inception there have been two chapters of the *Draft Framework* released – Chapter 1 (*The Objective of General Purpose Financial Statements*) and Chapter 3 (*Qualitative Characteristics of Useful Financial Information*). These chapters became effective within the existing *Conceptual Framework* in 2010.

The exposure draft of the *Conceptual Framework*, which forms the focus of this research paper, was issued in May 2015, and was open for public comment until November 2015. At the time of finalising this paper, the comment period had closed and the IASB staff were reviewing the comment letters. This will inform a decision by the IASB on the future direction of the *Conceptual Framework* project.

---

<sup>5</sup> Financial Accounting Standards Board: The Financial Reporting Standards setting board in the United States of America.

### 1.1. The Qualitative characteristics of useful financial information

The 2010 updates to the *Conceptual Framework* included revisions to the qualitative characteristics of useful financial information. These characteristics are intended to inform what financial information should be reported.

The qualitative characteristics comprise:

- (a) Fundamental qualitative characteristics, namely:
  - Relevance and
  - Faithful representation, and
- (b) Enhancing characteristics, namely:
  - Comparability
  - Timeliness
  - Verifiability, and
  - Understandability (IFRS Foundation, 2014a, par. QC19).

The IASB seeks to maximise these qualities to the greatest extent possible (IFRS Foundation, 2014a, par. QC33). Information needs to be both relevant and faithfully represented, to be useful. These characteristics, together with the additional enhancing characteristics, represent an ideal financial information-set that the developed IFRS are expected to help achieve. At all times, the benefit of obtaining the information with these characteristics needs to outweigh the cost of obtaining the information. This is known as the ‘cost constraint’, and is a pervasive constraint that is constantly reflected on by the IASB as they develop IFRS.

An understanding and awareness of these characteristics, and the cost constraint, is critical when evaluating the effects of the proposed changes in the *Draft Framework*, and indeed, any IFRS.

## 2. The relevance of contingent liabilities in practice

In public finance practice, information on contingent liabilities has aided the analysis of sovereign risk (Cebotari, 2008). This has proven to be particularly useful in assessing the “true financial position of the public sector” (Cebotari, 2008). For example, there are “implicit contingent liabilities [that] governments take on during periods of financial and economic distress by bailing out banks...or even private enterprises” (Cebotari, 2008). Furthermore, there has been a larger focus by credit rating agencies, such as Standard & Poor’s and Moody’s, in incorporating this information in their credit risk assessment of various economies (Cebotari, 2008).



**Adequate contingent liability disclosure for the purpose of making risk assessments can also fulfil a vital role in the private sector. The objective of general purpose financial reporting extends its meaning to aiding the users of financial statements in assessing the risks, timing and uncertainty of an entity's future net cash flows (IFRS Foundation, 2014f, par. OB3). There is greater need for the appropriate representation of these obligations if these users incorporate contingent liability disclosure in their risk assessment of an entity. Therefore, just as the information on contingent liability disclosure is incorporated in a public finance sphere, the decision to appropriately represent a liability in the financial statements is pivotal in fulfilling the objective of general purpose financial reporting.**

### 3. IAS 37 & Contingent Liabilities

IAS 37 contains specific guidance on accounting for the recognition, measurement, presentation and disclosure of provisions, contingent liabilities and contingent assets. This guidance is generally consistent with the principles embedded in the existing *Conceptual Framework* relating to defining and recognising liabilities.

IAS 37 defines a *provision* as a 'liability of uncertain timing or amount' (IFRS Foundation, 2014d, par. 10).

Provisions are recognised on the statement of financial position if they meet the general recognition criteria for liabilities i.e. a reliable estimate of the outflow can be made, and it is considered probable that the outflow will occur.

IAS 37 further states that the term "probable" means "**more likely than not to occur**" (IFRS Foundation, 2014d, par. 24). Accordingly, if there is a greater than 50% chance of an outflow occurring, a provision for the best (reliable) estimate of the outflow is recognised. If an outflow is not considered more than likely to occur, or if a reliable estimate cannot be made, the obligation is known as a *contingent liability*. Contingent liabilities can also arise due to a possible (as opposed to 'present') obligation, as discussed in the next section.

#### 3.1. Contingent liabilities in IAS 37

Per IAS 37, a contingent liability is defined as:

- “ (a) a **possible obligation** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) a **present obligation** that arises from past events but is not recognised because:

- i. it is not **probable** that an outflow<sup>6</sup> of resources embodying economic benefits will be required to settle the obligation; or
- ii. the **amount** of the obligation cannot be measured with sufficient reliability” (IFRS Foundation, 2014d, par. 10).

IAS 37 requires that a contingent liability be “disclosed...unless the possibility of an outflow of resources embodying economic benefits is remote” (IFRS Foundation, 2014d, par. 28). Accordingly, contingent liabilities are never recognised as liabilities on the statement of financial position and will therefore have no direct impact on the net assets nor financial performance of an entity. However, the relevant details relating to these items appear as disclosure in the notes to the financial statements.

The IASB emphasised the importance of recognition in satisfying the objective of general purpose financial reporting: “The failure to recognise an asset or a liability is not rectified by disclosure... If some assets or liabilities are not recognised, the resulting depiction of the entity’s resources and obligations would be incomplete and would thus provide a less faithful representation of the entity’s financial position” (IASB, 2013a, par. 4.24). The recognition decision is thus fundamental when assessing the information needs of users<sup>7</sup>.

It can be seen that the definition of a contingent liability is comprised of two components, a “possible obligation” and a “present obligation” that is unrecognised. These two components require separate consideration. *In order to do so effectively, each component of the contingent liability definition will be dealt with independently and hereinafter referred to as “**type (a)**”, being a contingent liability that is a “possible obligation”, and “**type (b)**”, a contingent liability that is a “present obligation” that is unrecognised.*

### 3.2. Problems with the existing recognition criteria

A concern with the probability criterion<sup>8</sup> within the existing recognition criteria is its inconsistent interpretation and application within various Standards. “Some existing Standards do not apply a probability recognition criterion, for example, IFRS 9 *Financial Instruments*. Those that do apply such a criterion use different probability thresholds. These include ‘probable’, ‘more likely than not’, ‘virtually certain’ and ‘reasonably possible’. The use of the different terms indicates a lack of consistency in

---

<sup>6</sup> “Outflow” refers to the outflow of future economic benefits in all cases

<sup>7</sup> *This research paper does not analyse the relative appropriateness of recognition versus disclosure in respect of reporting contingent liabilities. Rather, this paper simply identifies the IASB’s amendments to the Conceptual Framework and the potential reporting outcomes for contingent liabilities.*

<sup>8</sup> The probability criterion in the existing recognition criteria: “It is probable that any future economic benefit associated with the item will flow to or from the entity” (IFRS Foundation, 2014b, par. 4.38).

the meaning attached at the Standards-level to the term ‘probable’ as used in the *Conceptual Framework*” (IASB, 2015b, par. BC5.8).

IAS 37 states that the term “probable” means “**more likely than not to occur**” (IFRS Foundation, 2014d, par. 23). As a consequence, the mere fact that an outflow is less than fifty percent likely to occur will result in that item’s complete exclusion from recognition. Litigation was identified as an obligation prone to this disproportionate effect, where, as a court case developed, the probability of outflow could swing below and above this threshold and result in major accounting consequences for very small economic changes (IASB, 2015b). The result is that certain items are not recognised at all merely due to their *less-than-likely* outflow of economic benefits. This effect of not recognising obligations on the basis of a technical default potentially undermines the fundamental qualitative characteristics as set out in Chapter 3 of the *Conceptual Framework* (IFRS Foundation, 2014a).

#### 4. A comparison of liabilities in the existing and Draft Framework

##### 4.1. The definition of a liability

Existing definition:	Draft Framework’s definition:
“A liability is a present obligation of the entity as a result of past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits” (IFRS Foundation, 2014b, par. 4.4).	“A liability is a present obligation of the entity to transfer an economic resource as a result of past events” (IASB, 2015a, par. 4.24).

The guidance in the *Draft Framework* provides two conditions for a present obligation to exist:

“An entity has a **present obligation to transfer an economic resource** if both:

- (a) the entity has no practical ability to avoid the transfer; and
- (b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation” (IASB, 2015a, par. 4.31).

##### 4.2. A comparison of the definitions of a liability in the existing and Draft Framework

###### **No practical ability to avoid the transfer**

The existing definition describes the event to be obligating once the entity has *no realistic alternative* but to settle the obligation, while the *Draft Framework’s* definition

describes this rather as a *practical inability* to avoid the transfer of economic resources. The latter definition provides a seemingly greater extent of leeway through its use of the word “practical” as opposed to “realistic”. The IASB has, however, noted that these two terms are similar in meaning, but chose to propose the term “no practical ability to avoid” because [it thought] that it most effectively [conveyed] the need to identify what the entity [was] able to do, instead of what the probable outcome will be. Furthermore, it [mirrors] the term ‘practical ability’, which [is] applied in some existing Standards in assessing whether an entity has control of an asset” (IASB, 2015b).

Therefore, the emphasis in the *Draft Framework’s* approach has been shifted to the entity identifying whether it has committed an act sufficient enough to be an obligating event.

### **Arisen from past events**

Both the existing and *Draft Framework’s* liability definitions require the occurrence of a past event to give rise to a present obligation of the entity. In both cases, therefore, the recognition of a liability is not dependent on the future actions of the entity. The emphasis has therefore remained on an entity’s past actions and whether those actions are sufficient enough to give rise to an obligation.

There could, however, be considerable uncertainty as to what is sufficient for this purpose. The *Draft Framework* distinguishes between two forms of uncertainty:

- “ (a) uncertainty about whether an asset or a liability exists (***‘existence uncertainty’***)
- (b) uncertainty about whether an asset or a liability will result in any inflow or outflow (***‘outcome uncertainty’***)” (IASB, 2015a).

An example of existence uncertainty is in relation to litigation where an entity has committed an act but it is unclear whether they will be obliged to pay damages or a fine for their related actions (IASB, 2013a). This extends to the uncertainty in how the law applies to those particular events (IASB, 2010a:5).

The uncertainty inherent in the existing and *Draft Framework’s* liability definitions is primarily centred on existence uncertainty. Outcome uncertainty is more relevant to the recognition criteria (which is yet to be discussed).

To summarise, it is apparent that the definitions in the existing and *Draft Framework* are largely similar. The effect of the proposed change in the definition of a liability will be discussed further in Chapter 6, which analyses the effect of the proposed change for contingent liabilities.

#### 4.3. The recognition criteria for a liability

Existing recognition criteria:	<i>Draft Framework's</i> recognition criteria:
“(a) It is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) The item has a cost or value that can be measured with reliability” (IFRS Foundation, 2014b, par. 4.38).	<p>“[Assets and] liabilities should be <u>recognised</u> if such recognition provides users of financial statements with:</p> <ul style="list-style-type: none"> <li>(a) <b>relevant</b> information about the asset or the liability and about any income, expenses or changes in equity;</li> <li>(b) a <b>faithful representation</b> of the asset or the liability and of any income, expenses or changes in equity; and</li> <li>(c) information that results in the benefits exceeding the cost of providing that information” (IASB, 2015a, par. 5.9)</li> </ul> <p>In addition, “recognition <u>may not provide relevant information</u>:</p> <ul style="list-style-type: none"> <li>(i) if it is <u>uncertain</u> whether [an asset or] a liability exists;</li> <li>(ii) if an asset or a liability exists, but there is only a <u>low probability</u> that an [inflow or] outflow of economic benefits will result; or</li> <li>(iii) if all of the measurements of [an asset or] a liability that could be obtained have such a level of <u>measurement uncertainty</u> that the resulting information has little relevance” (IASB, 2015a, par 5.13).</li> </ul>

#### 4.4 A comparison of the recognition criteria in the existing and *Draft Framework*:

The former explicitly defined recognition criteria has been removed from the *Draft Framework*. Instead, *relevance* and *faithful representation*<sup>9</sup> have become the factors that will drive recognition decisions. In the view of the IASB, “basing recognition criteria on the qualitative characteristics should result in useful information” (IASB, 2015b, par. BC5.20).

The relevance, faithful representation and benefits of any information is primarily dependent “on the item and the specific facts and circumstances” (IASB, 2015a, par. 5.10). The exercise of judgement is therefore essential in determining the usefulness

<sup>9</sup> as set out in the chapter on the *Qualitative Characteristics of Useful Financial Information*

of information when applying the *Draft Framework's* recognition criteria. A detailed discussion of this criteria follows:

### **Relevant information**

The Draft Framework's recognition criteria incorporates three considerations for whether or not recognising the liability will result in *relevant* information. Information is *not* considered to be relevant when:

- i. It is uncertain whether an asset exists, or is separable from goodwill, or whether a liability exists:

The interpretations of the *Draft Framework's* liability *definition* establishes that existence uncertainty is a significant consideration for whether an entity has a *present obligation*. The presence of this type of uncertainty will likely result in an obligation not meeting the *Draft Framework's* definition of a liability. However, notwithstanding this practical filter within the *Draft Framework's* liability definition, an obligation would further fail to meet the *Draft Framework's* recognition criteria as a result of this additional consideration in the recognition criteria.

- ii. There is only a low probability that an inflow or outflow of economic benefits will result:

In certain cases, the probability of outflow could be so low that recognition of the liability would lead to irrelevant information, if estimated and recognised in the financial statements. In other situations, however, recognition of a liability even when there is a low probability of an outflow occurring may provide relevant information, especially if the measurement of the asset or the liability reflects the low probability and is accompanied by explanatory disclosures" (IASB, 2015a:53). Determining how probable the outflow is, may in itself be difficult to determine, especially where there is no observable transaction or price. This is particularly evident in the case of litigation as a result of its non-transactional nature. Ultimately, the probability of the outflow occurring assists in determining whether the reported information would be relevant or not.

- iii. A measurement of an asset or a liability is available (or can be obtained) but the level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measure is available (or can be obtained):

The recognition of an obligation requires the measurement thereof. The existing recognition criteria refers to the cost or value of an outflow as being "reliably measurable". Despite any unobservable transaction or price, the outflow can still be deemed to be reliably measurable through the use of estimation. There

are various measurement bases suggested in terms of the *Draft Framework* that could be used to obtain a reliable estimate (IASB, 2015a).

However, where the estimate of the amount of the potential outflow is subject to significant uncertainty, the “resulting information [has] little relevance, even if the estimate is properly described and disclosed. This may be the case when the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate, [or] measuring the resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured” (IASB, 2015a:54).

### **Faithful representation**

Just as faithful representation is equally as meaningful as relevance in providing useful financial information in the existing *Framework*, it has equivalent prominence within in the *Draft Framework*’s recognition criteria. It is apparent that the IASB has sought for the preparers of financial statements to balance these criteria, giving commensurate weight to each when making recognition decisions. However, many respondents to the Discussion Paper (IASB, 2013a) argued that “faithful representation” is redundant in the context of recognition. These respondents argued that “there are no circumstances when recognising an asset or a liability would provide information that is relevant but yet could not result in a faithful representation” (IASB, 2015b:68). The IASB, however, continued to affirm their view that faithful representation is necessary when making recognition decisions. This view was derived from the need for an entirely consistent application of the *Qualitative Characteristics* within the *Draft Conceptual Framework* (IASB, 2015b:68).

### **Cost constraint**

This cost constraint was already captured in Chapter 3: *Qualitative Characteristics of Useful Financial Information* (IFRS Foundation, 2014a:A30). Albeit having a greater prominence within the *Draft Framework*’s recognition criteria, this term has not deviated in meaning from the existing *Framework*.

## **5. Additional literature**

The subject matter of this research paper was primarily guided by the *Conceptual Framework*, both in its existing and revised Draft form, as well as IAS 37. Relevant additional literature includes the following:

### 5.1. IASB staff papers on the implication of the *Draft Framework* for the reporting of liabilities

The IASB staff have issued a number of agenda papers that address the likely impact of the *Draft Framework* on the recognition of liabilities (IASB, 2015c; 2015d; 2015e).

In these papers, a number of familiar examples, such as provisions for restructuring costs, legal requirements to install smoke detectors, and provisions for bonuses, are applied to the proposed liability definition and recognition criteria, with the conclusion drawn that the proposed amendments would not result in a change in the timing of the recognition of liabilities (IASB, 2015e, par. 2.17-2.20). The only exception to this is an example dealing with a provision for government levies payable, which would probably result in an outcome that is different to the current requirements of IFRIC 21 *Levies*, an interpretation that has been heavily criticised in any event (IASB 2015e, par. 1.18-1.19).

However, none of the examples in these agenda papers address the possible consequences of the *Draft Framework* for contingent liabilities. Hence this research paper fills a void in the current available guidance.

### 5.2. Contingent liabilities in IFRS 3

There is a notable exception in IFRS 3<sup>10</sup> to the recognition requirements of IAS 37 in relation to contingent liabilities. It is explicitly mentioned that the acquirer shall recognise contingent liabilities assumed in a business combination if “it is a present obligation that arises from past events and its fair value can be measured reliably” (IFRS Foundation, 2014c, par. 23). This is seemingly contrary to the general recognition criteria as a contingent liability should be recognised in a business combination “even if it is not probable that an outflow of resources would be required to settle that obligation” (IFRS Foundation, 2014c, par. 23). However, the expected probability of the obligation outflow was said to be encompassed in the fair value measurement of the contingent liability (IFRS Foundation, 2014e, par. 33). Therefore, despite the difficulty in measuring or estimating a probability for the outflow of these obligations, this exception implies that the IASB acknowledges the relevance in recognising these obligations, albeit with the use of a different measurement basis.

### 5.3. Literature conclusion

The purpose of this research paper is to investigate whether or not the proposed liability definition and recognition criteria within the *Draft Framework* would result in contingent liabilities being reported any differently in future, should the proposed criteria ultimately be incorporated into IAS 37. Such an investigation is by its nature, a highly technical analysis of a financial reporting concept. The literature mentioned thus far therefore contains the extent of the relevant technical concepts and principles

---

<sup>10</sup> International Financial Reporting Standard 3: Business Combinations



that inform the outcome of this investigation, and therefore no further literature is considered to be relevant for the purpose of this study.

## 6. Application of the proposed changes within the Draft Framework to contingent liabilities

### 6.1. The definition of liabilities

In spite of the changed terminology and supporting guidance, the liability definition in both the existing and the *Draft Conceptual Frameworks* are largely equivalent in meaning. The proposed liability definition will now be applied to the existing definitions of contingent liabilities, in order to determine whether or not what are currently known as ‘contingent liabilities’ would in future meet the formal (proposed) definition of a ‘liability’.

Recall that there are currently two types of contingent liabilities, namely “type (a)<sup>11</sup>” and “type (b)<sup>12</sup>” contingent liabilities. Recall further that the *Draft Framework’s* liability definition encompasses the term “present obligation”:

“ **A liability is a present obligation of the entity to transfer an economic resource as a result of past events**” (IASB, 2015a).

Accordingly, since *type (a)* contingent liabilities are merely *possible* obligations, they fail to meet the existing liability definition, and therefore similarly fail to meet the *Draft Framework’s* liability definition. As such, no change in the accounting treatment of *type (a)* contingent liabilities is expected.

However, for *type (b)* contingent liabilities, where a present obligation *does* exist but where the probability of outflow is uncertain or cannot be reliably estimated, the accounting treatment may differ in future.

### 6.2. The recognition criteria

#### “Type (b)” contingent liabilities:

An issue identified following the release of the Discussion Paper (IASB, 2013a) with the *Draft Framework’s* recognition criteria was that the range of assets and liabilities to be recognised will likely increase. The IASB have, however, noted that their aim

---

<sup>11</sup> a **possible obligation** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity” (IFRS Foundation, 2014d).

<sup>12</sup> a **present obligation** that arises from past events but is not recognised because:

- i. it is not **probable** that an outflow of resources embodying economic benefits will be required to settle the obligation; or
- ii. the **amount** of the obligation cannot be measured with sufficient reliability” (IFRS Foundation, 2014d).

“has been solely to develop tools that enable it to take decisions based on a more coherent set of principles, which result in useful information. The IASB has not had, and does not have, an objective of either increasing or decreasing the range of assets and liabilities recognised” (IASB, 2015b, par. BC5.13).

Nonetheless, despite the IASB’s stated objective in revising the recognition criteria, the *Draft Framework’s* recognition criteria could affect the recognition of “type (b)” contingent liabilities. Most notably, contingent liabilities that were previously unrecognised as a result of a less-than-fifty percent probability of outflow could forthwith be considered for recognition if the resultant effect provides relevant information to users that is faithfully represented, and the cost of preparing such information does not outweigh the benefits to be derived from its recognition.

It is clear that a thorough evaluation of the qualitative characteristics is necessary in order to determine which of the existing type (b) contingent liabilities would be required to be recognised (according to the proposed recognition principles). It is only once all of the facts and circumstances unique to each obligation are considered that it will be possible to judge whether that obligation should be recognised.

However we can conclude that **the *Draft Framework’s* definition and recognition criteria will likely lead to a greater number of obligations being recognised in future.**

## 7. Conclusion

In their *Conceptual Framework* update project, the IASB sought to address numerous concerns with the existing *Framework*. One concern that was investigated in this research paper was the outdated recognition principles that fail to reflect the current thinking of the IASB. The *Draft Framework’s* recognition principles have been established with direct reference to the *Qualitative Characteristics of Useful Financial Information*. In the view of the IASB, “basing recognition criteria on the qualitative characteristics should result in useful information” (IASB, 2015b, par. BC5.20).

It is clear that in doing so, more judgement will be required when making recognition decisions based on the *Draft Framework*. However, the link that has been established between the qualitative characteristics of financial information and the recognition criteria provides the recognition criteria with more meaningful context within the broader objective of financial reporting.

Although the IASB staff has issued a number of agenda papers that address the likely impact of the *Draft Framework* on the recognition of liabilities, none of the examples in these agenda papers address the possible consequences of the *Draft Framework* for contingent liabilities. Hence the findings of this research paper assist in providing additional guidance on the possible consequences of the proposals within the *Draft Framework*.

This paper shows that the proposed changes to the existing definition and recognition principles for liabilities will likely impact the way contingent liabilities are reported in the future, should the IASB amend IAS 37 to align with these principles. Specifically, present obligations that are 'contingent liabilities' and are not currently recognised, could meet the proposed definition and recognition criteria of a liability. The recognition of more liabilities would impact key financial statement indicators such as the net asset value and net profit of an entity.

The extensive use of judgement will likely have a knock-on effect for the assurance providers of financial statements. Such professions will need to place greater emphasis on their assessment of the judgements applied in the preparation of the financial statements

## References:

Cebotari, A., 2008. IMF Working Paper – Fiscal Affairs Department: *Contingent Liabilities: Issues and Practice*. (Working Paper Abstract). p. 3.

InvestorWords. (2015). Investor Words: *Economic Benefit*. [Online]. Available at: [http://www.investorwords.com/16380/economic\\_benefit.html](http://www.investorwords.com/16380/economic_benefit.html) [Last accessed 08 July 2015]

### Sources from the Papers released by the International Accounting Standards Board (IASB):

2015 a: International Accounting Standards Board (IASB). 2015. Conceptual Framework for Financial Reporting: *Exposure Draft (May)*, 1–92. [Online]. Available at: [http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED\\_CF\\_MAY%202015.pdf](http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED_CF_MAY%202015.pdf) [Last accessed 08 June 2015]

b: International Accounting Standards Board (IASB). 2015. Conceptual Framework for Financial Reporting: *Basis for Conclusions Exposure Draft (May)*, 1–134. [Online]. Available at: [http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/Basis-to-ED\\_CF\\_MAY%202015.pdf](http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/Basis-to-ED_CF_MAY%202015.pdf) [Last accessed 08 June 2015]

c: International Accounting Standards Board (IASB) Staff Paper. 2015. *Agenda Paper 14A Research – provisions, contingent liabilities and contingent assets. Project overview*. [Online]. Available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/June/AP14A-Research%20IAS%2037.pdf> [Last accessed 03 December 2015]

d: International Accounting Standards Board (IASB) Staff Paper. 2015. *Agenda Paper 14B Research – provisions, contingent liabilities and contingent assets. Possible problems with IAS 37*. [Online]. Available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/June/AP14B-Research-IAS%2037.pdf> [Last accessed 03 December 2015]

e: International Accounting Standards Board (IASB) Staff Paper. 2015. *Agenda Paper 14C Research – provisions, contingent liabilities and contingent assets. Implications of Conceptual Framework proposals*. [Online]. Available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/June/AP14C-Research%20IAS%2037.pdf> [Last accessed 03 December 2015]

- 2014 a: International Accounting Standards Board (IASB). 2014. Conceptual Framework: *Agenda Reference 10A: Summary of Tentative Decisions*, Staff Paper, (November), 1–23. [Online]. Available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/November/AP10A-CF.pdf> [Last accessed 30 May 2015]
- b: International Accounting Standards Board (IASB). 2014. Conceptual Framework: *Agenda Reference 10D: Summary of Potential Inconsistencies*, Staff Paper, (October), 1–14. [Online]. Available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/October/AP10D-Conceptual-Framework.pdf> [Last accessed 30 May 2015]
- c: International Accounting Standards Board (IASB). 2014. Conceptual Framework: *Agenda Reference 10B: Recognition*, Staff Paper, (May), 1-33. [Online]. Available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/May/AP10B-Conceptual%20Framework.pdf> [Last accessed 30 May 2015]
- d: International Accounting Standards Board (IASB). 2014. Conceptual Framework: *Agenda Reference 10B: Measurement – Measurement Bases*, Staff Paper, (October), 1-16. [Online]. Available at: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/October/AP10B-Conceptual%20Framework.pdf> [Last accessed 30 May 2015]
- 2013 a: International Accounting Standards Board (IASB). 2013. Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting*. [Online]. Available at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Discussion-Paper-July-2013/Documents/Discussion-Paper-Conceptual-Framework-July-2013.pdf> [Last accessed 30 May 2015]
- 2010 a: International Accounting Standards Board (IASB). 2010. Working Draft: *Liabilities (Feb 2010)*. [Online]. Available at: <http://www.ifrs.org/Current-Projects/IASB-Projects/Liabilities/Documents/IFRSLiabilitiesWorkingDraftFeb10.pdf> [Last accessed 24 May 2015]

Sources from A Guide through International Financial Reporting Standards (IFRS Foundation):

- 2014 a: IFRS Foundation. 2014. Chapter 3: Qualitative Characteristics of Useful Financial Information. *A Guide through International Financial Reporting Standards*. London. pp. A25-A31.
- b: IFRS Foundation. 2014. Chapter 4: The Framework. *A Guide through International Financial Reporting Standards*. London. pp. A33-A44.
- c: IFRS Foundation. 2014. International Financial Reporting Standard 3: Business Combinations. *A Guide through International Financial Reporting Standards*. London. pp. A139-A196.
- d: IFRS Foundation. 2014. International Accounting Standard 37: *Provisions, Contingent Liabilities and Contingent Assets*. *A Guide through International Financial Reporting Standards*. London. pp. A1291-A1315.
- e: IFRS Foundation. 2014. International Accounting Standard 38: *Intangible Assets*. *A Guide through International Financial Reporting Standards*. London. pp. A1317-A1354.
- f: IFRS Foundation. 2014. Chapter 1: The objective of general purpose financial reporting. *A Guide through International Financial Reporting Standards*. London. pp. A19-A22.

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**MAF 03: Public-Private Partnerships in South Africa: A  
tale of two prisons**

**Tim Prussing**

Department of Finance & Tax, University of Cape Town

**Carlos Correia\***

College of Accounting, University of Cape Town

Contact details:

\*Professor Carlos Correia

College of Accounting

University of Cape Town

South Africa

Email: [carlos.correia@uct.ac.za](mailto:carlos.correia@uct.ac.za)

**Abstract**

A public-private partnership is a contractual arrangement between a public entity and the private sector in order to enable the provision of services relating to infrastructure-based projects. A PPP project will include a concession agreement with an SPV, which will enter into contracts to finance, build and operate an infrastructure project for a fixed period of time. In order to overcome the significant overcrowding of prisons, the Departments of Correctional Services and Public Works adopted a procurement model of privately built and operated prisons from the UK. The South African government entered into two contracts for maximum-security prisons in Bloemfontein and Louis Trichardt with a concession period of 25 years. However, these prisons have been criticised due to the significantly higher costs of operating these PPP prisons.

This study analyses the project economics and funding arrangements of these two prisons to evaluate whether the costs, terms and financing rates were fair. The study analyses the NPV of the total costs of each prison as well as the cost per inmate and undertakes a comparable analysis of the IRRs, the costs of equity and implied equity premiums of these prisons in relation to PPP UK prisons and hospitals. The study also compares the cost per inmate in relation to PPP UK prisons. The cost per inmate for the South African prisons compares favourably to the cost per inmate in the UK, both on a capital expenditure and on an operating cost basis. However, the costs compare unfavourably to the costs of the public prison system.

The two South African prisons were highly geared and use was made of long term fixed rate debt at a time of historically high interest rates. The equity IRR and equity premium of Bloemfontein was significantly higher than Louis Trichardt and the latter's equity premium was aligned to equity premiums reported for PPP hospitals in the UK around the same time. The study benchmarks the total costs and financing costs and indicates how financing costs were impacted by unfavourable market conditions at the time of procurement. These projects were locked into high real interest rate yields and the use of floating rates or CPI-linked debt would have reduced costs over time. However, floating interest rates would have resulted in exposure to interest rate risk and significant cash flow and tax risks unless such risks were factored into contract prices.

## 1. Introduction

If structured and procured properly, Public Private Partnerships (PPPs) allow governments to pursue infrastructure projects in an efficient and cost effective way, offering value for money to the public and in some cases even enabling the development of infrastructure assets where traditional procurement would otherwise not have been possible ([CBI, 2011](#)).

Definitions for PPPs vary by country, framework and author. For the purposes of this paper, we understand a PPP to refer to a partnership between the public and private sector, where a private sector party participates in or provides support for the provision of infrastructure-based services ([Ng and Loosemore, 2007](#)). Delivery of the project is done through special purpose vehicle set up and typically financed from equity and debt in a highly leveraged structure ([Spackman, 2002](#)). As part of the partnership, the private party bears responsibility for financing, designing, building, operating and/or maintaining an infrastructure project for a set period of time ([Kwak, 2009](#)). This study explores South African prison PPPs as a case study.

### Problem statement

The problem of overcrowding and the cost of prisons in South Africa has been a key issue for government policy and funding in an environment of budgetary constraints and competing developmental objectives. A number of recommendations were made to reduce the cost of South Africa's prison services, including entering into PPPs to reduce costs and improve operating efficiencies.

This study analyses the two prison PPPs in order to determine whether these PPPs managed to achieve cost efficiencies and whether the PPPs led to a lower cost of prison services, including the cost of financing of these two prison projects.

## Research questions

The case study analyses the first two and only South African prison PPPs, which have been subject to significant criticism over their costs. Particularly, we focus on the following research questions:

- what was the background to the procurement of the prisons and what were the key terms and details of the projects;
- what were the total cost of the prisons and how do these costs compare to United Kingdom (UK) prison PPPs;
- what were the financing terms and were these fair; and
- could alternative financing solutions or structures have been used to bring savings to the public sector?

Firstly, we provide a background and an overview of these projects before reviewing key terms including the project structure, project costs and financing terms. We then calculate, analyse and benchmark the total costs of the projects before turning our attention to the financing costs. Financing costs are broken down (into cost plus a margin), analysed and benchmarked to assess whether the costs were priced competitively. We then isolate the impact of financing on the total cost of these projects and analyse if money could have been saved through employing some of the alternative funding methods.

## 2. Overview of the prison services and the PPP projects

Around the millennium, South Africa found itself at a significant shortage of prison space, which led to an overcrowding in the existing state-owned prison system. In order to address the problem of overpopulation, South Africa's departments of Correctional Services and Public Works imported a procurement model of privately built and operated prisons from the UK. The prisons were to be procured as PPPs and government called for private sector bids for the design and construction of 11 maximum-security prisons. Shortly after the public announcement, the number of prisons to be procured was revised down to only two contracts due to an underestimation of costs. In 2000, the South African government signed two 25-year concessions for maximum-security prisons in Bloemfontein and Louis Trichardt.

The winning consortia were responsible for designing, building, financing and operating the prisons before transferring them back to government after a 25 year operating term [a Design Finance Build Operate Transfer (DFBOT) contract] ([Farlam, 2005](#)). According to Ramagaga (2001), the South African overcrowding problem at the time was severe. The existing 241 prisons held a total of 162 162 prisoners but only had capacity for 118 154 people overcrowding the available prison space by as much as 37% ([Ramagaga, 2001](#)).

The first project procured as a PPP, was the Manguang prison in Bloemfontein (the "Bloemfontein prison"), which opened in July 2001 and became fully operational in January 2002. The second project was the Kutama-Sinthumule prison at Louis Trichardt in Limpopo (the "Louis Trichardt prison") which opened in February 2002 ([Open Society Foundation for South Africa, 2003](#)).



Shortly after the appointment of contractors and operators, the two PPP prisons became a topic of debate as the institutions were contracted to operate at much higher standards than prisons built and run by the public sector. Higher standards meant that these two prison PPPs attracted higher costs on a per prisoner basis than what existing public prisons were costing at the time. Critics of the PPP prisons argued that the costs far outweighed the claimed benefits of privatisation, and went as far as saying that high costs of these two prisons impacted the rest of South Africa's corrections system. Inquiries and reviews into the issue have shown that thousands of public sector jobs had to be frozen due to the money being allocated to the private prisons. While the two privately run prisons provided some additional capacity to the overall system, this was not nearly enough to address the general problem of overpopulation in the prison system.

Since then, South Africa's prison population has continued to rise resulting in even more overcrowding in the public prison system. As the private prisons are protected from overcrowding, additional prisoners have had to be accommodated within the state-run prisons ([Open Society Foundation for South Africa, 2003](#)).

In 2002, the National Treasury conducted a review of the two prison PPP deals providing some background to the deals and analysing their costs. According to the National Treasury, the specifications were designed with "inputs in mind rather than outputs". More specifically, the specifications for the prisons were imported from UK prisons, which had much higher standards than what was the norm for existing prisons, which resulted in a lack of parity to the rest of the country's correctional services system. The review also found that at the time of planning of the prisons, Treasury regulations for the procurement of PPPs were not yet in place. This lack of regulation meant that no feasibility study was conducted to test affordability, risk transfer and value-for-money. While the high specifications were a key factor contributing to the high cost of the prisons, this was deemed to be not the only cause. The review found that, among other factors, the high base interest rates at the time of the deals and a "higher than normal return on equity, reflecting the perceived risk of early deals", pushed up the long-term cost of the prisons to the public sector ([National Treasury, 2003](#)).

Du Plessis suggests that it was due to the high specifications and a high cost of financing at the time of procurement, that these prisons came at a cost which was forecast to take up roughly five per cent of the Department of Correctional Services' annual budget until at least 2026. In an effort to reduce costs, the Department of Correctional Services commissioned a consortium to try and find ways to make the private prisons more cost-effective. The consortium reported back in 2006 concluding that the contracts were inflexible and changes to the terms were impossible ([du Plessis, 2012](#)).

The Bloemfontein prison contract was signed in March 2000 with an opening date of July 2001 and a full capacity date of January 2002. The Louis Trichardt prison contract was the second South African PPP prison contract with an opening date of February 2002 and a full capacity date of September 2002. Both prisons were built with a similar capacity for around 3000 inmates.



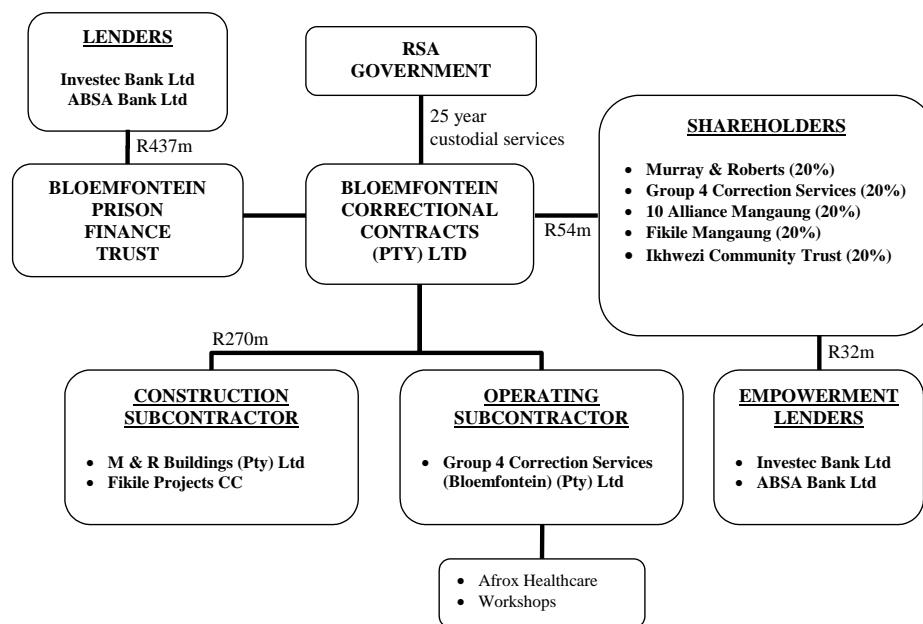
### 3. Ownership structures and contractual relationships

#### The Bloemfontein prison

Bloemfontein's PPP contract carried a 25-year operating term. Five equity investors each financed the project obtaining a 20% stake in the project. Notably, a large portion of the equity finance was financed by loans from empowerment lenders to the equity providers. Effectively, this increased the overall gearing on a look-through basis from an equity/debt ratio of 11:89 to a ratio of 5:95. The lenders provided financing to the SPV through a special trust, which was set up to provide debt finance to the project.

Construction and operations were subcontracted to separate providers out of the project SPV. Overall, the structure resembled that of a standard PPP. While the project gearing was high, this is not uncommon for projects receiving an availability payment based revenue stream ([National Treasury, 2003](#)). Figure 1 depicts the ownership structure of the Bloemfontein PPP project.

**Figure 1: Bloemfontein prison PPP ownership structure**

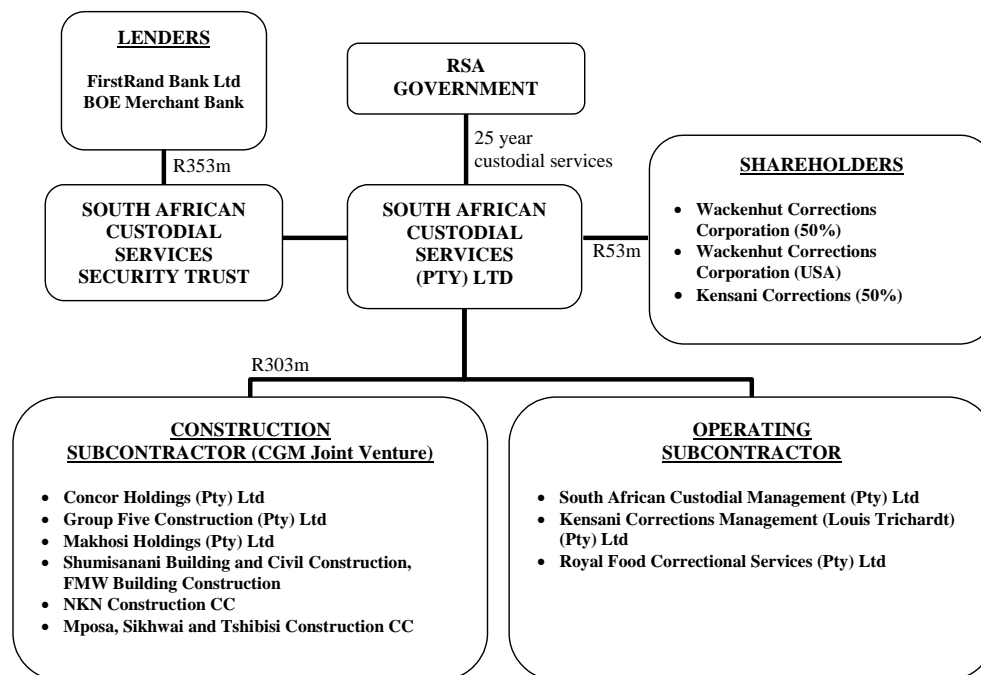


Source: National Treasury (2003)

#### The Louis Trichardt prison

The Louis Trichardt PPP contract also carried a 25-year operating term. Two equity investors financed the project, each obtaining a 50% stake in the project. The lenders provided financing to the SPV through a special trust set up to provide debt finance to the project. As with the Bloemfontein PPP, construction and operations were subcontracted to separate providers out of the project SPV. As with the Bloemfontein contract, the structure for the project also resembled that of a standard PPP contract ([National Treasury, 2003](#)). Figure 2 depicts the ownership structure of the Louis Trichardt PPP project.

**Figure 2: Louis Trichardt prison PPP ownership structure**



Source: National Treasury (2003)

### 3. Methodology

This study follows a case study methodology by undertaking a detailed analysis of two related projects, being the analysis of the costs and financing of the two PPP prisons in South Africa, which may affect public policy in the future. Case studies can be exploratory, explanatory and descriptive (Yin, 1993). Creswell (2003) defines the case study approach as the exploration in depth of a program, an event, an activity, a process, or one or more individuals and further states that the case is limited to a specific time period and activity.

This study undertakes a triangulation of data sources in relation to the structure and costs of two PPP prisons. This study applies macroeconomic data at the time and undertakes a comparative analysis by evaluating the costs of the South African PPP prisons to the costs of UK prisons and other PPP projects. Furthermore, corporate finance theory is applied to the data, as set out by the National Treasury, in order to derive some generalisations in regards to the costs of operating and financing of prisons using the PPP model.

### 4. Data Analysis

#### 4.1 Project economics

The total capital expenditure for the Bloemfontein prison was R435 million (approximately R954 million in real 2014 terms) of which R270 million (approximately R592 million in real 2014 terms) related to construction costs. Total capital expenditure for the Limpopo prison was R392 million (approximately R829 million in real 2014 terms) of which R303 million (approximately R640 million in real 2014 terms) related to construction costs. On a per

inmate basis, the Bloemfontein prison came in slightly more expensive than Louis Trichardt costing R148 566 per inmate compared to R129 630 ([National Treasury, 2003](#)).

It is noted that the pre-operating interest/fees for Louis Trichardt were significantly lower than for Bloemfontein. While insufficient information is available to determine the driver behind this difference with certainty, it is possible that the difference may have been caused by different drawdown profiles and priorities. The low pre-operating interest/fees for Louis Trichardt suggest that equity may have been drawn down before debt with most debt being drawn down towards the end of the construction period.

**Table 1: Summary of prison PPP costs and capacity**

Project	Bloemfontein		Louis Trichardt	
	Nominal	Real (2014)	Nominal	Real (2014)
Number of inmates	2,928		3,024	
Total capital expenditure (R million)	435	954	392	829
Construction (R million)	270	592	303	640
Pre-operating interest/fees (R million)	104	228	26	55
Start-up costs (R million)	58	127	49	104
Capital expenditure per inmate (R actual)	148,566	325,678	129,630	273,978
Construction cost per inmate (R actual)	92,213	202,145	100,198	211,774

*Source: Nominal figures as per National Treasury (2003), real 2014 figures based on own calculations*

## 4.2 Availability payments

While both projects were designed as availability payment type PPPs, the indexation mechanism of the availability payments for each project differed slightly. Both projects negotiated a variable and a fixed fee component. The fixed fee component is a non-indexed portion payable on a Rand per inmate capacity basis. The variable fee component is also payable on a Rand per inmate capacity basis, but is indexed at CPI inflation, which is further adjusted by a “K-factor”. The availability payment for both projects was thus adjusted by inflation plus the project specific factor on a semi-annual basis.

The Bloemfontein contract variable fee increased at inflation plus a factor of 0.623% in year one of operations. The factor thereafter slowly increased year on year to end up at inflation plus 0.789% in year 25 of operations. This profile seems to have been sculpted to more closely match project cash inflows to cash outflows. The key driver behind this profile was the forecast inflation of certain cost elements which was assumed to increase at a rate higher than CPI inflation ([National Treasury, 2003](#)).

The Louis Trichardt contract followed a slightly different schedule aiming to achieve a smoothing of returns, rather than a link to cost inflation. The K-factor for this contract was set at 1.06 (1 + 6%) in year two, decreasing by 0.01 (1%) every second year until it reached 1.00 in year 14 after which it stepped down to 0.97 (1 – 3%). Based on this profile, revenues increase at a higher rate than CPI inflation during early years and at a lower rate in later years. Project Finance deals typically are cash constrained in early years, while the project is still ramping up and while debt balances are at their highest levels.

For this reason, it is not uncommon for debt repayments to be sculpted during early periods, or for developers to negotiate capital grace periods to defer the repayment of debt principal. The downside for equity investors is that cash constraints during early years make it difficult to extract cash from the project, which can negatively impact equity returns. It is the authors' view that the K-factor for the Louis Trichardt contract would thus have allowed for a better smoothing of returns and resulted in the project being less cash constrained during early years.

As previously discussed, the payments for both projects were broken down into a fixed and variable component. The payments for both prisons were payable per inmate on a monthly basis over a period of 25 years from the start of operations. The payments are summarised in the table below.

**Table 2: Payments for the prison PPPs in real 2002 terms**

<b>Project</b>	<b>Bloemfontein</b>	<b>Louis Trichardt</b>
Variable fee per inmate (R' actual, 2002)	132.20	86.45
Fixed fee per inmate (R' actual, 2002)	83.50	73.91
<b>Total fee per inmate (R' actual, 2002)</b>	<b>215.70</b>	<b>160.36</b>

*Source: National Treasury (2003)*

The combination of fixed and variable fees with the variable fee being adjusted by a factor is a good example of how an availability type payment can be sculpted to smooth a project's cash flows. This technique is particularly useful for projects, which have cyclical or lumpy cash flow profiles. When paired with high gearing, cyclical or spiked cash flow profiles may present a challenge to projects using fixed rate debt. Normally, in order for such project to be able to meet debt service and stay within covenant requirements, debt repayments have to be sculpted and significant reserve accounts may have to be put in place. While sculpting the debt usually is not a problem for bank finance, it is not as easy to achieve a sculpted repayment profile if bond finance is used. However, there are still ways to effectively structure a project with bond finance even when project cash flows are lumpy. Such structures aim to manage variability and maximize flexibility while at the same time reducing cost. One such option is a structure, which combines bond finance with bank loans and/or facilities (such as a revolving credit facility). In such a structure, the more flexible bank loans and/or facilities act as a buffer for bond finance by offering more flexible repayment terms. Variability in cash flows is thereby absorbed by the more flexible bank loans and/or facilities while repayments on bonds remain fixed.

Crucially, having to sculpt debt may be seen by lenders as an indication of a more risky project, thereby attracting higher margins. Sculpting revenues presents an alternative to debt sculpting where the smoothing of cash flows is achieved through sculpting of cash inflows, rather than cash outflows. This technique can significantly decrease project risks and make a project more attractive from a financing perspective. A public sector considering this option should keep in mind that the required (real) budget requirement for a project would change from year to year (i.e. payments increase at a different rate than CPI). This may present a problem from a budgeting point of view in cases where a fixed portion of the budget would normally be set aside (which may increase by CPI inflation each year).

Another alternative solution is inflation-linked debt, which has a natural hedge to revenues, which typically are also inflation linked. The key issue around inflation-linked debt is that the market appetite for such typically is not as large as for fixed rate debt (although currently there is increased demand for inflation linked bonds due to inflation uncertainty). Nonetheless, it presents an attractive alternative, which is analysed in more detail later in this study.

#### 4.3 Analysis of total project costs

The 2002 National Treasury review suggested that the specifications of the prisons were designed with “inputs in mind rather than outputs” and that the specifications were imported from UK prisons which had much higher standards than what was the norm for existing South African prisons ([National Treasury, 2003](#)).

As the 2002 National Treasury review does not present the total public sector cost of the prisons, we estimate this by calculating the total estimated net present cost of payments<sup>13</sup> at the respective contract dates. We note that the overall cost of the two prisons is relatively similar with the Louis Trichardt prison being approximately 5% more expensive on a per inmate basis than the Bloemfontein prison. We have estimated the total cost assuming forecast inflation of 6% at contract date, as well as outturn inflation to 2014 and 6% thereafter.

**Table 3: Net present cost of prison PPP payments**

Project	Bloemfontein	Louis Trichardt
Net present cost using forecast inflation of 6% (Actual inflation to 2014 and 6% thereafter)	R1730 million (R1718m)	R1824 million (R1792m)

Source: Own calculations

To assess National Treasury’s argument that specifications being imported from UK prisons led to high total costs, we compare the total project costs calculated above to the costs of six Scottish PPP prisons procured at a similar time. Similar to the Bloemfontein and Louis Trichardt PPPs, these Scottish prison contracts were procured as PPPs of a design, build, finance, operate and maintain nature. Similarly to the South African prisons, the Scottish prisons were paid for using an availability payment mechanism over a 25 year operating period ([PricewaterhouseCoopers, 2001](#)).

The total cost for the Scottish prisons was calculated by PricewaterhouseCoopers as part of a review commissioned by the Scottish Executive Justice Department using a similar methodology to the one we applied in calculating the net present cost of South African PPP prisons. We have converted this cost into South African Rand to present the total cost per prison before calculating the cost per inmate and per inmate per year.

Notably, the total costs (discounted) of the South African PPP prisons were R1 717 million and R1 792 million respectively, which is less than the average total cost of the UK PPP prisons, which was R2 140 million. Despite having similar total costs, the South African prisons offered approximately six times the capacity of the UK prisons.

<sup>13</sup> Calculated by discounting the forecast payments over the project life. Discounted at 13.53% and 13.05% being the yield on the long-term (20 year) government benchmark bond at the time of agreement for Bloemfontein and Louis Trichardt respectively.

On a per inmate basis, the cost per prisoner was R586 749 for Bloemfontein and R592 593 for Louis Trichardt, compared to an average cost per prisoner of R3 609 264 for the UK prisons. On a per inmate per year basis (based on the 25 year operating term), this translates to R23 470 and R23 704 for Bloemfontein and Louis Trichardt and an average of R144 371 for the UK PPP prisons. The cost per inmate in the South African PPP prisons was therefore approximately one sixth of the cost per inmate in the UK PPP prisons.

However, there are limitations of undertaking a comparative analysis of the costs of the South African prisons to the costs of the UK prisons. This may be due to differences in specifications, differences in building codes, land values, differences in labour rates, and may be indicative of the nature of competition and firm concentration in the construction and security sectors as well as the imposition of other regulatory constraints. Yet, despite these limitations, the significantly lower costs of the South African prisons in comparison to the UK prisons should lead to a more balanced view in relation to understanding the drivers of the costs of the PPP prisons in South Africa.

Table 4 presents the net present cost per inmate of the South African prisons as compared to the UK prisons.

**Table 4: Net present cost of prison PPP benchmarked against UK prisons**

	Contract date	Total net present cost* Rm	Capacity	Cost per inmate	Cost per inmate per year
<b>Bloemfontein</b>	24/03/2000	1718	2928	586,749	23,470
<b>Louis Trichardt</b>	11/08/2000	1792	3024	592,593	23,704
Lowdham Grange	7/11/1996	1974	500	3,948,000	157,920
Kilmarnock	30/11/1997	1799	500	3,598,000	143,920
Ashfield	29/06/1998	1581	400	3,952,500	158,100
Forest Bank	2/07/1998	2551	800	3,188,750	127,550
Rye Hill	22/07/1998	1922	600	3,203,333	128,133
Dovegate	24/09/1999	3012	800	3,765,000	150,600
Average UK prison		2140	600	3,609,264	144,371

\*Total net present cost of UK prisons as at March 2001 and converted into South African Rand at an exchange rate of ZAR/GBP of 12.252

Source: Own calculations based on cost data as per PriceWaterhouseCoopers (2003)

The above analysis shows that even though specifications may have been imported from UK prisons, the cost per inmate was significantly lower for the South African prisons.

#### 4.4 Financing terms

Both projects were financed with debt and equity. The Bloemfontein project employed senior debt while the Louis Trichardt Project used senior debt and subordinated debt. Both projects were highly geared with equity to debt ratios of 11:89 (5:95 on a look-through basis) and 13:87 respectively. The Bloemfontein prison negotiated debt with a 13-year tenor<sup>14</sup>, a 2.25% margin and no capital grace period.

<sup>14</sup> The tenor refers to the term length of debt or a loan.

The Louis Trichardt Prison negotiated debt with a tenor of 18 years, a 2.50% margin and a 20 months capital grace period. The base interest rates at the time of agreement were fixed at 14.58% and 15% respectively ([National Treasury, 2003](#)). Based on an average inflation rate of 5.4% in the year 2000, we calculate the real base interest rates at 9.18% and 9.6% respectively. The cost of debt is analysed and benchmarked in more detail later in this report. Detailed data in regard to the cost of the debt financing arrangements are presented in Table 5.

**Table 5: Financing terms of prison PPPs**

	Bloemfontein	Louis Trichardt
<b>Funding</b>		
Equity (R million)	54	53
Total debt (R million)	437	353
Total funding (R million)	491	406
<b>Senior debt</b>		
Debt: Equity ratio	11/89	13/87
Tenor (post construction) - number of years	13	18
Repayments	Quarterly	Monthly
Grace period	None	20 months
Nominal base interest rate	14.58%	15.00%
Real base interest rate	9.18%	9.60%
Cost of Debt (margin on base rate)	2.25%	2.50%
Return on Equity	29.90%	25.10%

*Source: Data based on National Treasury (2003); real interest rate and debt to equity ratio based on own calculations*

#### 4.5 Analysis of financing

As suggested by the 2002 National Treasury review, the high costs of financing at the time of procurement were key cost drivers behind the two projects. Both projects were financed using a leveraged project finance structure. Financing costs can therefore be broken down into the cost of debt and the cost of equity. While the analysis presented in this paper will review both cost elements, the focus is on the cost of debt, which has received the most criticism.

##### 4.5.1 Methodology

In the following analysis, we first discuss and benchmark the cost of equity and cost of debt for the two projects. Due to a lack of publically available comparator information on South African PPPs, this benchmarking exercise is limited to a high-level analysis.

Thereafter, we estimate the cost of financing using the terms specified in the 2002 National Treasury review. We argue that market conditions at the time of procurement were highly unfavourable with base interest rates being close to a historic high.

Farlam (2005) argued that inflation-linked debt could have decreased the total costs of the two projects. To assess his argument, we estimate the total cost of financing using an inflation-linked debt structure. Following the discussion of debt financing, we discuss the options and benefits of refinancing the original debt under more favourable market conditions.



Lastly, we consider some of the alternative financing solutions discussed earlier in this paper and discuss whether any of these could have presented an alternative lower cost financing solution. We give particular focus to the option of a government contribution.

We perform the analysis of debt by isolating the estimated total debt service from the remainder of the project, as insufficient detail was available to model the entire project cash flows in detail. As the Department of Correctional Services gave bidders the option of a partially indexed availability payment with a K-factor, the profile of cash in- and outflows would have matched very closely, with project revenues following the overall cost profile.

The close matching of project cash in- and outflows means that there should be limited interaction effects between individual cash flows, allowing us assess and compare individual cash flows in isolation. The costs calculated in this exercise can therefore be directly compared among scenarios.

#### 4.5.2 Benchmarking the Cost of Equity

Equity returns for Bloemfontein and Louis Trichardt were shown to be 29.9% and 25.1% nominal ([National Treasury, 2003](#)), implying real equity returns of 23.2% and 18.6% respectively<sup>15</sup>. With 20-year government benchmark bonds yielding 13.53% on 24 March 2000 and 13.05% on 11 August 2000 (at the contract dates), the respective equity premia for Bloemfontein and Louis Trichardt can be calculated at 16.4% and 11.9% respectively. To test whether the equity returns were market related, an equity return benchmarking exercise should have been conducted during the feasibility study.

It is important to note that at the time of procurement and due to the prison PPPs being the first South African PPPs, no or limited comparable transaction information would have been available at the time. The returns would therefore have had to be benchmarked against a different group of assets or projects.

Today there is limited potential to analyse the returns in hindsight by considering comparable project finance transactions, which have taken place since then. Some comparators can be obtained from the South African REIPPPP (Renewable Energy Independent Power Producer Procurement Programme), which, according to Eberhard, Kolker and Leigland (2014), targeted 17% real equity returns in the first procurement round. This equates to approximately 24% nominal based on 6% CPI inflation<sup>16</sup>. To isolate the effect of underlying market rates at the time, we calculate and base the benchmarking on the equity premium.

The equity premium is the excess equity return over and above a risk-free benchmark rate. The implied equity premium can therefore be calculated by subtracting a benchmark risk-free interest rate (such as the yield to maturity on a government bond with a similar maturity) from the total equity return as measured by the nominal equity internal rate of return (IRR). This can be illustrated by the following equation where ERP presents the equity premium,  $E(r)$  the equity return and  $E(rf)$  the risk free rate.

$$ERP = E(r) - E(rf)$$

---

<sup>15</sup> Based on an average inflation rate of 5.4% in the year 2000.

<sup>16</sup> Based on the upper band of the target inflation rate and historical rates, which have been close to 6% in recent years.



The nominal returns thus imply an equity risk premium of 15.5% for the REIPPPP Round1. This would indicate that the prison PPPs may have been reasonably priced, keeping in mind that the procurements took place approximately 10 years apart and the projects had inherently different risk profiles ([Eberhard, 2014](#)). The equity risk premium for the REIPPPP of 15.5% was higher than the Louis Trichardt PPP prison but lower than the Bloemfontein PPP prison.

**Table 6: Prison PPP equity returns benchmarked against REIPPPP Round 1**

Project	Nominal Equity IRR	Real Equity IRR	Equity premium
Bloemfontein	29.9%	23.2%	16.4%
Louis Trichardt	25.5%	18.6%	11.9%
REIPPPP Round 1	24.0%	17.0%	15.5%

*Source: Equity IRRs based on National Treasury (2003) and Eberhard (2014); equity premia based on own calculations*

There is no publically available comparator information on South African PPP deals and while international comparators are of limited significance, such international benchmarks may offer an indication of whether the returns of South African Prison PPPs were within an acceptable range. A limitation with this type of comparison is that it ignores macro, regulatory and legal factors specific to a project and country.

With this caveat in mind, we consider a number of *Private Finance Initiative* (PFI) deals in the UK healthcare sector, which were procured at a similar time as the two South African Prison PPPs. The deals considered are typical social infrastructure *Design, Build, Finance, Operate* (DBFO) PFIs procured between 1997 and 2002. Hellowell reports the equity returns for the 10 PFI deals between 1997 and 2002 to have a range of between 12.43% and 22.58%.

This suggests an average return of 16.56% and a median of 15.65% ([Hellowell, 2013](#)). Based on these figures we calculate the range of equity premia at between 7.93% to 16.90%<sup>17</sup> with the average implied equity premium at 11.20% and the median equity premium at 10.63%. The approximate real equity IRRs<sup>18</sup> are within a range of 9.69% to 19.59% with a mean of 13.72% and a median of 12.82%

<sup>17</sup> Based on 25 year UK gilt rates in the month of contract start.

<sup>B</sup> Based on UK RPIX target inflation at the time of procurement.

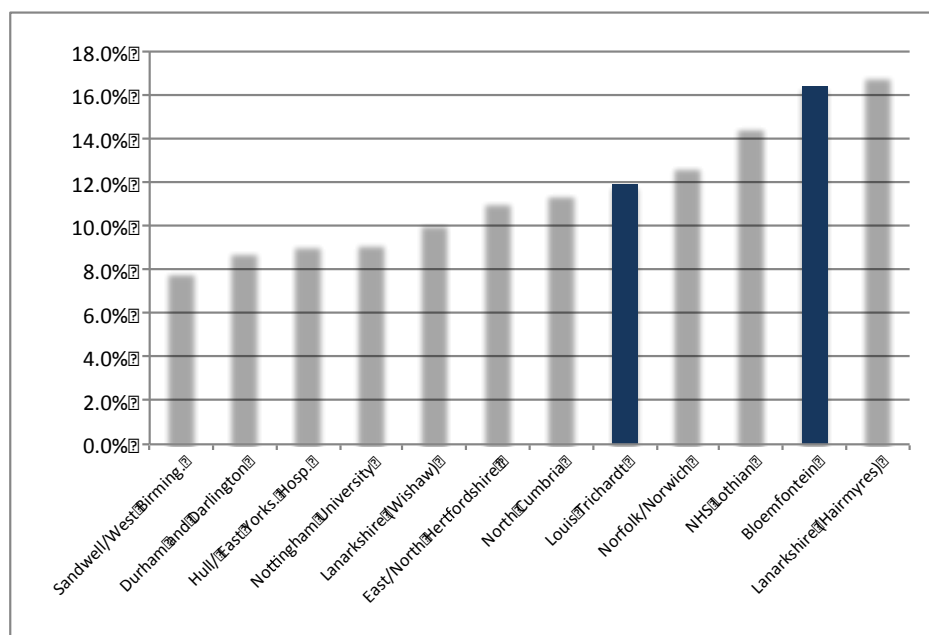
**Table 7: Equity returns for the prison PPPs benchmarked against UK PFIs**

Project	Contract start	Nominal Equity IRR	Real Equity IRR	25-year gilt at contract start	Implied equity premium
North Cumbria	Nov-97	17.8%	14.9%	6.3%	11.5%
Norfolk/Norwich	Jan-98	18.6%	15.8%	5.9%	12.7%
Durham and Darlington	Mar-98	14.5%	11.7%	5.7%	8.8%
Lanarkshire (Hairmyres)	Mar-98	22.6%	19.6%	5.7%	16.9%
Lanarkshire (Wishaw)	Jul-98	15.4%	12.6%	5.3%	10.1%
Nottingham University	May-99	14.8%	12.0%	5.6%	9.2%
NHS Lothian	Aug-98	19.7%	16.8%	5.2%	14.5%
East/North Hertfordshire	May-01	15.9%	13.0%	4.7%	11.1%
Hull/ East Yorks. Hosp.	May-01	13.9%	11.1%	4.7%	9.1%
Sandwell/West Birming.	Dec-02	12.4%	9.7%	4.5%	7.9%
Mean of comparators		16.6%	13.7%		11.2%
Median of comparators		15.6%	12.8%		10.6%
Bloemfontein	Mar-00	29.9%	23.2%		16.4%
Louis Trichardt	Aug-00	25.5%	18.6%		11.9%

Source: Dates and nominal IRRs based on Hellowell (2013); all else based on own calculations

With the equity premia for Bloemfontein and Louis Trichardt at 16.4% and 11.9% respectively, both project's equity returns fall within the range of comparative UK PFI equity premia at the time. While Louis Trichardt's equity premium is only 0.70% above the mean of comparators (11.9% - 11.2%), Bloemfontein's equity premium is closer to the upper end of the range. This is more clearly set out in Figure 3.

**Figure 3: Implied equity premiums for RSA and UK institutions**



It is worth noting that while payments extend over the life of the project, debt is repaid over a much shorter period. The time between the debt maturity date and the end of the project is typically referred to as the tail. The tenor of debt (measured from the start of operations) was 13 years in the case of Bloemfontein and 18 years in the case of Louis Trichardt implying a tail of 12 years and 7 years respectively. It is during this period, that equity investors typically extract significant cash due to lower overall costs, which free up project cash flow. Despite the longer tail, the equity premium of Bloemfontein was 4.5% higher than the equity premium of Louis Trichardt.

The shorter tenor also resulted in the average gearing for Bloemfontein being significantly lower than for Louis Trichardt, which in theory should have decreased equity returns, all else being equal. Further analysis indicates that increasing the tenor of the Bloemfontein debt to 18 years while decreasing the leverage to 87:13 (in line with the financing terms of Louis Trichardt) would have increased the equity IRR from 29.9% to approximately 33.9%<sup>19</sup>. Arguably, this could also be used as a basis to compare the returns of the two projects. With both projects having been procured at approximately the same time, being of similar sizes and with contracts under similar terms it is therefore not clear how the excess equity return for the Bloemfontein prison could have been justified. Perhaps, it is a premium for the project being a first-of-its-kind with contract signed about 6 months prior to Louis Trichardt.

#### 4.5.3 Benchmarking the Cost of Debt

In reviewing the cost of debt financing, we break down the all-in cost of debt into base rate and credit margin. The credit margin is set by lenders and is negotiated and priced according to the risk of the project. The base rates are market driven to the extent that interest rates are linked to such base rates. In the case of these two deals, both projects made use of fixed rate debt, which would have been set in line with market rates plus a swap margin. Complicating the benchmarking analysis of debt margins is the fact that all debt lent to South African PPPs has been financed by commercial lenders in private deals.

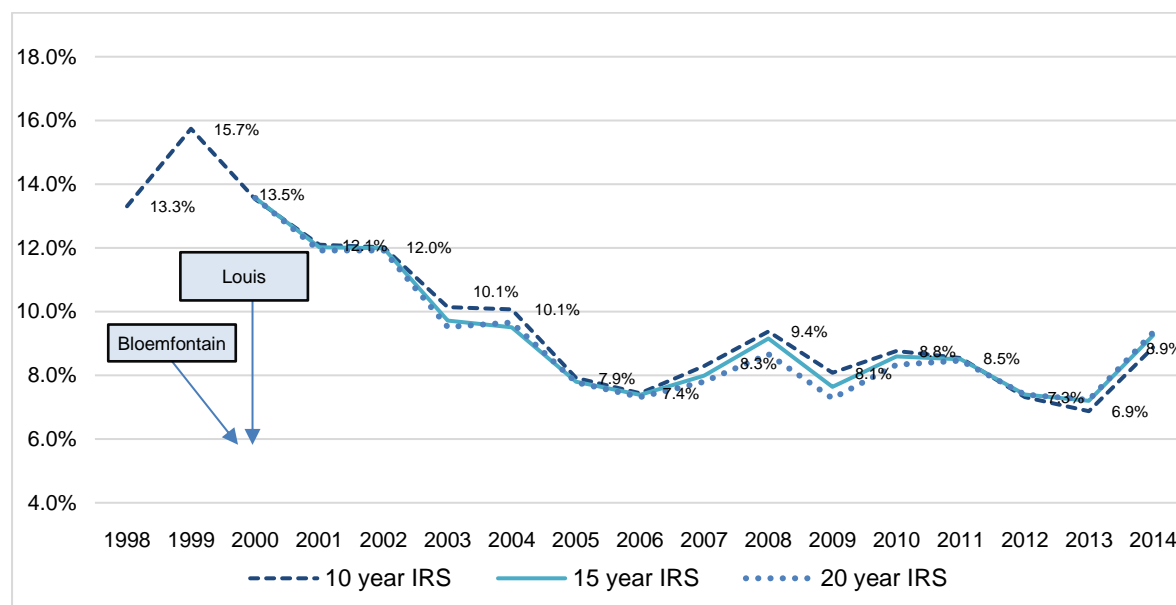
Ideally, we would have conducted a detailed analysis of the credit margins, but data on comparable South African credit margins at the time of procurement is not available. We do note that credit spreads for the two projects were quoted at 2.50% and 2.25% respectively. With margins being of similar magnitude while coming from different and competing lenders, it seems fair to assume that debt margins were priced competitively. To obtain an understanding of the magnitude, we compare the margins to the spread of the CPV Power bond which when first issued in March 2013, attracted a premium of approximately 5% over the South African government benchmark bond. This spread narrowed to approximately 3% after about one year of trading. Notably, this spread is significantly higher than the margins of 2.25% and 2.5% on the two South African prison PPPs. As such we conclude that there is an indication that the debt margins were priced competitively and limit further analysis to the base rate.

---

<sup>19</sup> Assuming a base availability payment of R215.7 per inmate in real April 2000 terms with 61.3% of the payment being indexed at CPI inflation bi-annually. CPI was assumed to be forecast at 6% at the time of the agreement, and adjusted for a K-factor of 0.623% increasing to 0.789% over 25 years. Debt is assumed to be amortised. Costs, as a balancing figure, were levelised over 25 years and increased at CPI inflation. Operating costs were assumed to be tax deductible and construction costs were assumed to be amortised for tax purposes over a period of 25 years.

As the following analysis will show, South Africa was experiencing a period of high nominal and real interest rates at the time of procurement. The figure below presents the 10, 15 and 20-year interest swap rates as observed in the South African market in January of each year between 1998 and 2014. With both Bloemfontein and Louis Trichardt reaching financial close around the year 2000, both projects financed the deals and locked into interest rates at a time at which rates were close to a 16-year high as observed in the market. The closest available benchmark for the base rates are the 15-year market swap rates which were quoted at 14.09% and 13.21% respectively. We note this is slightly lower than the rates of 14.58% and 15% as referenced in the 2002 National Treasury review. It is not clear what could have caused the difference.

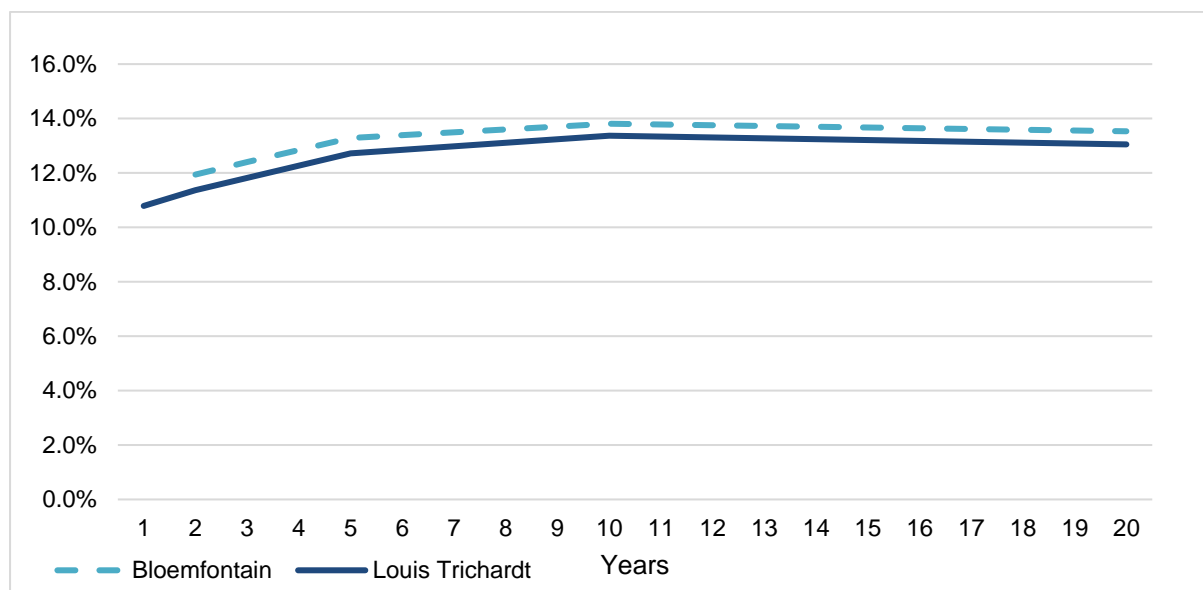
**Figure 4: Interest rate swap curve at time of prison PPP procurement**



Source: Thomson Reuters

The high swap rates seem to have been driven by high market rates as well as an expectation for market rates to remain high for a prolonged period, as indicated by the yield curve at the time of procurement. The figure below presents the yield curve at the contract date for both Bloemfontein and Louis Trichardt. Short-term yields at the time were between 11% and 12% while long-term yields were between 13% and 14%.

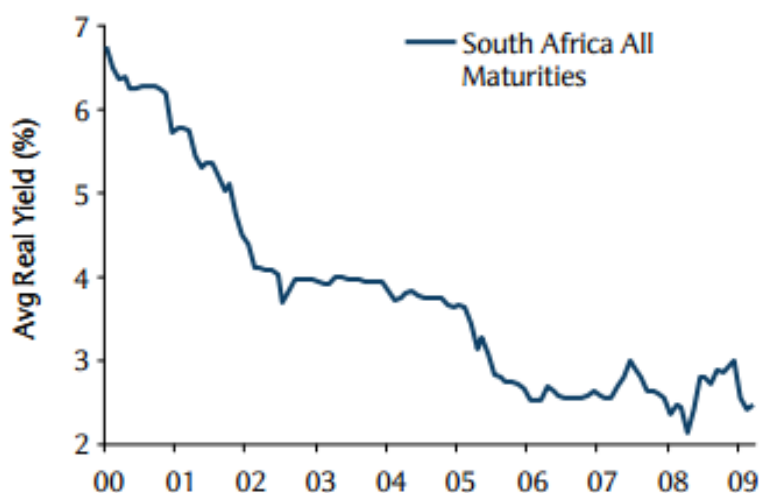
**Figure 5: Yield curves at time of prison PPP procurement**



Source: Thomson Reuters

The unusually high interest rates are further illustrated by the market implied real yields at the time of procurement. Figure 6 presents the real average yield of South African inflation linked bonds between March 2000 (when the first inflation linked bond was issued) and 2009. The real yield in 2000 was approximately 6.5% compared to a much lower average real yield over the period from 2000 to 2009 and an average real yield of 2.47% in 2009 ([Barclays Capital, 2009](#)).

**Figure 6 Historic real yields on South African inflation linked bonds**



Source: Barclays Capital (2009)

Crucially, both projects locked into fixed rate debt at a time when nominal and real market rates were unusually high.

#### 4.5.4 Discussion of the project rate of return

The above analysis argued that both projects locked into fixed rate debt at a time when market rates were unusually high while the actual credit margins seemed reasonable. Based

on an analysis of equity returns, Louis Trichardt seemed reasonably priced while the return for Bloemfontein was at the high end of the range. Crucially, both projects were financed using leveraged structures with high debt levels. With debt being cheaper than equity and also benefitting from a tax shield, this meant that the much lower cost of debt was the key driver behind the total cost of capital. Overall, Bloemfontein had a nominal project IRR of 18.27% while Louis Trichardt had a project IRR of 18.50% ([National Treasury, 2003](#)). By comparing this to the government benchmark rates at the time of procurement, we calculate that the projects came in at a 4.74% and 5.45% premium over the risk free rate. It could be argued that this premium represents the cost of privatisation and risk transfer to the private party.

**Table 8: Prison PPPs project returns**

Project	Bloemfontein	Louis Trichardt
Cost of Equity	29.90%	25.00%
Cost of debt (Pre-tax)	16.83%	17.50%
Cost of debt (After-tax)	12.12%	12.60%
Debt/Equity Ratio	12.36%	14.94%
Project IRR (A)	18.27%	18.50%
Government benchmark rate (B)	13.53%	13.05%
Premium (A-B)	4.74%	5.45%

*Source: Cost of Equity, pre-tax Cost of Debt and Project IRR based on National Treasury (2003); gearing and post-tax cost of debt based on own calculations*

#### 4.5.5 Discussion of floating rates and inflation-linked debt

The 2003 National Treasury review suggests that high base interest rates at the time pushed up the long-term cost of the prisons to government. The review does however not make any suggestions as to how this could have been avoided ([National Treasury, 2003](#)).

In his discussion of the contracts, Farlam agrees with the points made by National Treasury but suggests that the high base interest rates could have been avoided in favour of floating interest rates or CPI-linked debt ([Farlam, 2005](#)). While Farlam's argument of using floating interest rates may have reduced the overall project costs in the hands of the private party, financiers and developers would unlikely have agreed on such financing terms as it would have exposed them to interest rate risk. In a typical PPP, project cash flows are ring-fenced and all costs and debt service have to be met from the project cash flows. In the case of a default, lenders cannot seek compensation from beyond the project's assets and cash flows, as debt finance tends to be of a non-recourse nature.

Floating interest rates create a risk that base interest rates will rise unexpectedly causing the project to run into cash flow problems. In extreme cases, the project may run into a scenario where interest rates increase so far, that project cash flows are no longer sufficient to meet the debt servicing costs. Assuming financiers and developers would nonetheless have agreed on using floating interest rates, this would unlikely have led to cost reduction for the public sector. The deal was negotiated at a time when base interest rates were high.

Furthermore, market forecasts, as shown by the long-term swap curve as well as the yield curve at the time, were for interest rates to remain high.

As such, developers would have priced the deal under the assumption that interest rates would remain high for years to come. All else equal, the best estimate of interest rates at the time would have been the long term yield curve in which case pricing would have been similar under both floating and fixed rates. Arguably, some saving could have been achieved through the saving of the swap margin that would have been avoided by financing the project using floating rates. Offsetting this saving would have been higher credit margins and equity return requirements reflecting the increased risk around the uncertainty of interest rates. It may have been possible for the state to take on the risk of floating interest rates but it is submitted that this was unlikely at the time.

On a net basis, the use of floating rates would likely have outweighed the benefits of fixed rates while it is questionable if lenders would have agreed to such a structure in the first place. Assuming the project had still been financed using floating interest rates and without any increase in costs, a fall in base interest rates would only have reduced the costs in the hands of the private party and not the public sector, unless this was factored into the contract with the state.

If the public sector was prepared to structure payments on the basis of floating rates, then this may have enabled the use of floating rate debt. However, it is unlikely that the public sector would wish to take on interest rate risk, which may have led to budgetary constraints. As there was no way of predicting the future drop in interest rates at the time of agreement, the project would have been priced under the high base rates and, without a gain share, a drop in interest rates would have been to the benefit of the private party only.

While using floating rates may not have been an option, it is our view that the overall economic environment should still have been considered more carefully. At the time of procurement there was no way of knowing that interest rates would fall in future but such a scenario should at least have been considered. The analysis would have shown the impact on the project including the potential gains of a refinancing at more favourable conditions. Refinancing of debt is a common practise among PPPs with the contracts normally specifying terms for gain-shares to the public party. While the benefit of a gain-share can easily be identified in hindsight, it has to be acknowledged that gain-share clauses were not a common feature of PPPs in the early 2000s, even in developed markets.

It is our view that while using floating interest rates presents a risk to developers and financiers, inflation-linked debt can reduce risks by creating a natural hedge between interest and project revenues where such revenues escalate in line with inflation. For the two PPPs, linking interest rates to CPI inflation would have had the benefit of interest costs being hedged to the availability payments. To hedge the CPI exposure, bidders would likely have asked for a lower fixed and a higher indexed payment, which would have reduced the costs to the public sector under a scenario of low or falling inflation. Quantifying the impact of financing the deal using CPI linked debt is not straightforward. While there is clear benefit to the reduced risk from hedging interest rates through revenues, the overall impact is a function of various factors including the all in cost of debt. The scenario of financing the project with CPI linked debt is analysed in more detail in section 4.5.6.2.

#### 4.5.6 Estimated cost of debt financing under original terms

##### 4.5.6.1 Assumptions

We estimate debt finance costs as at project start date and under original project terms, where available. A number of simplifying assumptions have had to be made where information published was insufficient. Specifically, no information on the repayment terms beyond what is summarised in Table 5 has been published for either project. As such it is unclear what repayment profiles have been applied to the senior debt. Therefore, the following analysis is subject to this limitation.

Repayment profiles for bank debt in a project finance deal can take various forms including annuity style amortisation (keeping total debt service fixed), straight-line payments (keeping principal repayments fixed), bullet repayments as well as sculpted repayments. Additionally, some deals make use of a cash sweep, which uses excess cash to repay some of the outstanding debt early, thereby changing the overall debt repayment profile. For the purposes of this analysis and in absence of any additional information, senior debt we assumed an annuity style amortisation profile.

Such a repayment profile assumes total debt payments consisting of principal and interest to be the same in each repayment period. During earlier debt service periods, interest payments make up the majority of total debt service while principal repayments are the balancing figure. Over time and as principal is paid down, the principal portion of the total payment increases and the interest portion declines while the overall payment remains constant.

##### 4.5.6.2 Estimated costs at the time of agreement

The table below presents the total debt service for the Bloemfontein prison. In net present value terms, we calculate total debt service in 2001 for Bloemfontein as at R503 million<sup>20</sup> (an equivalent of R1 103 million in 2014 real terms). The net present value for the Louis Trichardt facility is estimated at R446 million<sup>21</sup> (an equivalent of R943 million in 2014 real terms). For Bloemfontein, the net present cost of interest only is calculated at R351 million<sup>22</sup> (an equivalent of R789 million in 2014 real terms). The interest cost for the Louis Trichardt facility is estimated at R367 million<sup>23</sup> (an equivalent of R801 million in 2014 real terms). Measured as a percentage of total project costs<sup>24</sup>, interest on debt made up approximately 20.3% in the case of Bloemfontein and 20.1% in the case of Louis Trichardt.

---

<sup>20</sup> Discounted at 13.53% being the yield on the long-term (20 year) government benchmark bond at the time of agreement.

<sup>21</sup> Discounted at 13.05% being the yield on the long-term (20 year) government benchmark bond at the time of agreement.

<sup>22</sup> Discounted at 13.53% being the yield on the long-term (20 year) government benchmark bond at the time of agreement.

<sup>23</sup> Discounted at 13.05% being the yield on the long-term (20 year) government benchmark bond at the time of agreement.

<sup>24</sup> As measured by the NPV of payments, see section 4.2.



**Table 9: Prison PPP cost of debt service under original terms**

Project	Bloemfontein Rm	Louis Trichardt Rm
Total debt service	1,211	1,339
NPV of debt service (2001)	503	446
NPV of debt service (2014, real)	1,103	943
Total interest on debt	722	933
NPV of interest (2001)	351	367
NPV of interest (2014, real)	789	801
NPV of debt service as % of total cost	29.1%	24.5%
NPV of interest as % of total cost	20.3%	20.1%

Source: Own calculations

#### 4.5.7 Estimated cost of debt financing using index linked debt

##### 4.5.7.1 Assumptions

In a typical inflation linked-debt structure, drawdowns and interest are calculated on a real basis before an inflation-uplift is applied to both elements. Interest is calculated based on a real interest rate plus a credit margin. The real interest rate typically is fixed for the term in which case a swap margin would apply (but can be floating as well). The inflation uplift is applied to both interest and capital. In calculating the estimated cost of inflation-linked debt, a forecast CPI inflation rate of 6%<sup>25</sup> was assumed. The credit margin was assumed to be the same as under the original terms with 2.25% for Bloemfontein and 2.50% for Louis Trichardt.

The real interest rates were thereby calculated by deflating the swap rates at 6% forecast CPI inflation to arrive at implied real rates of 8.09% and 8.49% respectively. To check the reasonability of these rates, such can be compared to the real yield of a South African government benchmark bond. For the purposes of this benchmarking exercise, we use the R189 inflation linked government bond. The R189 was the first South African inflation linked government bond, issued in March 2000 and yielded approximately 6.5% real at the time of procurement ([Barclays Capital, 2009](#)). While, this is slightly lower than the calculated real interest rates, the benchmark rate presents a floating real rate. By basing the calculated rates on the fixed rates (as per published terms), this calculation takes into account an estimate of the swap margin, which would have had to be paid to fix real interest rates. Consequently, we have based the analysis on the calculated real rates but use the benchmark rate as a sensitivity factor.

##### 4.5.7.2 Estimated costs at the time of agreement

The table below presents the estimated total debt service for the prisons assuming inflation-linked debt. The benefit to the public sector can be calculated by comparing the net present value (NPV) of debt service under inflation-linked debt to the NPV of debt service under the base case. For Bloemfontein this NPV in 2001 is calculated at R486 million<sup>26</sup> (an equivalent

<sup>25</sup> In line with the upper band of the South African target inflation band set at 3% to 6%.

<sup>26</sup> Discounted at 13.53% being the yield on the long-term (20 year) government benchmark bond at the time of agreement.

of R1 065 million in 2014 real terms). The cost for the Louis Trichardt facility is estimated at R436 million<sup>27</sup> (an equivalent of R922 million in 2014 real terms).

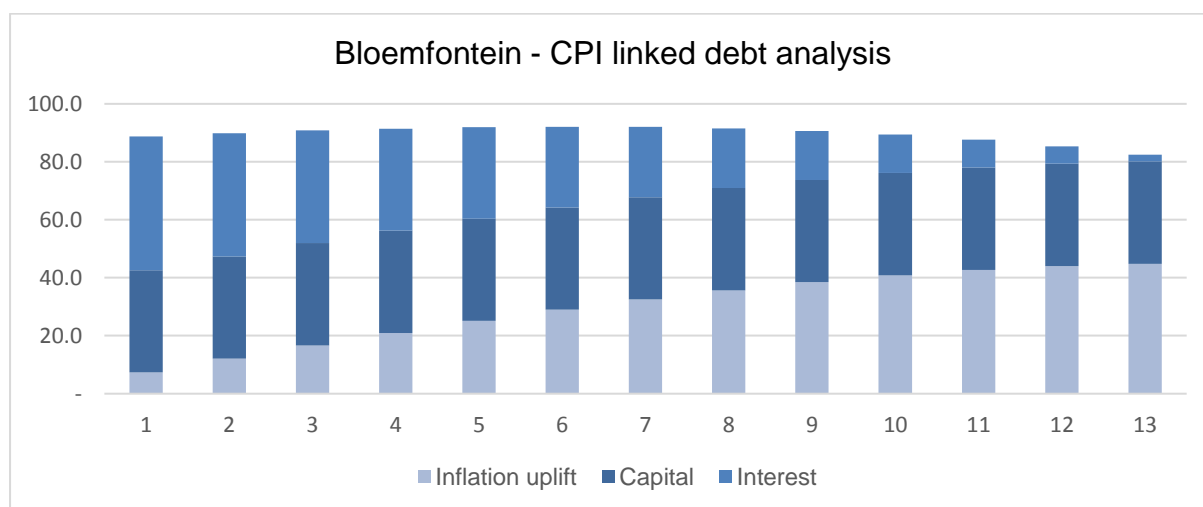
**Table 10: Prison PPP cost of debt service using inflation linked debt**

Project	Bloemfontein Rm	Louis Trichardt Rm
Total debt service	1,164	1,317
NPV of debt service (2001)	486	436
NPV of debt service (2014, real)	1,065	922
Savings compared to base case	17	10
Savings as a percentage of total costs	1.0%	0.6%

Source: Own calculations

As shown in the above analysis, moving to inflation linked debt would only have introduced marginal benefits of approximately R17 million and R10 million respectively (0.98% and 0.55% as a percentage of total project costs). This confirms that the total cost of debt would remain high using inflation linked debt, as base rates remain the key driver behind the total cost of financing. The following figures present the estimated debt service for inflation-linked debt under the assumptions outlined above.

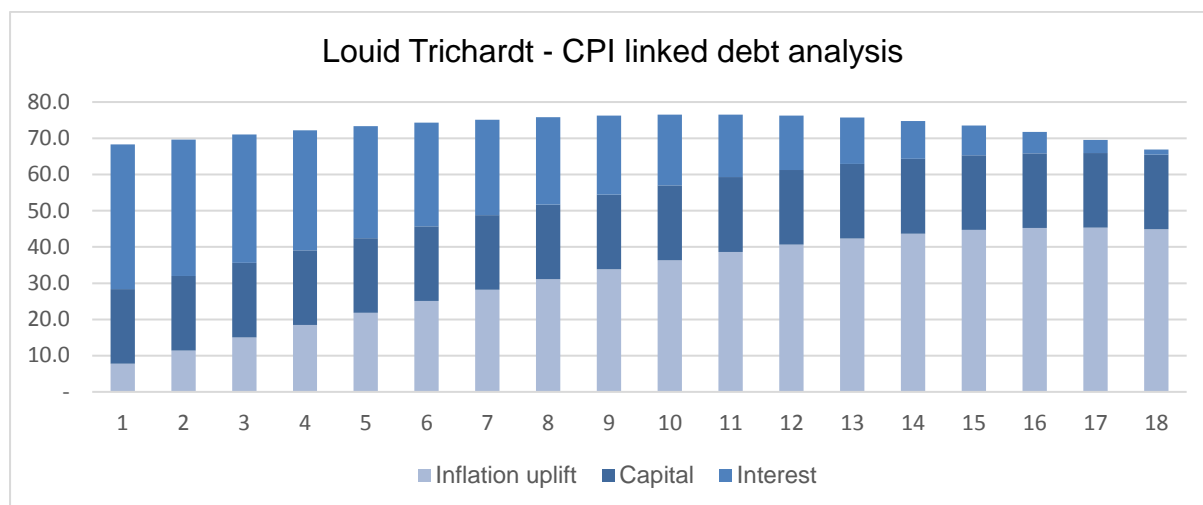
**Figure 7: Bloemfontein inflation linked debt profile:**



Source: Own calculations

<sup>27</sup> Discounted at 13.05% being the yield on the long-term (20 year) government benchmark bond at the time of agreement.

**Figure 8: Louis Trichardt inflation linked debt profile**



Source: Own calculations

#### 4.5.7.3 Sensitivity analysis of the estimated costs at the time of agreement

As a sensitivity analysis, we repeat the previous analysis using a real interest rate of 6.5% based on the real yield of the R189 inflation linked government benchmark bond. Under the sensitivity, moving to inflation linked debt would have introduced benefits of approximately R54 million and R19 million respectively (3.1% and 3.2% as a percentage of total project costs) which is significantly higher than the benefits of R17 million and R10 million in the base case. Notably, this sensitivity analysis omits the cost of a swap margin, which would reduce the benefit somewhat.

#### 4.5.8 Alternative financing options

In this section we consider whether some of the alternative financing solutions could have been beneficial for the two prison PPPs. Particularly, we discuss bond finance and a government contribution, as other options such as monoline insurance, development bank finance and government finance guarantees are either not applicable or would likely not have worked in a first-of-its-kind deal in a country which had no formal prior PPP experience at the time of procurement.

##### 4.5.8.1 Bond finance

Bond finance presents an alternative to bank finance, which can often turn out to be cheaper but also tends to be less flexible. Research suggests that bond financing requires a well-developed and active capital market with sufficient appetite for the bond issue. A key disadvantage to bond issues is that the cost of debt is unknown until the finance has been raised. For highly leveraged projects, such as these two PPPs, this can present a challenge.

It can be argued that the size of the two projects was too small to reap any of the benefits of a bond issue. At the time of procurement, project bonds had not yet been tested in the South African market and this would have presented the first such bond issue. It is therefore questionable if bond finance could have worked for these projects. A private placement could have been considered, however due to lack of market data, it is not clear if there would have been sufficient appetite among investors.

#### 4.5.8.2 The case for a government contribution

Financing costs presented a significant portion of total project costs. The financing costs, as discussed, were driven by the high base rates at the time of procurement. Given the high base rates, which lead to a high cost of debt and equity without a gain share mechanism, we argue that a government contribution towards the construction costs of these projects could have significantly decreased costs.

Providing a government contribution towards the construction costs of a PPP reduces private funding requirements by the same amount and alters the risk profile of projects. As private funding tends to be more expensive than government funding (the cost of public sector funding is measured at the risk-free rate), providing a contribution can significantly reduce overall project costs. How would this margin impact on costs? We use an extreme example to indicate the long-term impact of spreads or margins. We will assume for the purposes of this illustration that the total cost of R491m and R406m is borrowed and the principal and interest is payable as a bullet payment in 25 years time.

*Table 11: Future value of capital and rolled-up interest*

Cost (Rm)	491	406
Risk-free rate (government bond yield)	14.58%	15.00%
Margin	2.25%	2.50%
Borrowing rate	16.83%	17.50%
Future value of debt and interest at (Rf)	14,750.3	13,365.1
Future value of debt and interest at (Rf+ margin)	23,985.1	22,880.9

The cost would be effectively amortised over a 25 years or a shorter period but the above analysis indicates the potential impact on total cost of a relatively competitive margin of 2.25-2.5% at the time if the cost was not amortised. The cost would be 1.63 to 1.7 times the cost if funded directly with government debt. The effective amortisation of the debt would reduce this cost difference but the above analysis serves to indicate the potential impact on the total cost by undertaking private borrowings to finance the projects.

However, the disadvantage of a contribution is that it may decrease risk transfer as it reduces the private party's investment in the project. In certain circumstances, the reduction in risk transfer could result in a decrease in value for money, which should be considered carefully in evaluating the option.

In South Africa, it is common for the public sector to provide a contribution to PPP projects, especially on projects with large capital outlays as evidenced by the 5 out of the 11 South African DFBOT PPPs which have received contributions ranging from 10% to 87% of capital value ([PPP Unit, 2013](#)).

#### 4.6 Conclusions in respect to financing options

The 2002 National Treasury review suggested that the operating costs of the PPP prisons (i.e. operating cost excluding financing) were relatively competitive but argued that total costs were nonetheless high due to specifications being imported from UK PPP prisons. In our analysis, we compared the total cost of the prisons to a number of UK PPP prisons and

found that the cost per inmate was approximately six times less expensive than the cost per inmate for UK prisons built around the same time.

Some have criticised the financing costs and suggested that these were a key driver behind the overall costs of the prisons. While our analysis confirmed that the financing costs of the PPP prisons were high, this seems to have largely been driven by unfavourable market conditions at the time of procurement, and not by excessive returns. Once we isolated the impact of high base interest rates at the time of procurement, we found, that financing costs seemed reasonably priced.

While alternative funding solutions, such as inflation linked debt or bond finance, may either not have been possible or not have been able to bring significant cost savings, there is a strong argument that the Department of Correctional Services should have explored other financing structures more closely and thereby should also have considered the option of a government contribution. While we acknowledge that the impact on risk transfer and value for money would also have had to be considered, our analysis showed that a government contribution could have resulted in significant cost savings.

#### **4.7 Lessons learned**

A key issue with the two deals was the inflexibility of contract terms, which locked the public sector into payments driven by the high initial costs. Failure to consider and include clauses for gain-share mechanisms meant that there is no upside or claw back mechanism for the public sector. However, both prisons were procured at a time when gain share mechanisms were not common practise among PPPs, even in developed PPP markets.

While we have not discussed or examined the output specifications as part of this paper, the review done by National Treasury suggests that the specifications were set unnecessarily high. Thus, the Department of Correctional Services should possibly have considered a more flexible and cheaper prison design. A more flexible and structured financing solution that included a government contribution would have reduced the total costs of the prisons.

#### **4.8 The future of PPP prisons in South Africa**

According to du Plessis, the future for PPP prisons in South Africa does not look bright. Following the procurement and building of the first two PPP prisons in Louis Trichardt and Bloemfontein, former president Thabo Mbeki, in his 2002 State of the Nation Address, announced the building of the next four new prisons in Nigel, Klerksdorp, Leeuwkop and Kimberley, with 3,000 bed spaces each.

The announcement came a few months after the completion of the first two prison PPPs, but there was no indication of whether these new facilities would be state-controlled or be run as PPPs. Only the Kimberly prison was built as a public sector initiative financed and run by the state, and not as a PPP. In 2006, Mbeki announced the building of four more prisons in Paarl, Port Shepstone, East London and Polokwane. None of these prisons have been built to date.

By 2008, the Department of Correctional Services decided to go ahead with four different prisons, all of which were in new locations being Klerksdorp, East London, Nigel and Paarl. These prisons were to be procured as PPPs and four consortiums were shortlisted. In November 2011, Correctional Services Minister Mapisa-Nqakula called a press conference

to announce that the procurement of the new PPP prisons was cancelled because the tender requirements had changed to such an extent that bids fell short of the new criteria. It was estimated that each consortium had spent R20 million on their bids which were not recoverable ([du Plessis, 2012](#)).

While the unrecoverable bid costs most certainly were a large cost to the consortia, the actual cost of cancelling the projects may have had a more significant impact causing a lack of credibility for the public sector and the South African PPP framework. Bidders already have to bear significant risks in bidding for a contract and may choose not to tender for future projects if there is a lack of credibility and risk of procurements being cancelled.

## **5. Conclusions and summary**

Given the highly levered nature of a typical PPP, debt plays a key role in the financing of PPPs. We therefore focussed on debt financing solutions and discussed the various options available. Comparing this to the financing solutions used on South African projects, we found that the South African market is heavily reliant on bank debt. While the South African PPP framework is well developed, the number of projects procured under the framework has been too low for the market to properly develop a deep available PPP financing market. Li found that such an available financial market was one of the top three factors required for the development of successful PPPs in the UK ([Li, 2005](#)). The lack of alternative funding solutions for South African PPPs may be hindering the development of future projects and driving up costs.

While the recent REIPPPP cannot technically be classified as a South African PPP, the programme shared numerous similarities with PPPs. The REIPPPP was a positive development for the financing market as it caused an increase in interest among institutional investors and development banks, both local and international. The increase in involvement by such parties may be signalling that investors are slowly opening up to South African infrastructure project finance deals. The issue of the first investment grade infrastructure project bond, in particular, is a strong indication that the South African infrastructure project finance market may be developing and readying itself for alternative financing solutions.

In this study, we assessed the various criticisms of the PPP prisons but found, that the total cost (on a per inmate basis) was significantly lower than the cost of UK PPP prisons at the time, although such comparisons are subject to limitations. We also found that financing costs, which received significant criticism, were driven by unfavourable market conditions at the time. Once we isolated the unusually high market interest rates, we found that financing costs for the prisons seemed to have been priced competitively. It is submitted that a government contribution could have brought significant savings to the public sector. We do however note that the prisons were procured before South African Treasury Regulations for PPPs were put in place. Currently, South Africa requires the Treasury to approve PPPs proposals in a four stage process before the signing of a contract ([Irwin, 2010](#)). A feasibility study is conducted as part of the approvals process which aims to assess costs and value for money under various financing options ([PPP Unit, 2004](#)). It should be noted that while this process, in theory, should result in more optimally structured deals, the final cost is still heavily impacted by the state and availability of suitable and effective financing solutions.

Hence, a deep and available financial market should be one of the key objectives for policy makers and industry participants.

#### *Recommendations for further research*

The success of the Renewable Energy Independent Power Producer (REIPPP) programme, which has resulted in the investment of over R100 billion in three years up to 2010, stands in stark contrast to the lack of the success of the PPP prisons. It would be relevant to research the factors that led to the success of the REIPPP programme, undertake a comprehensive comparative analysis in relation to the PPP prisons and derive policies and the management strategies that may be applied in other PPP projects.

This study employed data that was publicly available and it would be useful to use a more extensive data set in order to undertake a more precise analysis of the costs of the PPP prisons in relation to the costs of publicly operated prisons. In particular, the effective cost subsidy of overcrowding in the current public prisons should be taken into account in making comparisons.

This study focused on a limited comparative analysis of PPP prisons to the UK experience. This comparative analysis can be extended to other countries such as the USA, which has a long experience with privately owned and operated prisons.

#### **Conclusion**

This study provides equity benchmark returns for early South African PPP projects by comparing such project returns to both local and international comparators. It provides a response to some of the critics of the South African prison PPPs and expands on areas, which the 2002 National Treasury review did not review or evaluate. Furthermore, this study calculates the total cost of the South African prison PPPs and benchmarks this against a set of international comparators. Subject to limitations, the conclusions of this study indicate that costs and returns implicit within the PPP prisons were not unreasonable in relation to the UK PPP projects, and simply reflect high market interest rates at the time. Spreads and equity premiums appeared to be reasonable, particularly for the Louis Trichardt prison. Whilst, the objective of the study was not to compare costs and returns in relation to the public prisons, the lower costs of the public prisons may also reflect the impact of overcrowding on the relative costs per inmate. Whilst PPP prisons may not be optimum in terms of public policy, an analysis of the costs and returns of such prisons should lead to a more accurate assessment of PPP projects in South Africa.

#### **References**

- AKBIYIKLI, R., EATON, D. & TURNER, A. 2006. Project finance and the private finance initiative (PFI). *The Journal of Structured Finance*, 12, 67-75.
- ASENOVA, D. & BECK, M. 2003. The UK financial sector and risk management in PFI projects: a survey. *Public Money and Management*, 23, 195-202.
- BARCLAYS CAPITAL 2009. South Africa Government Inflation-linked Bond Index Guide. Johannesburg.

- BOVAIRD, T. 2004. Public-private partnerships: from contested concepts to prevalent practice. *International Review of Administrative Sciences*, 70, 199-215.
- CBI 2011. Written evidence submitted to UK House of Commons Select Committee on Private Finance Initiative funding. *"House of Commons Committee news", Confederation of British Industry evidence*.
- CRESWELL, J.W. 2003. Research Design: Qualitative, Quantitative and Mixed Approaches, 2<sup>nd</sup> edition, Sage Publications, Thousand Oaks, California
- DAVIES, P. & EUSTICE, K. 2005. Delivering the PPP promise: A review of PPP issues and activity. *London: PWC*.
- DEPARTMENT OF ENERGY 2011-2013. REIPPPP Tender Notices and Briefing Notes. accessed online at <http://www.ipp-renewables.co.za>.
- DU PLESSIS, C. 2012. How The Private Prisons Were Barred. *Criminal Justice Initiative of Open Society Foundation for South Africa*.
- EBERHARD, A., KOLKER, J. & LEIGLAND, J. 2014. South Africa's Renewable Energy IPP Procurement Program: Success Factors and Lessons. *PPIAF*.
- ESTY, B. C. 2004. Why study large projects? An introduction to research on project finance. *European Financial Management*, 10, 213-224.
- FARLAM, P. 2005. *Working together: assessing public-private partnerships in Africa*, South African Institute of International Affairs.
- GRIMSEY, D. & LEWIS, M. K. 2002. Evaluating the risks of public private partnerships for infrastructure projects. *International Journal of Project Management*, 20, 107-118.
- HELLOWELL, M. 2013. What return for risk? The price of equity capital in public-private partnerships. *Rethinking Public-Private Partnerships: Strategies for Turbulent Times*, Routledge, Oxon, 57-77.
- HM TREASURY 2002. Refinancing of early PFI transactions: code of conduct. London, UK.
- IRWIN, T. 2010. Managing Contingent Liabilities in Public-Private Partnerships. Washington DC: The World Bank, PPIAF.
- KWAK, Y. H., CHIH, Y. & IBBS, C. W. 2009. Towards a comprehensive understanding of public private partnerships for infrastructure development. *California Management Review*, 51, 51-78.
- LI, B., AKINTOYE, A., EDWARDS, P. J. & HARDCASTLE, C. 2005. Critical success factors for PPP/PFI projects in the UK construction industry. *Construction management and economics*, 23, 459-471.
- NATIONAL TREASURY 2003. Review of the Public Private Partnership Prison Contracts: National Treasury briefing to Portfolio Committee on Correctional Services. Pretoria: National Treasury.
- NG, A. & LOOSEMORE, M. 2007. Risk allocation in the private provision of public infrastructure. *International Journal of Project Management*, 25, 66-76.
- NGAMLANA, P. X. 2009. *Improving public-private partnership deal flow for infrastructure delivery in South Africa: the role of National Treasury*. Stellenbosch: University of Stellenbosch.
- OPEN SOCIETY FOUNDATION FOR SOUTH AFRICA. Prison Privatisation. Prison Privatisation, 2003 Cape Town.
- PPP UNIT 2004. Public Private Partnership Manual. In: TREASURY, N. (ed.). Pretoria, South Africa.



- PPP UNIT 2013. PPP Projects signed in terms of Treasury Regulation 16, AS AT. Pretoria, South Africa: National Treasury.
- PRICEWATERHOUSECOOPERS 2001. Financial Review of Scottish Prison Service Estates Review.
- RAMAGAGA, T. 2001. Lessons from Prisons & Public-Private Partnerships in South Africa. *National & International Perspectives on Crime and Criminal Justice*, Crime and Justice Programme, Institute for Security Studies, Conference presentation, National & International Perspectives on Crime and Criminal Justice, 1-2 December, 2011, Johannesburg.
- REGAN, M., SMITH, J. & LOVE, P. E. 2010. Impact of the capital market collapse on public-private partnership infrastructure projects. *Journal of construction engineering and management*, 137, 6-16.
- SPACKMAN, M. 2002. Public-private partnerships: lessons from the British approach. *Economic Systems*, 26, 283-301.
- THE WORLD BANK 2012. Focus on Public-Private Partnerships.
- YIN, R. (1993). *Applications of case study research*. Newbury Park, CA: Sage Publishing.
- ZHANG, X. 2005. Criteria for selecting the private-sector partner in public-private partnerships. *Journal of construction engineering and management*, 131, 631-644.

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**MAF 04: Dividend Yield as a Model for Value Investing on  
the JSE**

**Celso Zuccollo**

College of Accounting, University of Cape Town

**Carlos Correia\***

College of Accounting, University of Cape Town

Contact details:

\*Professor Carlos Correia

College of Accounting

University of Cape Town

South Africa

Email: [carlos.correia@uct.ac.za](mailto:carlos.correia@uct.ac.za)

**ABSTRACT**

In terms of the efficient market hypothesis, equity prices reflect all available relevant information and evidence indicates that active investing is not able to consistently offer higher returns than a strategy of passive investing. Yet a value investing strategy, following on the principles of Graham and Dodd and further expanded by Buffett and other value investors, implies that searching for and investing in companies trading below intrinsic value provides higher risk adjusted returns than comparable market proxies. Value investing may include a number of strategies such as investing in low P/E companies and investing in companies trading below net tangible value. Another value investing strategy involves finding and investing in high dividend yield companies or investing in companies offering dividend yields at least equal to 2/3 of the long-term government bond yield. The objective of this study is to evaluate whether investing in a portfolio of high dividend yield companies provides significantly greater returns than investing in a relevant market proxy or a portfolio of low dividend yield companies. This study ranks shares on the basis of dividend yields and back-tests share returns of investing in a portfolio of high dividend yield shares in relation to a relevant market proxy and/or investing in a portfolio of low dividend yield shares. In order to address to some extent the issue of survivorship bias, the relative returns of investing in high dividend yield shares as identified in prior published research reports are compared to the returns of investing in a relevant market proxy.

## 1. Introduction

In the book “Security Analysis,” Benjamin Graham and David Dodd (1934) introduced the strategy of *value investing* which has subsequently become one of the most widely-accepted strategies in the investment community. Value Investing is the search for companies that are trading at a price which is less than the intrinsic value of the assets that the business currently has in place (Damodaran, 2012).

The purpose of this study is to evaluate whether value-investing strategies outperform the market index by selecting high dividend yielding shares to construct a value portfolio.

These “value” stocks are thought to be created as a result of the “Overreaction Theory,” which proposes that equity investors often overreact to new information, resulting in some security prices deviating meaningfully from their intrinsic values, for a prolonged period. This overreaction is then followed by “mean reversion,” as these securities trade back to their intrinsic values over time, thereby allowing investors to attain abnormal returns should they correctly identify these mispriced stocks. De Bondt and Thaler (1985) found long-term negative serial dependence, consistent with investor overreaction for the NYSE. Cubbin, Eidne, Firer, and Gilbert (2006) found significant evidence of investor overreaction for the JSE, which suggests that investors could potentially attain abnormal risk-adjusted returns by following a value investment strategy on the JSE.

In order to identify “value” stocks, Graham (1949) suggested a number of investment screens<sup>28</sup>, based on underlying company fundamentals. The most widely-used of these screens identify companies that have high dividend yields, low price/earnings ratios and low price/tangible net asset value (“Price/Book”) ratios (Visscher & Filbeck, 2003). Studies have tested the effectiveness of these screens in allowing investors to produce abnormal returns, and persistent, significant evidence has led academics to conclude that it is difficult to deny the existence of the value effect (Fama & French, 1998). The question, however, is whether this value effect is an invalidation of the Efficient Market Hypothesis (EMH), or evidence of risk factors that are not accurately captured by CAPM (Lintner, 1965; Mossin, 1966; Sharpe, 1964; Treynor, 1961). This therefore means that the performance of value stocks should be analysed on the basis of relative returns and risk-adjusted returns.

The majority of studies on value investing have been conducted on stock markets in developed economies. The majority of value investing research studies have focused on the price/earnings (Basu, 1977) and price/book screens (Fama & French, 1992; Lakonishok, Shleifer, & Vishny, 1994); or these screens in conjunction with a dividend yield screen. This means that the effectiveness of value investing strategies based on dividend yields alone remains a relatively under-researched area. Due to the ease and lack of investment expertise required to implement such a strategy, evidence that it could provide abnormal risk-adjusted returns could provide a valuable tool for the equity market investor.

The purpose of this study, therefore, is to analyse the effectiveness of value investing in a South African emerging market context. The study focuses specifically on the use of the high

---

<sup>28</sup> A screen is a technique to filter a large number of possible investments based on values for selected variables. For example, an investment screen may be constructed to identify shares with a dividend yield above 5%. Alternatively, an investment screen could be constructed to select shares with a price to book ratio of less than one.

dividend yield screen as a measure to identify value stocks, and therefore obtain abnormal risk-adjusted returns on the JSE. A back-test of a portfolio of the 30 highest dividend yielding stocks on the JSE is performed over the period from 1 January 2006 to 31 December 2015. The returns generated by this portfolio are then benchmarked against the returns attained on the FTSE/JSE J203 All Share Index (ALSI) Total Return Index (TRI) and other relevant market proxies. These returns are compared on an absolute, and Sharpe (1966) ratio basis, after adjusting for taxes and transaction costs.

Arguably, the conceptual basis for many of the value indicators may be a puzzle for academic studies outside the realm of behavioural finance. As a general study of value investing, the period studied extends the recent study by Van Heerden and Van Rensburg (2015) on value indicators by four years. In relation to the use of DY specifically, this may involve different risk-return profiles relative to other value indicators. The results of this study support this premise when evaluating a high dividend yield investing strategy relative to investing in the ALSI TRI benchmark. Furthermore, the dividend yield reflects cash flows to investors which may be indicative of lower operating and financial risks, often in situations where these companies may be going through difficult times, and which may offset to some extent the perception implicit in other indicators such as the price to book ratio. This study focused on the long-term performance of a portfolio of high dividend yield shares.

The study will follow the following structure: Section 2 is a literature review of value investing in the international and South African context, followed by its interaction with the EMH; and concludes with an analysis of the effectiveness of dividend yield investment strategies, both globally and on the JSE. Section 3 provides a description of the test methodology applied, including an examination of the data. Section 4 analyses the results of the testing, and Section 5 summarises and concludes the study.

## 2. Literature Review

Benjamin Graham and David Dodd introduced the strategy of "Value Investing" to the world in the 1934 book entitled "Security Analysis." Graham (1949) subsequently refined the principles of value investing in "The Intelligent Investor". Since then, eminent investors such as Warren Buffett, Walter Schloss, Seth Klarman, Christopher Browne and Irving Kahn have made themselves known as value investors. The underpinning principle of this investment strategy is to purchase stocks that are trading at a price below their intrinsic value, after the market has overreacted to the release of adverse company information (Visscher & Filbeck, 2003). The investor then sells the stocks once they have traded back to their intrinsic values, obtaining an abnormal return whilst taking on little additional risk (Lakonishok et al., 1994). Identifying stocks that are trading at below their intrinsic values, however, is far more difficult than this may suggest and value investors often have to sustain long periods of underperformance. In order to identify such stocks, Graham (1949) provided 10 definitive "screens," based on underlying company fundamentals. Over the years, these screens have been widely accepted by the academic community as indicators of value, yet these screens are generally applied more loosely than indicated by Graham (1949). Resultantly, value stocks can be identified as having low price/earnings [PE] ratios, high book/market [B/M] ratios and high dividend yields (Visscher & Filbeck, 2003).

## Efficient Market Hypothesis

Samuelson (1965) suggested that security price changes are completely independent of one another, and therefore that security prices follow a “random walk.” The implication of this is that future price changes should be impossible to predict, as they have no relationship with the past. Eugene Fama (1965 & 1970) proposed that all security prices fully reflect all available information in an efficient market, which gave birth to the “Efficient Market Hypothesis” [EMH]. Fama described 3 forms of market efficiency - weak-form, semi-strong form and strong form efficiency. Under this model investors are therefore only compensated for the risk that they take on, and abnormal risk-adjusted returns are unattainable. Jensen (1978) and Malkiel (2003) then went as far as to suggest that a trading strategy that consistently produces positive risk-adjusted returns does not necessarily refute the EMH, unless it does so after trading costs and throughout various different time periods. As value investing relies on the fact that stock prices can deviate meaningfully from their intrinsic values, it is in direct contradiction with the theory of EMH, particularly weak-form and semi-strong form of market efficiency.

In their seminal study, however, De Bondt and Thaler (1985) investigated the presence of the “Overreaction Theory” in equity markets. This theory suggests that investors regularly overreact to both positive and adverse new company information, leading to inaccurate market pricing, and therefore a degree of market inefficiency. A phenomenon called “Mean Reversion” then occurs, as stock returns revert to a relevant mean return. De Bondt and Thaler (1985) analysed the difference in the returns between 2 portfolios over the period from 1926-1982 on the New York Stock Exchange [NYSE]. The first portfolio consisted of the 35 stocks with the highest PE ratios on the market, known as the “winners” as their prices had previously performed very well. The second, “loser,” portfolio represented the bottom 35 PE stocks. Over the period of the study it was found that the loser portfolio, on average, outperformed the winner portfolio by over 25% in a 3-year measurement period, whilst also being significantly less risky. This provided conclusive evidence that the NYSE was not an efficient market over the period of the study.

Chopra, Lakonishok, and Ritter (1992) reperformed this study on the same data set, whilst adjusting for market risk and the size effect. It was found that the loser portfolios still outperformed the winners by between 5% and 10% per year over the measurement period. Cubbin et al (2006) then applied the methodology developed by De Bondt and Thaler to the JSE over the period from 1983 to 2005. Again it was found that the loser portfolio outperformed the winner portfolio by an average of 11% per year. This provided compelling evidence that the JSE is not a perfectly informationally efficient market, and therefore that it could be possible for a value investment strategy to attain excess risk-adjusted returns.

This being said, however, tests of market efficiency are inherently limited by a phenomenon known as the “Joint Hypothesis Problem” (Fama & French, 1996). This is because an equilibrium asset pricing model is used to calculate the expected returns that act as the benchmark when testing market efficiency. As CAPM (Lintner, 1965; Mossin, 1966; Sharpe, 1964; Treynor, 1961) is often used as this asset pricing model, tests that seemingly refute market efficiency can either present evidence of an inefficient market, or risk factors that are not captured by CAPM. The outperformance of loser portfolios discussed above, could therefore just be commensurate return for risk taken on that is not effectively measured by

CAPM, and not evidence of market inefficiency. Fama and French (1996) indicate that the size effect and market to book ratios capture the risks not captured by CAPM.

### International Evidence

Basu (1977) studied the effectiveness of the PE ratio value screen on NYSE industrial stocks over the period from 1957 to 1971. Basu created portfolios of high and low PE stocks, and compared their returns to randomly constructed portfolios of equivalent risk, as measured by CAPM. It was found that the low PE portfolios significantly outperformed the randomly constructed portfolios, whilst the high PE portfolios were unable to outperform. Basu considered this an invalidation of semi-strong form market efficiency, and termed it the “value effect.”

In 1992, Fama and French conducted a study that tested the ability of a firm’s book/market [BM] ratio to predict future stock returns. They tested NYSE and NASDAQ listed stocks over the period from 1962 to 1989 and found that there was a significantly positive relationship between BM ratios and stock returns. High BM ratios generally resulted in high future stock returns, consistent with the value investing approach to selecting shares. Fama and French (1992), however, contested that the higher returns attained were merely compensation for holding riskier stocks, and that BM ratios captured risks not considered by CAPM. The results of Lakonishok et al (1994), however, provide strong evidence against this assertion. Lakonishok et al (1994) tested the same data set as the Fama and French study, finding that the increased return on value stocks, as identified by high BM ratios, was not matched by a commensurate increase in risk. Lakonishok et al. (1994) stated that the higher returns for high BM shares were due to the behavioural biases of investors, who extrapolate past performance too far into the future. This leads to high BM firms becoming under-priced, creating opportunities to purchase shares below their intrinsic value.

In one of the more recent seminal value investing papers, Fama and French (1998) tested the presence of the value premium in several global equity markets from 1975-1995. They found evidence of such a value premium in 12 of the 13 major markets tested. Value screens based on the BM ratio, earnings yield, cash flow yield and dividend yield were all found to be significant. Importantly, this study also found a significant value premium in 16 emerging markets that were studied. South Africa, however, was not included in the analysis.

### South African Evidence

Prior to 2001, value investing had been a significantly neglected area of research in South Africa, specifically given its extensive coverage internationally and its reputation as a profitable investment strategy (M. Graham & Uliana, 2001). The first South African value investing study was undertaken by Plaistowe and Knight in 1986 who found evidence that the BM ratio significantly predicted returns on the JSE between 1973 and 1980.

Klerck and Maritz (1997) then tested the effectiveness of Benjamin Graham’s (1949) stock selection criteria on industrial shares traded on the JSE, between 1977 and 1994. A “value portfolio” was created, consisting of all stocks that met Graham’s PE, dividend yield and debt screens. This portfolio significantly outperformed the market index, but was also found to be riskier. Once risk-adjusted, however, the returns to Graham’s (1949) value investing strategy

were still significantly greater than the market proxy, suggesting the increase in risk was not commensurate to the extra return attained.

Graham and Uliana (2001) then tested the BM effect again, but only considered industrial shares due to the differing definitions of BM in various JSE market sectors. No conclusive evidence of a value premium was found, as high BM stocks failed to outperform low BM stocks between 1987 and 1996. High BM stocks, however, were actually found to be less risky, and outperformed on a risk-adjusted basis. This suggested that Fama and French's (1992) assertion that high BM stocks exhibited risk factors not captured by CAPM did not necessarily hold for the JSE. Mutooni and Muller (2007) replicated this study, testing data from 1986 to 2006. Again, significant evidence of the BM value effect was found, even after adjusting for the size effect. This is backed-up by Basiewicz and Auret (2009) who found that the BM effect even survived adjustments for transaction costs and thin trading on the JSE.

Rousseau and Van Rensburg (2003) tested the PE ratio value effect, comparing the returns on a series of portfolios of the lowest PE industrial stocks on the JSE to portfolios of the highest PE stocks. The low PE portfolios outperformed over all time periods tested between 1982 and 1998. Interestingly, it was found that the outperformance of the low PE portfolios increased as the holding period of the portfolios increased; providing evidence that value investing is a long-term strategy.

It can be seen that the body of research in South Africa finds overwhelming evidence of a value premium on the JSE. Auret and Cline (2011), however, found no significant evidence of the value effect between 1988 and 2006. Their study, however, considered all shares on the JSE, whilst all previous studies had focused only on the industrials sector. This suggests that the value effect previously found could be time-dependent (Malkiel, 2003) or not extend to the entire body of JSE shares. This leaves scope for more research on the entire body of JSE shares and the existence of the value effect in more recent times.

In addition to this, the landmark JSE value investing studies have mainly focused on the BM and PE value screens, leaving the effectiveness of a dividend yield strategy relatively under-researched. This gives weight to the need for this study, as it considers a dividend yield investment strategy, over the entire body of JSE listed shares, during a recent time period.

### Dividend Theories

Benjamin Graham's (1949) screen for identifying value stocks based on a high dividend yield, has become one of the most widely-accepted value investing screens in the investment community (Visscher & Filbeck, 2003). Initially, Graham (1949) suggested that value stocks were characterised by a dividend yield which is greater than two-thirds of the AAA corporate bond yield (Damodaran, 2012). This is roughly analogous to the long-term government bond yield, which in South Africa is currently 8.82%; meaning that value stocks should have a dividend yield of greater than 5.88% (based on the R186 SA government bond – 30/06/2016)(Bloomberg, 2016). As discussed, this screen is often relaxed in the investment community, requiring stocks to have only a "high" dividend yield in order to qualify as a value stock. For dividend yields to be an effective screen of value stocks, however, there needs to be a relationship between dividends and intrinsic firm value, which begs the question as to why this relationship exists (Fakir, 2013).



In a 1961 study, Miller and Modigliani put forward their famous “Dividend Irrelevance Theory.” This theory explained that dividends bore no relationship to firm value as they did not impact on a firm’s earning potential, and that investors are therefore indifferent to the levels of dividend pay-outs. This theory was created under the restrictive assumptions of no transactions costs and taxes, perfect information, efficient equity markets, rational investor behaviour and several more. These assumptions often break down in the real world. This theory, however, is somewhat supported by Warren Buffett (2013) who argues that dividends are irrelevant due to investors’ ability to create “synthetic dividends” by selling shares, as and when their income needs arise. Black and Scholes (1974) added weight to this dividend irrelevance argument. Black and Scholes found no evidence that differences in dividend yields led to differences in stock returns, and it was therefore concluded that dividend policy does not affect stock returns. According to this, dividend yields should therefore have no power in forecasting future stock returns, and dividend yield strategies will not allow the investor to attain abnormal risk-adjusted returns.

In contrast to this, Miller and Rock (1985) found significant evidence of the “Dividend Signalling Theory.” This theory relaxes the assumption of perfect information, admitting that there is an asymmetry of information between company managers and investors. As managers hold far more information regarding the future prospects of the company, it is thought that dividends are a signal of this information to the public. High (low) dividend levels can therefore be thought of as optimistic (pessimistic) signals about the company’s future earnings potential, which in turn should lead to stock price appreciation (depreciation)(Erasmus, 2013).

The fact that dividends must be paid out of free cash flows is also an indicator of a company’s underlying financial health and quality of earnings, although companies can and do borrow at times in order to meet dividend requirements. Earnings are subject to accounting manipulation, whilst dividends offer a more positive indication of a company’s future cash generating ability (Tweedy Browne Company LLC, 2014). Higher dividend levels can therefore indicate increased future cash flows, and increased valuations, allowing investors to obtain abnormal risk-adjusted returns by investing in high dividend yielding companies. In more recent times, companies have also increased share repurchases as a way of distributing cash to its shareholders. However, this study focuses on dividend yields.

Whilst both dividend irrelevance and relevance theories have been discussed above, the body of academic research strongly suggests that dividends are relevant to firm value, and therefore that they can be used as a predictor of future stock returns. This literature is discussed below.

## Dividend Yield as a Value Investing Strategy

### International Evidence

In their 1974 paper, Black and Scholes (1974) tested the ability of dividend yields to predict future stock returns. The entire universe of stocks listed on the NYSE from 1947 to 1966 was tested. Over the time period analysed, the returns on 25 portfolios of the highest dividend yielding stocks on the exchange, were compared to those portfolios of the lowest dividend yielding stocks. The high dividend yield portfolios did not significantly outperform the low yield portfolios, either before or after adjustment for taxes. Black and Scholes therefore



advised that dividend yields should be ignored when making investment decisions; and suggested that investors should rather attempt to reduce risk through improving diversification in order to attain improved risk-adjusted returns.

This study is partly supported by Fama and French (1988), which performed a regression of dividend yields against stock returns, in order to measure their forecasting power. Consistent with Black and Scholes, it was found that less than 5% of monthly and quarterly return variation is explained by a stock's dividend yield, as measured by the regression's  $R^2$ . Contrary to this, however, dividend yields explain a significant portion of stock returns (greater than 25%) when the return period is extended to between 2 and 4 years. This gives evidence to the ability of a value investing strategy based on dividend yields to outperform a market proxy. It also strongly supports the assertion of Rousseau and Van Rensburg (2003) that value investing is a long-term strategy. A study by Litzenberger and Ramaswamy (1979) found a "strong positive relationship between before-tax expected returns and the dividend yields of common stocks" on the NYSE between 1952 and 1977.

In an influential paper in favour of the efficient market hypothesis, Fama and French (1996) tested the existence of the value premium using several value screens, with equilibrium returns being measured using the "Fama and French 3 Factor Model" instead of the CAPM. The 3 factor model attempts to better capture asset risk, and calculates asset equilibrium returns as a function of market risk ( $\beta$ ), the small firm premium and the value premium (as measured by the BM ratio). It was found that significant abnormal risk-adjusted returns could no longer be attained using a dividend yield investment strategy. Fama and French therefore argued that the dividend yield value effect is not an invalidation of the EMH, but rather is evidence of investors attaining increased returns by taking on commensurate increased levels of risk. This places some doubt on the effectiveness of a dividend yield strategy to produce abnormal risk-adjusted returns.

In recent times, however, investing based on dividend yield strategies has continued to gain momentum, and one of the most popular strategies has become known as "The Dogs of the Dow" (Visscher & Filbeck, 2003). In terms of this strategy, the investor purchases the 10 highest dividend yielding stocks within a large-capitalisation index on an exchange at the end of the calendar year. The portfolio is then held for a year, before rebalancing takes place. Visscher & Filbeck (2003) studied the results of implementing this strategy on the Canadian Toronto 35 index from 1987 to 1997. The results showed that the "dogs" strategy outperformed the Toronto 35 index and the TSE 300 (market proxy) by a compound annual return of 6.13% and 6.46%, respectively. In addition, this outperformance was statistically significant, even after adjusting for taxes and transaction costs. Brzeszczynski and Gajdka (2008) replicated this study for the Polish stock market, and Brzeszczynski, Archibald, Brzeszczynska, and Gajdka (2008) tested dividend yield investing for the London Stock Exchange. Again, these studies found that the "dogs" strategy significantly outperformed the relevant market proxy, even after adjusting for taxes and transaction costs.

### South African Evidence

In 2004, Hendrik Wolmarans decided to test a high dividend yield investing strategy for the JSE (colourfully referred to as the "Dogs of the Dow" strategy). Whilst several variations of this strategy were also tested, it was shown that the original high dividend yield ("dogs") strategy managed to outperform the ALSI by an average annual rate of 9.8% from 1985-

1998. This proved to be significant even after an adjustment for risk was made. In addition, several variations of the “dogs” strategy, all based on high dividend yields, managed to significantly outperform the ALSI on a risk adjusted basis. This gave strong evidence to the effectiveness of high dividend yield strategies for the JSE.

The first study on the presence of the dividend yield value effect on the JSE, was conducted by Fraser and Page (2000). This study sorted all industrial shares into 5 portfolios, by dividend yield and BM ratios. The highest BM and dividend yield portfolio (value) was found to outperform the lowest BM and dividend yield portfolio (growth) by approximately 8% per annum from 1973 to 1997. The study also found that dividend yields could significantly predict share returns on the JSE, although its predictive power was weaker than the BM ratio.

Van Rensburg and Robertson (2003) applied a multiple regression methodology to determine the capability of 24 company-specific fundamental factors to explain the average monthly returns of that company over the period from 1990 to 2000. They found that dividend yield was one of only 6 significant explanatory variables over this time period, suggesting that dividend yields can significantly predict returns on the JSE. This study was then replicated by Auret and Sinclair (2006), including the BM ratio, which had previously been ignored. It was found, however, that the BM ratio completely subsumed the dividend yield effect when included in the regression analysis, making it a better predictor of future stock returns. In a prior study, Van Rensburg (2001) had found that the earnings yield and the dividend yield were both significant indicators of value.

Muller and Ward (2013) again tested for significant explanatory variables of equity returns, but used an improved data set, from 1985 to 2011, including all shares listed on the JSE, whereas previous studies had only focused on industrial shares. A graphical time-series approach was used to test these variables. They formed 5 portfolios of 32 shares each, based on each attribute and tracked each portfolio's return over the measurement period. It was found that the highest dividend yield portfolio outperformed the lowest dividend yield portfolio by an average of 12.6% per annum, whilst also outperforming the ALSI total return index by an average of 5.5% per annum. This study therefore found that a “dividend yield style [effect] does exist” on the JSE.

Kruger and Toerien (2014), however, noted that the majority of these South African tests on the value effect had been done during stable market conditions, and therefore tested to see whether these anomalies were consistent over the sub-prime mortgage financial crisis of 2008. Their tests showed that the dividend effect failed to be significant over this crisis period, and therefore that this effect may be time dependent. Despite all of the previous literature that has shown significant evidence of the dividend value effect, it may not be an invalidation of the EMH due to this time dependency, as this effect cannot be exploited to attain abnormal risk-adjusted returns if it does not persist into the future (Malkiel, 2003).

These findings, however, are contradicted by the findings of Fakir (2013), who specifically tested the performance of high dividend yield portfolios over a 9-year holding period, beginning in 2004 and ending in 2012, and therefore including the financial crisis period. Firstly, Fakir separated the 160 biggest shares on the JSE (based on market capitalisation) into high and low dividend yield portfolios. Over the holding period, the high yield portfolio

returned 1.78 times more than the low yield portfolio, although this was not found to be statistically significant. In a second test, the returns on the 10 highest dividend yielding stocks were compared to those of the JSE Top 40 Index (used as the market proxy). Here, the top 10 stocks outperformed the market proxy by a statistically significant 1.45 times, after the top 10 portfolio was adjusted for risk and taxes. This provided more strong evidence of the potential that a value investment strategy, based solely on dividend yields, has on the JSE.

A comprehensive study of value and momentum effects for the JSE was undertaken by Van Heerden and Van Rensburg (2015) for the period 1994 to 2011 and this study included price-to-earnings (P/E), price-to-book(P/B), price-to-cash flow (P/CF) and price-to-sales (P/S), as well as dividend yield (D/Y), as value indicators. Van Heerden and Van Rensburg (2015) found that value factors were found to be the most significant in explaining the cross section of returns on the JSE. The cash flow to price ratio followed by the book value to market ratio were found to best capture the value effect. In contrast to other studies (Cubbin et al., 2006, Strugnell et al., 2011), the price earnings ratio was not found to be as significant. Van Heerden and Van Rensburg tested two sub-periods, 1994 to 2002 and 2003 to 2011. Although the dividend yield was not significant for the first sub-period as well as the whole period 1994-2011, the results for the second period of 2003-2011 indicate that dividend yield was very close to being significant indicator of value (t-statistic of 1.999). The latter period includes some overlap with the period analysed for this study, which was 2006-2015.

## Conclusions

Due to the results of several seminal studies that have focused on value investing (Basiewicz & Auret, 2009; Fama & French, 1992 and 1998), it would be difficult to refute the claim that value investing has historically been able to attain abnormal equity market returns, both internationally and in the South African, emerging market context. This evidence also suggests that the EMH may not hold, at least to some degree. The value premium often survives adjustment for transaction costs, risk, taxes and has tended to persist over time (Basiewicz & Auret, 2009). This means that it is difficult to argue that the EMH holds, even by Jensen (1978) and Malkiel's (2003) definitions.

Globally, the literature appears to suggest that the most significant value investment screen has been based on the book/market ratio (Auret & Sinclair, 2006; Fama & French, 1998). The evidence concerning the dividend yield screen is less convincing, especially within South Africa. Many studies, however, have found evidence that implementing a high dividend yield strategy has led to significant, risk-adjusted outperformance (Fakir, 2013; Wolmarans, 2004). It is against the backdrop of this research literature that this study evaluates dividend yield investing strategy on the JSE.

### 3. Research Methodology

#### Research Question

The research question is as follows: Can an individual investor outperform the JSE market (an investible proxy for the market) in the long run, after adjusting for risk, taxes and transaction costs, by following a value investing strategy focused solely on investing in shares with a high dividend yield?

#### Hypothesis

$H_0$ : The compound annual return on the high dividend yield portfolio  $\leq$  the compound annual return on the ALSI TRI, after appropriate adjustments

$H_1$ : The compound annual return on the high dividend yield portfolio  $>$  the compound annual return on the ALSI TRI, after appropriate adjustments

In testing this hypothesis, this study has combined the methodologies employed by Fakir (2013) and Muller & Ward (2013). This involves measuring cumulative returns and wealth relatives and assuming the reinvestment of dividends.

A 10-year time period, starting on 1 January 2006 and ending on 31 December 2015, has been selected. This is in accordance with the suggestions made by Rousseau and Van Rensburg (2003) that value investing is a long-term strategy, and that outperformance tends to improve as the investment period is increased. This time period also includes the financial crisis; therefore allowing the opportunity to analyse the performance of a dividend yield value investing strategy before, during and after a major financial crisis. This may offer evidence to either help refute or strengthen any time-dependency argument, especially that put forth by Kruger and Toerien (2014).

The value portfolio was made up of the 30 highest dividend-yielding stocks on the JSE, from a pool of the 160 largest stocks, as measured by market capitalisation ("market cap"). The study was limited to this group as they make up the All Share Index, representing roughly 99% of the JSE's market cap. Shares that fall outside of this range also exhibit far greater illiquidity (Muller & Ward, 2013), and data for these companies is far more difficult to come by and often less precise. In addition, Real Estate Investment Trusts [REITs] were excluded from the universe of JSE stocks. This is due to the fact that REITs are characterised by unusually high dividend yields, as they are exempt from paying income taxes on earnings that are immediately distributed to shareholders in South Africa. This means that, in the case of REITs, high dividend yields are not necessarily an indicator of value.

In order to monitor long-term performance, this study did not follow a rebalancing strategy each year. This is in line with the general premise that value investing is a long-term strategy. Renowned value investors such as Walter Shloss and Seth Klarman have referred to a holding period of 4 to 6 years.

The decision to include 30 companies in the value portfolio was based on the study done by Bradfield and Kgomari (2004), which found that a minimum of 30 shares is required to achieve diversification for the JSE, due to the effects of single-stock concentration on the market.

The JSE All Share Total Return Index was chosen as the appropriate market proxy upon which to benchmark the value portfolio's performance. This is particularly relevant because of the high dividend nature of this investment strategy, necessitating the comparison of total returns. As noted by Tweedy Browne Company LLC (2014), "the return from dividends has been a significant contributor to the total returns produced by equity securities."

Finally, there are several different methods in which dividend yields can be calculated. For the purposes of this study, dividend yield has been calculated as follows:

*Formula 1*

$$\text{Dividend Yield} = \frac{\text{Dividends Per Share Paid over the Previous 12 month Period}}{\text{Share Price at Year End}}$$

This measure of dividend yield has been selected as it considers the most recent dividends that have been paid, regardless of financial year. It was therefore believed to be the best dividend yield measure in describing the cash generative ability of a firm. Non-normal (i.e. special) dividends were not included in dividends per share, as they are non-recurring.

### Data Collection

All data was obtained from the Bloomberg information terminal. This included the dividends paid, market capitalisation, sector description and year-end closing prices of all shares listed on the JSE on the 31<sup>st</sup> of December 2005. In addition to this, the daily ALSI TRI value, yearly risk-free rate (R186); annual dividends paid and daily closing prices of the shares in the value portfolio from 2006-2015 were obtained.

In order to avoid a survivorship bias, any companies where subsequent corporate action has taken place (e.g. an acquisition, delisting, liquidation etc.) were included in this universe, representing the information that an individual investor would have had access to on 31 December 2005.

### Procedure and Data Analysis

This section will outline the procedure and the data analysis that was followed in order to test the hypothesis.

### Portfolio Construction

Using the data described above, the population of all stocks listed on the JSE were ranked (in descending order) according to their market cap on 31/12/2005. Any stocks falling outside of the top 160 largest were then eliminated from the sample. Using sector information, all stocks forming part of the Industry Classification Benchmark (ICB) Real Estate sector were then excluded from this sample of 160 stocks.

Using formula 1, the dividend yield for each of these stocks on 31/12/2005 was then calculated, and all stocks were ranked according to this measure. The 30 highest dividend yielding of these stocks were then included in the value portfolio. The companies making up this portfolio are set out in Table 1.

**Table 1:** Composition of Value Portfolio on 31 December 2005

Companies forming part of the value portfolio, with associated dividend yields on 31/12/2005								
1	REAL AFRICA HOLDINGS	19.80%	11	ARCELORMITTAL	6.17%	21	JD GROUP LTD	4.58%
2	EVRAZ HIGHVELD STEEL	17.45%	12	CLIENTELE LIFE	5.92%	22	STANDARD BANK GROUP	4.50%
3	SUPER GROUP LTD	16.27%	13	BRAIT SE	5.59%	23	SASFIN HOLDINGS	4.42%
4	CORONATION	9.09%	14	CITY LODGE HOTELS	5.49%	24	EDGARS	4.18%
5	E MEDIA HOLDINGS	7.91%	15	RMB HOLDINGS LTD	5.45%	25	CADIZ HOLDINGS	4.16%
6	DORBYL LTD	7.84%	16	NAMPAK LTD	4.96%	26	BIDVEST GROUP	3.88%
7	AVI LTD	6.60%	17	MMI HOLDINGS LTD	4.68%	27	MUTUAL & FEDERAL	3.87%
8	GLENRAND MIB LTD	6.38%	18	INVICTA HOLDINGS	4.64%	28	DISTELL GROUP	3.84%
9	BARNARD JACOBS	6.35%	19	ALEXANDER FORBES	4.62%	29	MR PRICE GROUP	3.80%
10	MUSTEK LTD	6.19%	20	OCEANA GROUP LTD	4.62%	30	PICK'N PAY HOLDINGS	3.77%

### Portfolio Return Calculation

An initial investment of R1 000 000 was assumed, and all stocks were equally-weighted in the portfolio, according to their price on 31/12/2005. For all transactions in this test, total costs (brokerage costs, transaction taxes etc.) of 0.86% of the transaction value were assumed. This was based on the total costs of performing an equity transaction through the Standard Bank (2016) Share Trading platform.

Where a company in the sample ceased trading during the holding period, their last closing price before they ceased trading was used as a proxy for the cash payment received by the shareholder during that year, in keeping with the methodology applied by Muller & Ward (2013). Total cash payments received per year were therefore the sum of all distributions received on the portfolio and these cash payments.

The annual distribution received was calculated based on the number of shares of each company held in the portfolio at the beginning of each calendar year. These payments were then re-invested into the portfolio on the final day of each calendar year in the study, and the individual holdings of each company re-calculated. Again, these purchases were equally-weighted (based on the number of shares in the portfolio that were still trading), based on the closing share prices on each respective date.

Daily returns throughout the study were calculated as the weighted-average of the returns on each stock that was still trading, based on their value as a proportion of the total portfolio value.

Finally the compound annual growth rate [CAGR] and annual, total and cumulative returns were calculated on the portfolio, using the following formulas:

*Formula 2*

$$\text{Portfolio Return}(r) = \frac{\text{Value}(t+1) - \text{Value}(t) + \text{Dividend Received}}{\text{Value}(t)} \times 100$$

*Formula 3*

$$\text{CWI}_n = \text{WI}_0 (1+\text{HPR}_1) (1+\text{HPR}_2) \dots (1+\text{HPR}_n)$$

$\text{CWI}_n$  is the cumulative wealth index and  $\text{WI}_0$  is the beginning wealth index. HPR is the holding period return for each period. This study uses a starting wealth index of R1m for the Value Portfolio and the ALSI TRI benchmark portfolio.

*Formula 4*

$$\text{Compound Annual Growth Rate} = \left( \left( \frac{\text{End Value}}{\text{Beginning Value}} \right)^{\frac{1}{n}} - 1 \right) \times 100$$

### Portfolio Risk Calculation

Using the calculated daily portfolio returns, the daily standard deviations for each individual year, and for the entire period of the study, were computed. The following formula was used:

*Formula 5*

$$\text{Standard Deviation } (\sigma) = \sqrt{\frac{\sum (x - \mu)^2}{n - 1}}$$

These values were then converted to match their respective time periods using the following formula:

*Formula 6*

$$\text{Period } \sigma = \text{Daily } \sigma \times \sqrt{\text{Trading Days in Period}}$$

### Benchmark Return and Risk Calculation

Using the daily ALSI TRI values that were obtained, the CAGR and daily, annual, total and cumulative returns were calculated on the benchmark for the period starting on 01/01/2006 and ending on 31/12/2015. This was done using formulas 2, 3 and 4. Using the calculated daily benchmark returns, the daily standard deviations for each individual year, and for the entire period of the study, were computed (formula 5).

Formula 6 was again used to convert these daily values to match their respective time periods.

### Calculation of Annual Sharpe Ratios

Annual and total portfolio and benchmark Sharpe ratios were also calculated using the Sharpe Ratio, which measures a portfolio's excess return in relation to a portfolio's standard deviation. This enables the determination of a risk-adjusted return and the Sharpe ratio has become the standard measure of a portfolio's return relative to its level of risk as indicated by the volatility of returns.

*Formula 7*

$$\text{Sharpe Ratio} = \frac{R_p - R_f}{\sigma_p}$$

This study also followed the graphical time-series approach used by Muller & Ward (2013), so that the cumulative return index of each portfolio is plotted over the test period in order to present a visual comparison between the two portfolios.



## Limitations of the Study

There are, however, several limitations associated with this study, which are set out below:

- The results may be overly dependent on the starting date. In order to evaluate long-term performance, the study measured the relative performances of a portfolio of high dividend yield shares constructed on a single date and the ALSI TRI which may solve one drawback of a rebalancing strategy by creating a disadvantage of an over-dependence on the starting date<sup>29</sup>. It is submitted that the results of this study need to be evaluated with the results of other studies on the use of high dividend yield strategies.
- The effects of both dividend tax and capital gains tax have been ignored. However, these taxes would impact both the value portfolio and the benchmark portfolio. It may be argued that the relative tax effects would probably not be material for the findings of this study, particularly over the longer term.
- The assumption that the final closing price of shares that ceased trading can be used as a proxy for the payment received by shareholders may be unrealistic.
- Dividends to determine the portfolio return was included on the final day of each year and this may impact on relative volatilities for the portfolio in relation to the ALSI TRI which includes dividends on each payment date.
- The results of this study could have been impacted by factors other than just the differences between dividend yields, which are not considered. This could have either positively or negatively biased the relationship found between dividend yields and future stock returns.
- The inclusion of the financial crisis in the period studied may have introduced a bias to the results, which therefore may mean that the dividend yield-stock return relationship found may not be indicative of normal JSE conditions.

## 4. Results

The results are firstly analysed in terms of the cumulative returns of the Value Portfolio in relation to the ALSI TRI. Thereafter, the results are set out in terms of comparing the compound annual returns, standard deviations and Sharpe ratios of the Value Portfolio as compared to the ALSI TRI.

Figure 1 presents the cumulative returns of investing in the Value Portfolio in relation to investing in the ALSI TRI over the period January 2006 to 31 December 2015. This simply tracks the investment of R1m in either the Value Portfolio or the ALSI TRI on 1 January 2006, which factors in movements in share prices and the reinvestment of dividends.

The Value Portfolio of high dividend yield companies would have resulted in a final cumulative total amount of R5.134m as compared to a final cumulative total amount of R3.74m by investing in the ALSI TRI benchmark portfolio.

---

<sup>29</sup> However, the portfolio of high dividend yield shares tracked the ALSI TRI closely for most of the period January 2006 to January 2012 (see Figure 1), which is suggestive that the results of this study are not overly dependent on the starting date.



**Figure 1:** Cumulative returns of investing in the Value Portfolio and the ALSI TRI

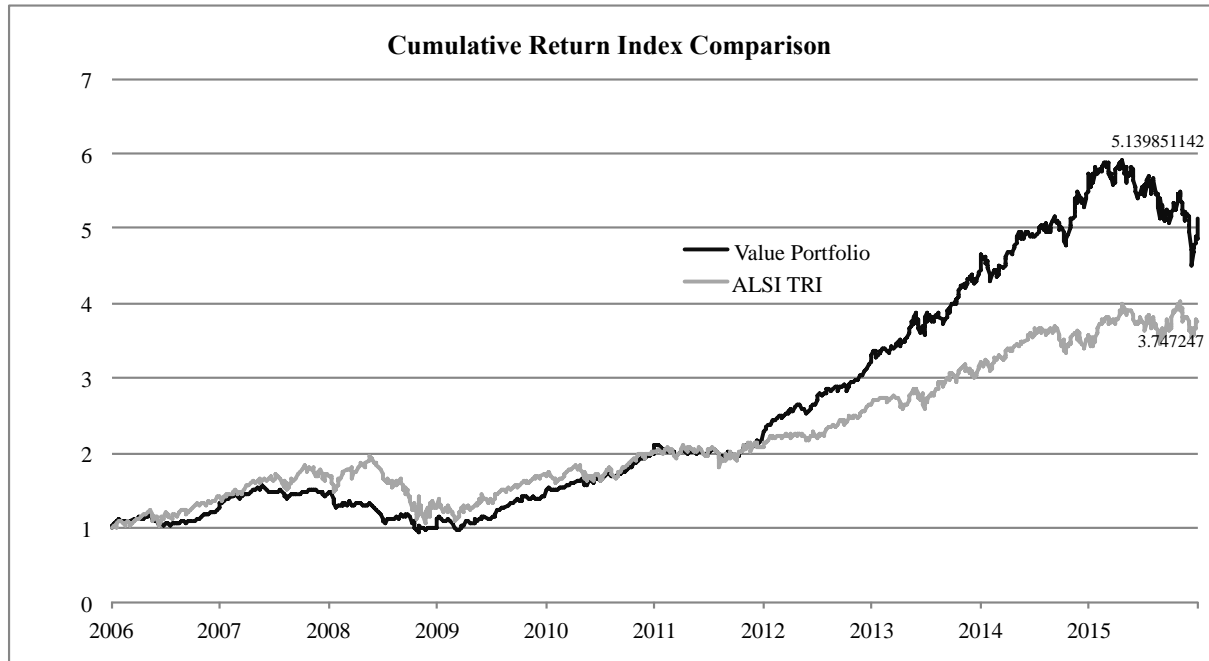


Figure 1 demonstrates that the value portfolio underperformed although it roughly tracked the return of the benchmark ALSI TRI until the beginning of 2012, when the Value Portfolio started to significantly outperform the ALSI TRI. This adds weight to Graham's (1949) belief that value investing is a long-term strategy, and provides some confirmation to the results of Rousseau and Van Rensburg (2003) which found that the value portfolio's outperformance increased as the holding period increased. Figure 1 also indicates that in 2015, the value portfolio dramatically underperformed the benchmark ALSI TRI. Figure 1 is also consistent with the premise that a value portfolio may underperform the benchmark for a significant period of time.

An analysis of Figure 1 also provides some support to the findings of Kruger and Toerien (2014) who suggested that dividend yields did not have any significant power to predict future stock returns during the financial crisis. This study indicates that the return on the Value Portfolio tracked the return on the ALSI TRI during 2008 and 2009, the main years of the financial crisis. It did, however, meaningfully outperform on a risk-adjusted basis.

Prior to the financial crisis (2006 & 2007), the value portfolio underperformed, but once again it outperformed on a risk-adjusted basis. These pre-financial crisis findings, however, are fairly inconclusive as only 2 years were studied. The relative underperformance may also be a result of the value portfolio being constructed so recently, meaning that the value effect had not yet taken place.

Post the financial crisis, however, the value portfolio outperformed significantly (as shown in Figure 1), except in the final year of the study. This provides some evidence of the dividend yield value effect, especially in the post-financial crisis period for the JSE.

An analysis of compound annual returns, standard deviations, annual returns, annualised standard deviations and the annual Sharpe ratios is set out in Table 2. The Value Portfolio

of high dividend yield companies was able to outperform the ALSI TRI over the period 2006 to 2015 at a significantly lower level of risk as indicated by relative standard deviations and Sharpe ratios.

**Table 2:** Annual returns, compound returns, standard deviations, Sharpe ratios and cumulative wealth indices (CWI)

Year	VALUE PORTFOLIO			JSE ALSI TRI PORTFOLIO			Difference Value - ALSI
	Return	Period $\sigma$	Sharpe ratio	Return	Period $\sigma$	Sharpe ratio	
2006	32.27%	12.47%	1.99	41.23%	21.91%	1.54	-8.96%
2007	12.56%	9.57%	0.47	21.98%	19.20%	0.72	-9.42%
2008	-25.33%	18.73%	(1.73)	-26.77%	42.16%	(0.80)	1.44%
2009	35.60%	13.71%	1.94	36.43%	25.18%	1.09	-0.84%
2010	39.19%	9.94%	3.11	17.73%	16.85%	0.56	21.46%
2011	9.47%	9.69%	0.10	3.27%	18.58%	(0.28)	6.20%
2012	44.31%	8.17%	4.54	25.92%	11.39%	1.64	18.39%
2013	39.57%	12.32%	2.54	18.10%	14.61%	0.68	21.47%
2014	24.06%	11.48%	1.40	13.73%	12.80%	0.45	10.32%
2015	-10.44%	16.90%	(1.20)	5.56%	16.70%	(0.37)	-16.01%
<b>Average</b>	<b>20.12%</b>	<b>12.30%</b>	<b>1.32</b>	<b>15.72%</b>	<b>19.94%</b>	<b>0.52</b>	4.41%
<b>CAGR</b>	<b>17.47%</b>		<b>0.60</b>	<b>14.09%</b>		<b>0.20</b>	3.38%
<b>Daily <math>\sigma</math></b>		<b>0.81%</b>			<b>1.36%</b>		
<b>Annualised <math>\sigma</math></b>		<b>12.78%</b>			<b>21.38%</b>		
<b>CWI<sub>2015</sub></b>	<b>513.98%</b>			<b>373.65%</b>			
<b>Relative CWI</b>	<b>1.38</b>						

The value portfolio only managed to outperform the benchmark in 6 of the 10 years, on an absolute basis. When it did outperform, however, it often did so by a large amount. On a total basis, the value portfolio outperformed substantially, recording a cumulative wealth index (CWI) of 513.98% as compared to 373.65% over the 10-year period. The CWI measures the return as a multiple of a R1 initial investment and compounds returns over the 10-year period. We assumed an initial investment of R1m and the value portfolio resulted in an additional return of R1.4m over the period. The relative CWI was 1.38 (513.98%/373.65%) so that the Value Portfolio resulted in a 38% increase in value over the period.

The compound annual return (geometric mean) is 17.47% for the Value Portfolio and 14.09% for the benchmark ALSI TRI index resulting in an outperformance of 3.38% per year over the 10-year period on a compound return basis. The return for the Value Portfolio was 4.14% higher per year on an arithmetic average basis.

Furthermore, the Value Portfolio exhibited less risk than the market proxy, as measured by standard deviation. The daily standard deviation for the Value Portfolio was 0.81% whilst the ALSI TRI indicated a daily volatility of 1.36%. On an annualised basis, the standard deviation of the Value Portfolio is 12.78% as compared to 21.38% for the ALSI TRI.

The Sharpe ratios support the premise that the risk adjusted return for the Value Portfolio is greater than the ALSI TRI benchmark. The Sharpe ratio over the period and measured on the basis of the compound annual returns was found to be 0.60 for the Value Portfolio as compared to 0.20 for the ALSI TRI benchmark.

The lower standard deviation is in direct contradiction of the suggestions made by Fama & French (1992) that the increased returns offered by value portfolios are merely compensation for taking on increased risk. It also supports the results of Graham and Uliana (2001), who found that the value portfolio was less risky. Over the entire period, the benchmark's standard deviation was 1.67 times higher than that of the Value Portfolio.

The value portfolio managed to outperform in 7 of the 10 years, after an adjustment for risk, as evidenced by its higher Sharpe ratios.

In order to obtain a visual impression of the relative volatilities and to obtain further assurance in regard to the data, Figure 2 presents volatilities of the Value Portfolio and the ALSI TRI by plotting the daily returns of the portfolio and the ALSI TRI benchmark.

**Figure 2:** Relative share returns of the Value Portfolio and the ALSI TRI

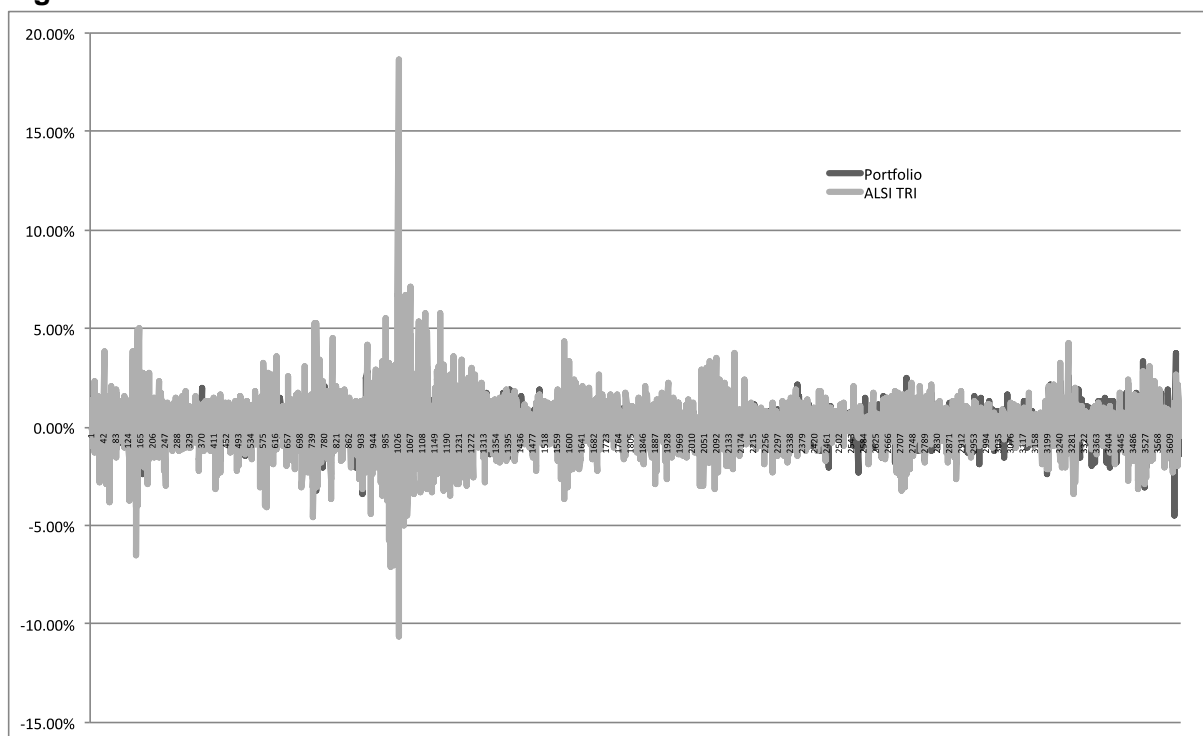


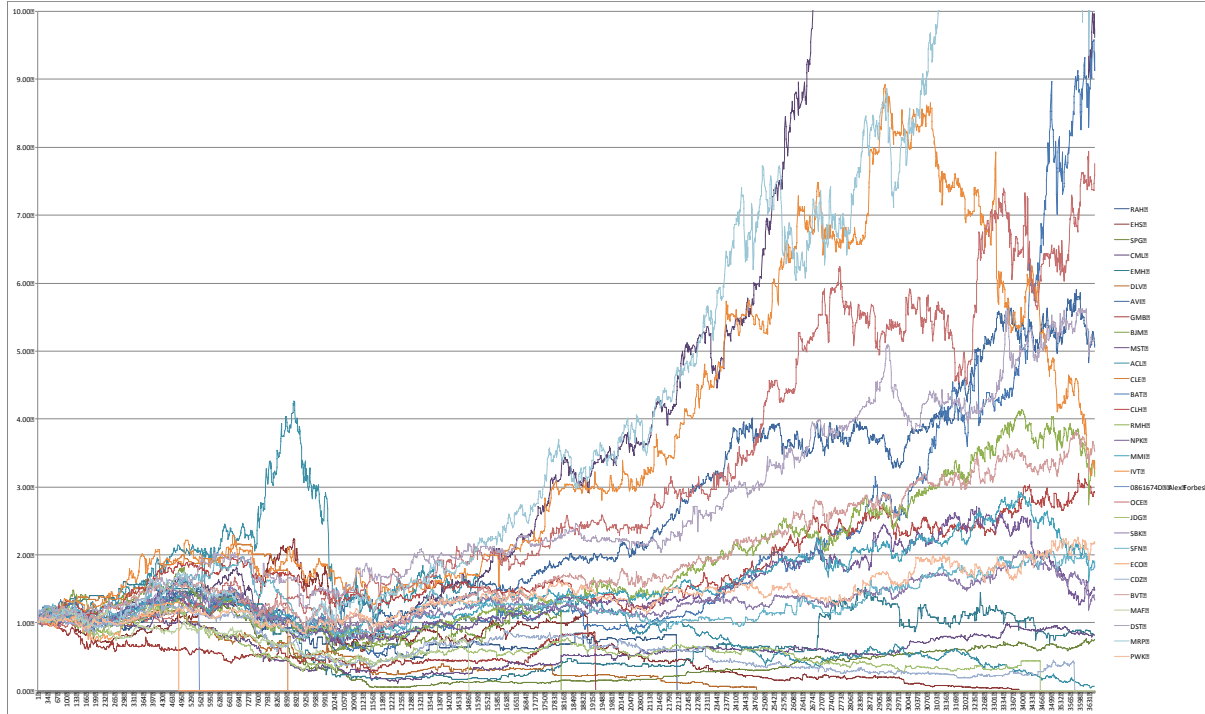
Figure 2 indicates that the volatilities of returns of the Value Portfolio, except in the period, were dominated by the volatilities of the returns of the ALSI TRI. The higher returns for the Value Portfolio was supported by a lower level of volatility of returns, Figure 2 is a visual presentation of the daily returns that support the results set out in Table 2.

The maximum daily drawdown for the Value Portfolio was -5.92% over the period. In contrast, the maximum daily drawdown for the ALSI TRI benchmark portfolio was -10.64%

Figure 3 presents the cumulative returns assuming a R1 investment in each share of the Value Portfolio. The scale has been capped to a max 10x of the initial investment in order to obtain a clearer depiction of the relative returns. In fact CML (Coronation Fund Managers) managed to achieve a height of 20x the initial investment prior to falling back to 10x the initial investment. The value portfolio is highly dependent on the performance of a few

companies such as MRP (Mr Price), IVT (Invicta Holdings), BAT (British American Tobacco), OCE (Oceana), DST (Distell) and AVI.

**Figure 3: Share returns per share in the Value portfolio (max = 10x)**



A closer analysis of Figure 3 indicates a number of corporate actions, which resulted in the delisting of companies initially included in the Value Portfolio. All in all, 10 companies (1/3 of the portfolio) were subject to corporate actions. On delisting, these companies are reflected in Figure 3 as zero, thereby explaining the straight line down to zero. The funds from these companies were reinvested in the remaining companies.

Any companies with cumulative returns less than one will reflect losses on the initial investment. Table 3 sets out the companies that remained listed at the end of the 10-year period and the companies that delisted during the period.

**Table 3:** Listed and delisted companies at end of period

Delisted	RAH	EHS	DLV	GMB	BJM	CLE	Aforbes	ECO	CDZ	MAF										
Listed	SPG	CML	EMH	AVI	MST	ACL	BAT	CLH	RMH	NPK	MMI	IVT	OCE	JDG	SBK	SFN	BVT	DST	MRP	PWK

The number of companies that delisted was 10 out of a total portfolio of 30 companies. This is significant because despite the corporate actions leading to a high number of delistings, the portfolio still outperformed the ALSI TRI materially as indicated in Figure 1. Of course, this may also mean that risk is not captured fully by the relative volatilities as indicated by the standard deviations and Sharpe ratios set out in Table 2.

## 5. Conclusions

### *Summary and Implications*

Graham and Dodd (1934), introduced the concept of *value investing* to the world in 1934. Academic research has focused on the ability of value investing to earn abnormal risk-adjusted returns, as well as measuring the effectiveness of various value screens. The literature provides evidence both for and against the value effect - internationally, in the emerging market context, and even on the JSE itself. The majority of research studies, however, suggest that the value effect does exist, and that the most effective indicator of a value stock is a high book/market ratio. There is, however, convincing literature to suggest that the value effect persists when value stocks are screened on a dividend yield basis.

This study therefore sets out to test the effectiveness of the dividend yield value screen on the JSE, where value investing, especially relating to dividend yields, is relatively less well researched. It did so by testing the ability of a portfolio of high dividend yielding shares to outperform the ALSI TRI, after adjusting for risk and transaction costs, over the most recent 10 calendar years. This time frame included a global financial crisis, therefore offering the opportunity to also study the time-dependency of any dividend yield value effect.

The results showed that the high dividend yield (value) portfolio outperformed the chosen benchmark by 1.38 times over the study period on the basis of the cumulative wealth index and by 3.33% per year on an annual compound return basis. The value portfolio failed to convincingly outperform its benchmark (on an absolute basis) before and during the financial crisis. After risk adjustment, however, the value portfolio tended to outperform before, during and after the crisis – giving evidence that it may not be time dependent.

Importantly, these findings present a possible further invalidation of the EMH, at least in its semi-strong form. The higher returns of the Value Portfolio were matched by a significantly lower risk as indicated by a lower standard deviation. As the dividend yield effect also survived adjustment for risk, this study suggests that it is not just an indicator of risk factors that are not captured by the CAPM (Fama & French, 1992). In addition to this, it appears to not be time-dependent and may present a profitable trading strategy, even after adjustment for transaction costs. This study therefore suggests that the JSE is not an efficient market, even by Jensen (1978) and Malkiel's (2003) definitions. Importantly, however, this study did not consider taxes for either holding the benchmark or the Value Portfolio.

Fama & French (1992) suggest that the higher returns of following such value investing strategies as investing in low market to book ratio companies is due to risk factors not captured by CAPM. In contrast, Thaler & De Bondt (1985) are of the view that the higher returns from value investing relate to behavioural factors (thereby implying that markets are not efficient). The interesting aspect from the results of our study is that the higher returns of the value portfolio are not matched by higher risks as indicated by the relative volatility of returns. This may point to the latter behavioural explanation for the higher returns from investing a portfolio of high dividend yield shares.

Most importantly, however, this study provides evidence that value investing, and more specifically, a value investing strategy based solely on dividend yields, may work in the long term on the JSE. Due to the simplicity of this investment strategy, it provides the opportunity

for the individual investor to obtain abnormal risk-adjusted returns on the JSE. However, the lower risk of the Value Portfolio may also be due to constraints in regard to the liquidity of the underlying shares. As the study focused on daily returns, low levels of volatility for a few companies may have resulted in a downward effect on the volatility of returns for the Value Portfolio.

### Opportunities for Further Research

Avenues for future research include studying the effects on taxes on relative returns. Furthermore, the relative liquidities of individual listings should be evaluated. Although, this may not be a major consideration for small investors, institutions will be highly affected by a lack of relative liquidity. This study selected 30 high dividend yield companies at 31 December 2005 and tracked the performance of these shares over a period of 10 years. It would be relevant to apply an annual rebalancing of the portfolio to evaluate whether this may result in higher returns over the same period. Future research involving an out of sample testing of a high dividend yield investing strategy would add further credence to the results of this study. Although, the objective of this study was to evaluate performance over the long-term of holding a portfolio of high dividend yield shares, future research studies could include rolling periods over a few years and which require to hold each portfolio for a period of 4 to 6 years.

### References

- Auret, C., and Cline, R. (2011). Do the value, size and January effects exist on the JSE? *Investment Analysts Journal*, (74), 29–37.
- Auret, C. J., and Sinclair, R. a. (2006). Book-to-market ratio and returns on the JSE. *Investment Analysts Journal*, 35(63), 31–38.
- Basiewicz, P. G., and Auret, C. J. (2009). Another look at the cross-section of average returns on the JSE. *Investment Analysts Journal*, 38(69), 23–38.
- Basu, S. (1977). Investment Performance of Common Stocks in Relation to Their Price-Earnings Ratios : A Test of the Efficient Market Hypothesis. *The Journal of Finance*, 32(3), 663–682.
- Black, F., and Scholes, M. (1974). The effects of dividend yield and dividend policy on common stock prices and returns. *Journal of Financial Economics*, 1(1), 1–22.
- Bloomberg. (2016). Bloomberg Data Terminal.
- Bradfield, D., and Kgomari, W. (2004). *Concentration - should we be mindful of it?* Cadiz financial strategists, Unpublished research report.
- Brzezczynski, J., Archibald, K., Brzezczynska, J., and Gajdka, J. (2008). Dividend yield strategy in the British stock market 1994-2007, (February 28, 2008), Available at SSRN: <http://dx.doi.org/10.2139/ssrn.1100623>
- Brzezczynski, J., and Gajdka, J. (2008). Performance of high dividend yield investment strategy on the Polish Stock Market 1997-2007. *Investment Management and Financial Innovations*, 5(2), 86–92.

Buffett, W. (2013). Berkshire Hathaway Annual Shareholder Letter. *Berkshire Hathaway Website*, 3–24. Available: <http://www.berkshirehathaway.com/letters/2013ltr.pdf>

Chopra, N., Lakonishok, J., and Ritter, J. (1992). Measuring abnormal performance: Do Stocks Overreact? *Journal of Financial Economics*, 31(2), 235–268.

Cubbin, E., Eidne, M., Firer, C., & Gilbert, E. (2006). Mean reversion on the JSE. *Investment Analysts Journal*, 35(63), 39–48.

Damodaran, A. (2012). *Investing for grown ups? Value Investing*. New York University. Available at SSRN: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2042657](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2042657)

De Bondt, W., and Thaler, R. (1985). Does the Stock Market Overreact? *The Journal of Finance*, 40(3), 793–805.

Erasmus, N. (2013). *Dividend Yield Investment Strategies in the South African Stock Market. Wits Institutional Repository Environment*. University of the Witwatersrand. Available: [http://wiredspace.wits.ac.za/bitstream/handle/10539/13073/Nelmarie Erasmus 691106.pdf?sequence=1](http://wiredspace.wits.ac.za/bitstream/handle/10539/13073/Nelmarie_Erasmus_691106.pdf?sequence=1)

Fakir, R. (2013). Dividend yield as a superior investment strategy. *University of Pretoria, Gordon Institute of Business Science*, Unpublished MBA dissertation, Available: [http://www.repository.up.ac.za/dspace/bitstream/handle/2263/40563/Fakir\\_Dividend\\_2013.pdf?sequence=1](http://www.repository.up.ac.za/dspace/bitstream/handle/2263/40563/Fakir_Dividend_2013.pdf?sequence=1)

Fama, E. (1965). The Behavior of Stock-Market Prices. *The Journal of Business*, 38(1), 34–105.

Fama, E. (1970). Efficient Capital Markets: A Review of Theory and Empirical Work. *The Journal of Finance*, 25(2), 383–417.

Fama, E. F., and French, K. (1998). Value Versus Growth: The International Evidence. *The Journal of Finance*, 53(6), 1975–1999.

Fama, E. F., and French, K. R. (1988). Dividend yields and expected stock returns. *Journal of Financial Economics*, 22(1), 3–25.

Fama, E., and French, K. (1992). The Cross-Section of Expected Stock Returns. *The Journal of Finance*, 47(2), 427–465.

Fama, E., & French, K. (1996). Multifactor Explanations of Asset Pricing Anomalies. *The Journal of Finance*, 51(1), 55–84.

Fraser, E., and Page, M. (2000). Value and Momentum Strategies: Evidence from the Johannesburg Stock Exchange. *Investment Analysts Journal*, 51, 25-35.

Graham, B. (1949). *The Intelligent Investor*. Harper (First Edit). Harper & Brothers.

- Graham, B., and Dodd, D. L. (1934). *Security Analysis*, 2<sup>nd</sup> ed., McGraw-Hill.
- Graham, M., and Uliana, E. (2001). Evidence of a Value-Growth Phenomenon on the Johannesburg Stock Exchange. *Investment Analysts Journal*, 53, 1–11.
- Jensen, M. C. (1978). Some anomalous evidence regarding market efficiency. *Journal of Financial Economics*, 6(2-3), 95–101.
- Klerck, W., and Maritz, A. (1997). A Test of Graham's Stock Selection Criteria on Industrial Shares Traded on the JSE. *Investment Analysts Journal*, 45, 25–33.
- Kruger, R., and Toerien, F. (2014). The Consistency of Equity Style Anomalies on the JSE during a Period of Market Crisis. *The African Finance Journal*, 16(1), 1–18.
- Lakonishok, J., Shleifer, A., and Vishny, R. (1994). Contrarian Investment, Extrapolation, and Risk. *The Journal of Finance*, 49(5), 1541–1578.
- Lintner, J. (1965). The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets. *The Review of Economics and Statistics*, 47(1), 13–37.
- Litzenberger, R. H., and Ramaswamy, K. (1979). The effect of personal taxes and dividends on capital asset prices. Theory and empirical evidence. *Journal of Financial Economics*, 7(2), 163–195.
- Malkiel, B. G. (2003). The Efficient Market Hypothesis and Its Critics. *Journal of Economic Perspectives*, 17(1), 59–82.
- Mcqueen, G., Shields, K., and Thorley, S. R. (1997). Does the “Dow-10 Investment Strategy” Beat the Dow Statistically and Economically? *Financial Analysts Journal*, 53(4), 66–72.
- Miller, M., and Modigliani, F. (1961). Dividend Policy, Growth, and the Valuation of Shares. *The Journal of Business*, 34(4), 411–433.
- Miller, M., and Rock, K. (1985). Dividend Policy under Asymmetric Information. *The Journal of Finance*, 40(4), 1031–1051.
- Mossin, J. (1966). Equilibrium in a Capital Asset Market. *Mossin*, 34(4), 768–783.
- Muller, C., and Ward, M. (2013). Style-based effects on the Johannesburg Stock Exchange: A graphical time-series approach. *Investment Analysts Journal*, 77, 1–16.
- Mutooni, R., and Muller, C. (2007). Equity Style Timing. *Investment Analysts Journal*, 65, 15–24.
- Plaistowe, T., and Knight, R. (1986). Premium to Book Value may be a contrary indicator. *Investment Analysts Journal*, 28, 35–39.
- Rousseau, R., and Van Rensburg, P. (2003). Time and the payoff to value investing. *Journal of Asset Management*, 4(5), 318–325.
- Samuelson, P. (1965). Proof that properly anticipated prices fluctuate randomly. *Industrial*



*Management Review*, 6(2), 41–49.

Sharpe, W. (1964). Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk. *The Journal of Finance*, 19(3), 425–442.

Sharpe, W. (1966). Mutual Fund Performance. *The Journal of Business*, 39(1), 119–138.

Standard Bank. (2016). Standard Bank Online Share Trading. Available:  
<https://securities.standardbank.co.za/ost/>

Strugnell, D., Gilbert, E. and Kruger, R. (2011) Beta, size and value effects on the JSE, 1994-2007. *The Investment Analyst Journal*, 74, 1-17.

Treynor, J. (1961). Market Value, Time and Risk. *Unpublished Manuscript*, 95–209.  
Available at SSRN: <http://dx.doi/10.2139/ssrn.2600356>

Tweedy Browne Company LLC. (2014). The High Dividend Yield Return Advantage: An Examination of Empirical Data Associating Investment in High Dividend Yield Securities with Attractive Returns Over Long Measurement Periods. *Investment Report*. Available:  
<http://www.independentinvestor.info/PDF-Downloads/HOW-TO-INVEST-RETURNS-INDEXES-02/doc.1457-Tweedy-Browne-2003-Dividend-investing-studies.pdf>

Van Heerden, J.D., and Van Rensburg, P., (2015) The cross-section of Johannesburg Securities Exchange listed equity returns (1994-2011), *Studies in Economics and Finance*, 32(4), 422-444

Van Rensburg P. 2001. A decomposition of style-based risks on the JSE. *Investment Analysts Journal*, 54, 45–60.

Van Rensburg, P., and Robertson, M. (2003). Style Characteristics and the Cross-Section of JSE Returns. *Investment Analysts Journal*, 57, 7–15.

Visscher, S., and Filbeck, G. (2003). Dividend-Yield Strategies in the Canadian Stock Market. *Financial Analysts Journal*, 59(1), 99–106.

Wolmarans, H. (2004). “Dow Investing” possibilities for the small investor: Evidence from South Africa. *Investment Management and Financial Innovations*, 1(3), 40–50.

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**MAF 05: The Fight Against Poverty:  
Review of the Applicability of the Grameen Bank Model in  
South Africa**

**James McWha**

University of Cape Town, South Africa

**Gizelle Willows** (corresponding author)

University of Cape Town, South Africa

Email: [gizelle.willows@uct.ac.za](mailto:gizelle.willows@uct.ac.za)

**ABSTRACT**

This paper reviews the Grameen Bank model by looking at its implementation in Bangladesh and the key success factors in its alleviation of poverty. The analysis reveals that well trained staff, a group-based lending program and no need for collateral were contributing success factors of the model. The practicality of replicating the model is reviewed, with specific focus on South Africa. The results show that the spirit of Ubuntu and the practices of stokvels in South Africa have similar characteristics to those that are employed in the Grameen Bank model. The paper concludes by suggesting that the model be further considered for possible implementation in South Africa to assist alleviating poverty.

## 1. INTRODUCTION

The existence of poverty in society suggests that there are challenges to eradicate it and in South Africa this is noticeably true. With slow economic growth as well as high unemployment and poverty levels, South Africa needs a sustainable solution to combat poverty and empower the poor. However, without employment opportunities the poor must find other sources of income to raise themselves out of poverty such as entrepreneurship, social grants or other expensive forms of credit from moneylenders. Traditionally, the cost of credit available to the poor is so high that it often keeps them trapped in poverty (Yunus et al. 2010). Social grants place a burden on the government and taxpayers especially, if the percentage of the population that lives in poverty is high. Following from this it would seem that sustainable income-earning structures require an initial financial investment that is likely to be beyond the financial capabilities of people living in poverty.

Severe poverty in Bangladesh is what led the Grameen Bank, founded by Professor Muhammad Yunus, to develop a model that seeks to eradicate poverty. This paper seeks to identify the factors that contributed to the success of this model followed by an analysis of successful replications in other countries in an attempt to determine whether the Grameen Bank model could practically be applied to combat poverty in South Africa.

Section two provides a background of the Grameen Bank and its operations. Section three explains the success factors identified within Bangladesh. Section four discusses other instances in which the model was replicated and section five deals with the practicality of the Grameen Bank model in South Africa. This final section assesses the South African culture of Ubuntu and the use of stokvels, and gives a brief analyses of the already available system of microfinance in order to provide practical recommendations on the applicability of the Grameen Bank model in South Africa.

## 2. BACKGROUND

The Grameen Bank initially started as a research project of Professor Muhammad Yunus in Chittagong, Bangladesh in 1976 in which he sought to test whether poor people were creditworthy for small unsecured loans (Dowla 2006). Professor Yunus tested the hypothesis that providing the poor with affordable financial assistance would create productive employment without the assistance of an external party (Sarker 2001). After seven years of experimentation, with assistance from the Nationalised Commercial Banks and eventually becoming a project of the Central Bank of Bangladesh, the Grameen Bank was formally established in 1983 as a specialised bank with its own licence to deal exclusively with the poor (Dowla 2006).

The objective of the Grameen Bank is to provide microloans to the poor who are defined as individuals that own assets to the value of less than half an acre of cultivatable land (Dowla 2006). The poor are unable to access affordable credit from conventional banks as they have no credit histories, do not have any collateral to offer or cannot fill out the required paperwork owing to high illiteracy rates (Yunus et al. 2010). By providing the necessary capital, the Grameen Bank created the opportunity for entrepreneurs to start businesses that buy and sell goods on the free market allowing them to generate income to repay the loan and use the excess to pay daily living expenses (Hulme 2008). The Grameen Bank offers loans averaging US\$100 and in 2006 the Grameen Bank was jointly awarded a Nobel Peace Prize along with

its founder Professor Yunus “for their efforts to create social and economic development” using an inclusive approach at the lowest income bracket of the economy (Nobelprize.org 2015) in Bangladesh and abroad in other replications of the model.

Sarker (2001) described the organisational structure used by the Grameen Bank to comprise several levels in the form of a hierarchy. At the top level is the head office in Dhaka, which supervises the organisation as a whole and makes the broad general management decisions. The next level comprises the zone offices, which form the pinnacle of the field operations. Zone offices supervise, monitor and audit around 10 to 15 area offices each which are themselves responsible for monitoring and coordinating 10 to 15 branches each. The branches oversee and coordinate around 120 to 150 centres in 15 to 22 villages. Each centre hosts an average of 8 groups and provides a meeting space for training and weekly payment collections (Sarker 2001).

The Grameen Bank currently provides four interest-bearing loans including an income-generating (general) loan at 20%, a housing loan at 8%, a student loan at 5% and a struggling member loan (or beggar loan) at 0% per annum (Grameen Bank 2015b). The struggling member program is intended to provide beggars on the streets with capital to purchase items to sell, gradually teaching them entrepreneurial skills while encouraging them to join a Grameen Bank centre (Hulme 2008).

Members are also required to pay a once-off deposit of about 5% of the initial loan amount into a group fund. This deposit, known as a group tax, serves to provide finance to the Grameen Bank for general operations and to the group members in case of any emergency. This deposit is not recoverable from the Grameen Bank when members discontinue the banking services. The Grameen Bank never writes off any loans but rather chooses to restructure the terms to meet the needs of the individual at risk of defaulting (Hussain et al. 2001).

The Grameen Bank also embraces the social business model devised by Professor Yunus of “a self-sustaining company that sells goods or services and repays its owners’ investments, but whose primary purpose is to serve society and improve the lot of the poor” (Yunus et al., 2010, p.309). It is through these social businesses that the Grameen Bank ideology is implemented and the model for micro-financing is used to create tailored and area-specific solutions to the financing needs for the poor. Examples of social businesses include partnerships such as Grameen Phone, Grameen Veolia and Grameen Danone.

As of April 2015, the Grameen Bank has cumulatively disbursed around US\$17 million of which US\$15.5 million has been repaid, a repayment rate of over 98% since inception. Total membership during April 2015 amounted to 8,673,233 members of which 96% are women (Grameen Bank 2015a).

### 3. KEY SUCCESS FACTORS

A number of critical success factors have been identified in the literature, namely: 1) the group-based lending approach, 2) not requiring collateral, 3) well trained and incentivised staff, and 4) the relationships between the key role players in the organisation (Boysen & Sahlberg, 2008). This section will explain and analyse each success factor.

### 3.1 Group-based lending

The first and most common of the success factors identified is the group-based lending approach. Members are required to form groups of five people on average with no relatives or people from the same household being permitted to join the same group (Sarker 2001). Groups are male or female only.

The Grameen Bank provides the group with training in literacy, entrepreneurial skills and finance and initially only provides loans to two of the members. After an observation period of 6-8 weeks two more members receive loans. Whilst not formally jointly liable for the loans, members are allowed to assist the other members of their group if they are unable to make repayments. This forms a collective responsibility amongst the members of the group for individual loans.

The Grameen Bank did implement a policy of not furthering additional credit to any individual member if they were members of a group with a defaulting member. Whilst this policy succeeded in creating collective responsibility, it is not implemented in practice (Boysen & Sahlberg 2008). Because members assumed a mutual accountability for the loans, they were careful when screening group partners as they were under the impression that defaulters could potentially spoil opportunities for the rest of the members (Hussain et al. 2001).

The group-based approach therefore forms a key component of the Grameen Bank model as it increases the efficiency of the Grameen Bank's delivery system by maximising contact between the bank and the members. This increased level of contact also places the Grameen Bank in a unique position to make use of a cost-effective monitoring tool that provides the bank with an in-depth knowledge of their members and facilitates preventative steps to mitigate the risk of default (Boysen & Sahlberg, 2008). The shared group dynamic also assists the Grameen Bank in encouraging meaningful participation from the members.

### 3.2 No collateral

In order to mitigate the risk of unsecured lending, the Grameen Bank instituted less conventional means of security with the group-based lending approach. The group-based lending system replaced physical capital with social collateral, such as peer pressure and peer monitoring (Dowla 2006). Not requiring collateral is an important feature of the Grameen Bank model because its aim is to assist those stuck in poverty who, by virtue of their circumstances, are not able to better their living standards and do not have any material possessions to offer as security for a loan.

### 3.3 Staff are well trained and incentivised

The staff members of the Grameen Bank are well trained, patriotic and highly motivated. They played a key role in furthering the social agenda of the bank. The importance of well-trained, highly motivated, dedicated and loyal staff is apparent for any type of business. However, it is particularly important for the operation of the Grameen Bank model, as often staff members will be performing hard work in remote and very poor locations whilst receiving little compensation. The nature of the work that the Grameen Bank model aims to perform is not likely to result in the ability to compensate staff with high salaries, which emphasises the importance of the staff believing in the goals of the Grameen Bank model. Therefore, carefully designed incentive systems and other forms of motivation such as recognition for the work

performed by the staff forms a crucial part of maintaining a strong workforce. The Grameen Bank has demonstrated that this level of commitment is attainable.

A well designed incentive system contributed towards employees actively promoting the Grameen Bank and its services (Mamun 2012). At the start of their employment, staff are informed of the importance of “hard work, staying in the rural areas, honesty, and sincerity” (Sarker, 2001, p.11). Sarker (2001) described how applicants underwent an extensive on-site training programme after which only those applicants that were truly committed to the purpose of the Grameen Bank obtained employment. This commitment translated into a highly motivated, reliable and hard-working workforce to which the Grameen Bank owes much of its success (Sarker 2001).

The Grameen Bank typically hires young graduates who had not yet grown accustomed to the traditional banking practices followed by older employees (Hulme & Moore 2006). A lack of alternative employment opportunities may potentially contribute to the young employees adopting a more risk-averse and loyal behaviour towards the Grameen Bank with the additional benefit of dissuading any potential corruption. Hiring young graduates also assisted the Grameen Bank in sustaining their practice of challenging the conventional wisdom of banking entrenched in older bankers by replacing it with innovative thinking from the graduates (Sarker 2001).

Furthermore, Sarker (2001) noted that the staff motivation was maintained through informal rewards such as recognition of work, pride in the social objectives of the Grameen Bank, international recognition (such as the Nobel Peace Prize) and a sense of belonging or identity.

### 3.4 Relationships

The relationships between the various stakeholders and the Grameen Bank can be split into three main categories namely: member-to-member, bank-to-member and bank-to-staff.

Member-to-member relationships are formed because members are part of the same group or social programmes and share a common identity as a Grameen Bank participant. Group interaction and networking provides members with opportunities and knowledge that may not have been available otherwise, which also adds to the value derived from joining the Grameen family (Boysen & Sahlberg, 2008).

Bank-to-member relations form the cornerstone of the Grameen Bank’s culture and strategy. This relationship focuses on an in-depth knowledge of the members that is achieved through maintaining close relationships throughout the loan period. The relationship between the group and the centre is crucial in ensuring assigned tasks are carried out as needed (Sarker 2001). The Grameen Bank focuses solely on their members and their needs to form a relationship with its members based on trust, whilst encouraging each party to fulfil their obligations (Dowla 2006).

Lastly, the bank-to-staff relationship is cultivated from the onset of the extensive training program undergone by staff applicants mentioned earlier. The Grameen Bank instils a great sense of pride amongst Grameen Bank employees as well as a genuine care for the poor, partly as a result of the intense training program, but also due to the moral boost from global recognition of the bank’s work (Dowla 2006).

The social relationship element of the Grameen Bank model can therefore be seen as a crucial element in winning the loyalty and participation of as many stakeholders as possible in the

fight against poverty. With this high level of involvement the Grameen Bank model can reach far beyond the confines of its membership to improve the lives of non-member or potentially even entire communities.

#### 4. REPLICATIONS ACROSS THE WORLD

Numerous countries including Australia, the United States of America (USA) as well as countries in Europe, Asia, Africa and South America, have applied the Grameen Bank model with varying levels of success. A brief summary of some of these applications is as follows:

- In Norway, success was found in using the Grameen Bank model with the Norwegian Women Network Bank. The Norwegian Women Bank first started in the Lofoten fishing industry and now has over 200 members (Grameen Bank 2015b).
- In India, CASHPOR, a “network of Asia-Pacific Grameen replications” (Hussain et al., 2001, p.35), successfully implemented the Grameen model as a network institution. CASHPOR’s main objective is to teach the necessary skills required to replicate the model on a large scale throughout Asia in a financially viable manner.
- In China, the Funding the Poor Cooperative (FPC) was the first microfinance institution. Launched by the Rural Development Institute (RDI) of the Chinese Academy of Social Sciences (CASS) it now operates as a non-governmental organization servicing 16 000 active borrowers using the Grameen Bank model, and achieving a 95% repayment rate using the Grameen Bank model (Hussain et al., 2001) .

These replications show that the Grameen Bank model can be successfully applied in different countries regardless of their socio-cultural differences.

Whilst the model could be successfully applied in Europe, it would not be without obstacles. One barrier in western culture is individualism which conflicts with the operation of a peer group lending system (Hussain et al. 2001). This is supported by the findings of Gould (2010) who described the difference between a collectivist and an individualist society. In a collectivist society “the group’s welfare is part of an individual member’s self-identify and reputation within his or her community” (Gould, 2010, p.4) and the individual’s mindset is that the well-being of the group supersedes personal interests (Gould 2010). Individualists are more solitary in their pursuit to satisfy personal needs. Individualists may be more opposed to cooperation in the group setting and are more likely to strictly guard financial information. This distinction is important when attempting to replicate the model in a western culture as the model was developed in a collectivist society (Gould 2010).

In the USA, the first attempt for the Grameen Bank model was in Arkansas in the late 1980’s (Gould 2010). In an attempt to recreate the social ties necessary for the group-based system, a six-week training program was enforced and participants were split into groups. However, this level of familiarity was insufficient and the bank was unable to achieve a repayment rate higher than 70 percent owing to a lack of ‘social cohesion’ (Gould 2010). Gould (2010) concluded that while the model might not have been the most appropriate for micro-lending in the USA it could still be utilized after making adjustments to the underlying cultural basis of the model.

Notwithstanding, Grameen America (2015) has subsequently been successfully implemented. Grameen America (2015) uses the group-based approach and assists members in setting up businesses such as hair salons, pet grooming, cleaning services, food carts and flower shops.

In the 2013 financial year, 26 300 members were granted loans in seven cities creating just under 57 000 jobs. The financial information provided by Grameen America (2015) indicates that the majority of income generated is from grants and donations. However, program income (the income generated from the interest charged on loans) has been steadily increasing from 11.5% of total expenses in 2010 to 24% in 2013 showing increasing sustainability of the organization (Grameen America 2015).

## 5. PRACTICABILITY OF THE GRAMEEN BANK MODEL IN SOUTH AFRICA

As of July 2015, little research has been performed on organisations using the Grameen Bank model in African countries, with the exception of the Grameen Foundation that operates predominantly in Northern Africa. South Africa is an example of a country that could potentially benefit from the use of the Grameen Bank model and it is the aim of this section to determine whether implementation would be feasible.

Compared to Bangladesh (population of 159 million people), South Africa is a smaller country with a population of 54 million people (Statistics South Africa 2015). Both countries have high levels of poverty with 31.5% of Bangladesh's and 53.8% of South Africa's population living below the poverty line (The World Bank 2015).

With a Gini coefficient of 65<sup>30</sup>, income distribution inequality in South Africa is amongst the highest in the world. This equates to around 53.8% of the country's wealth being in the hands of the top (richest) 10% of the population and only 1.1% of the wealth in the bottom (poorest) 10% of the population (Kiersz 2014). Furthermore, the official unemployment rate in South Africa, using the broad economic definition, is at 35.8% (Business Tech 2015). This rate is significantly higher than 4.3% in Bangladesh (Trading Economics 2015).

A lack of employment opportunities and poor income distribution has been a cause for major strife in South Africa, resulting in numerous labour strikes that severely impact local industry. Added to this is the high level of crime and corruption in South Africa. There is a need for a suitable and sustainable model that can assist the creation of jobs to alleviate poverty. As of July 2015, there is little economic and financial support available to the poorest people in South Africa from the formal financial institutions. As such the poor must turn to alternative self-help sources of finance for survival. An example of this is a stokvel (Moliea 2007).

The Grameen Bank model has shown to assist various countries in combatting poverty to some extent. Certain factors, such as Ubuntu and stokvels, and the similarities they share with the Grameen Bank model as it is applied in Bangladesh, indicate that the model could be successfully implemented in South Africa. This section will proceed by explaining and discussing each factor in turn and conclude on the practicality of adopting a similar approach in South Africa to that of the Grameen Bank. Furthermore, a brief financial analysis will be performed to assess whether the performance of the Grameen Bank in Bangladesh, when compared to banks in South Africa, indicates that the Grameen Bank model will be commercially viable.

---

<sup>30</sup> The Gini coefficient is a statistical economic measure that illustrates the equality of the distribution of income in a country. A zero coefficient indicates that perfect equality in income distribution exists and vice versa. Therefore, a Gini coefficient of 65 indicates that South Africa's income is poorly distributed.



## 5.1 Ubuntu

For any organisation wanting to commence operations in a foreign country, the local tradition and culture should inform the policy and procedures of that organisation to allow for a sustainable practice to be established. Ubuntu is said to underlie the ethical and moral principles of the majority of indigenous African cultures (Gade 2012). A sound understanding of Ubuntu would therefore seem crucial to any business operating in South Africa.

When asking the question 'What is Ubuntu?' Gade (2012) found two potential definitions, namely: 1) "the moral quality of a person" and 2) "a phenomenon according to which persons are interconnected" (Gade, 2012, p.487). For this paper the second definition will be focused on for the purposes of informing the discussion, although, it is important to note that Ubuntu potentially influences behaviour on both a personal level and a community level.

Mangaliso (2001) discussed using Ubuntu from a management perspective to build a sustainable competitive advantage and noted the following about the various aspects of Ubuntu:

- Relationships with others: A symbiotic relationship exists among members of a community that is driven by a strong sense of interdependence and a suppression of self-interest. This places a strong emphasis on synergistic teamwork and the understanding that people working together in a team can accomplish more than if they had been working as individuals. The phrase 'umuntu ngumuntu ngabantu' (roughly translated as 'a person is a person is a person through others') (Gade 2012) emphasises the importance of relationships amongst members of a community as it is through these relationships that African people identify themselves.
- Communication: Under Ubuntu the social aspect of communication is emphasised. Unity and understanding as well as forming and reinforcing relationships are regarded more important than the efficiency of communication.
- Decision Making: In contrast to the Western approach to decision-making, which is very linear, under Ubuntu the process is more circular. Strong emphasis is placed on ensuring that all voices are heard and the decision with the most support is chosen even if it may not be the most rational or correct choice.

A society that embraces Ubuntu can be interpreted to represent a collectivist society. Aspects of the Grameen Bank model can therefore be interpreted to closely resemble the key aspects of Ubuntu. The group-based lending approach would facilitate social interaction between the members and provide a platform from which meaningful communication could take place between the prospective bank and its members. Trust and solid relationships are important aspects of both Ubuntu and the Grameen Bank Model. Similarly, if the members were to own a portion of the bank that would be sufficient to allow control, the members could ensure that decisions are made according to the views and needs of the members themselves, much as is done in Bangladesh. It could therefore be suggested that Ubuntu and the Grameen Bank model would complement each other if adopted by an organisation in South Africa.

## 5.2 Stokvels

There is already a practice adopted by the poor in South Africa that shares some characteristics with the Grameen Bank model. This practice, locally known as stokvels, is

strongly underpinned by the principles of Ubuntu and to some extent caters to the financial needs of the poor in South Africa (Verhoef 2001) but without the Grameen poverty lifting vision.

A stokvel is an informal voluntary saving organisation in which members of a community will band together and agree to contribute a fixed amount into a fund that can be used for various purposes. The stokvels in South Africa are most commonly used for subsistence purposes such as funding day-to-day living expenditure or large events (Verhoef 2008) rather than as a source of finance for microenterprise, which is more common in other countries and is practiced by foreign nationals in South Africa (Arko-Achemfuor 2012).

Stokvels exist partially because the poor do not have access to credit or other banking services from formal banking institutions because they cannot provide collateral or establish a credit history due to irregular income patterns (Moliea 2007). While access to credit is an important factor influencing individuals to join a stokvel it is not the only reason, as other incentives to join exist that are, in some cases, seen as more important. The literature identified the following incentives to join a stokvel:

- Members of stokvels are forced to save a fixed amount on a regular basis. It was noted that individuals find it easier to default on their obligations with formal institutions, as the repercussions are seen as less severe than those they would face if they defaulted on a stokvel payment. High levels of peer pressure, through economic and social sanction, result in very low default rates. Members see this in a positive light, as they had no choice but to save for their future (Verhoef 2008).
- Perhaps among the most important incentives to join are social in nature. Stokvels provide members with a chance to expand social connections, exchange business ideas and survival strategies, or obtain advice from fellow members (Moliea 2007).
- For women, membership in a stokvel provides them with a certain level of status and support. Women in South Africa are most commonly in charge of maintaining the household with limited income while their husbands are either away working or not seen as reliable. Stokvels provide them a means with which they can support their families and improve their households (Verhoef 2001).
- Many individuals, especially those that are illiterate, find the formal financial institutions impersonal and intimidating. Stokvels offer a form of savings that the members are better able to understand and relate to as they are receiving money from people in their community that they know and trust and in turn will contribute to assist those people in the future (Verhoef 2001).
- Hosting stokvel gatherings (social occasions at which contributions are collected and pay-outs made) provides the host with an income earning opportunity through the sale of food and refreshments or by charging a nominal entrance fee. Hosting opportunities are rotated between members, or even non-members (Verhoef 2001).
- Stokvels offer access to credit without the need for collateral or a credit history as they are based on trust between members that are already familiar with each other. An individual seeking to join a stokvel is to some extent screened to ensure that they are trustworthy and an upstanding member of the community (Moliea 2007).

While stokvels and the Grameen Bank model do have rather different aims, one to cope with poverty, the other to get people out of poverty, the two models do share many similar features. The group system and peer pressure is common to both as well as the emphasis on building

solid relationships. Physical collateral is not required and membership and lending is based on trust. However the Grameen Bank model provides members with training and advice that, along with the regular meetings and a sense of unity with the bank, could potentially align with the social incentives that increase stokvel membership. This social interaction may also assist the potential organisation in overcoming the impersonal and intimidating perception given off by other financial institutions. Lastly, the practice of forced saving observed in stokvels is similar to the savings required by the Grameen Bank model on a weekly basis.

A key point to note is that stokvels in South Africa focus primarily on funding subsistence expenditure whereas the Grameen Bank model focuses on providing capital to establish microenterprises. This key difference shows that there is a large gap between funding subsistence expenditure and traditional financial capital streams (most of which are inaccessible to the poor) that the Grameen Bank model could fill.

Next, microfinance in South Africa will be discussed to assess whether any existing financial institutions are providing services that may bridge the gap and whether the Grameen Bank model would be able to sustainably operate in the South African low-income market.

### 5.3 Microfinance in South Africa

Commercial banks have acknowledged the importance of stokvels in South Africa by offering special accounts to facilitate the safekeeping of stokvel funds, offer multiple signatory rights and good returns on the invested funds but do not formalise the stokvels themselves (First National Bank 2015). Furthermore, there are few programs or products provided by the formal banking sector that are similar to stokvels. The most similar product available to the poor takes the form of microfinance which is described as the provision of savings and credit to low-income individuals on a small scale that is targeted at improving the well-being of the poor (Moliea 2007).

While the intentions of microfinance institutions (MFIs) are similar to those of stokvels and the Grameen Bank model in that they aim to provide credit to low income earners, certain challenges exist that may prevent typical commercial microfinance providers from attaining success. Moliea (2007) noted one such challenge is that microfinance organisations are argued to be unsustainable without the aid of donations or subsidies. This concern for sustainability arises from the tendency of poor individuals to use the financing for subsistence expenditure rather than on forming income-earning structures to repay the loans, which makes it difficult for the banks to establish reliable revenue streams.

Another issue raised is that MFIs often exist to offer a product rather than focus on the requirements of the customers. This results in MFIs “offering highly standardised products to a market which is perceived homogenous, but which in reality is highly variable in its constituency” (Moliea, 2007, p.15). Other challenges such as a lack of collateral, the high cost of setting up branches in remote locations and high risk also restrict the ability of MFIs to cater for the poor from a commercial standpoint.

Many aspects of the challenges faced by traditional microfinance providers are similar to those that shaped the Grameen Bank model. The organisational structure of the Grameen Bank allows it to access remote locations at relatively low costs and the lack of collateral and high risk is compensated for by social capital created through group based lending and peer pressure. The Grameen Bank model was also developed with the needs of the poor in mind

resulting in operations and services offered being designed to achieve a specific purpose rather than to sell a product.

Capitec Bank (Capitec) is an example of a South African bank that has attempted to access the lower-income target market through microfinance and has achieved a relatively high level of success quickly grounding itself as one of the major banks in South Africa's well-established banking industry. This success could be attributed to Capitec adopting an approach that focuses foremost on the needs of their target market rather than on establishing an acceptable risk profile through effective internal controls. This resulted in simplified financial products, such as microloans or savings accounts, that the poor are better able to understand and a relative ease of use of these products (McNulty 2009). Capitec provides the closest and most appropriate comparison of an institution that caters to a similar target market to that of the Grameen Bank model.

The analysis of Ubuntu, stokvels and microfinance in South Africa above suggests that the Grameen Bank model has a high chance of being implemented successfully. The Grameen Bank model fits in with the cultural elements of Ubuntu and closely resembles the characteristics of stokvels, but has clearer poverty alleviation goals and might better benefit South African society if it can be successfully introduced. Microfinance institutions in South Africa are not able to access a large portion of the low-income bracket and as such there is a large gap in the market in which an organisation adopting the Grameen Bank model can operate and expand. Therefore, it would appear that it would be feasible to adopt the Grameen Bank model in South Africa.

## 6. CONCLUSION AND RECOMMENDATIONS

Poverty is a vicious cycle of "low income, low savings, low investment and low income" (Sarker, 2001, p.5). Without access to credit and other financial support the people stuck in poverty have very few options at their disposal with regards to improving their standard of living or even for basic survival. In South Africa, unemployment and poverty levels are high resulting in an increased strain on the taxpaying population.

This paper has found that the Grameen Bank model is a powerful tool for alleviating poverty in many environments, including both developing and developed countries. The key success factors of the Grameen Bank model identified from the application in Bangladesh are sufficiently similar to the culture of Ubuntu and the incentives that individuals have to join stokvels in South Africa that it is likely that the Grameen Bank model will be able to garner support and acceptance with the poor South Africans. If the Grameen Bank model were to be replicated in South Africa the findings of this paper suggest that it will provide an innovative solution that can be utilised to reduce poverty. Following from this, the Grameen Bank model can focus on providing the capital for establishing income-earning structures and would therefore not compete with the service provided by stokvels that primarily focuses on funding subsistence expenditure.

Further research by means of interviewing and holding panel discussions with relevant stakeholders is recommended in an attempt to further understand the relevant limitations for implementation. Further, financial ratio analysis of the financial results of the Grameen Bank and comparison against Capitec Bank would provide further insight into capital adequacy, interest margins and relevant costs to income.

## BIBLIOGRAPHY

- Arko-Achemfuor, A., 2012. Financing Small, Medium and Micro-Enterprises (SMMEs) in Rural South Africa: An exploratory study of stokvels in the Naledi Local Municipality, North West Province. *Journal of Social Anthropology*, 3(2), pp.127–133.
- Boysen, V. & Sahlberg, R., 2008. *The Key Success Factors of Grameen Bank - A Case Study of Strategic, Cultural and Structural Aspects*. Lund University.
- Business Tech, 2015. The Real Employment Rate in South Africa.
- Dowla, A., 2006. In credit we trust: Building social capital by Grameen Bank in Bangladesh. *Journal of Socio-Economics*, 35(1), pp.102–122.
- First National Bank, 2015. First National Bank stokvel account.
- Gade, C.B.N., 2012. What is Ubuntu ? Different Interpretations among South Africans of African Descent. *South African Journal of Philosophy*, 31(3), pp.484–502.
- Gould, C., 2010. Grameencredit: One solution for poverty, but maybe not in every country. *UCLA Pacific Basin Law Journal*, (c), pp.1–26.
- Grameen America, 2015. *Grameen America*.
- Grameen Bank, 2015a. *Grameen Bank*,
- Grameen Bank, 2015b. *Interest Rate*.
- Hulme, D., 2008. From Subsidised Microcredit to Market-based Microfinance November 2008 BWPI Working Paper 60. , (November), pp.1–11.
- Hulme, D. & Moore, K., 2006. Why has microfinance been a policy success in Bangladesh (and beyond)? , p.29.
- Hussain, M.M., Maskooki, K. & Gunasekaran, A., 2001. Implications of Grameen banking system in Europe: prospects and prosperity. *European Business Review*, 13(1), pp.26–42.
- Kiersz, A., 2014. Here Are The Most Unequal Countries in The World. *Business Insider*.
- Mangaliso, M. P. (2001). Building Competitive Advantage from Ubuntu: Management Lessons from South Africa. *Academy of Management Executive*, 15(3), 23–33.  
<http://doi.org/10.5465/AME.2001.5229453>
- Mamun, C.A. Al, 2012. Assessing the Factors that Led to the Success of Microfinance in Bangladesh : A Case Study on Grameen Bank. *World Review of Business Research*, 2(2), pp.75–90.

- McNulty, A., 2009. Behind Capitec's Successful Model. *Leader.co.za*.
- Moliea, H., 2007. *Stokvels as Alternative Microfinance Institutions : Conversations with Women from Venda*. University of Pretoria.
- Nobelprize.org, 2015. Grameen Bank - Facts.
- Sarker, A.E., 2001. The secrets of success: the Grameen Bank experience in Bangladesh. *Labour and Management in Development Journal*, 2(1).
- Simpson, S.D., 2015. The Banking System: Commercial Banking - Key Ratios/Factors. *Investopedia*.
- Statistics South Africa, 2015. *Mid-year Population Estimates*,
- The World Bank, 2015. World Bank Data.
- Trading Economics, 2015. Bangladesh Unemployment Rate.
- Verhoef, G., 2001. Informal Financial Service Institutions for Survival : African Women and Stokvels in Urban South Africa. *Oxford University Press*, 2(2), pp.259–296.
- Verhoef, G., 2008. *Social Capital in Voluntary Savings Organisations in South Africa in Historical Perspective*. University of Johannesburg.
- Yunus, M., Moingeon, B. & Lehmann-Ortega, L., 2010. Building social business models: Lessons from the grameen experience. *Long Range Planning*, 43(2-3), pp.308–325.

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

**ISBN number: 978-0-620-74761-5**



---

**MAF 07: An investigation of the factors to consider for a  
free higher education system in South Africa**

Mzikazi Ntintelo & Ilse Lubbe (College of Accounting, University of Cape Town)

Contact: [ilse.lubbe@uct.ac.za](mailto:ilse.lubbe@uct.ac.za)

**Abstract**

South Africa has been at an uproar since the student protests of October 2015 over the proposed higher education fee increases. The result of which was a 0% fee increment in 2016. Much speculation within the economy has been around how the government fiscus is going to cater for the 0% fee increment and going forward, whether the country can afford free higher education. The overarching issue concerning the goal of increasing higher education participation is that the cost of higher education continues to increase and the funding thereof is limited, placing a barrier on those who qualify for higher education opportunities but cannot afford it.

Against this background, the treasury has allocated an increased amount in its 2016/17 budget to the Department of Higher Education and Training (DHET). The equitable allocation of a limited budget to the different spheres of government based on the valid needs of the citizens of the country remains a challenge. Some argue that the provision of higher education is not necessarily the role and responsibility of government, and that the necessity for basic education requires a higher budget allocation. Further, the concept of free higher education will compromise the quality of the education provided and come at a cost of depriving other areas of service delivery. This raises the question whether free higher education is affordable and feasible, and if so, at what cost?

This study describes the considerations for free higher education in similar developing economies, such as African countries. The South African budget allocation to higher education is then compared over a period of six years, followed by an analyses of a student's cost for studying, and comparing that to the funding that is potentially made available to a student in need. A case is made that the government is already contributing a large amount to higher education (in the form of subsidies to universities) as well as funding through the NSFAS. However, alternative options need to be identified to support students who cannot afford the study fees in order to prevent exclusion based on financial shortages.

## **Introduction**

In the wake of a democratic South Africa, the government pledged to prioritise education, with basic education being its main responsibility. That being said, basic education is only the beginning of an academic foundation of any individual and concerns regarding the rising costs of higher education in South Africa sparked unrests in late October 2015. The nation's reaction towards the rise in higher education fees can be understood at a time when the monetary policy committee (MPC) was fighting to keep inflation down and manage the cost of living. South Africa finds itself in a challenging position, as it needs to increase the number of students from disadvantaged backgrounds in higher education institutions. This should be seen against the limited government resources and the question: should higher education be free in South Africa? And if so, at what cost and on what basis?

Since the beginning of the protest action against an increase in higher education fees in October 2015 across South African higher education institutions, much debate has circulated about the call for a free higher education system to be implemented within the country. Amongst the reasons highlighted for this request, are that there is a need to increase accessibility of higher education opportunities to previously disadvantaged students and that the continuous increase in study fees will negatively affect that goal. Arguments for and against the implementation of free higher education have been raised in South Africa and the standing principle is that the country is in unison about the need to increase the number of students from previously disadvantaged backgrounds in higher education institutions, however the manner in which that will be achieved is where differences in opinion appear.

The plea to cut fee increases for the 2016 academic year was not merely based on the rising cost of higher education that was exacerbated by inflation, but at ground level issues that affected poorer students at higher education institutions. Amongst these ground level issues was financial exclusion of financially challenged students irrespective of academic performance. The challenge for an institution is that the failure to collect fee income results in a shortfall of revenue and backlog of costs to maintain their facilities and resources. The implication of financial exclusion is that even in the instance of a student being academically capable, the limited availability of funding directly affects their ability to remain engaged in higher education.

The important factors to note, therefore, are that the students affected by this cycle are the poorer students who come from impoverished backgrounds and do not have the means to seek alternative funding for student fee debts. The South African reality is that students who come from poor socio-economic backgrounds are almost always the first, in their families, to attend university or a higher education institution. Families will be depending on those students graduating in record time, so as to provide a sustainable income for the family and invest back home, what is commonly referred to as "Black Tax". If a student is no longer able to continue with their tertiary studies due



to exhausted funds and is financially excluded, the expectation is that the student will seek some form of employment so as to help provide for the needs of the family. Of great concern is that the employment sought after is usually hard, non-rewarding labour and very few of these students ever get the opportunity and time to focus on full time studies again.

So much is wrong with the picture created by this cycle, as the consequence of those who don't end up seeking or finding employment is that they become part of the youth unemployment statistic (Van der Bank & Nkadameng, 2014). There is a great urgency in addressing the challenge around funding higher education for students who cannot afford it, and addressing the question whether as a nation, South Africa is currently able to adopt a cost free higher education system. An investigation of the factors to consider for a free higher education system in South Africa will therefore be conducted by this report.

The literature reviewed in the next section focuses on studies that investigate why funding higher education is an issue, globally as well as locally, and who are affected the most. It also considers implications of a free higher education system given the limited resources available to the South African developing economy. Finally, the literature provides some suggestions to increase access to higher education in South Africa.

### **Literature Review**

This literature review concentrates on a few papers, with dominance being placed on South African literature for the purposes of emphasising the most relevant arguments. Of importance to note, is the timing of the dominant literature reviewed. Two of the papers reviewed are by Gerald Wangenge-Ouma (2012, 2010) and are based on research before the student protest action in South Africa in October 2015, evidencing that the issue is not a new conundrum, and is a global issue. "Modern Trends in Higher Education Funding" (Maria & Bleotu, 2013) explains that the issue around higher education fees is not just a South African issue, but that thus far South Africa has been better off than most countries on the African continent in funding higher education and availing access to higher education. Other reviews respond to the issues around the 2015 higher education fee protests in South Africa.

### ***Challenges for funding higher education***

There has been a gradual decline in public expenditure on higher education. This decline is not confined to developing countries, such as South Africa, this trend is noticeable globally (Tilak, 2005). The majority of countries in the world charge fees in higher education, in some cases small amounts, while in others reasonably large amounts. In countries such as Sweden and Finland, there is no charge for higher education studies (Tilak, 2005). However, developing countries such as India and

South Africa have hiked study fees selectively, while providing subsidised higher education and funding to many students.

African countries that have employed free higher education in the past include Kenya, Zambia, Mozambique, Nigeria, Burkina Faso, and Egypt. In some countries higher education remains free, however, most African countries have moved towards subsidising higher education to a certain extent and making basic education free (Wangenge-Ouma, 2010). Previously, because the post-colonialism university was seen the driving force of the spurring African development and that charging fees for higher education would obstruct the development and power of individuals, higher education was free in these African nations. It was believed that African economic transformation was going to be achieved through higher education because of the level of skill shortage on the continent. The government's intervention to fully subsidise higher education was therefore to enable many students to benefit from university education. In Africa, free university education meant equity of access was achieved. The implementation and call for free higher education received an overwhelming response in these countries. As such, local and global support for the movement was in abundance. The limited number of students and sufficient resources at the time, made this system possible to implement (Wangenge-Ouma, 2010).

The issue with higher education in these nations was that it became increasingly expensive and unaffordable by the governments especially due to the decreasing economic growth in Africa at the time. The combined effect of strained economies and rising higher education costs lead to these governments decreasing funding for higher education. This issue was exacerbated by the growing demand in Africa for higher education as enrolments increased faster than the planned capacity. The result of this was suboptimal conditions for learning, as decreased government funding created a shortfall in maintaining capacity (Wangenge-Ouma, 2010).

The 2004 World Bank policy paper on higher education emphasised the importance of public higher education in national development (Tilak, 2005). However, this and other similar reports have not made any significant impact on the policies of governments or international development organisations in relation to funding higher education. Tilak (2005) argues that the best method of financing education, including higher education, is financing by the state through its tax and nontax revenues. The White Paper on higher education (Department of Education, 1997) set a broad transformation agenda that is underpinned by a core principle of redress of past inequalities through equity of access and the distribution of achievement along lines of race, gender, class and geography. Higher education, it is argued, emphasises the neo-liberal global trend that emphasises contribution to economic development and global competitiveness by developing a highly skilled labour force and through innovative knowledge production (McLean and Walker, 2012).

In South Africa, the literature reviewed places emphasis on the link between funding higher education and achieving the goal of increasing the number of previously under-represented students in higher education institutions. Wangenge-Ouma (2010) has raised several key issues in *“Funding and the Attainment of Transformation Goals in South Africa’s Higher Education”*. The paper addresses the issues around funding higher education in South Africa and how they can affect access by previously under-represented racial groups, which the study has strictly defined as “African Blacks” and “Coloureds”. The study highlights that the cost of higher education has increased due to the growth in student numbers. The increasing cost is said to harm poorer students the most as the limited availability of funding leaves them with no option but to drop out of higher education institutions or to not participate at all.

A current available source of funding is the National Student Financial Aid Scheme (NSFAS). Student loan programmes, it is argued, seem to create more problems than what they solve (Tilak, 2005) as it has the underlying assumption that higher education is “neither a public good nor a social-merit good, but, rather, a highly individualised private good” (p5), that shifts the responsibility of funding higher education from society to the families and individual students. Poor rates of recovery of student loans is an international problem (Tilak, 2005), where several loan programmes were changed into income-contingent loans, and banks took responsibility for government-operated loan schemes. While we can appreciate the existence of a funding model that assists students in financial need, the funding scheme is partly ineffective as it hardly covers the full cost of studies in most higher education institutions. Because NSFAS caters for poorer students, the remaining uncovered costs still threaten the student’s ability to remain in higher education institutions. Funding therefore creates a huge barrier to access for many students.

Wangenge-Ouma (2010) points to the implication of increasing study fees on access to higher education, highlighting that there has been an evident general decrease in the government’s funding for higher education and that the combination of that issue with increasing study fees magnifies the existence of inequality and socio-economic imbalances. The breakdown of the national funding framework (NFF) points to an “institutional factor grant” that is awarded to a higher education institution on the basis of a large proportion of students registered being students of low socio-economic backgrounds. With government funding showing a decreasing trend, concerns are raised that institutions that house a majority of disadvantaged students get lesser funding, due to decreasing government funding. Those who cannot afford higher education will suffer the most, especially in institutions where most of the students are from the previously under-represented groups (Wangenge-Ouma, 2010).

Government’s mandate is to focus on making basic education free and accessible to all, however, as one of its key priorities, about 5% of the national budget is spent specifically on higher education (Wangenge-Ouma, 2010). On that point it is necessary to understand why there has been a gradual decrease (in real terms) in

higher education funding by the government. Wangenge-Ouma's argument is that the policy around the funding of higher education is based on allocated funding outlined in the annual budget and not the actual costs for higher education. The consequence is a shortfall in allocated funding due to the demands of other essential services like public health, basic education, national defence, etc. Universities have become concerned about cost recovery, resulting in the introduction of 'user' charges for many other services provided, such as housing, food and transport (Tilak, 2005). The decrease in government funding has, for example, resulted in the reduction of funding utilised for constructing new buildings and facilitating repairs and renovations (Wangenge-Ouma, 2010).

The structure of the NFF policy is criticised in that one of the key funding determinants, the institutional factor grant, uses race and not socio-economic backgrounds to determine the part of the government funding allocation to a higher education institution with previously under-represented students as majority. The contention with this is that disadvantaged students of other races that fall under previously under-represented cannot benefit from this funding. Therefore, with a decrease in government funding and an allocation system that favours some and not all previously under-represented students, hope of these students gaining access to higher education in future slowly withers (Wangenge-Ouma, 2010).

This does not only make evident that there's a decreasing trend in government funding for higher education, but also emphasises that higher education institutions have to rely on their own funding (reserves and fee income) or loans for capital expenditure and the result of that is having to increase study fees. Study fee increases are linked to a high drop-out rate of these previously under-represented students because increases in study fees affect the poor students the most. Wangenge-Ouma (2010) concludes this argument by stating that the implications of study fee increases harm the equity of access because universities need to sustain themselves through study fee increases to fulfil their mandate. If government funding decreases over time, much reliance must be placed on study fee income for the maintenance of higher education institutions. An increase in the number of enrolments implies that institutions would need more resources and the inability to grow finances as rapidly to invest in those resources led to a mediocre higher education system in Africa (Wangenge-Ouma, 2010).

### ***Implications of a free higher education system in South Africa***

Different spheres of government, each with its own priorities, all compete for budget allocations and funding of projects. There is increasing pressure from other spheres of government, including health, safety and security and public infrastructure that are all pivotal to the functioning of the state, for larger budget allocations. This, along with the fact that government's funding for higher education has not increased in proportion to the increase in the actual cost of higher education, questions the sustainability of a

free higher education system. Wangenge-Ouma (2010) explains the effects of a free higher education system by emphasising the effect it will have on the same issues that currently hinder poor students from gaining access into higher education institutions. The consensus drawn is that free higher education is not sustainable as the decreasing funding available for government and state of the economy put strains on budget allocations and funds that are available for higher education (Wangenge-Ouma, 2010)

The feeling of marginalisation amongst the student body is a burden that they have carried for quite some time. The issue spread throughout the country when protests against fee increases were initiated. The unrest was sparked by the #RhodesMustFall movement established earlier in 2015 at the University of Cape Town. This was followed by a nation-wide #FeesMustFall movement, in which South Africa's youth responded to issues facing students. One of the reasons for the establishment of the movement was an outrage at the release of proposed university fees for 2016 and subsequent to that was the widespread publication of the proposed increase in fees for 2016. The response to issues such as increasing higher education fees is part of the consequences of this marginalisation. In relaying the implications of free higher education, this study refers to a paper that was written in response to these movements. In a Rand Mail article by Stuart Theobald *"How to fund university education for all"* (October, 2015) it is explained that a free education system will result in decreased government funding due to the increased demand for higher education and increased costs to maintain universities. The resultant decrease in overall government funding will force study fees to increase to sustain higher education institutions (because the government grant will have to decrease to ensure fairness in allocation across all higher education institutions) and thereafter that will decrease the level of access for poorer students. The free higher education system is detrimental to the sustainability of an institution and may result in universities resorting to charging for other services that don't constitute study, for example internet usage, transportation/shuttle services, higher residence fees, etc. Free higher education would make higher education cheaper for the rich in that a cost free higher education system would only benefit those that can already afford it (Theobald, 2015).

In a response to a media report following the #FeesMustFall movement, Anthony Farr, CEO of the Allan Gray Orbis Foundation, a fellowship programme that awards up to 100 full scholarships annually, issued a report explaining his views on the impact of free higher education. The report, titled *"Response to media reporting on fees must fall"* (Farr, 2016) states that free higher education in an unequal society does not achieve access. The current systems of external bursaries and accelerated fee systems provide access to students who would otherwise not have been able to afford higher education. The accelerate fee systems result in wealthier students paying the fees of poorer students as they bear the full cost of study fee increases which provide means for all to benefit from increased capacity. External funding in the form of

bursaries and scholarships would be lost to the industry if the cost-sharing system had to be eradicated. This report further highlights that the point of access is to ensure that those who cannot afford fees and have not secured bursaries/scholarships, are still able to access higher education. The barriers to access within funding itself are not just funding (limitation thereof in absolute terms) and increasing study costs, but also the growing demand for funding. Of key importance is the fact that higher education costs do not only comprise study, but also accommodation, food and living expenses. Free higher education would require a decrease in the number of students enrolled and in need of funding in order to cover full costs. If enrolments decrease, access is directly affected. Thus, if higher education had to be fully funded by the state, higher education institutions would not be able to sustain large student numbers when there is no funding to increase capacity (Farr, 2016).

Amongst other significant factors, Farr's (2016) report draws attention to the fact that free higher education system is harmful to access of poor students into university. This is because the majority of students who enrol for university are from middle class socio-economic backgrounds. A free higher education system will result in capacity constraints that will in turn limit the amount of spaces available for students in university. Therefore, in competing for a space in the constrained university environment, middle-class students will invest in, for instance, top high school grades to ensure they have a good chance of entry. The result of this would effectively mean that poorer students are eliminated competitively and crowded out due to the inability to invest in schooling that will give them that competitive advantage and, in that way, their access into higher education institutions is harmed (Farr, 2016).

A study that substantiates the preceding point is (Wangenge-Ouma, 2012) "*Study Fees and the Challenge of Making Higher Education a Popular Commodity in South Africa*". This paper suggests that the positive impact of free higher education in South Africa specifically will address growth externalities and possibly increase access to the poor in the midst of rising study costs, which may achieve transformation and social justice. The study, however, questions whether it would benefit the poor due to the following issues: NSFAS funding shortages and current funding challenges suggest that the government cannot afford free higher education. There are concerns around the impact of free higher education due to the large level of inequalities that exist in South African schools where majority of poor students attend low-quality schools that offer limited opportunity for university access, meaning few of the poor students obtain access. The availability of free higher education would then be futile if such an opportunity cannot be utilised by those who need it most; the poorer students. The points raised also emphasise that the fight for free higher education is ineffective if poorer students receive basic education from schools that do not prepare them adequately to qualify for entrance in higher education institutions (Wangenge-Ouma, 2012).

Both authors, therefore, conclude that the argument should not be one of cost free higher education, but one of increasing access to higher education i.e. channels of funding availability so that those who qualify for free higher education may not be held back by finances.

### ***Suggestions to increase access to higher education in South Africa***

The studies reviewed have pointed to mechanisms for higher education access that are affordable for the government and that will achieve the ultimate goal of representation from poorer students in higher education institutions. Wangenge-Ouma (2010) specifically outlines the following recommendations: that the NSFAS funding should be increased even though it hardly covers the full cost of study. The study also points out that there should be a revised model pertaining to NSFAS and the NFF as the race-based allocation favours only a select few of the poorer students.

Further, the paper motivates for the private sector's involvement in increasing higher education access equitably and suggests that private sector companies should be incentivised to have their own bursaries and to contribute to NSFAS funding by the government availing tax benefits for such initiatives. The study also encourages the provision of information regarding available resources for higher education funding for students in out-skirted areas. The motivation for this is that, while there is a growing demand for higher education funding, some students fail to apply for entry into higher education institutions due to a lack of information. Awareness programmes and mentorship within rural areas to facilitate the flow of information about funding resources is a necessity motivated by this paper.

A vital point made by this study is the need to improve the basic education system of South Africa so that more students can qualify for university entrance. There can be no benefit in available funding if there are no students to utilise that funding. This statement is based on the paper pointing out that a majority of students, predominantly black, underperform in university entrance benchmark tests, which is evidence of a failing basic education system. Wangenge-Ouma (2012) adds that in order for a free higher education system to be effective whilst inequality is high, funding must be concentrated at lower schooling levels for poorer students as that will facilitate a larger amount of access if the funding provides for improved quality schooling.

The only shortfall in the abovementioned literature, which is also a potential area of research, is that it fails to actively address macroeconomic issues that affect the government's ability to increase funding for higher education through altering the national funding framework. The literature also only focuses on funding as the main barrier in South Africa to achieving access to higher education by the poorer students. The literature has pointed to social inequality being a very large part of the issue regarding underlying barriers to access of higher education by poorer students. Wangenge-Ouma (2012) substantiates this point by highlighting that internal inefficiencies like drop-outs, and the failure to graduate on time are the result of other

issues that are inherent to poorer students specifically. These issues are relevant because if poorer students are affected the most, even in the event of funding being available and if the surface-level issues are not resolved the cycle is bound to continue. As a way forward in study therefore, the above aspects should be looked into as the reliance on the government to alter the funding framework for higher education is currently not plausible given existing pressures.

### **Research Methodology**

This is a descriptive report that draws from investigations and findings in the literature and recent media coverage. This is followed by a scrutiny of additional information that is available in the public domain, such as the cost of studying at a university, the annual budget allocation to higher education, and the NSFAS financial statements. The methodology will deal with data collected from university documentation, however it is imperative to note that government's funding for higher education includes funding Further Education and Training (FET) institutions. The information obtained is analysed and interpreted to inform the factors for consideration whether South Africa should consider the implementation of a free higher education system.

The following methodology was followed to collect information and draw evidence on the issues around access to higher education and rising higher education fees:

#### ***Estimated cost of studying full-time***

The cost of higher education for an individual student was determined by obtaining the cost of a standard 3 year BCom Accounting degree across four South African universities viz. University of Cape Town, University of Johannesburg, University of the Witwatersrand and Stellenbosch University. The purpose of using the mentioned higher education institutions was not for comparison of the cost of the degree across the different institutions, however it was so as to get an average cost that was used as a proxy for the cost of study and residence fees for a standard degree nationally.

This cost was then combined with the cost of living in South Africa, which was not obtained using a formal collection method, but from information presented in the relevant university cost schedules, with particular reference to student handbooks for the cost of residence, catering and reference to miscellaneous annual expenses like travelling. This detail is aimed at arriving at a total cost of educating a student per annum so as to get an estimate of the cost of higher education with reference to costs other than study. From that cost estimate the report has highlighted the number of students in need of funding for higher education and the multiple of the cost and number of students in need for funding was contrasted with funding allocation nationally. This cost was derived to be compared to the funding provided by NSFAS per student so that commentary could be made on the discrepancy between funding allocated and funding needed and the significance of that discrepancy.



### ***Analysis of budget allocations to higher education in South Africa***

Commentary on the national budget allocation is meant to provide answers to why this discrepancy occurs. The critical point to establish is whether the total funding required is anywhere numerically close to the entire South African budget allocation (national expenditure as a whole), and establishing an answer to this can form a basis for arguing whether the South African government can maintain free higher education.

This analysis has aided the comparison of South Africa's higher education funding system with that of other developing countries and was contrasted with the system applied in a developed nation. The aim is to gauge whether South Africa is eligible to apply similar measures. From this analysis judgement based conclusions can be drawn as to whether the South African higher education budget allocation is appropriate to achieve the objective of maximum access to higher education. The analysis is also to assess the effectiveness of a free higher education system in the studied African countries and if found to be ineffective, whether South Africa has any advantages that could absorb the cause of that ineffectiveness. Lastly, the contrast with a developed nation was used to assess the appropriateness of adopting similar measures in South Africa to achieve free higher education now or in future.

An analysis of the budget allocation for higher education in South Africa specifically over the last 5 years was conducted. Of particular interest to this report is to establish the impact of the 0% fee increment in higher education fees for 2016 on the higher education budget allocation. This point also serves to establish whether any other significant service i.e. health, or safety and infrastructure, have suffered as a result of higher education funding pressures.

### ***Current student funding available in South Africa***

Lastly, student funding that is currently available through the National Student Financial Aid Scheme (NSFAS) is investigated. The information that is available in the annual reports of NSFAS for the financial years 2011 to 2015 was analysed, with specific reference to information relating to the numbers of students that receive financial assistance, and the average amount of financial assistance available to a student. This information is particularly useful when compared to the estimated cost of full-time study per year. From the compilation of the number of students in need of funding, this report has studied whether there is an increasing trend in the number of financially challenged students. An estimate of how many students are unable to be financially supported was derived, along with emphasis made on the drop-out rate to highlight the issue of equitable access. This analysis highlights the need to involve third parties such as private entities, to finance higher education because the cost of higher education studies cannot be for the account of the government only.

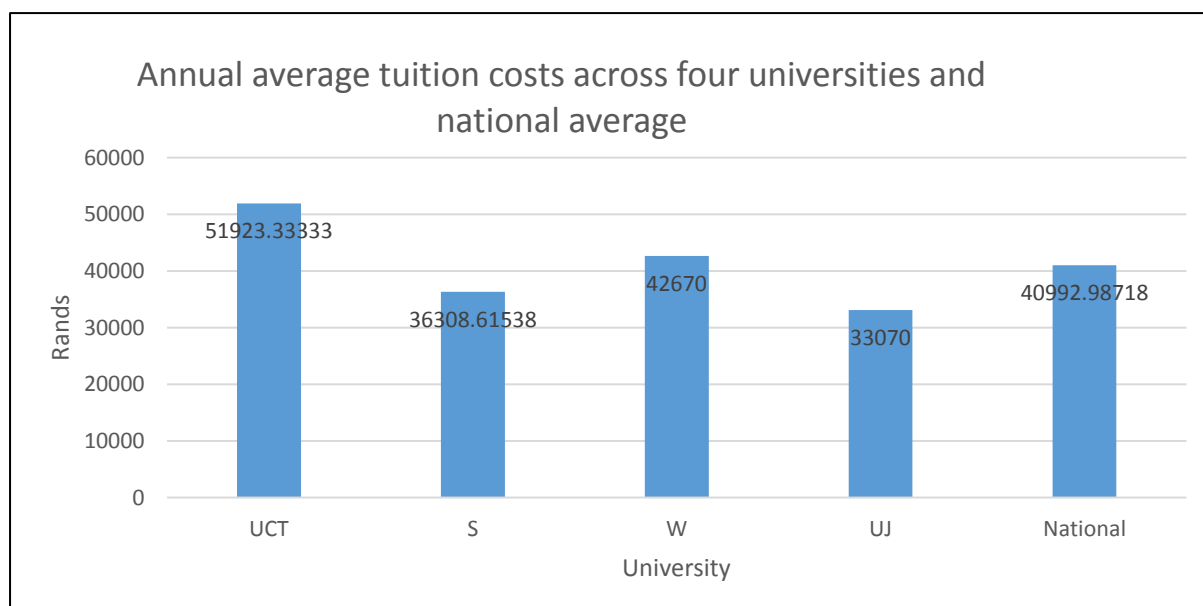
## **Data collected, interpretation, and findings**

This section discusses how the data was collected, the data is then interpreted using graphs and diagrams, and the findings are described. The data collected includes the estimation of the average cost per year of studying full time in 2015 at a South African university, which is then compared with the average financial assistance that is available to a student (via NSFAS). The proportion that is allocated to higher education in the annual government budget over the last five years is compared, and discussed with reference to the state's funding allocations to other, equally important, services.

### ***Cost of higher education in South Africa and the impact of additional costs incurred by institutions***

Based on the literature reviewed, the rising costs of higher education were noted as a key issue in obstructing the goal towards equitable transformation in higher education. A diagrammatic representation of the approximate study costs and total cost of higher education in South Africa is included below. The graphs presented have been based on 2015 fee structures as the fees for 2016 have been maintained at 2015 levels as a result of the October 2015 student protests against rising study costs. Four South African universities have been used as a basis of attaining these costs: University of Cape Town (UCT), University of the Witwatersrand (Wits), Stellenbosch University and University of Johannesburg (UJ).

**Graph 1: Average annual study costs across four universities, including national average**



In graph 1 above, the average study cost nationally, is currently at R 40 993 per annum, per student. These costs are based on a standard 3 year BCom Accounting degree and do not include the cost of residence fees, transportation, meals or a living

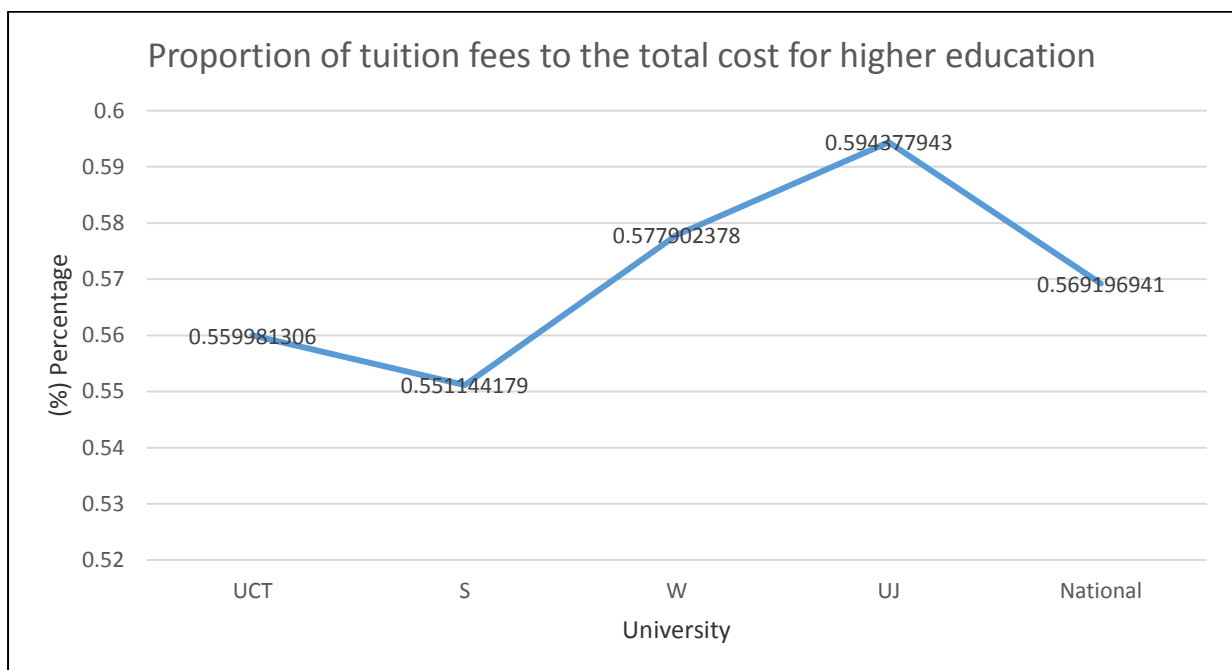
stipend. For the purposes of highlighting the cost of higher education in South Africa, reference must be made to these additional costs to highlight the extent to which higher education fees are an issue for the majority of South Africans. Residence fees will be discussed separately. As noted in the literature review, the issue around student fees and the effect it has on access to higher education affects poorer students the most. *To illustrate this point, an analogy is made using facts that are relevant to a poorer university student:*

South African university term breaks are spread around April, June, September and December. The poorer student can only afford to make means to go home (if studying at an institution that is far from home, which is ordinarily the case) during the longer breaks; June and December. Travelling home would be by means of a bus, as this is the most affordable option. The average bus ticket price over long distances is at R580 ([www.computicket.co.za](http://www.computicket.co.za)) and having to cover this cost twice a year, for a return trip, would bring travel costs to approximately R2 320 in the absence of other factors. Due to the difference in meal cost structures across the different higher education institutions, and due to some universities not offering catering as part of the costs, it is necessary to consider the meal costs of the abovementioned institutions only as a basis of determining average annual meal costs. The meal cost determination would be based on a standard 3 meals per day, 7 days a week meal plan. The average annual meal cost for this meal plan at these institutions is R14 000 per student (UCT student fees handbook, 2016). The meal cost ordinarily covers meals for February to November annually, bringing it to an approximate monthly cost of R1 400 or R47/day. Additional sundry expenses that a student must account for are the costs for textbooks and stationery (R6 000), educational equipment (R3 000), living and sundry expenses, excluding transportation (R5 180) (UCT student fees handbook, 2016). The additional sundry expenses are not an accurate measure or representation of sundry expenses for the average South African student, and should only be used for illustrative purposes. The cost is based on one institution as it is the only institution with a fee handbook that breaks down the relevant costs, which may differ marginally for students in other provinces and institutions. The cost of living is a subjective variable and, therefore, it is worthy to note that the use of a fee handbook is an aim to reflect an objective account of costs.

The above break down of costs would bring the total annual cost (study, meals, travelling, living expenses, educational equipment and textbooks and stationery) of higher education, excluding accommodation, to R71 493 per student per year. Based on this projection and consideration for the household that most poor South African students come from, it is already evident that covering this cost could be challenging. As mentioned in the literature review, most underprivileged students come from secondary schools that are under resourced and where most of them have never had to pay for secondary school fees. How then are South African students, and specifically poorer students, of which the majority are the “Black” students, expected

to manage the jump from not paying any fees for almost 12 years of basic schooling to now paying over R70 000 annually per student and over R214 500 (excluding accommodation) over 3 years if a student manages to complete their qualification in the standard 3 years? This analogy, therefore, highlights the reality of many South African students who find themselves in a position of having to either drop-out of university or face financial exclusion due to the lack of financial assistance and the impact of rising study costs.

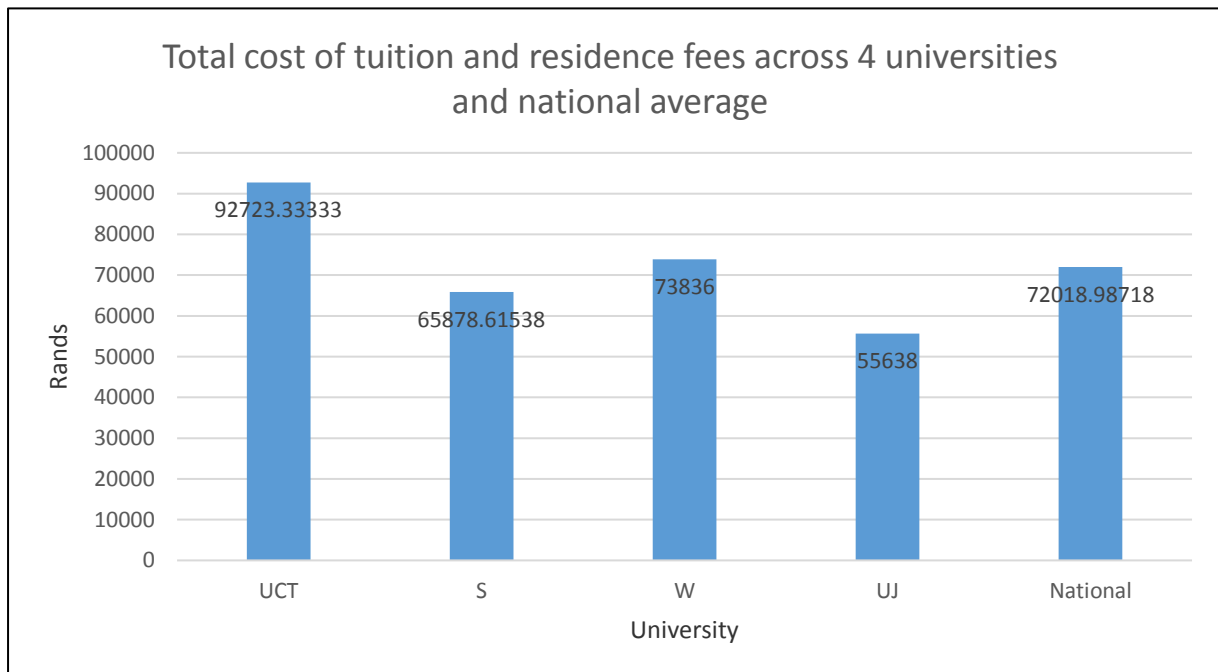
**Graph 2: Proportion of study fees (only) to the total cost (study and residence) of higher education in South Africa**



As depicted in graph 2 above, the argument regarding the negative impact of higher education fee increases still holds for students not in residence. Based on graph 2 it is evident that study costs comprise a large proportion of total higher education costs. In being unavoidable, study costs play a crucial role in determining whether a student goes to a certain higher education institution, studies for a particular qualification and whether they re-register in the following year.

A poor student's life is, therefore, determined by this one factor; a clear indication for the need for intervention. If the government needs to restructure their contribution towards higher education, do they have the means to do so?

**Graph 3: The total cost of study and residence (combined) across four South African universities, including a national average**



As depicted in graph 3 above, the total average annual cost for higher education nationally is R72 019 per student per year. The total national average cost comprises study and residence fees. Residence fees are based on accommodation only, for a standard double room across the four institutions. Average cost of accommodation is R31 026 per year (Student fees handbooks, 2016). Residence fees are relevant to the consideration of higher education costs as residence life is part of the higher education experience. Universities face additional challenges in the allocation of space in residence as the demand exceeds capacity every year. As such, many institutions have attempted to restructure the residence policy, as the previous system led to an over allocation of spaces in residence that led to many students having to seek alternative measures at a crucial time like the start of the academic year ([www.varsitynewspaper.co.za](http://www.varsitynewspaper.co.za); February 2016). Amongst the group of students having to seek alternative measures, would be a number of first year students whose homes are far from the institution, who would have to familiarise themselves with a new environment and find accommodation. The requirement to pay an initial fee (registration fees) before the start of the academic year applies to residence fees as well and if students are unable to provide this payment, another opportunity to participate in the higher education environment, is forgone.

The literature review highlights the need to explore other significant factors, in addition to finances and socio-economic backgrounds that affect a student's ability to function within the tertiary environment. One such factor is the emotional suffering experienced by students who are forced to seek alternative accommodation after learning that they

have no place in residence. This is particularly more challenging on a first year student who is away from home. In the midst of these challenges, these particular students would not only have to settle into university/tertiary life, but would have to deal with the additional emotional challenge of settling into an accommodation setting that might not have all the necessary facilities that a normal residence has. Bearing in mind that the above is all happening within the start of the academic year, consideration must be made for the effect that this could have on a student's performance as the ability to adjust timeously is frequently stressed.

Another (added) cost for higher education institutions is the recent call for insourcing of non-core activities, such as cleaning, maintenance, shuttle transportation and protection services. Part of the student protests at the end of 2015 against higher education fee increases was the need to demand an end to outsourcing and the exploitation of workers that form part of non-core university services by introducing insourcing. The effect of the introduction of insourcing in higher education institutions is relevant as this further increases the overall annual expenditure of higher education institutions. The ripple effect, as noted before in this report, of rising higher education maintenance costs is that study fees are increased to fund these services and the maintenance of infrastructure, especially with the increase in the number of students each year. The issue of addressing increased higher education costs is a challenge for government, as the rising costs imply that the government would have to allocate a larger portion of the national budget towards higher education each year to ensure that the service quality of higher education institutions is maintained. Even though a large portion of universities' income is represented by government grants, student fees seem to account for ever higher proportions.

In an article by Sara Gon, "UCT insourcing: not squaring the circle" ([www.politicsweb.co.za](http://www.politicsweb.co.za); June 2016), it is stated that insourcing is going to cost the institution far more than outsourcing as the fulfilment of the cost will require the use of university reserves for capital expenditure and additional annual operating costs must now be budgeted for. Dr. Max Price, Vice Chancellor of UCT, is quoted in the article, stating: "The justification for the austerity measures that are in place is because of a decreased government subsidy allocation to UCT over the last 5 years". The government's shortfall in the cost increases was approximately R50 million annually; R250 million cumulatively. The shortfall was compensated for by increasing fee income at a rate significantly above inflation and even then, the university remains with a shortfall and additional financial challenges were created by the 0% fee increase for 2016. Insourcing is introduced at a time when institutions can actually not afford it.

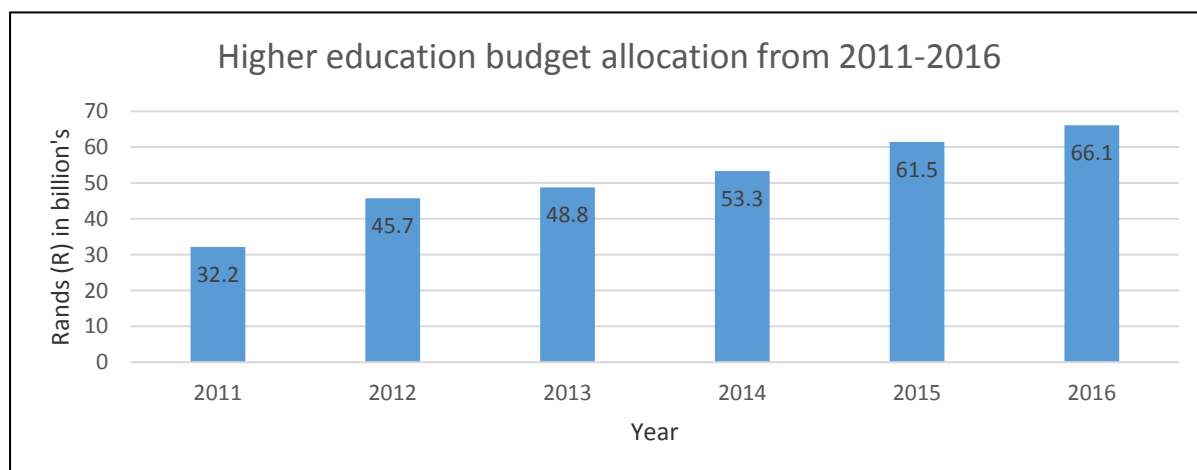
An additional concern with the introduction of insourcing is that the additional cost is towards non-core services and not services that will directly impact the student's access to higher education and related resources. Gon (2016) states further that "[t]he 2014 Report on Outsourcing at UCT was commissioned by the UCT Council. The

report estimates that the total additional costs of insourcing all services at the university would be R58 million a year, with additional upfront asset purchase costs of R68 million. The university will not be able to absorb this cost without raising student study fees significantly, and this would impair student access to UCT” (Gon; [www.politicsweb.co.za](http://www.politicsweb.co.za); June 2016). This statement highlight’s the university’s challenge in securing limited government subsidy each year, which increases their reliance on fee income for the maintenance of costs.

Emphasis has been placed on how this will affect the student in that the cost would inevitably be an account for the student to settle. The question is however, in addressing the issue of exploitation of outsourced workers by introducing insourcing: Is this approach not counter-intuitive if the student has to bear the cost, and in particular, the cost of a non-core service? This implies that the fight against rising higher education fees is nullified. The policy of a 0% fee increment in higher education fees for 2016 has resulted in austerity measures being introduced across institutions. The article highlights that if these austerity measures are ineffective in cost cutting, institutions may have to encourage early staff retirement or voluntary separation and resignation packages. This approach would harm the achievement of the core services for higher education, which directly impact the student, because in the instance where fee income cannot be increased above a certain limit, academic staff (which arguably comprise a large portion of operational expenditure), may have to be released.

The core focus of higher education institutions is teaching and research. If academic staff have to be retrenched, once again students suffer. The introduction of insourcing, therefore, could accelerate the effect of the release of academic staff and increasing fees. Of greater concern, however, is whether there is a consistent decreasing trend in government subsidy for higher education and if so, why? An analysis of government subsidy is provided below.

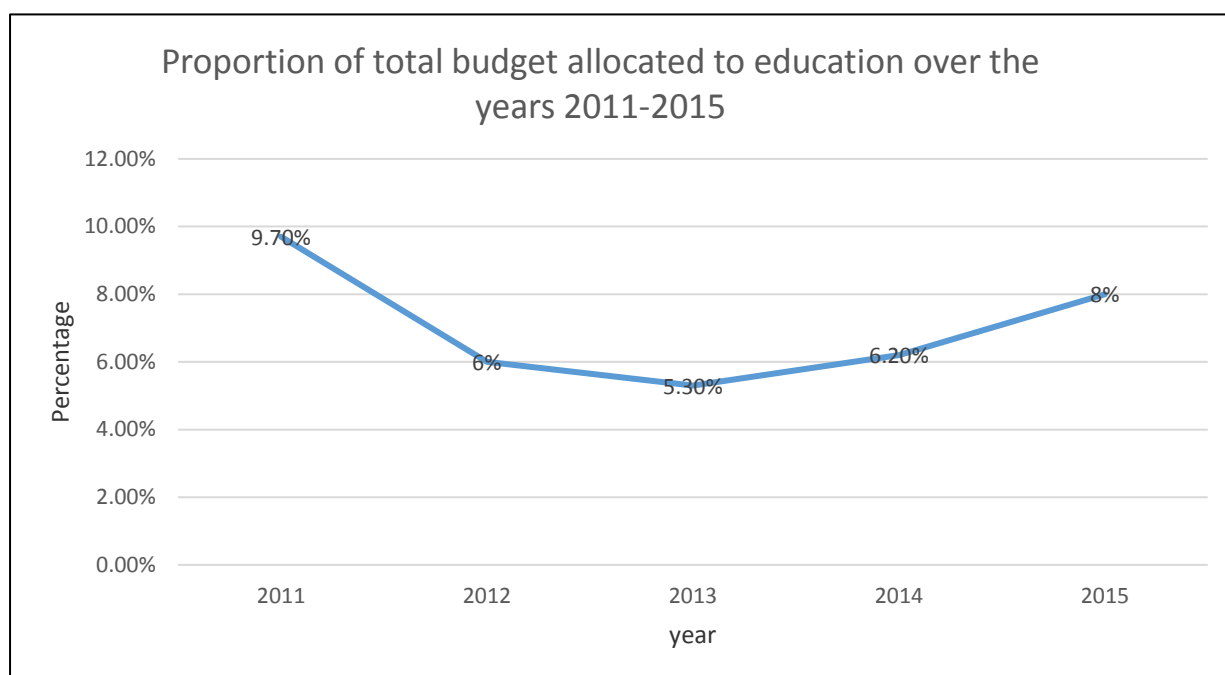
**Graph 4: Indication of the budget allocation for higher education from 2011-2016**





For the purposes of collating the total cost allocated to higher education and for consistency, higher education comprises: university transfers, FET institutions and adult education and lastly, vocational and continuing education and training. In some budget highlights, skills development costs are included in this cost schedule. As depicted in graph 4 above, the allocation of the annual budget towards higher education depicts an upward trend for the period 2011-2016. This suggests that in absolute terms, the amount of funding allocated to higher education has increased over the years. What this image fails to depict is whether the funding increased for all classes of higher education institutions. As noted in the reviewed literature, government funding is not allocated on a system that benefits institutions that house a majority of previously under-represented students. Also, in as much as the absolute amount of funding has increased, it has not increased in line with rising costs of higher education, therefore cost increases are not in real terms. To validate this statement, an allocation of the total national budget to education (basic and higher education) is depicted below in graph 5:

**Graph 5: Proportion of the total national budget allocated to education (basic and higher) for 2011-2015**



From graph 5 above, government's funding towards education (basic and higher) as a social service has decreased from 9.7% to 5.3% (based on the amounts presented in the annual budgets and adjusted for inflation only) between 2011 and 2013. Higher education is a small portion of the budget allocation. Therefore, a decreasing allocation to education as a whole is bound to affect higher education the most. A slight increase is realised in 2014 and 2015 where the allocation rose to 6.2% and 8% respectively



(appendix 3). Despite the slight increase over the last two years, the allocation is still well below what it used to be in 2011.

Since higher education comprises a smaller proportion of the total education budget, the effects of this decreased allocation over the years explain and validate the conclusion reached by higher education institutions and the reviewed literature, that government spending on higher education has decreased over the years. In analysing the exact proportion of the education budget allocated towards higher education: In 2011, 13.5% of the education budget was spent on higher education, increasing to 19.4% in 2012. However, from 2013 onwards, a drastic decrease towards higher education funding was seen as the proportion fell to 7.25% and 6.8% in 2013 and 2014 respectively (*budget review 2013, 2014*). This explains the need for higher education institutions to rely on accelerated fee increases for the maintenance of institutions as government subsidy decreases while costs are rising.

In 2015 the allocation of the education budget to higher education increased by a margin to 8.6%. The main reason for decreases in the higher education funding was for the government to cater for the growing needs of basic education: increasing the number of schools, school infrastructure, and the increase in teacher's salaries after the national teacher's strike in 2010. All for a system that, as is evident from the literature, is flawed in its ability to prepare learners adequately for access to higher education. This, amongst other factors such as the need to respond to other social services like public health, has exacerbated the funding crisis in higher education. This report can ascertain therefore from an analysis of the annual budget highlights (based on the respective year's budget speech), that government's inability to prioritise higher education is also due to the need to focus on other areas of the country. Between 2011 and 2013, the state's funding for public health, housing, public safety and general public services decreased notably. The budget allocation towards economic affairs, however, increased from -5.9% in 2011, to 7.7% and 10.8% in 2012 and 2013 respectively. This was at a time when South Africa was experiencing immense political instability, coupled with economic pressures as response to the previous neglect of economic affairs evidenced by the decreased allocation in 2011.

The impact of the 0% fee increment on higher education fees has not gone unnoticed by the government. Government has seen the largest increase (in absolute terms) in 2016 in the budget for education from R265.7 billion in 2015 to R297.5 billion in 2016 (*Budget review, 2015, 2016*). The proportion of the education budget for 2016 that will go towards funding higher education is yet to be confirmed. In analysing the impact of a 0% fee increment on higher education fees for 2016, it is necessary to isolate the 2016/2017 national budget allocation for higher education. The isolation is to assess what the government's strategy regarding the shortfall that the failure to increase student fees in the current year, has created.

According to the 2016 National Budget speech (Annual budget speech 2016), an additional R16.3 billion has been allocated for higher education for the next three years (2016-2018). R5.7 billion of this addresses the shortfall that was created by higher education fees for 2016 remaining the same as that of 2015. R2.5 billion has been allocated to NSFAS to clear outstanding student debt from 2015, and lastly a further R8 billion over the medium term to allow currently registered students to complete their studies. A detailed breakdown per the classes of higher education institutions has not been given regarding the additional amount of R16.3 billion allocated for 2016-2018 across all higher education institutions. Whether this amount will be sufficient to cater for the effects of the 0% fee increment, is questionable.

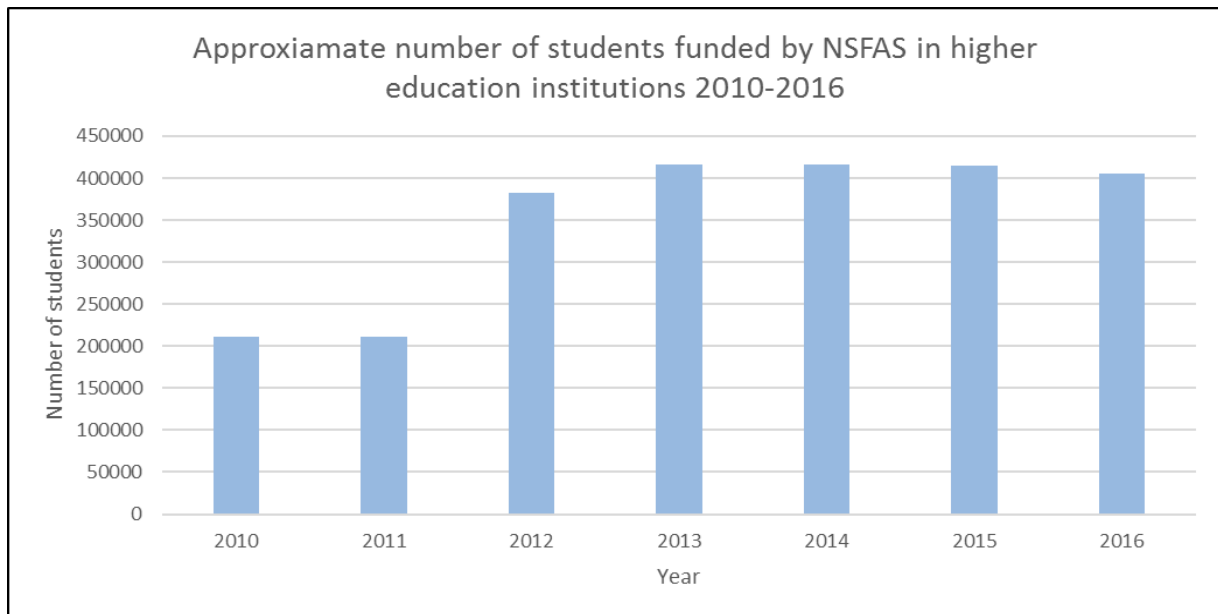
The above conclusions raise concerns as to whether a cost-free higher education system can exist in South Africa and if so, at what cost? Higher education institutions are highly dependent on fee income to support the functioning of institutions including payment of academic staff and maintenance of facilities used by students. If fee income is to be removed and the above trend in the government's allocation of the budget to higher education continues, South Africa runs the risk of possibly harming any efforts towards achieving equitable access to higher education. If the responsibility to maintain a cost-free higher education was solely placed on the government, this too would be impractical and ineffective given other existing social needs and the already decreasing government subsidy for higher education.

### ***NSFAS and the discrepancy between the cost of higher education and financial assistance available***

To emphasise the impracticality of a cost-free higher education system in the midst of rising higher education costs, this report will briefly analyse the NSFAS funding model. The link between the costs of higher education in South Africa noted above and the financial assistance offered through NSFAS, reflects that even with the existence of financial assistance, some costs still remain uncovered. In a free higher education system, institutions would be forced to avoid high operational costs by capping the amount of students they can provide for, which is against the mandate of achieving access to higher education, particularly for underprivileged students.

Below is a depiction of the number of students assisted by the distribution of funding for higher education fees of students in need by NSFAS between 2010 and 2016. Since 1991, NSFAS has distributed over R50 billion in financial assistance to over 1.5 million students ([www.nfsas.co.za](http://www.nfsas.co.za)) This graph aims to study the trend in the allocation of funding for the proposed range, to highlight the amount of students who require financial assistance from NSFAS and the proportion of higher education fees covered by the financial assistance offered.

**Graph 6: Approximate number of students funded by NSFAS in higher education institutions for 2010-2016**



Graph 6 above indicates that there has been a gradual increase in the amount of students assisted by the financial aid scheme, which receives a portion of its funding from the state. The most significant increase in the number of students assisted was seen between 2011 and 2012 and since then there's been a fairly consistent number of students assisted. Much of the increase is not only attributed to the growing demand for students in need of financial assistance, but also the effectiveness of awareness programmes by higher education institutions and private organisations that inform prospective students about funding opportunities. Of importance to note, however, is the decrease in the approximate number of students to be funded in 2016. The number of students to be funded could go from 414 802 in 2015 to 405 000, a decrease of 9 802 students. This may be a direct impact of the 0% fee increment in study fees for 2016 (coupled with the identified trend of decreased government spending on higher education), as part of NSFAS funding has been rolled out to extinguish student debt and not for additional funding of 2016 fees.

The negative effect of a growing demand for financial assistance, is the limitation of available funding and the extent to which it can cover the full cost of higher education per student. Numerous reasons contribute to the inability of the financial aid to cover the full cost of studies. Funding is a constraint for the organization, which indirectly affects the number of students it can accommodate. Once again, this emphasises the effect funding has on an eligible student's ability to participate in higher education. Student drop-outs lead to a delay in recouping funds that were issued as loan assistance. As such, fewer students are potentially able to be funded in the following year as students can only repay loans once they are employed. In addition to these issues, some graduates fail to fulfil their obligation to repay any loan assistance back

to NSFAS, which results in the organization having to write off some debts as unrecoverable. The failure of students to respond to the moral obligation to repay a student loan also harms the goal of access for underprivileged students because funding is a scarce resource.

Below is a representation of the amount of funding allocated as assistance for students over the specified years. The estimated number of students to be funded in 2016 is 405000 (NSFAS 2014/2015 annual report)

**Table 1: Number of students, total funding allocated by NSFAS and estimated annual funding per student for 2010-2015**

Year	Number of students funded	Total financial assistance in billion R	Average annual assistance per student * in R
2010	210592	3.6	17 095
2011	210576	5.9	28 018
2012	382686	7.7	20 121
2013	416174	8.7	20 905
2014	415901	9	21 640
2015	414802	8.96	21 601

\*The calculation of the average annual assistance per student is not an accurate representation of the amount allocated to each student for funding, as that differs across the different institutions. The calculation was done by taking the total financial assistance in each year divided by the number of students funded in each year. The calculation is included for comparability against the approximate cost of higher education based on the breakdown given in this report for the cost of a standard BCom Accounting degree across the four abovementioned institutions.

The average annual assistance per student, based on table 1, has increased from just over R17 000 per student in 2011, to over R21 000 in 2015. This suggests that in the universities used for the cost estimation, the average annual assistance per student covers mainly study fees and no additional university fees. The increase is in line with the rising number of students requiring financial assistance and the rising cost of higher education. The total cost (study and residence fees) of higher education, however, has been estimated at R72 493 (based on calculations above). This implies that in 2015, if a student were to study in one of the institutions used to compile the total cost estimate, and the bursary portion of the loan was unconfirmed, the student would be at a shortfall on their fee cover by approximately R50 892. If we use this

shortfall amount and multiply by the estimated number of students NSFAS plans to assist financially in 2016 (415 000), the total shortfall comes to just over R20.06 billion. If this figure is compared to the 2016 education (basic and higher education combined) budget allocation of R297.5 billion, it is 6.7% of the budget allocation for education as a whole. That same proportion of 6.7% is comparable to 2015's higher education budget allocation of 6.2% compared to the total budget. Therefore, 6.2% of the total budget would have to be removed from another government service to fund the shortfall. The shortfall is also comparable to higher education's budget proportion of 6.5% of the total education budget, implying that the education budget would have to be increased by 6.5% to fund the shortfall.

If higher education's budget allocation could be increased by the R20.06 billion shortfall, that could possibly enable the full cost of studies to be covered for those being financially assisted or it would allow for even more students to be assisted. However, consideration must be made for the fact that NSFAS does not and cannot accommodate all financially needy students and this number could be considerably higher if all students in South Africa without funding for higher education fees were considered. Also, if higher education's budget allocation would have to increase by this amount or higher, the state would possibly have to reduce spending in other sectors and as noted in the annual budget highlights analysis, this has negative consequences.

The issue reflected in the above computations highlights the difficulty and strain that the government would take to achieve free higher education, against the reality that reduced spending by the government on other public services is not sustainable.

### **Recommendations**

If South Africa is to work towards achieving free higher education, higher education institutions would have to find a way to ensure that the core functions of the institution are still maintained and of the same standard if not better. This may be a great challenge, as nothing worth any value is free. The same holds for one's education. Higher education institutions would need, at the very least, the following functions to be maintained:

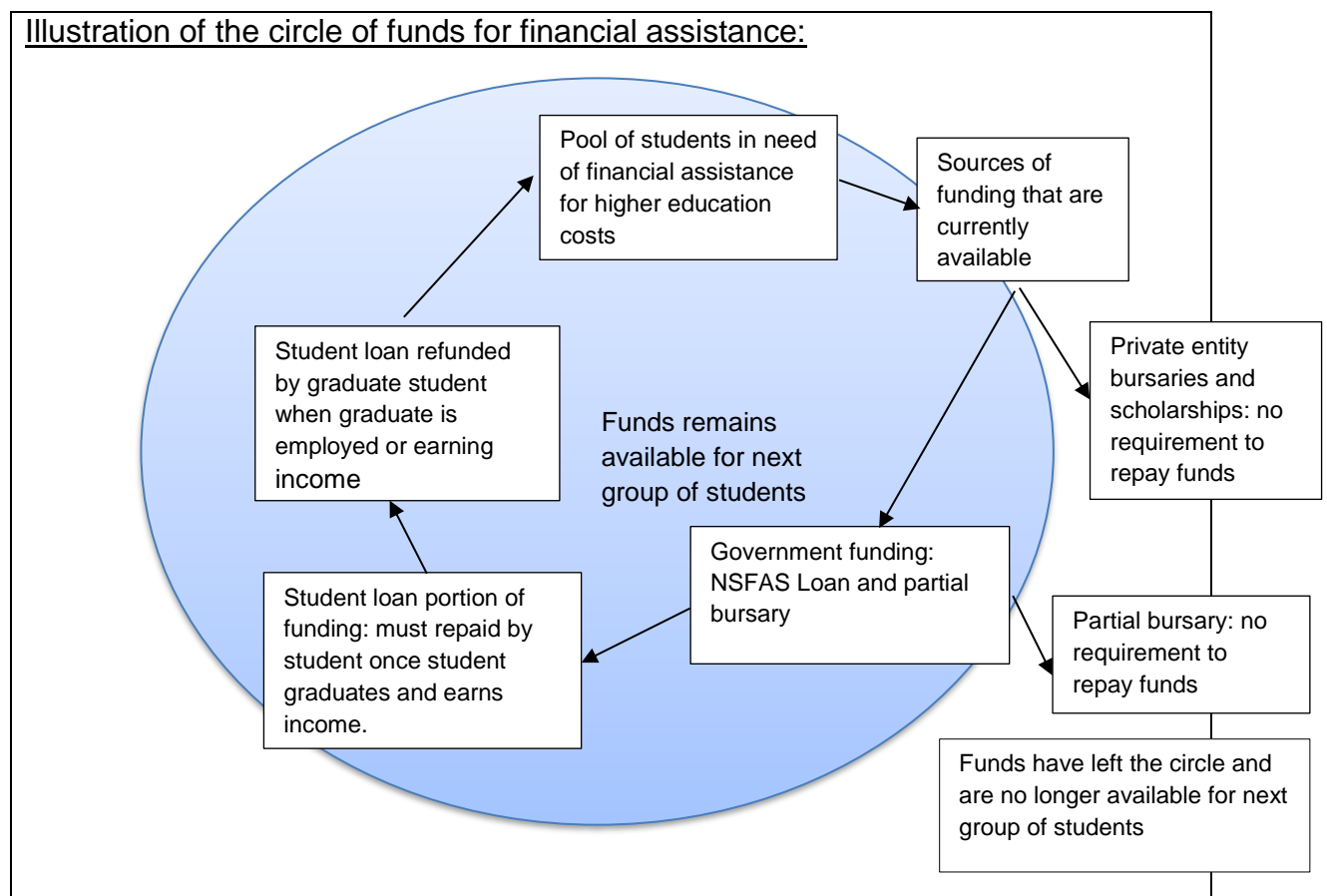
- Academic and administrative staff
- Research facilities
- Lecturing facilities and student course material
- Maintenance staff (cleaning and ground staff) and infrastructure

The abovementioned functions form the bulk of a higher education institution's operational expenditure annually. If there is no fee income, the institutions cannot pay academic staff salaries. Academic staff plays a crucial role in administering core functions of the institution and must be compensated in line with their responsibilities and experience. Maintenance is an unavoidable cost and is set to increase with the

move towards insourcing. If the institutions cannot pay for these functions due to eliminated fee income, these functions cannot exist and neither can the institution.

The recommendation is that private entities increase the amount of bursaries and scholarships that are made available for students and across all qualifications. To incentivise private entities in this regard, the government can introduce incentives such as tax deductions for these scholarships. What this proposal achieves is that more students are able to access higher education and that reduces the burden of unemployed youth on the government in future. In as much as the state would be collecting less tax revenue, compensation can be made by altering the tax structure in areas where poor South Africans would not be affected by this. An example would be increasing the corporate tax rate (by a margin), which has remained at 28% for the sometime. This will compensate for the tax deductions allowed as incentives to increase funding for higher education.

One of the challenges reflected in this report is NSFAS' ability to recoup, from employed graduates, financial assistance that was issued in the form of a loan. A more stringent policy needs to be adopted by the organization in terms of ensuring that employed graduates, as responsible citizens, fulfil that responsibility. To stress this point, an illustration of the circle of funds for financial assistance is depicted below:



As shown in the above illustration of the circle of funds for financial assistance, the portion of the NSFAS funding that is allocated as loan assistance is recouped in the circle of funds so as to assist other students in need of financial aid. There is a responsibility therefore, for students to pay this money back once they are earning income. This responsibility is both contractual and ethical. The financial assistance in the form of a study loan, is the one form of funding that never leaves the circle with the student, unlike the funding through bursaries and scholarships. It is vital that the only hindrance to the collection of these funds be the delay in time as result of students seeking employment or completing their studies and not due to uncollectability (bad debts).

The cycle reflected above points to many similar experiences in South Africa and the fear therefore, with implementing a free higher education system is achieving the same outcome, where the quality of education produced becomes mediocre. Further conclusions drawn by Wangenge-Ouma, (2010) are that a free higher education system benefits those that are already privileged. This statement is based on the consequences of a free higher education system in other nations. Free higher education in Africa reproduced and reinforced colonial inequalities with regards to the distribution of schools and beneficiaries of free higher education. Because the distribution of good schools was uneven, the beneficiaries of free higher education were select individuals from certain ethnic groups that repeated the same patterns of colonial inequality. In addition to this, lower levels of education were not free at that stage and therefore those who couldn't afford lower levels of education would be left out of the circle of beneficiaries of free higher education, leaving it for students from elite backgrounds to benefit from (Wangenge-Ouma, 2010).

In the context of South Africa, this report has noted numerous times the need to invest in a stronger basic education system. The need for this is evident from the above information that if lower levels of education create inequalities (poor education quality and uneven distribution of resources), those inequalities persist and higher education becomes a commodity that only those who can afford it can have or becomes accessible by those who could afford to go to private schools at a basic school level.

A developed nation that operates under a "free" higher education system is Sweden ([www.theatlantic.com](http://www.theatlantic.com) ; May 2013). The justification for this system in that country specifically, is that the cost of living is high. The state therefore compensates the families of students by allowing students to study on a loan account, which is similar to the South African national student funding model, where students pay that money back to the state upon graduating and becoming employed. The difference, however, is the way in which the study funds are repaid to the state. Students who become employed graduates either pay the money back through adjusted taxes that account for the repayment that must go to the state or through paying in the form of a low interest loan. Both repayment terms are structured such that graduates are still able to have a reasonable disposable income.

Employing a similar system in South Africa would require an adjustment to be made in the tax administration system to tax graduates accordingly. Whether or not this is possible, is an area of further study. Of importance to note, is that even in the context of a developed country, there is a cost for higher education, it is not free. This validates, therefore, the concern about whether South Africa, as a developing country, is ready to adopt a cost free higher education system, given the system's failures in the past under similar conditions as the South African environment.

Lastly, there is a great need to initiate awareness programmes about the availability of funding for all qualifications. Life Orientation is a subject done throughout the basic education syllabus ([www.education.gov.za](http://www.education.gov.za)) and is a subject used to expose learners to career guidance in Grade 11. A recommendation is that school visits by funding institutions (government and private) be included in the Life Orientation career guidance programmes so that learners are aware ahead of time of what funding mechanisms are available. This will allow learners to prepare mentally and academically to work towards attaining both access to higher education and funding.

### **Areas of further research**

This report has noted a number of key issues that have affected the government's ability to maintain and increase its spending on higher education. The South African tax administration is known to be very efficient. A recommended area of research therefore, would be a more beneficial revenue collectability model for the government. The government's ability to collect tax revenues from areas where tax is being evaded, could be beneficial in enabling the economy to be more robust and maintain a cost free higher education system in years to come.

Based on the issues identified in the literature, it is also necessary to further study the additional factors that contribute to a student's ability to remain in the higher education system. Financial constraints have been highlighted as the dominant cause, however in an instance where finances have been provided for, the objective to maximize access is still hindered by a high drop-out rate from poorer students.

Much investigation needs to go into the basic education system of South Africa. The foundation phase of a child's education has been noted to be a very critical stage in their learning. It is, therefore, of great importance that the country moves towards prioritising the resources in this area too, as basic education is the government's responsibility.

### **Conclusion**

The evidence of decreased government funding over recent years questions the sustainability of a free higher education system and whether the government can in fact afford a cost free higher education system. The prevalence of a current deficit, evaluation of the country as junk status as a foreign investment designation and a



currency that is in jeopardy are just a few of the external pressures evidencing that the government may not be able to sustain free higher education at the moment.

It goes without saying that the cost of higher education in South Africa is paramount and with the increasing demand for higher education, those who need financing suffer the most from fee increases. The challenge therefore, is that in the midst of a country that is currently not ready to take on a cost free higher education system (based on the research), and with higher education institutions needing to fund their operations predominantly through fee income, who should take responsibility for the cost when students are unable to qualify for access to higher education due to financial constraints?

Based on the 3 responsible agents for higher education costs (the financially challenged students, the institutions and the government), it is clear that no one can in fact afford the cost of higher education. While cost free higher education would be the solution to many transformation and socio economic issues in the country, higher education institutions cannot be administered in such a system. If higher education institutions cannot afford to maintain core services like academic staff and continuous research, which depend highly on fee income, the existence of institutions could be compromised in the long run, if not the quality of education and graduates produced.

As a nation, South Africa needs to address the country's sensitivity to changes in the higher education system by assessing what the country is ready to lose and what the country can afford to maintain. As is, the government is not fully equipped financially to sustain a cost free higher education system. This is based on its inability to meet the growing demands of higher education over the recent years. Higher education institutions cannot operate without revenue (mainly fee income) to fund its operations and provide resources that are used by the growing number of tertiary students.

The interim solution lies in maximizing on the funding that is available to achieve maximum access to higher education by eligible students. This will enable more graduates to contribute to the economy by improving the youth employment rates as more graduates become employed. Increasing youth employment can contribute to the growth in the country's economy. In that way, the government can gradually increase spending on higher education, implying that more students with financial difficulty can be supported and that access to higher education can be improved. It is worth noting that there are other issues that the country needs to address to prepare itself for free higher education. The level of corruption and its impact on the economy, the quality of basic education and investing in resources like infrastructure and skills development for educators are but a few of the areas that need focus. Prioritising basic education will also ensure that learners are prepared for higher education.

This report does not take a position against free higher education in South Africa, neither is the conclusion that South Africa should not implement such a system. The standpoint is that South Africa needs time to rectify what has gone wrong at a basic

education level, so that if a free higher education system is implemented, maximum access can be achieved by those most affected by the rising higher education costs. The country also needs time to develop further as an economy and rebuild its statute as the powerhouse of Africa. The time will allow the economy to adjust and possibly alter its revenue collection structure so that the state is prepared to adopt an equitable higher education system, which is more sustainable than a free higher education system.

### **REFERENCE LIST:**

- Academic fees; other fees and levies. (2016). *University of Cape Town student fees 2016* (pp. 7-8-16)
- Altbach, P. G. (2015). Perspectives on internationalizing higher education, *International Higher Education*, 27, 6–8.
- Annual report 2011*. (2011). Cape Town: National Student Financial Aid Scheme.
- Annual report 2012*. (2012). Cape Town: National Student Financial Aid Scheme.
- Annual report 2013*. (2013). Cape Town: National Student Financial Aid Scheme.
- Annual report 2014*. (2014). Cape Town: National Student Financial Aid Scheme.
- Annual report 2015*. (2015). Cape Town: National Student Financial Aid Scheme.
- Budget review 2011*. (2011). Pretoria: Department of National Treasury.
- Budget review 2012*. (2012). Pretoria: Department of National Treasury.
- Budget review 2013*. (2013). Pretoria: Department of National Treasury.
- Budget review 2014*. (2014). Pretoria: Department of National Treasury.
- Budget review 2015*. (2015). Pretoria: Department of National Treasury.
- Budget review 2016*. (2016). Pretoria: Department of National Treasury.
- Department of Education (South Africa) (1997). Education White Paper 3: A Programme for Higher Education.
- Gordhan, P. (2016). *2016 Budget speech*. Cape Town: National Treasury. doi:17/2016
- Lebeau, Y., Stumpf, R., Brown, R., Lucchesi, M. A. S., & Kwiek, M. (2012). Who shall pay for the public good? Comparative trends in the funding crisis of public higher education. *Compare: A Journal of Comparative and International Education*, 42(1), 137-157.

- McLean, M., & Walker, M. (2012). The possibilities for university-based public-good professional education: a case-study from South Africa based on the “capability approach.” *Studies in Higher Education*, 37(5), 585–601. <http://doi.org/10.1080/03075079.2010.531461>
- Ntshoe, I., & De Villiers, P. (2013). Funding sources for public higher education in South Africa: Institutional responses. *Perspectives in Education*, 31(4), 71.
- Theobald, S. (2015). How to fund university education for all: How do we create something that ensures that every capable individual in South Africa is able to study? *Rand Daily Mail*.
- Tilak, J.B.G. (2005). Global trends in funding higher education. *International Higher Education*. 5-6
- Maria, T. D., & Bleotu, V. (2014). Modern Trends in Higher Education Funding. *Procedia-Social and Behavioral Sciences*, 116, 2226-2230.
- Study fees. (2016). *University of Johannesburg student fees 2016* (pp. 4-5, 8, 14)
- Gon, S. (2016). UCT insourcing: Not squaring the circle. *Politicsweb* ([www.politicsweb.co.za](http://www.politicsweb.co.za))
- University of Stellenbosch Student fees* (2016). Stellenbosch: University of Stellenbosch.
- Van der Bank, C., & Nkadameng, M. (2014). Exploring funding in higher education to eliminate poverty in South Africa.3(1), 353-354-357. doi:Doi:10.5901/ajis.2014.v3n1p353
- Walker, M., McLean, M., Dison, A., & Vaughan, R. (2010). Higher education and poverty reduction: the formation of public good professionals in universities. *Studies in Higher Education*, 17.
- Wangenge-Ouma, G. (2010). Funding and the attainment of transformation goals in South Africa's higher education.36(4), 481-482-497. doi:10.1080/03054985.2010.491181
- Wangenge-Ouma, G. (2012). Study fees and the challenge of making higher education a popular commodity in South Africa.64, 831-832-844. doi:10.1007/s10734-012-9531-6

[www.nsfas.co.za](http://www.nsfas.co.za)

<http://www.rdm.co.za/politics/2015/10/22/how-to-fund-university-education-for-all>

<http://www.politicsweb.co.za/opinion/uct-insourcing-not-squaring-the-circle>

<http://varsitynewspaper.co.za/news/4396-student-housing-crisis>

[www.theatlantic.com](http://www.theatlantic.com)

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**MAF 08: LONG-TERM INCENTIVES: DO SHAREHOLDERS  
GET WHAT THEY PAY FOR?**

Francois Steyn & Carol Cairney – University of the Western Cape

E-mail: [gsteyn@uwc.ac.za](mailto:gsteyn@uwc.ac.za)

**Abstract**

As a result of high economic inequality, executive remuneration has long been a fierce topic of debate in South Africa (SA). The high levels of long-term incentives awarded are often highlighted as a source of discontent amongst stakeholders. The literature offers various theories surrounding executive pay: Labour market theory suggest that high pay is required to secure the talent required for better company performance, while optimal contracting theory advocates the use of long-term incentive compensation (LIC) to achieve goal congruence between managers and shareholders.

The findings of international studies on the link between CEO pay and future company performance, however, cast doubt over the efficacy of LIC to motivate shareholder value creation. Excess CEO-compensation was found to be negatively associated with abnormal future total shareholder returns for up to five years (Balafas & Florackis, 2014; Cooper, Gulen & Rau, 2014; Core, Holthausen and Larcker, 1999). Due to the difficulty in valuing LIC, it tends to be neglected in South African studies. The relationship between CEO pay and future company performance has also not been investigated in the local context.

This paper aimed to contribute to the field in two ways: 1) establishing the significance of LIC pay levels and the proportion of LIC to total compensation for the top 100 JSE listed companies, overall and by size grouping, 2) by investigating the relationship between excess LIC and future abnormal total shareholder return (TSR).

The findings show that while LIC makes up a significant proportion of pay in SA, there seems to be no clear relationship between the levels of excess LIC and abnormal future TSR.

Key words: Pay-performance sensitivity; Optimal contracting; Agency theory; Executive remuneration; Long-term incentives; South Africa

## Introduction

The level of compensation earned by executive managers of companies in the private sector is a contentious issue worldwide. Discontent is fuelled by the increasing disparity in compensation between executives and the average worker (AFL-CIO, 2015; COSATU, 2014). Long-term incentive plans, specifically, have driven executive pay up to “unwarranted levels” without delivering the same improvement in company performance (Garside, 2015). Cooper *et al.* (2014) found that companies in the United States (U.S.) that pay their CEOs in the top ten percent of excess pay earn negative abnormal returns of nearly -8% in the subsequent three years. This casts doubt over the economic justification for ever increasing executive compensation, and similar results in SA would be concerning.

On the other end of the debate, proponents of labour market theory argue that in a competitive environment good leaders are required (Chalmers, Koh and Stapleton, 2006) and companies need to compensate CEOs adequately in order to retain quality talent (Bizjak, Lemmon & Naveen, 2008). According to agency theory, once the appropriate talent has been secured, management needs to be incentivised to act in the best interest of the shareholders of the company. It is further argued that if companies perform well, they contribute to the economy and more jobs are created.

South African studies that investigate this link between company performance and executive pay ignore long-term incentives due the difficulty of determining the values, as well as the insignificance of LIC in some industries (Shaw, 2011). This study aims to establish the significance of long-term incentive compensation of CEOs in South Africa, and whether there is a positive association between CEO long-term incentive compensation and future company performance.

## Background and literature review

Most of the studies that investigate executive remuneration mainly focus on the compensation of the highest paid individual, the CEO (Balafas & Florackis, 2014; Chalmers *et al.*, 2006; Cooper *et al.*, 2014; Core *et al.*, 1999; Edmans & Gabaix, 2009; Jensen & Murphy, 1990a; Jensen & Murphy, 1990b; Tosi & Gomez-Mejia, 1994) and as a result this study excludes compensation of other executives.

The literature review is arranged as follows: First a brief explanation of the various theories that aim to explain CEO compensation, followed by defining the components of CEO pay and measures of company performance. A short summary of international and local pay-performance sensitivity studies are presented, before the research objectives are formulated.

### Theories explaining managerial pay

There are various theories that try to explain the levels of CEO compensation. Agency theory arose due to the separation of the control and ownership of companies, which might cause self-serving managers pursue their personal goals above that of the company (Jones & Ville, 1996). These undesirable activities of the managers can be limited by establishing appropriate incentives for the managers (Jensen & Meckling, 1976). Optimal contracting

theory suggests that a well-designed pay package should attract the right CEOs; incentivise them to exert effort and exploit growth opportunities; and reject wasteful projects while limiting the cost of doing so (Edmans & Gabaix, 2009). Optimal contracting theory suggests that the problem of appropriate CEO compensation is not just a question of how much the executive managers should be paid, but also how their compensation packages should be structured (Jensen & Murphy, 1990b). Labour market theory views CEO compensation levels as the efficient outcome of a labour market in which companies optimally compete for managerial talent (Frydman & Jenter, 2010). A positive association between pay and future performance would support agency theory, optimal contracting and labour market theory.

### **Compensation and company performance variables**

Studies that investigate the sensitivity of CEO compensation to company performance – pay-performance sensitivity studies – have to decide on how to measure CEO compensation and company performance respectively.

Total compensation (TC) is made up of two major components, namely: short-term cash compensation (SCC) and long-term incentive compensation (LIC). SCC mainly comprises base salary, other benefits and cash bonus, while LIC is made up of one or more of the following: deferred short-term incentives, performance shares, share options and gains on shares held. The value of the SCC earned by the CEO is readily available from annual reports and databases such as INETBFA. The value of LIC in South Africa is however only disclosed by a handful of the largest listed companies and has to be calculated for the remainder of the companies using the information published in remuneration reports, a time consuming exercise.

Company performance may be measured in various ways that can be broadly categorised as either accounting measures or market-related measures of company performance. Accounting measures include absolute measures such as revenue or profit, or ratios, including earnings per share (EPS), return on equity (ROE) and return on assets (ROA). The basic problem with using accounting measures as an indication of company performance is that accounting measures do not measure shareholder value (Correia, Flynn, Uliana & Wormald, 2013) and it may be manipulated in various ways (Healy, 1985). Due to the shortcomings of accounting ratios as a measure of company performance the trend in the pay-performance sensitivity literature is moving towards a market related measure of shareholder wealth: total shareholder return (TSR) (Abowd, 1990; Conyon & Leech, 1994; Main, Bruce & Buck, 1996; Masson, 1971; Murphy, 1986; Stathopoulos, Espenlaub & Walker, 2005). TSR is generally regarded as the best indicator of company performance, since it combines capital growth (gain in share price) and cash flow (dividends) to provide ultimate shareholder returns (O'Neill & Iob, 1999). A study that aims to investigate the link, between CEO pay and company performance, would be most valuable if LIC is included in CEO pay and company performance is measured in terms of TSR.

### **The link between CEO pay and company performance**

Early studies on the link between company performance and CEO pay found that the size of the company is more closely related to the level of CEO compensation than the performance (McGuire, Chiu & Elbing, 1962; Roberts, 1959). Later studies rejected this theory of sales

maximisation, reporting that executive compensation is primarily related to share market returns (Lewellen & Huntsman, 1970; Masson, 1971).

Studies that exclude LIC report a weak relationship between pay and performance in large listed companies (Benito & Conyon, 1999; Conyon & Leech, 1994). Girma, Thompson & Wright (2007) also exclude long-term incentives from compensation and use accounting-based measures of company performance and found a weak pay-performance relationship.

In contrast to studies that focus on SCC, studies that include LIC and measure company performance in terms of TSR, report a positive relationship between pay and performance (Jensen & Murphy, 1990a; Main *et al.*, 1996; Murphy, 1986; Stathopoulos *et al.*, 2005). Barber, Ghiselli and Deale (2006) similarly report a positive but weak correlation among CEO compensation (including long-term share-based incentives), sales, profit and share price in the U.S. restaurant industry.

Eichholtz, Kok and Otten (2008) use both accounting and market-related measures of performance, and include long-term incentive compensation and report that compensation is strongly linked to company size (similar to the findings of Girma *et al.* (2007)). Eichholtz *et al.* (2008) also report that long-term incentives – but not cash pay – are explained by performance, consistent with the earlier studies of Lewellen and Huntsman (1970), and Masson (1971).

One study, however, reported an inverse relationship between compensation (including share options) and TSR over the previous five years and concluded that job size and complexity largely determine compensation (O'Neill & Iob, 1999). The results reported by pay-performance sensitivity studies are as varied as the measures of pay and performance that are included. It is, however, clear that the inclusion of LIC and some market related measure of company performance is preferable. These studies all investigated the effect of company performance on CEO pay, without considering the effect that the pay package has on the future performance of the company.

### **Pay for future performance**

How performance affects compensation is well researched, but limited research exist on the reciprocal relationship of how compensation affects future performance (Murphy, 1999), in other words: whether shareholders get what they pay for.

Abowd (1990) investigated whether the sensitivity of cash based compensation to company performance is positively related to company performance in the subsequent year and reports that where there was a stronger relationship between company performance and CEO pay in the base year, companies performed better in the subsequent year. Other studies that investigated whether CEOs that earn in excess of their peers perform better, all report a negative association between abnormal future share returns and excess CEO compensation (Balafas & Florackis, 2014; Cooper *et al.*, 2014; Core *et al.*, 1999). If similar results were to be found in South Africa, where pay inequality is arguably more severe, it would be very concerning.

## South African pay-performance studies

In South Africa, the literature on the link between executive pay and performance is in its infancy, with pay-performance sensitivity of executive compensation only attracting the interest of SA researchers since 2011. Local studies on executive compensation mainly focus on the correlation between accounting measures of company performance and short-term cash compensation, neglecting long-term incentives (Bradley, 2011; Dommissie, 2011; Modau, 2013; Shaw, 2011). Reasons for excluding LIC include the lack of available information and relative insignificance of LIC compared to TC (Shaw, 2011). Some studies include the change in the share price as a market related measure of company performance, but report no consistent relationship with SCC (Barrett, 2014; Scholtz & Smit, 2012; Theku, 2014). Only one study adequately include LIC and use TSR to measure company performance (Bussin & Blair, 2015), but it investigated which performance measures are included in the composition of the LIC, rather than the incentivisation effect of CEO pay on future company performance.

The South African literature has clear shortcomings when compared to the norms internationally: Firstly, no local study adequately included LIC as part of CEO compensation. Cooper *et al.* (2014) reported a 99% correlation between LIC and TC, and only 38% between SCC and TC. A similar composition in SA would cast doubt over the majority of pay-performance sensitivity studies. Secondly, local studies mainly measure company performance using accounting measures, rather than TSR. Finally, the link between pay and future performance has not been considered in South Africa.

## Research objectives

The norm in the international literature to include LIC and measure company performance using TSR, as well as the shortcomings in the local literature lead to the formulation of two research objectives:

Research objective 1 is to establish the significance of long-term incentive compensation relative to total compensation for the largest 100 companies listed on the Johannesburg Stock Exchange (JSE) for 2011 to 2013.

Research objective 2 is to investigate and analyse the relationship between the level of CEO long-term incentive compensation (LIC) and the abnormal future total shareholder returns (TSR) in South Africa. This relationship between total compensation (and short-term cash compensation) and future TSR is the focus of another study.

## Research design and methodology

This study examines the significance of CEO long-term incentive compensation for the largest 100 companies listed on the JSE in South Africa for the period 2011 to 2013. The relationship between CEO long-term incentive compensation (LIC) and future company performance (as measured by abnormal total shareholder return (TSR)) is then investigated.



## Data

The study is based primarily on data that is publicly available (namely the companies' annual reports and INETBFA), but also includes information that was calculated and supplied by PricewaterhouseCoopers (PwC) that is subject to a confidentiality agreement (further details are provided below).

The study focused on the largest 100 companies in terms of market capitalisation that are listed on the JSE. The reason for limiting the population to the top 100 (which includes large- and mid-cap companies) is the availability of the expected value of the long-term incentives for these companies as calculated and supplied by PwC. Included in the top 100 company codes on the JSE are other instruments, including exchange traded notes (ETNs) and warrants which are not operating companies managed by a CEO, and consequently were excluded from the sample. The number of companies remaining in the sample is 79 in 2011, 92 in 2012 and 92 in 2013.

The variables used to measure CEO pay and company performance in this study are defined in sections 3.1.1 and 3.1.2 respectively.

## Compensation variables

The categories of long-term incentive compensation identified in the literature that are included in this study are shown in Table 11. Gains on shares held are excluded since executives may decide to retain or dispose of these shares at any time. This is supported by Main *et al.* (1996) who are of the view that these constitute a personal investment, not compensation.

**Table 11: Compensation variables included in this study**

Long-term incentive compensation (LIC)	
<u>CASH</u>	<b>This study:</b>
Deferred STI (bonus)	Included
<u>SHARE-BASED</u>	
Performance shares	Included
Share options	Included
Gains on shares held	Excluded

The compensation data has been obtained from PwC who publishes an annual report on the practices and trends of executive remuneration (PwC, 2014). The number of options and performance shares granted, as well as the vesting conditions, were retrieved directly from the annual financial statements by PwC. The valuation methodology of the expected values of the long-term incentives was discussed with PwC to confirm that the valuation methodology is consistent with generally accepted finance theory and that the assumptions are considered to be reasonable. Spot checks to INETBFA were also performed on certain data to verify the reliability of the thereof.

In order to describe compensation levels and structures, raw pay levels were used. Compensation for 2011 and 2012 was adjusted for inflation to reflect 2013 values. The year-on-year Consumer Price Index (CPI) (StatsSA, 2015) for the financial year-end month of each company was used to adjust the compensation level of the CEO of each company. Excess LIC was calculated as the difference between the absolute level of LIC of an individual CEO and the median LIC of the peer group based on size. This study follows the same classification as Steyn (2015) who defined four different size groups (based on revenue), namely: “Mega”, “Large”, “Medium” and “Small” as per Table 12.

**Table 12: Size groups (based on revenue)**

Size group	Revenue (R Billions)	Number of observations		
		2011	2012	2013
Mega	>100	8	9	11
Large	40 – 100	17	22	21
Medium	10 – 40	33	35	36
Small	< 10	21	26	24

Steyn (2015) tested whether mean total compensation differs between groups using a t-test and the Mann-Whitney u-test. Both tests reported statistically significant differences in means when comparing pairs of size groups. Similar tests were performed on four major industry groupings to test whether evidence of benchmarking on industry exists. Steyn (2015) found no such evidence and concluded that size plays a bigger role in determining pay levels than industry.

### Performance variables

Total shareholder return (TSR) is used to measure company performance and is calculated as  $(P_1 - P_0 + D) / P_0$  where:

- $P_1$  is the closing share price at the end of the quarter
- $P_0$  is the closing share price at the end of the previous quarter
- $D$  is the dividends declared and paid of which the last day to trade (LDT) falls within the specified quarter

Closing share prices and dividends for the top 100 JSE listed companies were downloaded from the Sharenet database for the period 2010 to 2015. The TSR for each quarter was calculated by adding the dividend to the share price appreciation for the quarter in which the LDT for the dividend fell. For dividends disclosed in foreign currency, the relevant exchange rates were downloaded and applied on the inclusion date (LDT). Daily historical midpoint exchange rates were downloaded from Oanda.com.

## Research design

### First research objective

The first research objective of this study is to establish the significance of long-term incentive compensation relative to total compensation for the largest 100 companies listed on the Johannesburg Stock Exchange for 2011 to 2013.

The international literature identifies the significance of long-term incentives in terms in the value thereof relative to total compensation. Further, the contrast in findings between pay-performance sensitivity studies that include and exclude long-term incentives is also evident, potentially as a result of LIC being a more significant driver of total compensation than short-term cash.

The first two research questions respond to the lack of readily available information regarding the significance of LIC in South Africa, given that the importance of these is dismissed in the local literature (Shaw, 2011).

Research question 1: What is the proportion of long-term incentive compensation (LIC) relative to total compensation (TC)?

In order to address research question 1, the mean and median level of LIC, as well as the proportion of LIC to TC were calculated for the largest 100 companies listed on the JSE in South Africa for the period 2011 to 2013 overall, and per size group (based on revenue). The proportion was calculated by dividing the total LIC by the total TC, as well as dividing the median LIC by the median TC, overall and for each size group.

Most South African pay-performance sensitivity studies use SCC as a proxy for TC and exclude LIC. In the U.S., Cooper *et al.* (2014) reported a near perfect correlation between LIC and TC (99%), compared to a correlation between SCC and TC of only 38%. Similar result in SA would cast doubt over the reliability of SA pay-performance sensitivity studies.

Research question 2: Is LIC more closely correlated to TC than SCC?

In order to address the second research question the following hypothesis was set:

Hypothesis 1 ( $H_1$ ): The correlation between LIC and TC is stronger than the correlation between SCC and TC.

In order to test hypothesis 1 the correlation between the components of compensation was determined.

### Second research objective

The second objective of this study is to investigate and analyse the relationship between the level of CEO long-term incentive compensation (LIC) and the abnormal future total shareholder returns (TSR) in South Africa.

The general experience reported in the international literature is a positive pay-performance relationship where long-term incentives are included in total compensation and lagged TSR

is used to measure company performance. The pay-performance sensitivity relationship using this combination of variables has not been tested in South Africa.

A handful of studies in the international literature extend the investigation of the pay-performance relationship to consider future company performance. Surprisingly, most of these studies found the association between LIC and future abnormal TSR to be negative (Balafas & Florackis, 2014; Cooper *et al.*, 2014; Core *et al.*, 1999).

The third research question considers this un-researched relationship in the South African context, questioning whether a positive relationship between long-term incentive compensation and future company performance (measured by TSR) exists.

Research question 3: Does a positive relationship between LIC and future company performance (as measured by TSR) exist?

The relationship between LIC and TSR was investigated in terms of excess LIC and abnormal future TSR. It was necessary to use excess compensation – that is, the absolute value of LIC less the median of LIC of the peer group – rather than the absolute value of LIC in order to control for the effect of benchmarking on compensation. The peer groups are based on size groupings defined by Steyn (2015) as previously described in section 3.1.1. Abnormal TSR was used in order to eliminate the effect of general share market movements, calculated as the TSR of each company less the benchmark of the equally weighted (EW) TSR of the top 100 JSE listed companies. In order to address research question 3, the following hypothesis was set:

Hypothesis 2 (H<sub>2</sub>): A positive relationship between excess long-term incentive compensation (LIC) and abnormal future total shareholder return (TSR) exists.

The approach taken to test hypothesis 2 was to firstly analyse the situation descriptively in order to establish the apparent relationship between excess LIC and abnormal TSR. This relationship was then tested statistically in order to confirm or reject the hypothesis.

### Descriptive relationship

The approach taken in the descriptive analysis was to first compare the abnormal returns of the extreme cases of excess pay, since the distinction would be clearest when contrasting the situations of companies with highest and lowest excess pay relative to peers, given the obvious existence of other factors affecting abnormal returns. In order to do this, companies were ranked on excess LIC and decile portfolios were formed. The abnormal TSR of the top and bottom deciles of excess pay were compared.

In order to investigate whether the relationship between excess compensation and abnormal returns was consistent across the remaining deciles, with abnormal returns declining as excess pay diminished, the remaining deciles were taken into consideration. The groupings were progressively broadened to include the next highest/lowest decile and the average abnormal returns for the larger groups were calculated. This process was repeated until the entire sample was split into two groups, being the top and the bottom half. A steadily

decreasing abnormal return across groupings from highest to lowest decile would indicate a consistently positive relationship between excess LIC and abnormal TSR.

The abnormal future TSR was calculated for the top and bottom decile portfolios of excess LIC. The return holding period was limited to nine quarters due the availability of compensation data. Even though the incentivisation effect of compensation on company performance may take several years to manifest, international studies on the pay for future company performance relationship have reported significant results for holding periods as short as one year (Cooper *et al.*, 2014; Core *et al.*, 1999).

Decile portfolios were formed at the start of the calendar year in which the CEO compensation was reported. The companies' actual financial years were disregarded for simplicity of the calculation. This simplification is supported by the findings of Cooper *et al.* (2014) who report that a similar relationship between pay and future performance exists regardless of forming portfolios on calendar year ends or financial year ends. Steyn (2015) also reports a similar relationship between SCC and future abnormal TSR regardless of calendar year-end or financial year-end portfolio formation. Portfolios were created at the start of the calendar year, since it is argued that a CEO will be aware of how his/her compensation package is structured at the start of the year and any incentivisation effect would commence immediately. The equally weighted abnormal TSR for the companies in the top and bottom deciles of excess compensation were then calculated. Equal weighting eliminates the disproportionate effect that large companies may have on portfolio returns.

In order to investigate whether the relationship appears to be consistent when testing the relationship in different ways, an alternative measure of future returns, as well as an alternative measure of excess pay was tested, as follows:

- Due to the variability in share returns, the relationship may be skewed by the effect of extreme cases. The median abnormal TSR was calculated for the top and bottom deciles of excess compensation in order to eliminate the effect of outliers.
- As a result of the small sample size and the high variability in total compensation, calculating excess pay using different cut-off points between size groups may affect the relationship between pay and future performance. In order to eliminate the effect of different size groupings, LIC was regressed on company revenue and the resultant residual plots of each observation were used as excess pay. Excess pay calculated in this manner is referred to as "residual pay" for the remainder of this study, to distinguish this approach from the primary method determining excess pay used in this study. Abnormal returns were equally-weighted and portfolios formed on calendar years.

A summary of the various descriptive analyses performed and the sections in which the results can be found is presented in

Table 13 below.

### Statistical relationship

In order to test the statistical significance of any relationships that appear to exist in the descriptive analysis, the Pearson's  $r$  was calculated to measure the linear correlation between the excess long-term incentive compensation (in terms of the median per size group) and the abnormal TSR for quarter. Due to the large variation in LIC in the population, the Spearman's Rho is also calculated for corroborative purposes. The abnormal returns were calculated from the start of the financial year to which the total compensation relates, in order to better match the compensation and return periods.

As a result of the small sample size, the Pearson's  $r$  and the Spearman's Rho were re-calculated by defining excess LIC as the residual plots, relative to the predicted LIC, when regressing LIC on revenue. A summary of the statistical tests performed is presented in

Table 13 below.

**Table 13: Summary of various descriptive analyses and statistical tests**

**Panel A: Descriptive analyses**

Abnormal total shareholder return		Excess total compensation	Results
Weighting	Year-end	Basis for determining excess	Section
Equal	Calendar	Absolute vs. median per size group	5.1.1
Median	Calendar	Absolute vs. median per size group	5.1.1
Equal	Calendar	Residual vs. predicted	5.1.1

**Panel B: Statistical tests**

Test	Abnormal total shareholder return	Excess total compensation	Results
Correlation	Year-end	Basis for determining excess	Section
Pearson's $r$	Financial	Absolute vs. median per size group	5.1.2
Spearman's Rho	Financial	Absolute vs. median per size group	5.1.2
Pearson's $r$	Financial	Residual vs. predicted	5.1.2
Spearman's Rho	Financial	Residual vs. predicted	5.1.2

## Relative significance of long-term incentive compensation

The level of CEO total compensation (TC) varies greatly amongst the largest 100 companies, ranging from a maximum annual TC of R137 million to a minimum annual TC of R1.4 million being paid to CEOs across the three year period. This excludes one CEO who did not earn any compensation at all over the three year period.

Table 14 reports descriptive statistics on inflation adjusted levels of CEO compensation and its components (short-term cash compensation (SCC) and long-term incentive compensation (LIC)) for the pooled population over 2011 to 2013.

**Table 14: Descriptive statistics on compensation components for the JSE Top 100 companies**

	<b>Short-term cash compensation (SCC) [TGP + CB] R'000</b>	<b>Long-term incentives (LIC) R'000</b>	<b>Total compensation (TC) [SCC + LIC] R'000</b>
Mean	12 737	7 757	20 494
Median	10 348	3 479	14 709
Standard deviation	9 146	13 058	18 882
Maximum	52 842	130 454	136 713
Minimum	1 431	-	1 431
% of sum	62%	38%	100%
% at median	72%	28%	100%

The maximum cash compensation granted to any CEO during the three years from 2011 to 2013 was R53 million, whereas the maximum long-term incentive compensation was two and a half times higher at R130 million. Although maximum SCC was smaller than maximum LIC, the difference between the two is not as extreme as in the U.S., where the maximum LIC was nearly six times that of the maximum SCC (Cooper *et al.*, 2014). Similar to the U.S., the standard deviation in South Africa showed less variation in cash compensation than LIC, although the difference in variation between SCC and LIC is smaller locally. The standard deviation of cash compensation in SA is nearly 70% of that of incentive compensation, while the same relationship is only one fifth in the U.S. (Cooper *et al.*, 2014).

The median short-term cash compensation and long-term incentive compensation were R10.3 million and R3.5 million respectively, in contrast to \$1 million and \$1.4 million respectively in the U.S. (Cooper *et al.*, 2014). It is clear from the above results that in South Africa, cash compensation makes up a relatively larger portion of total pay than in the U.S. Out of the 263 observations (over the three year period 2011 to 2013), 70 pay packages (nearly 27%) did not include any long-term incentive compensation as part of overall compensation and 74% of CEOs earned below average LIC suggesting a small proportion of CEOs earn a large portion of their wealth in the form of LIC.

## Proportion of long-term incentive compensation

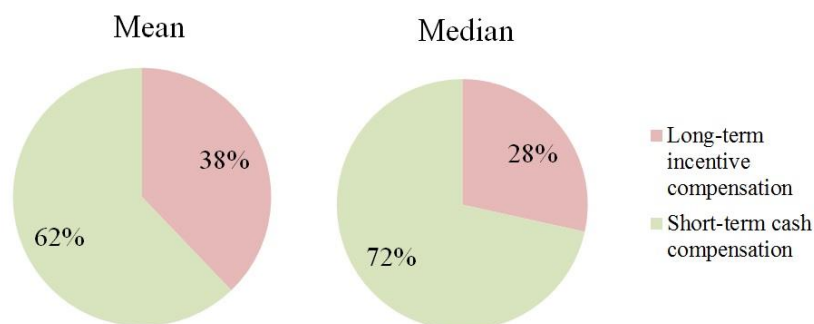
This section considers the relative importance of LIC and SCC as expressed in research question 1. The proportion of LIC is calculated by dividing the total LIC by the total TC, as well as dividing the median LIC by the median TC, overall (section 4.1.1) and for each size grouping (section 4.1.2).

### Overall

Even though the mean and median long-term incentive compensation (LIC) is less than that of short-term cash compensation (SCC) locally, the relative proportions of LIC to total compensation (TC) are not insignificant. The median LIC of R3.5 million is less than half of the mean (R7.8 million) due to 27% of companies not awarding any long-term incentives over the three year period 2011 to 2013.

When considering the pay of all the companies cumulatively, total compensation comprises of 62% SCC (salary, benefits and bonus) and 38% LIC. At the median level of all observations, 72% is SCC and 28% is LIC (refer to Figure 4). Even though the relative proportion of LIC to TC in South Africa is smaller compared to the U.S., where Cooper *et al.* (2014) reported a 48/52 split between cash and incentive compensation respectively at the median level, the proportion of LIC to TC is large enough not to be ignored.

**Figure 4: Proportion of long-term incentive compensation and short-term cash compensation**



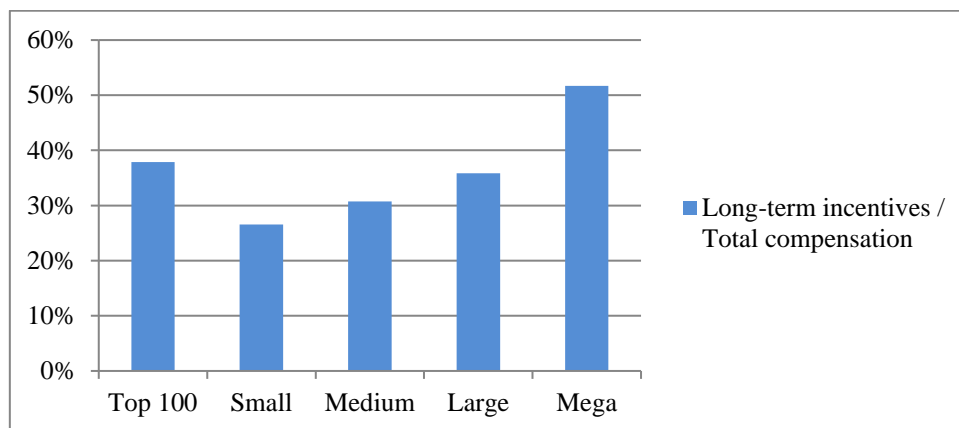
### Compensation structure per size group

The median short-term cash compensation for small- and medium sized companies (R6.3 million and R9.2 million respectively) was three to four times as much as the median incentive compensation (R2.1 million and R2.3 million respectively), with large companies paying roughly twice as much cash compensation as incentive compensation (R14.5 million and R7.4 million respectively). Only the group of mega-sized companies reported higher median long-term incentive compensation (LIC) than short-term cash compensation (SCC) (R31.1 million and R27.6 million respectively).

Figure 5 clearly shows the relationship between company size and the proportion of long-term incentive compensation to total compensation.



**Figure 5: Proportion of long-term incentives to total compensation per size group**



A large proportion of the companies in the mega size group are dual listed multinational companies, thus reflecting the higher incentive component that was found by Cooper *et al.* (2014) in the U.S. Mega companies in total reported a proportion of 52% long-term incentive compensation followed by large-, medium- and then small companies (36%, 31% and 27% respectively).

### Correlation of compensation components

In order to address research question 2, the correlation is calculated between the different components of CEO compensation: total compensation (TC), short-term cash compensation (SCC), and long-term incentive compensation (LIC).

The variation in total compensation is driven by both incentive and cash compensation, being positively correlated to all aspects of compensation (refer Table 15). It is interesting to note that even though short-term cash compensation comprises a larger proportion of total pay overall and at the median level (refer Table 14 earlier), the long-term incentive compensation is more closely correlated to total pay than short-term cash compensation and consequently hypothesis 1 is accepted.

**Table 15: Correlations between components of raw compensation**

	TC	SCC	LIC
Total compensation (TC)	1.000		
Short-term cash compensation (SCC)	0.781	1.000	
Long-term incentive compensation (LIC)	0.899	0.429	1.000

Our findings suggest relatively close relationships between both SCC and TC, as well as between LIC and TC. This is inconsistent with results from the U.S. where total incentive pay showed a near perfect correlation of 98.6% with total pay, but total cash pay only explaining 37.7% of total pay (Cooper *et al.*, 2014).

It appears as if cash compensation plays a relatively more important role in determining total pay in South Africa than the U.S. The strong correlation between SCC and TC (78.1%) may suggest that using short-term cash compensation as a proxy for total compensation (as most prior SA studies have done) is not entirely inappropriate.

## The relationship between long-term incentive compensation and future company performance

The negative abnormal returns reported for the highest paid executives internationally (Balafas & Florackis, 2014; Cooper *et al.*, 2014; Core *et al.*, 1999) suggest that managerial compensation components such as long-term incentives – meant to align the interests of management with shareholder value – do not necessarily translate into higher future shareholder returns.

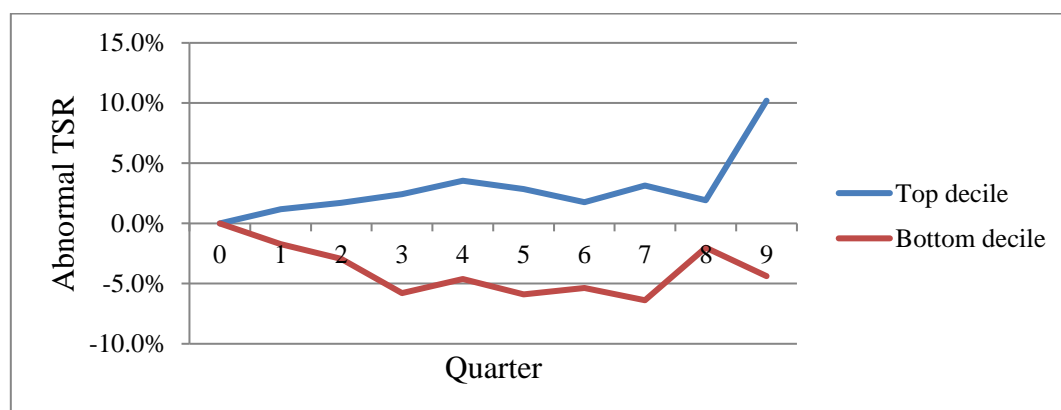
This section reports on this relationship in South Africa in addressing the second research objective of this study, to investigate and analyse the relationship between the level of CEO long-term incentive compensation and future total shareholder returns in South Africa.

### Descriptive relationship

The abnormal TSR of the top and bottom deciles was calculated on the basis of equal weightings of abnormal TSR for each company. Abnormal TSR was calculated from the start of the calendar year to which the excess LIC relates, defined as the excess TSR over the equally weighted TSR of the top 100 JSE listed companies.

From Figure 6 it is evident that the companies in the top decile of excess LIC outperform the companies in the bottom decile.

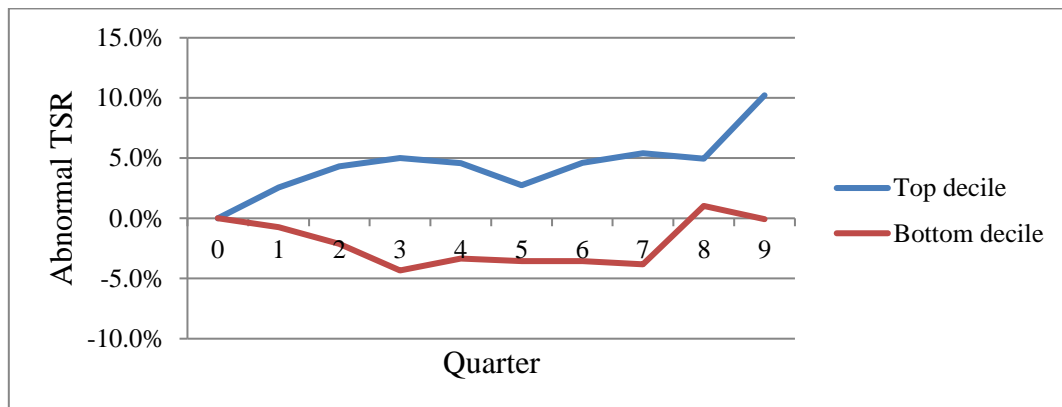
**Figure 6: Equally-weighted abnormal returns earned by companies with CEOs in the top and bottom deciles of excess long-term incentive compensation**



The companies with CEOs earning the highest excess long-term incentive pay earn abnormal returns of 3.6% in the first year, which improve to 10.2% over the subsequent five quarters. The CEOs in the lowest excess LIC decile earned a negative return of -4.6% in the first year.

The relationship between LIC and abnormal future TSR was also investigated on the basis of median abnormal returns, in order to investigate the influence of outliers. A similar pattern is reported using median returns. The negative abnormal TSR of the bottom decile disappeared, while the positive abnormal TSR of the top decile remain largely unchanged, suggesting that only the bottom decile is significantly affected by outliers (refer Figure 7).

**Figure 7: Median abnormal returns earned by companies with CEOs in the top and bottom deciles of excess long-term incentive compensation**

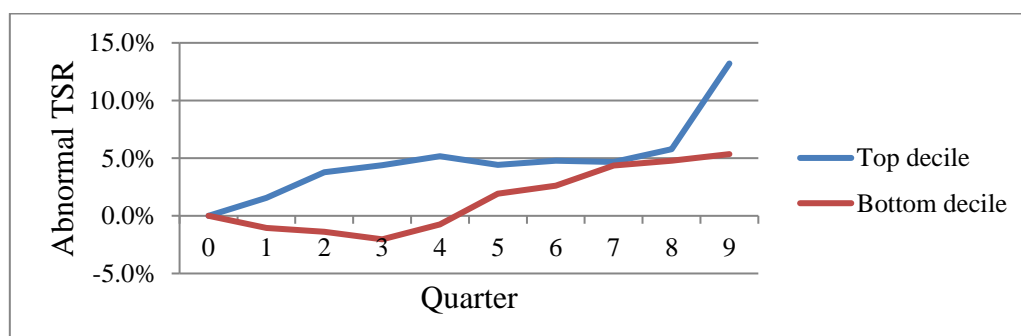


The small negative abnormal returns of the bottom decile of excess LIC that disappear after two years is consistent with the findings of Cooper *et al.* (2014). The top decile of excess LIC, however, moves in the opposite direction from the U.S. study, where the top 10% of companies in terms of LIC is associated with negative abnormal returns of up -9.38% after three years.

Lastly, in order to test whether the relationship between LIC and future performance remain consistent regardless of the company size groupings used as peers to benchmark LIC, companies were ranked according to residual LIC (instead of excess LIC) to form decile portfolios.

The top decile remains associated with higher positive and increasing abnormal returns (13.2% after nine quarters), while the bottom decile reports negative cumulative abnormal TSR only for the first year, after which it turns positive to end on 5.3% after the full nine quarters (refer to Figure 8).

**Figure 8: Equally-weighted abnormal returns earned by companies with CEOs in the top and bottom deciles of residual long-term incentive compensation**



The graphical relationship between LIC and abnormal TSR changes when excess compensation is calculated in different ways, suggesting that the apparent relationship is not that clear, and in fact there may be little to no such relationship.

#### Conclusion to descriptive analysis

The graphs depicting the relationship between excess/residual LIC and abnormal TSR when reporting only the extreme deciles suggest top paid CEOs outperform CEOs earning the least. Caution should however be taken when only comparing the top and bottom deciles, since there may be greater variation in the rest of the sample.

The remaining eight deciles were also considered and no consistent relationship is visible across the remaining deciles. There could be several reasons for this lack of a clear trend: Firstly, it could be that, as a result of mega companies paying such large LIC relative to the other size groups, the mega companies paying positive excess LIC would be in high deciles while the mega companies paying lower LIC than their peers (negative excess LIC) would be in lower deciles. This is in comparison to the medium and small companies that have much lower median LIC, where any excess LIC paid by these smaller companies (whether positive or negative) would be much less than the excess paid by the mega companies, and thus would be concentrated in the middle deciles. This would result in a small or medium company paying no LIC (with a small negative excess LIC of less than R2.1 million or R2.3 million respectively) being ranked in a higher decile than a mega company paying a large LIC that is less than the median of R31 million for their peer group.

Secondly, the negative returns earned by the resource companies in the mining sector that still paid large LIC resulted in a concentration of the mining companies in certain of the higher deciles, having a strong negative influence on the abnormal TSR of those deciles.

Finally, it could be that unlike the SCC package of CEOs that remain relatively constant from year to year, the LIC component varies notably within the same company from year to year. For example, 30% of companies (for which three years' data were available) were found to pay no LIC in one year, but make a large LIC payment in another. The company that paid the highest LIC in the population as a whole in one year paid no LIC in the following year. To control for the lumpiness of LIC payments the average inflation adjusted LIC for the three year period was calculated and the portfolios reformed on this basis. The results, however, were no more consistent than originally found, with the top two deciles showing strong positive abnormal TSR, while the rest of the deciles remained jumbled.

In conclusion, the abnormal TSRs of the top and bottom deciles show that the top decile of excess LIC consistently outperforms the bottom decile. The gap does, however, narrow when using median abnormal TSR. Other than the top two deciles, the remaining deciles appear jumbled and no clear relationship between LIC and abnormal TSR for these deciles is evident. When using residual LIC to form portfolios the gap between the top and bottom deciles is severely diminished.

These results find no support in South Africa for the suggestion in the international literature that LIC is an optimal component of the CEO's pay package, except where LIC is very large relative to the peer group. This brings into question the effectiveness of LIC as a mechanism

to incentivise future performance and potentially supports the argument that LIC is merely an unjustified inflation of the CEO's pay package.

The superior performance of the top two deciles of excess LIC does, however, stand out. This may be explained by the high proportion of "mega"-sized companies that pay higher LIC in those deciles, supporting labour market theory which suggests that larger companies can afford the best talent, which is capable of outperforming their peers.

### Pearson's $r$ and Spearman's Rho

Descriptively, no clear relationship between excess LIC and future TSR appears to exist, except at the extreme cases of excess LIC. In order to confirm the descriptive relationship, the correlation between excess LIC (as well as residual LIC) and abnormal TSR was calculated.

From the results of the statistical tests that are reported in Table 16 below, it is clear that there is no correlation between excess LIC and abnormal TSR.

**Table 16: Pearson's correlation coefficient and Spearman's rank correlation coefficient for excess LIC and abnormal TSR**

	2011 n = 79				2012 n = 92				2013 n = 92			
	Pearson		Spearman		Pearson		Spearman		Pearson		Spearman	
Quartile	$r$	$p$ -val.	$\rho$	$p$ -val.	$R$	$p$ -val.	$\rho$	$p$ -val.	$r$	$p$ -val.	$\rho$	$p$ -val.
Q1	-0.05	0.68	-0.05	0.68	0.15	0.16	-0.11	0.28	0.13	0.20	0.08	0.46
Q2	-0.00	1.00	0.00	1.00	0.15	0.16	-0.11	0.30	0.09	0.40	0.04	0.73
Q3	-0.02	0.90	-0.02	0.87	0.11	0.28	-0.05	0.64	0.09	0.39	0.04	0.72
Q4	0.02	0.86	-0.04	0.70	0.13	0.23	-0.04	0.68	0.08	0.47	0.01	0.94
Q5	0.04	0.75	-0.04	0.72	0.10	0.33	-0.04	0.67	0.09	0.39	0.06	0.59
Q6	0.04	0.74	-0.08	0.47	0.11	0.28	-0.05	0.62	0.09	0.41	0.08	0.46
Q7	0.05	0.68	-0.05	0.66	0.08	0.45	-0.03	0.78	0.11	0.29	0.09	0.40
Q8	0.06	0.58	-0.04	0.75	0.12	0.27	-0.08	0.46	0.10	0.34	0.09	0.40
Q9	0.08	0.50	-0.03	0.83	0.08	0.43	-0.04	0.68	0.10	0.36	0.11	0.29

Based on the lack of a steady decline in the cumulative abnormal TSR from highest to lowest deciles, the absence of a statistically significant relationship between excess LIC and abnormal TSR was not unexpected. This is in stark contrast to the U.S. experience where the pay-performance relationship is generally stronger when including LIC. It also contradicts the findings of Cooper *et al.* (2014) who report a statistically significant negative relationship

between excess LIC and abnormal TSR for the top three deciles as a result of CEO overconfidence.

In order to test whether the calculation of excess LIC affected the relationship, the Pearson's and Spearman's correlations are recalculated using residual LIC instead of excess LIC. The results confirm that there is no statistically significant relationship between LIC and future company performance, for the three year period.

## **Conclusion to research objective 2**

Even though the top decile in terms of excess LIC outperforms the bottom decile, the abnormal TSRs of the remaining deciles are jumbled and the statistical tests indicate that there is no relationship between excess LIC and abnormal TSR and hypothesis 2 is rejected.

These results are largely corroborative of those of Cooper *et al.* (2014), who similarly found a lack of a relationship between LIC and company performance, (other than for companies paying in the top deciles of excess compensation, where a negative relationship exists). These results however are in contradiction to those of other international studies who find that CEO LIC is negatively associated with future company performance (Balafas & Florackis, 2014; Cooper *et al.*, 2014; ore *et al.*, 1999).

## **Limitations and scope restrictions**

This study only covers three years (2011 to 2013) due to the limited data available on LIC. Future returns are also limited to nine quarters. International studies include up to 18 years of CEO compensation (Cooper *et al.*, 2014) and return holding periods of up to five years (Balafas & Florackis, 2014; Cooper *et al.*, 2014). Core *et al.* (1999), however, report a significant relationship for a sample including only three years and some studies report significant relationships for holding periods as short as one year (Cooper *et al.*, 2014; Core *et al.*, 1999).

International studies regularly include very large sample sizes, but despite the limitation of this study to the top 100 companies, it contributes to the literature by extending the population size over prior local studies (Bradley, 2011; Shaw, 2011; Theku, 2014). Furthermore, the largest 100 companies represents 94% of the total JSE capitalisation as at 7 May 2015 (calculated using fundamentals data downloaded from the Sharenet database).

This study is limited to the relationship between excess LIC and abnormal future TSR and ignores other potential variables that may affect CEO pay (for example CEO age, CEO tenure and composition of the board of directors) as well as other factors that may affect the abnormal TSR (for example the slump in commodity prices in the resources industry). This study also focuses on TSR as a measure of company performance, since accounting measures do not measure shareholder value.

## Conclusion and areas for future research

Even though it seems that South African companies rely less on long-term incentive compensation than companies in the U.S., long-term incentive compensation (LIC) is not insignificant in the local context and cannot be ignored in studies investigating the link between CEO pay and company performance. While LIC is more closely correlated to total compensation (TC) than short-term cash compensation (SCC), both SCC and LIC is highly (positively) correlated to TC.

The link relationship between excess LIC and abnormal future total shareholder returns (TSR) is non-existent, which presents a disturbing picture: Long-term incentives are intended by corporates to provide incentivisation regarding long-term company performance and represents substantial amounts of cash. If LIC is a generally ineffective (or negatively effective) form of incentivisation, or only sporadically effective (as the broad distributions, non-linear relationship and lack of statistical significance suggest), then the question must be asked – why? It is beyond the ability of quantitative empirical research to answer this question and it is suggested that qualitative research into the question of why LIC schemes may lack effectiveness (or even be detrimental to company performance, as Cooper *et al.* (2014) suggest) is required. The interpretive approach intrinsic in qualitative research would be helpful in allowing the reality of the causal effects of long-term incentive schemes to show themselves freely, without conditioning it by the parameters set in place by quantitative empirical research, contributing to generating new knowledge that explains the inconclusive and sometimes contradictory results reported in the body of existing literature (Ciao, 2010). Due to the time it takes for the potential influence of a CEO in the performance of a company, a similar study that covers a longer time frame and an extended return holding period might provide more reliable results.

## References

Abowd, J. M. (1990). Does performance-based managerial compensation affect corporate performance? *Industrial and Labor Relations Review*, Vol. 43(3): 52S-73S.

AFL-CIO America's Unions. (2015). Executive pay watch. High paid CEOs and the low-wage economy. [Online]. Available from: <<http://www.aflcio.org/Corporate-Watch/Paywatch-2015>>. [8 June 2015].

Balafas, N. & Florackis, C. (2014). CEO compensation and future shareholder returns: Evidence from the London Stock Exchange. *Journal of Empirical Finance*, 27: 97-115.

Barber, N., Ghiselli, R. & Deale, C. (2006). Assessing the relationship of CEO compensation and company financial performance in the restaurant segment of the hospitality industry. *Journal of Foodservice Business Research*, 9(4): 65-82.

Barrett, S. (2014). *Effects of race on CEO pay-performance sensitivities*. Masters of Business Administration dissertation. Pretoria: University of Pretoria.

Benito, A. & Conyon, M. J. (1999). The governance of directors' pay: Evidence from UK companies. *Journal of Management and Governance*, 3: 117-136.

Bizjak, J. M., Lemmon, M. L. & Naveen, L. (2008). Does the use of peer groups contribute to higher pay and less efficient compensation? *Journal of Financial Economics*, 90: 152-168.

Bradley, S. (2011). *Chief executive officer compensation and the effect on company performance in a South African context*. MCom dissertation in Accounting. Rhodes: Rhodes University.

Bussin, M. (2011). *The remuneration handbook for Africa*. Knowres Publishing. Randburg. South Africa.

Chalmers, K., Koh, P. -S. & Stapleton, G. (2006). The determinants of CEO compensation: Rent extraction or labour demand? *The British Accounting Review*, 38: 259-257.

Ciao, B. (2010). Qualitative Approach for Management Studies: Collecting Methodological Choices and Reflections from a Research Experience. Presented at EIASM "Workshop in-depth and case studies in entrepreneurship and small business management". Brussels.



- Canyon, M. J. & Leech, D. (1994). Top pay, company performance and corporate governance. *Oxford Bulletin of Economics and Statistics*. Vol. 56(3): 229-247.
- Cooper, M. J., Gulen, H. & Rau, P. R. (October 1, 2014). Performance for pay? The relation between CEO incentive compensation and future stock price performance. [Online]. Available from: <<http://ssrn.com/abstract=1572085>> or <<http://dx.doi.org/10.2139/ssrn.1572085>>. [3 June 2015].
- Core, J. E., Holthausen, R. W. & Larcker, D. F. (1999). Corporate governance, chief executive officer compensation, and firm performance. *Journal of Financial Economics*, 51: 371-406.
- Correia, C., Flynn, D., Uliana, E. & Wormald, M. (2013). Financial Management, Seventh Edition. Juta and Company Ltd. Cape Town, South Africa.
- COSATU. (30 April, 2014). COSATU condemns exorbitant executive pay. [Online]. Available from: <<http://www.cosatu.org.za/show.php?ID=8705>>. [29-5-2015].
- Dommissie, J. (2011). *Is die vergoeding van die uitvoerende hoofde van die 120 top-maatskappye van die Johannesburgse Aandelebeurs in verhouding tot hul omset, inkomste of wins voor rente en belasting geregverdig?* Masters of Business Administration dissertation. Stellenbosch: University of Stellenbosch.
- Edmans, A. & Gabaix, X. (2009). Is CEO pay really inefficient? A survey of new optimal contracting theories. *European Financial Management*, Vol. 15(3): 486-496.
- Eichholtz, P. M. A., Kok, N. & Otten, R. (2008). Executive compensation in UK property companies. *Journal of Real Estate Finance & Economics*, 36: 405-426.
- Frydman, C. & Jenter, D. (2010). *CEO Compensation*. (Working Paper 16585). Massachusetts: National Bureau of Economic Research.
- Garside, J. (2015). Long-term incentive plans for bosses 'damage firms'. *Mail & Guardian*. [Online]. Available from: <<https://www.theguardian.com/business/2015/may/13/long-term-incentive-plans-for-bosses-damage-firms>>. [15 April 2016].
- Girma, S., Thompson, S. & Wright, P. W. (2007). Corporate governance reforms and executive compensation determination: Evidence from the UK. *The Manchester School*, Vol 75(1): 65-81.
- Healy, P. M. (1985). The effect of bonus schemes on accounting decisions. *Journal of Accounting and Economics*, 7: 85-107.

Jensen, M. C. & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Economics*, Vol. 3(4): 305-360.

Jensen, M. C. & Murphy, K. J. (1990a). Performance pay and top-management incentives. *Journal of Political Economy*, Vol.98(2): 225-264.

Jensen, M. C. & Murphy, K. J. (1990b). CEO incentives – It's not how much you pay, but how. *Harvard Business Review*, No.3: 138-153.

Jones, S. R. H. & Ville, S. P. (1996). Efficient transactors or rent-seeking monopolists? The rationale for early chartered trading companies. *The Journal of Economic History*. 56(4): 898-915.

Lewellen, W. G. & Huntsman, B. (1970). Managerial pay and corporate performance. *The American Economic Review*, Vol. 60(4): 710-720.

Main, B. G. M., Bruce, A. & Buck, T. (1996). Total board remuneration and company performance. *The Economic Journal*, Vol. 106(439): 1627-1644.

Malmendier, U. & Tate, G. (2008). Who makes acquisitions? CEO overconfidence and the market's reaction, *Journal of Financial Economics*, 89: 20-43.

Masson, R. T. (1971). Executive motivations, earnings and consequent equity performance. *Journal of Political Economy*, 79: 1278-1292.

McGuire, J. W., Chiu, J. S. Y. & Elbing, A. O. (1962). Executive income, sales and profits. *The American Economic Review*, Vol. 52(4): 753-761.

Modau, M. F. (2013), "The relationship between Chief Executive Officer (CEO) remuneration and financial performance of an organisation", Masters of Business Administration dissertation, Gordon Institute of Business Science, University of Pretoria, Pretoria.

Murphy, K. J. (1986). Incentives, leaning, and compensation: A theoretical and empirical investigation of managerial labor contracts. *The RAND Journal of Economics*, Vol.17(1): 59-76.

Murphy, K. (1999). Executive compensation. In: Ashenfelter, O., Card, D. (Eds.), *Handbook of Labor Economics*, vol. 3B: 2485-2563.

O'Neill, G. L. & Iob, M. (1999). Determinants of executive remuneration in Australian organizations: An exploratory study. *Asia Pacific Journal of Human Resources*, 37(1): 56-75.

PricewaterhouseCoopers Inc. ("PwC") (2014). *Executive Directors' Remuneration - Practices and Trends Report. Sixth Edition. South Africa – July 2014.*

PricewaterhouseCoopers, the South African firm.

Roberts, D. R. (1959). *Executive compensation*. Glencoe, Illinois. Free Press.

Scholtz, H. E. & Smit, A. (2012). Executive remuneration and company performance for South African companies listed on the Alternative Exchange (AltX). *South African Business Review*, Vol. 16(1).

Shaw, P. (2011). *CEO pay-performance sensitivity in South African financial services companies*. Masters of Business Administration dissertation. Pretoria: University of Pretoria.

Stathopoulos, K., Espenlaub, S. & Walker, M. (2005). The compensation of UK executive directors: Lots of carrots but are there any sticks? *Competition & Change*, Vol. 9(1): 89-105.

Statistics South Africa ("StatsSA"). (2015). CPT History: 1960 onwards. [Online]. Available from: <<http://www.statssa.gov.za/publications/P0141/CPIHistory.pdf?>>. [1 July 2015].

Steyn, G. F. (2015). *The relationship between CEO compensation and future share returns in South Africa*. Masters of Commerce dissertation. Bellville: University of the Western Cape.

Theku, M. (2014). *CEO compensation sensitivity to performance in the South African mining industry*. Masters of Business Administration dissertation. Pretoria: University of Pretoria.

Tosi, Jr., H. L. & Gomez-Mejia, L. R. (1994). CEO compensation monitoring and firm performance. *Academy of Management Journal*, Vol. 37(4): 1002-1016.

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**MAF 10: Are there benefits to diversification across the  
largest African stock markets?**

Carlos De Jesus and Professor Phillip De Jager

University of Cape Town

Email: [carlos.dejesus@uct.ac.za](mailto:carlos.dejesus@uct.ac.za)

**ABSTRACT:**

This study examines the co-movements of selected African stock exchanges, including Nigeria, Morocco, Egypt and South Africa, as well as the USA, in local currency and in USD terms, for the period January 2004 to June 2014. The study sheds light on African market cointegration before, during, and post the financial crises of 2007/2008 to identify whether there are benefits to diversification in stock exchanges across Africa and how this has changed over time. Only the four biggest exchanges are examined, to eliminate the effects of illiquidity and ensuring the size of indices used result in conclusions that are practical to investors. This study looks at long term relationships using cointegration, and the direction of the relationships using causality tests. We find no consistent cointegration relationships over the periods tested. There are no consistent causality relationships between the various countries. The implication of these results are that there are likely benefits to diversification across the four African exchanges examined.

**Keywords:**

Cointegration, African Exchanges, Diversification in Africa, Investment in Africa.

## 1. INTRODUCTION

“The benefits of international diversification have been recognized for decades”  
(French & Poterba, 1991)

Stock market integration can be defined as a condition in which stock markets move together and have the same expected risk adjusted returns (Sharma & Seth, 2012). The benefits of international diversification can only be realised if the markets do not move together.

As will be discussed in the literature review below, often tests for integration are performed around crises, for example: the 1987s equities crisis (Arshanapalli & Doukas, 1993; Longin & Solnik, 1995; Butler & Joaquin, 2002; Meric & Meric, 1989) or the Asian crisis in 1997 (Ghosh, Johnson & Saidi, 1999; Kamin, 1999; Wang, Yang & Bessler, 2003), as this is when the main benefits from diversification are gained (Butler & Joaquin, 2002). Diversification aims to decrease variance of returns (Markowitz 1952), and during a crisis the market has a high variance from expected returns and thus benefits can be had from diversification.

Given the above benefits of diversification, the objective of this paper is to shed light on whether a diversification benefit can be gained from investing across Africa, from a practical perspective. Practical in this sense, implying an investor is investing in just equities, and on a global basis. As these diversification benefits are most needed in times of financial crisis, this study thus examines whether there are the benefits discussed above, before during and after the financial crisis of 2007/2008 by investing across the four largest African exchanges. This is relevant as due to globalisation markets have become more cointegrated and the benefits are potentially being lost.

This study aims to test the cointegration, and causality relationships among four of Africa's largest and most liquid exchanges to determine whether there are diversification benefits to international and African investors investing across the continent. More specifically this paper examines the long-term relationships between indices in the different markets, and the strengths of these interactions, as well as the direction of the relationships. The results of the tests performed will be useful for investors in the compilation of a diversified portfolio, specifically using exchanges within Africa. The outcome of this study should also increase our understanding of how the different large African markets react with respect to each other, especially in times of a global crisis, as this is when the benefits of diversification are most necessary.

This study examines four African stock markets, namely the Johannesburg Stock Exchange (JSE), Nigeria Stock Exchange (NSE), Casablanca Stock Exchange (CSE), and the Egyptian Stock Exchange (EGX). These are compared with US stock exchanges, represented by Standard & Poor's 500 index (S&P 500). The objective is to establish where there are benefits to investing across Africa from a local perspective, examining the relationships among the African exchanges. We then look from an international perspective examining the relationships between the African exchanges and the S&P 500.

The four exchanges were selected because of their size and liquidity, which make them a viable investment option for large institutional and foreign investment. All four exchanges are also members of the World Federation of Exchanges (WFE). Being registered with the WFE is significant as of the end of 2012 only four African stock exchanges have fulfilled the criteria entitling them to become members of this regulatory body (Riscura, 2013).

The reasons for the inclusion of the S&P 500 are twofold: Firstly, the United States Dollar (USD) is used as a proxy for relative value across the African exchanges, enabling us to see in USD terms if they are integrated. The USD was chosen because it is the “dominant medium for international transactions” (Goldberg, 2010), and is arguably the most obvious choice as a base for value movements. International investors needing to compare the performance of African stocks to other international investments would require the returns to have a relative value base, and in this case the USD is being used as that base. Raj and Dahl (2008) also test stock prices in local and USD terms, and find the currency denomination used affected their cointegration results. This could be of specific benefit to international investors.

According to Graham et al. (2013), “The diversification benefits, if any, may be contaminated by foreign exchange risk when returns from prices denominated in local currency are used”. This study thus also attempts to remove the effects of currency depreciation and exchange rate changes, although imperfectly.

A significant benefit of this study, when compared to previous literature, is that this study has real-world application. The indices used in this study have the required size and liquidity to make them viable investment options, as they represent the largest and most liquid stocks. The aforementioned factors result in this study having application value to institutional and larger individual investors. In previous studies, Graham et al. (2013) use the Morgan Stanley Capital International (MSCI) indices, Collins and Biekpe (2003) use local benchmark indices, and Chen et al. (2014) use MSCI, Russell’s’ Frontier markets and the S&P indices.

The results of this study are similar to other African studies. No relationships are found over the full period January 2004 to June 2014, using either the Johansen or Engle-Granger cointegration tests, and no cointegration relationships for longer than a single sub-period are found using the Engle-Granger or Johansen tests for cointegration.

The remainder of this study will be organised as follows. Section 2 provides a review of the literature relating to market integration in order to give the study the required context and background. Sections 3 and 4 deal with the data collected in the study, as well as the research approach. Section 5 provides an analysis of the results found from the data, and Section 6 brings the information together in a summary of the outcomes of the research and a conclusion. Appendix A has unit root tests results referred to in section 5 below and Appendix B has a complete list of Acronyms and abbreviations used in this study.

## 2. REVIEW OF RELATED LITERATURE

In our introduction we discussed the need for diversification when building an optimum portfolio. As stated by Markowitz (1952), “Diversification is both observed and sensible; a rule of behavior which does not imply the superiority of diversification must be rejected both as a hypothesis and as a maxim.”

### 2.1 Integration of African stock markets

#### 2.1.1 Why African stock markets?

High growth in emerging and frontier markets attracts foreign direct investment (Speidell, 2011). Investing in a frontier market is associated with risk. Thus if the African frontier markets are cointegrated with emerging or developed markets it may be beneficial to invest in the less risky emerging or developed markets.

Market integration of developing African stock exchanges is fundamental to economic development (Jefferis, 1995; Kenny & Moss, 1998; Piesse & Hearn, 2002; Bekaert, Harvey & Lumsdaine, 2002). The degree to which these African stock exchanges are globally integrated is important for this primary goal, as this attracts foreign direct investment (Kenny & Moss, 1998).

Financial development has also been proven to have a causal effect on the rate of economic growth (Irving, 2005). Financial integration also has implications for financial stability (Sharma & Bodla, 2010), with markets that are more integrated also being more financially stable. Consequently, such well-integrated stock exchanges can play an important role in the promotion of African economic growth. Research aimed at understanding the financial integration of African stock markets is therefore important for the future growth and success of Africa.

#### 2.1.2 Findings from previous literature on emerging markets

Since the early 1990s emerging markets have become a more viable asset class, leading to a growing interest in African market integration. During the 1990s several significant events occurred, including the Mexican peso crisis, the Asian crisis, and the Russian and Brazilian bond defaults. These have provided data and spurred further interest in the integration of emerging and global markets (Collins & Biekpe, 2003). Harvey argues that emerging markets are segmented from world markets because their returns are influenced by local rather than international factors (Harvey, 1995). The same study finds that including emerging market equities in a portfolio can increase returns and decrease volatility (Harvey, 1995).

Alagidede, Panagiotidis and Zhang (2011) explore the implications of integration among African economies and stock exchanges to assess the effectiveness of portfolio diversification. They find few long term relationships between African countries and even between African countries and the rest of the world. They conclude that investors could diversify their portfolios by including African stocks, because international stock market shocks would have little effect on African stock markets because of this lack of integration. Alagidede et al. (2011) also show the relevance of

research in deciding whether African shares should be used to diversify an investment portfolio. However, much research still needs to be done in terms of African stock market integration.

Previous studies seem to focus on specific regions rather than Africa as a continent, thus this study is relevant for global investors looking to invest in Africa.

### 2.1.3 Previous literature on African market cointegration

Adjasi and Biekpe (2006) show that long term relationships exist between several African stock markets. South Africa was shown to be affected in the long term by reactions from other markets, such as Egypt, Kenya, Mauritius, Nigeria, and Ghana. The South African market must regularly monitor developments in these other markets, due to their long run impacts. They also showed that South Africa, being the larger market, was helping to correct any disequilibrium and that the country had a significant effect on the relatively inactive Ghanaian market. This study brings to light not only the presence of South Africa as a major influence in Africa, but also the extent to which economies affect each other. Egypt, in particular, has been shown to have a long running effect on South Africa. This study will ascertain whether this long term effect still exists.

Graham et al. (2012) tests the strength of co-movements between the US and 22 Emerging markets, including Egypt, Morocco, and South Africa, using the Wavelet analysis tool. The key findings from the study were as follows: Stock market integration is constantly changing over time and there is more of a trend of co-movements over the long term, and more short term co-movements after 2006. Thus there are still benefits to American investors to investing in emerging markets, but more so in the short-term.

Middle East and North Africa region (MENA) market integration has been tested by Yu and Hassan (2008), and Graham et al. (2013). Yu and Hassan (2008) compare MENA stock exchanges to those in the USA, UK, and France to see if the market returns are cointegrated, for the period 1 January 1999 to 31 December 2005. They find cointegration between the Gulf Cooperation Council (GCC) and Non-GCC markets tested, and well as the US stock market exhibiting Granger causality with non-GCC markets.

The study by Graham et al. (2013) is similar to this study, in that it looks at co-movements with the USA and co-movements within the MENA region. Using data from June 2002 to June 2010, this study finds there are co-movements with the USA (S&P 500) in the long term. However, the relationship does not exist in the short term, implying the benefits of diversification in the short term (Graham et al., 2013). This study by Graham et al. (2013) also finds a rise in co-movements after the onset of the financial crisis in 2008. This is consistent with other research on increased cointegration in times of greater volatility.



### 3. DATA

The following indices were used to represent the four African countries equities markets: Johannesburg Stock Exchange Top 40 Index (JSE Top 40 – representing South Africa); Nigeria Stock Exchange Allshare Index (NGSE – representing Nigeria) and Nigeria Stock Exchange Top 30 Index (NSE 30 – representing Nigeria); Egyptian Stock Exchange Top 30 (EGX 30 – representing Egypt); Casablanca Stock Exchange Top 25 (CFG 25 – representing Morocco). The data used was the weekly closing prices of the respective indices. Liquidity and the index being practically investable are key in this study and thus weekly tests were run to include the NSE 30 which best represents liquid and practically investable stocks.

The period of analysis is from 1 January 2004 to 30 June 2014. This period is further divided into three sub-periods to address the potential impact of the global financial crisis on the African stock exchanges, as well as their integration with global markets. The crisis period for the purposes of this study is considered to run from October 2007 to the end of March 2009, with the post-crisis period starting at the beginning of April 2009. It is difficult to pinpoint the exact start and end of the crisis. However, using the S&P 500 as a proxy for US stocks it can be seen that the decline in the S&P 500 index started in October 2007 and the S&P 500 reached a low in March 2009. Most of the benefits of diversification would be gained during the crisis period. Analysis of the preceding and subsequent periods provides further insight into whether there has been a change in the relationship between the African exchanges, and those in the USA.

The reasons for having the longer periods are twofold. Firstly, the number of observations decreased substantially which required a longer period to get a statistically significant number of observations. Secondly, weekly data was only available for the NSE 30 from 1 January 2007. Thus it makes sense to split the data into three periods to get an even observation distribution over the period tested.

The periods for the weekly data have been split as follows:

- Period 1: January 2004 – December 2006
- Period 2: January 2007 – December 2010
- Period 3: January 2011 – June 2014

#### 3.1 Data Issues

It is important to note that in using an index, there is always the issue of “capping”. As with most indices, the maximum weighting of a stock in an index is limited. This means by using an index we are not capturing the complete movement of stocks in the movement of the index. This affects the cointegration relationships between various exchanges.

In 2011 the Egyptian stock market struggled, largely due to political unrest in the country. The market capitalisation dropped from approximately 500 billion at the beginning of January 2011 to 374 billion in March 2011 and 291 billion in December 2011 (EGX, 2013). Our

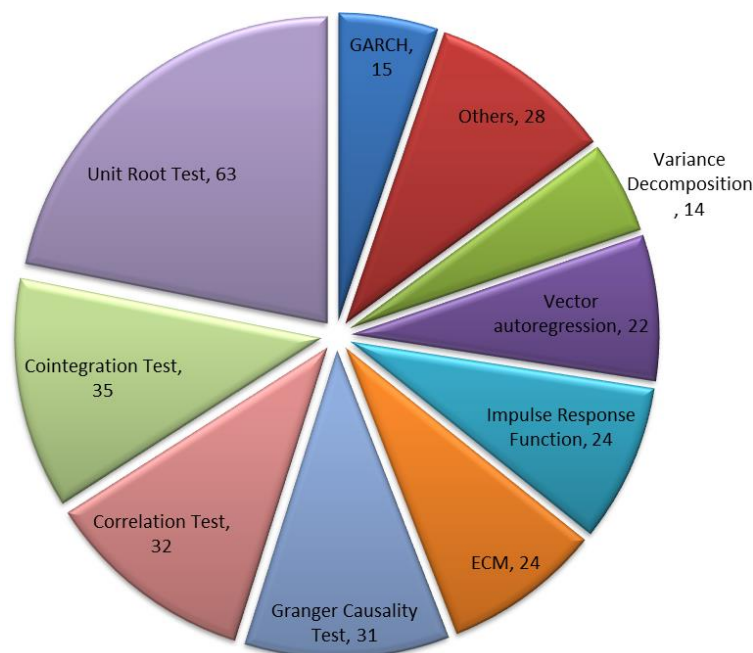
analysis shows that the Egyptian revolution did have an effect on the Stationary tests run on the weekly data.

## 4. RESEARCH APPROACH

The research approach used here follows the most common approach for researching stock exchange integration and its effect on diversification. Sharma and Seth (2012), who analysed 105 research papers on stock market integration, identified the econometric tools used most frequently in this type of research. Figure 1 below shows that the majority of the studies examined used the unit root test to test for stationarity, followed by Johansen's cointegration test, the correlation test, the Granger causality test, followed by other tests (Sharma & Seth, 2012).

Based on their findings, the following methods of analysis, discussed below, were employed in this study: The unit root tests for stationarity, the cointegration tests (Both Engle-Granger and Johansen), and Granger pairwise causality tests. Correlation tests were not run on the data as although this may indicate a co-movement relationship it does not shed light on whether there is a causal relationship or the direction of the relationship. Both the Augmented Dickey-Fuller test and the Phillips-Perron unit root test were run on the data.

**Figure 1: Frequency of econometric tools used for data analysis**



(Source: Sharma & Seth, 2012)

#### **4.1 Unit root tests for stationarity**

A unit root test looks at whether a time series, such as a stock exchange index, is stationary, using an autoregressive model. The time series is stationary if the roots of its characteristic polynomial lie strictly inside the unit circle (Alexander, 2008). Testing for a unit root and cointegration can also determine market efficiency (Arshanapalli & Doukas, 1993). The null hypothesis implies that the data need to be differenced to make it stationary, while the alternative hypothesis states that the data is stationary. If we reject the above null hypothesis, we can conclude that the series is indeed integrated of order 1, rather than having a higher order of integration (Alexander, 2008).

#### **4.2 Cointegration and causality**

Cointegration is a measure of long term dependency between two stock exchange indices or other financial assets and is used to examine the co-movement of index prices in this paper. The null hypothesis for the cointegration tests is that the two indices are not cointegrated.

The Engle-Granger methodology performs an ordinary least square (OLS) regression of one integrated variable on the other integrated variables, and is used in this study to determine the extent of cointegration. The Johansen test is a vector autoregression (VAR) based cointegration test using the methodology developed in Johansen (IHS Global Inc., 2013).

Finally, once the error correction model (ECM) has been defined, it may to be used to test the Granger causality flows. Granger causality measures the lead-lag relationship between the two indices (Alexander, 2008).

The above tests indicate whether diversification benefits could be had by investing in the exchanges analysed in this study, as discussed in the introduction above.

### **5. RESULTS**

Below see the results of this study, including graphical representations of the various indices, the results of unit root, cointegration, and causality tests run on the weekly logged data in both local currency and USD.

#### **5.1 Tests performed and tests results found on weekly logged closing price data**

Unit root testing is a prerequisite for testing cointegration between the stock exchanges. The implication of cointegration is that, individually, the series may be non-stationary, while their linear combination may be stationary (IHS Global Inc., 2013). Thus below the test results begin with the unit root test results followed by the cointegration and Granger causality tests.

### 5.1.1 Unit root tests on weekly logged closing price data

**Table 1: Unit root tests results using the Augmented Dickey-Fuller (ADF) unit root test**

Weekly logged data	Augmented Dickey-Fuller test results									
	Full period		Periods 2&3		Period 1		Period 2		Period 3	
	T-stat	Prob	T-stat	Prob	T-stat	Prob	T-stat	Prob	T-stat	Prob
Egypt local	-3.4216	0.0107	-1.4859	0.5399	-1.8150	0.3722	-1.1964	0.6762	-1.0777	0.7243
Egypt USD	-3.4652	0.0093	-1.4876	0.5391	-1.7833	0.3877	-1.1961	0.6763	-2.0306	0.2736
Morocco Local	-2.4131	0.1385	-1.1804	0.6841	-0.0674	0.9499	-2.0768	0.2544	-1.8063	0.3766
Nigeria Local	-1.3439	0.6103	-1.7164	0.4222	-1.0737	0.7254	-0.7209	0.8379	0.2036	0.9722
Nigeria USD	-1.3324	0.6159	-0.8351	0.8076	-1.0771	0.7241	-0.5599	0.8753	-0.2954	0.9219
Nigeria Top 30 Local	-0.6985	0.8444	-0.6985	0.8444	N/A	N/A	-1.1313	0.7034	-0.0390	0.9529
Nigeria Top 30 USD	-1.0877	0.7218	-1.0877	0.7218	N/A	N/A	-0.8426	0.8044	-0.4220	0.9016
South Africa local	-1.2793	0.6406	-0.3728	0.9107	0.2360	0.9741	-1.7408	0.4093	0.0992	0.9649
South Africa USD	-2.1185	0.2375	-2.0660	0.2588	-0.4716	0.8923	-1.4497	0.5572	-3.3308	0.0149
USA	-0.8426	0.8057	-0.6602	0.8537	-0.5821	0.8700	-1.4098	0.5770	-0.2402	0.9296

**Notes:** Critical values of ADF are -2.86 at a 5% level and -3.44 at a 1% level (see MacKinnon, 1996). Lag length for ADF based on Schwartz information criterion. Egypt in both local currency and USD over the full period, and South Africa in USD for period 3 were found to be stationary at a 5% level.

Where the null hypothesis was rejected at a 5 percent level, as was found for Egypt over the full period and South Africa in USD in period 3. Phillips-Perron, Elloitt-Rothenberg Stock DF, Kwiatkowski-Phillips-Schmidt-Shin, Elloitt-Rothenberg Stock and Ng-Perron tests were performed with the results in Appendix A. There were conflicting results from the unit root tests for Egypt over the full period in both USD and local currency. Given that this paper is mainly concerned with the change in relationship over the 3 periods, and there is no conclusive evidence of stationarity issues found in any of the individual periods (other than South Africa in USD period 3), cointegration tests have been performed on the data.

### 5.1.2 Engle-Granger Cointegration results and Granger Causality test results

It is important to note that South Africa in USD was found to be stationary in period 3, and thus these cointegration relationships are not statistically reliable. Period 2&3 was run as a separate period as the NSE 30 was only available from the beginning of period 2.

No long term cointegration relationships were noted over the full period. The following shorter period relationships can be seen: South Africa and the USA, in local currency, are cointegrated pre (period 1) and post (period 3), but not during the crisis (period 2). Nigeria Top 30 and the USA; Egypt and South Africa; Morocco and Nigeria, were all found to be cointegrated during the crisis period. It is interesting to note that no relationship was found between Nigeria and Nigeria Top 30. The NSE 30 was the only African stock exchange index with a cointegration relationship with the USA during the crisis.

In terms of the Granger causality in local currency there are few relationships, with South Africa leading the USA in period 1, and Egypt in period 2. The USA then leads Nigeria Top 30 and South Africa in periods 2 and 3 respectively. In USD, as South Africa was stationary in period 3, the only relationship is between Nigeria Top 30 and Nigeria. It should be noted that there is no sign of a constant cointegration relationship between Nigeria and Nigeria Top 30, which would seem counterintuitive. This however, does show that the choice of index can have a significant influence on the effects of cointegration and causality tests.

### 5.1.3 Johansen Cointegration results and Granger Causality test results

When looking at the local currency results the Johansen tests show a long term (Period 2&3) and crisis period (2) relationship between Nigeria and Nigeria Top 30 which was expected, with Nigeria Top 30 leading Nigeria for periods 2&3. Egypt and Morocco show a cointegration relationship during the crisis period with Egypt leading Morocco. Post crisis there are relationships between South Africa and the USA, with South Africa causing the USA. South Africa and the USA are both found to lead Egypt.

**Table 2: Results from Engle-Granger cointegration tests and pairwise Granger causality tests for all periods in both local currency and USD****Cointegration findings in local currency**

	Egypt	Morocco	Nigeria	Nigeria Top 30	South Africa	USA
Egypt						
Morocco						
Nigeria			2			
Nigeria Top 30						
South Africa	2					
USA					2 1,3	

**Cointegration findings in USD**

	Egypt	Morocco	Nigeria	Nigeria Top 30	South Africa	USA
Egypt						
Morocco						
Nigeria						
Nigeria Top 30				2		
South Africa	3		3		3	
USA						3

A Pairwise Granger Causality test was run to try further understand the cointegration relationships identified above. The results of the Pairwise Granger causality tests are as follows:

South Africa causes the USA (1)  
 South Africa causes Egypt (2)  
 Nigeria causes Morocco (2)  
 The USA causes Nigeria Top 30 (2)  
 The USA causes South Africa (3)

A Pairwise Granger Causality test was run to try further understand the cointegration relationships identified above. The results of the Pairwise Granger causality tests are as follows:

Nigeria Top 30 causes Nigeria (2)  
 South Africa causes Egypt (3)  
 South Africa causes Nigeria (3)  
 South Africa causes Nigeria Top 30 (3)  
 No pairwise relationship was found for South Africa and the USA (3)

31

**Note:** The different time periods are represented by the number 1-3, 2&3 and the letter “f”. “f” represents the full period, and numbers “1,2,3” represents the different respective periods. 2&3 represents period 2 and 3 together. The different numbers and “f” are only shown in the table when the null hypothesis for the Engle-Granger cointegration tests is rejected. The null hypothesis states that the pair of stock exchanges is not cointegrated at a five percent significance level. If a Granger causality relationship was found the direction is shown by means of which Country “causes” the other. The number in brackets denotes the period to which the causality relationship relates.

Period key: Full period: 1 Jan 2004 – 30 Jun 2014;  
 2006;

Period 2&3: 1 Jan 2007 – 30 Jun 2014;  
 Period 2: 1 Jan 2007 – 31 Dec 2009;

Period 1: 1 Jan 2004 – 31 Dec  
 Period 3: 1 Jan 2010 – 30 June 2014

**Table 3: Results from Johansen cointegration tests and pairwise Granger causality tests for all periods in local currency and USD****Cointegration findings in local currency**

	Egypt	Morocco	Nigeria	Nigeria Top 30	South Africa	USA
Egypt						
Morocco	2					
Nigeria						
Nigeria Top 30			2, 2&3			
South Africa		3				
USA		3				3

A Pairwise Granger Causality test was run to try further understand the cointegration relationships identified above. The results of the Pairwise Granger causality tests are as follows:

Egypt causes Morocco (2)  
 South Africa causes USA (3)  
 South Africa causes Egypt (3)  
 USA causes Egypt (3)  
 Nigeria Top 30 causes Nigeria (2&3)  
 No pairwise relationship was found for Nigeria and Nigeria Top 30 (2)

**Cointegration findings in USD**

	Egypt	Morocco	Nigeria	Nigeria Top 30	South Africa	USA
Egypt						
Morocco	2, 2&3					
Nigeria						
Nigeria Top 30			2, 2&3			
South Africa			2&3	2&3		
USA			2, 2&3			

A Pairwise Granger Causality test was run to try further understand the cointegration relationships identified above. The results of the Pairwise Granger causality tests are as follows:

Egypt causes Morocco and vice versa (2,2&3)  
 No pairwise relationship was found for Nigeria and Nigeria Top 30 (2)  
 USA causes Nigeria (2)  
 Nigeria Top 30 causes Nigeria (2&3)  
 South Africa causes Nigeria (2&3)  
 Nigeria causes the USA and vice versa (2&3)  
 Nigeria Top30 causes South Africa and vice versa (2&3)

32

**Note:** The different time periods are represented by the number 1-3, 2&3 and the letter “f”. “f” represents the full period, and numbers “1,2,3” represents the different respective periods. 2&3 represents period 2 and 3 together. The different numbers and “f” are only shown in the table when the null hypothesis for the Johansen cointegration tests is rejected. The null hypothesis states that the pair of stock exchanges is not cointegrated at a five percent significance level. If a Granger causality relationship was found the direction is shown by means of which Country “causes” the other. The number in brackets denotes the period to which the causality relationship relates.

Period key: Full period: 1 Jan 2004 – 30 Jun 2014;  
 2006;

Period 2&3: 1 Jan 2007 – 30 Jun 2014;  
 Period 2: 1 Jan 2007 – 31 Dec 2009;

Period 1: 1 Jan 2004 – 31 Dec  
 Period 3: 1 Jan 2010 – 30 June 2014



In USD terms we see some noteworthy results, as this shows several long term relationships between the different indices. Nigeria Top 30 as well as South Africa are found to lead Nigeria for period 2&3 (January 2007 to June 2014). Nigeria Top 30 and South Africa are found to be cointegrated and have a causality effect on each other. Nigeria and the USA also are found to cause each for period 2&3. Egypt and Morocco also share this a long term relationship, both having a causality effect on each other.

Running a Johansen test offered very different results to those of the Engle-Granger test for cointegration. Two relationships appear quite prevalent in the results: Nigeria and Nigeria Top 30 appear to be cointegrated and Nigeria Top 30 leads Nigeria. Egypt is found to lead Morocco in local and USD terms.

## 5.2 Results discussion

Cointegration results when both Johansen and Engle-Granger Cointegration tests are combined show only two instances of cointegration. This is consistent with the results from Alagidede et al. (2011) and Jefferis and Okeahalam (1999:44), who suggest there were few or no long term relationships to be found respectively.

The first is the USA and South Africa in period 3 in local currency, where the USA was found to lead South Africa. This relationship is intuitive, as during this period the global markets saw large drops in value and this movement did start in the USA. The second case is between Nigeria and Nigeria Top 30 in period 2 in USD, where it was found that Nigeria Top 30 caused the movement in Nigeria. However, one would expect to see a relationship between Nigeria Top 30 and Nigeria, and it is interesting to note there was only a relationship found for one period.

Collins and Biekpe (2003) find contagion in Egypt and South Africa and also that other smaller African markets did offer diversification to more developed markets, and also that African market interactions appeared to be regional. The findings of this study support the finding that African markets do offer diversification benefits, but there is little evidence to support regional market integration.

Wang et al. (2003), studying the same countries but also including Zimbabwe, found limited cointegration between African countries and also between African countries and the USA. There was some cointegration between South Africa and the USA as well as Nigeria and the USA, but this was very limited. Graham et al. (2013), looking at the MENA region, did find long term linkages with the USA and Egypt was included in their sample. This differs from the results in this study, where cointegration between the Egypt and the USA was only evident in period 3 and only using the Johansen cointegration test.

Chen et al. (2014) find there was integration, and the US market caused frontier market movements, and supported the leading market hypothesis. They also expected the leading markets to become more integrated with frontier markets in the future. This is supported by the results of the Johansen cointegration test run on the data in USD. However, in local



currency terms, or using both Johansen and Engle-Granger tests, this study's results do not support the conclusion of Chen et al. (2014).

## 6. CONCLUSION AND AREAS FOR FURTHER RESEARCH

### 6.1 Conclusion

The cointegration tests on the weekly logged closing prices offer several long term relationships for the period 1 January 2007 – 30 June 2014 in USD. These relationships did not show in local currency except for Nigeria and Nigerian Top 30. These long term relationships were only shown when using the Johansen tests.

There might be a variety of reasons explaining the movement in the various exchanges and this study is limited to looking at cointegration with some brief explanations as to the reasons. The use of local currency verses USD offered differing results. The number of cointegration relationships over time did not tend to increase. These results imply that there are potential benefits from diversification, which could be obtained by investors, over the long term, across the four African exchanges, with this finding being practical due to the size and liquidity of the indices used.

### 6.2 Areas for further research

In addition to running the tests on logged data the tests were also run on unlogged data and yielded differing results thus the effect of logging should be investigated further. As with logging, capping the weightings of stocks in an index would also have an effect on the results, which has not been noted in this study but should be explored further. It has also been noted through discussions with emerging market analysts that the stationarity found between South Africa and the USA in period 3 is an emerging market phenomenon that is not limited to South Africa (Wales, personal communication 2015, June 17). This would be an interesting topic to research further. The extent of the link between the Nigerian All Share index and the Nigerian Top 30 index would also be interesting to explore further.

## REFERENCES

- Adjasi, C. & Biekpe, N. 2006. Cointegration and the dynamic causal links amongst African stock markets . *Investment Management and Financial Innovations*. 3(4):102-119.
- Alagidede, P., Panagiotidis, T. & Zhang, X. 2011. Why a diversified portfolio should include African assets. *Applied Economics Letters*. 18(14):1333-1340.
- Alexander, C. 2008. *Market Risk Analysis: quantitative methods in finance*. Vol. 1. West Sussex, England: John Wiley & Sons Ltd.
- Arshanapalli, B. & Doukas, J. 1993. International stock market linkages: evidence from the pre-and post-October 1987 period. *Journal of Banking & Finance*. 17(1):193-208.

- Bekaert, G., Harvey, C.R. & Lumsdaine, R.L. 2002. Dating the integration of world equity markets. *Journal of Financial Economics*. 65(2):203-247.
- Butler, K.C. & Joaquin, D.C. 2002. Are the gains from international portfolio diversification exaggerated? The influence of downside risk in bear markets. *Journal of International Money and Finance*. 21(7):981-1011.
- Chen, M.P., Chen, P.F. & Lee, C.C. 2014. Frontier stock market integration and the global financial crisis. *The North American Journal of Economics and Finance*. 29:84-103.
- Collins, D. & Biekpe, N. 2003. Contagion: a fear for African equity markets? *Journal of Economics and Business*. 55(3):285-297.
- Engle, R. & Granger, W. 1987. Cointegration and error correction: representation, estimation and testing. *Econometrica*. 55(2):251-276.
- French, K.R. & Poterba, J.M. 1991. Investor diversification and international equity markets. *The American Economic Review*. 81(2):222-226.
- Ghosh, A., Johnson, K. & Saidi, R. 1999. Who Moves the Asia-Pacific Stock Markets-US or Japan ? Empirical Evidence Based on the Theory of Cointegration. *The Financial Review*. 34(1):159-169.
- Goldberg, L.S. 2010. Is the international role of the Dollar changing? *Current Issues in Economics and Finance*. 16(1):1-7
- Graham, M., Kiviahio, J. & Nikkinen, J. 2012. Integration of 22 emerging stock markets: a three-dimensional analysis. *Global Finance Journal*. 23(1):34-47.
- Graham, M., Kiviahio, J., Nikkinen, J. & Omran, M., 2013. Global and regional co-movement of the MENA stock markets. *Journal of Economics and Business*. 65:86-100.
- Harvey, C.R. 1995. Predictable risk and returns in emerging markets. *Review of Financial studies*. 8(3):773-816.
- IHS Global Inc. 2013. *Eviews 8 user guide II*. Irvine, United States of America: IHS Global Inc. Available:  
<http://www.eviews.com/EViews8/EViews8/EViews%208%20Users%20Guide%20II.pdf>
- Irving, M.J. 2005. *Regional Integration of Stock Exchanges in Eastern and Southern Africa: progress and prospects* (IMF working paper; no. 5-122). (s.l.): International Monetary Fund.
- Jefferis, K.R. 1995. The Botswana share market and its role in financial and economic development. *World Development*. 23(4):663-678.
- Jefferis, K.R. & Okeahalam, C.C. 1999. International stock market linkages in Southern Africa. *South African Journal of Accounting Research*. 13(2):27-51.
- Johansen, S. 2007. *Correlation, regression, and cointegration of nonstationary economic time series*. (CREATES research paper; 2007-35). University of Aarhus, Denmark: Center for Research in Econometric Analysis of Time Series.

- Kamin, S.B. 1999. The current international financial crisis: how much is new? *Journal of International Money and Finance*. 18:501-514.
- Kenny, C.J. & Moss, T.J. 1998. Stock markets in Africa: emerging lions or white elephants? *World Development*. 26(5):829-843.
- Longin, F. & Solnik, B. 1995. Is the correlation in international equity returns constant: 1960–1990? *Journal of international money and finance*. 14(1):3-26.
- MacKinnon, J.G. (1996). Numerical Distribution Functions for Unit Root and Cointegration Tests. *Journal of Applied Econometrics*. 11(6):601-618
- Markowitz, H. 1952. Portfolio selection\*. *The Journal of Finance*. 7(1):77-91.
- Meric, I. & Meric, G. 1989. Potential gains from international portfolio diversification and inter-temporal stability and seasonality in international stock market relationships. *Journal of Banking and Finance*. 13(4):627-640.
- Piesse, J. & Hearn, B. 2002. Equity market integration versus segmentation in three dominant markets of the Southern African Customs Union: cointegration and causality tests. *Applied Economics*. 34(14):1711-22.
- Raj, J. & Dhal, S., 2008. Integration of India's stock market with global and major regional markets. *Press & Communications CH 4002 Basel, Switzerland*: 202.
- Riscura. 2013. *Bright Africa: A look at equity investment across the continent*. (Research report). Cape Town, South Africa. Available: <http://www.riscura.com/brightafrica/wp-content/uploads/2015/07/RisCura-Bright-Africa-2013.pdf> [2016, January 07].
- Sharma, A. & Seth, N. 2012. Literature review of stock market integration: a global perspective. *Qualitative Research in Financial Markets*. 4(1):84-122.
- Sharma, G.D. & Bodla, B.S. 2010. Are the Global Stock Markets Inter-linked? Evidence from the Literature. *Global Journal of Management and Business Research*. 10(1):29-40.
- Speidell, L. 2011. Frontier market equity investing: finding the winners of the future. Available: <http://www.cfapubs.org/doi/abs/10.2470/rf.v2011.n2.1> [2015, December 15].
- The Egyptian Exchange. 2013. *The Egyptian Stock Exchange: market capitalisation historical data*. Available: <http://www.egx.com.eg/English/MCData.aspx> [2014, July 20].
- Wang, Z., Yang, J. & Bessler, D.A. 2003. Financial crisis and African stock market integration. *Applied Economics Letters*. 10(9):527-533.
- Yu, J.S. & Hassan, M.K. 2008. Global and regional integration of the Middle East and North African (MENA) stock markets. *The Quarterly Review of Economics and Finance*. 48(3):482-504.

## APPENDIX A

Where stationarity was found using the Augmented Dickey-Fuller unit root tests in section 5.1, further testing was performed to confirm that the data is stationary. The below table shows the results of the various unit root tests.

**Table 4 - Unit root test results for additional tests performed on weekly logged data**

Egypt Local (Full period)	Phillips-Perron test statistic		Elliott-Rothernberg-Stock DF-GLS test statistic		Kwiatkowski-Phillips-Schmidt-Shin		Elliott-Rothernberg-Stock test statistic		Ng-Perron test statistics				
	Adj. t-Stat	Prob.*	Test critical values:	t-Statistic	Asymptotic critical	LM-Stat.	P-Statistic	Test critical values:	Asymptotic critical values*	MZa	MZt	MSB	MPT
	-3.173757	0.0221		0.701832		0.69066	131.996			0.50489	0.71003	1.40632	117.85
			1% level	-2.565646	1% level	0.739	1% level	1.99	1%	-13.8	-2.58	0.174	1.78
			5% level	-1.940918	5% level	0.463	5% level	3.26	5%	-8.1	-1.98	0.233	3.17
			10% level	-1.616637	10% level	0.347	10% level	4.48	10%	-5.7	-1.62	0.275	4.45
Egypt USD (Full Period)	Phillips-Perron test statistic		Elliott-Rothernberg-Stock DF-GLS test statistic		Kwiatkowski-Phillips-Schmidt-Shin		Elliott-Rothernberg-Stock test statistic		Ng-Perron test statistics				
	Adj. t-Stat	Prob.*	Test critical values:	t-Statistic	Asymptotic critical	LM-Stat.	P-Statistic	Test critical values:	Asymptotic critical values*	MZa	MZt	MSB	MPT
	-3.191776	0.021		0.465162		0.583591	123.6986			0.34031	0.4726	1.38872	110.658
			1% level	-2.565646	1% level	0.739	1% level	1.99	1%	-13.8	-2.58	0.174	1.78
			5% level	-1.940918	5% level	0.463	5% level	3.26	5%	-8.1	-1.98	0.233	3.17
			10% level	-1.616637	10% level	0.347	10% level	4.48	10%	-5.7	-1.62	0.275	4.45
South Africa USD (Period 3)	Phillips-Perron test statistic		Elliott-Rothernberg-Stock DF-GLS test statistic		Kwiatkowski-Phillips-Schmidt-Shin		Elliott-Rothernberg-Stock test statistic		Ng-Perron test statistics				
	Adj. t-Stat	Prob.*	Test critical values:	t-Statistic	Asymptotic critical	LM-Stat.	P-Statistic	Test critical values:	Asymptotic critical values*	MZa	MZt	MSB	MPT
	-3.218879	0.0205				0.186489	2.627894			-10.8178	-2.31099	0.21363	2.32404
			1% level	-2.565646	1% level	0.739	1% level	1.99	1%	-13.8	-2.58	0.174	1.78
			5% level	-1.940918	5% level	0.463	5% level	3.26	5%	-8.1	-1.98	0.233	3.17
			10% level	-1.616637	10% level	0.347	10% level	4.48	10%	-5.7	-1.62	0.275	4.45

## APPENDIX B - ACRONYMS AND ABBREVIATIONS

Below is a list of the acronyms and abbreviations used throughout the study for ease of reference.

ADF	Augmented Dickey-Fuller
CSE	Casablanca Stock Exchange
CFG 25	Casablanca Stock Exchange Top 25 Index
ECM	Error correction model
EGX	Egyptian Stock Exchange
EGX 30	Egyptian Exchange Top 30 Index
GCC	Gulf Cooperation Council
JSE	Johannesburg Stock Exchange
JSE Top 40	Johannesburg Stock Exchange Top 40 Index
MENA	Middle East and North Africa region
MSCI	Morgan Stanley Capital International
NGSE	Nigerian Stock Exchange All Shares Index
NSE	Nigeria Stock Exchange
NSE 30	Nigeria Stock Exchange Top 30 Index
OLS	Ordinary Least Square
S&P 500	Standard and Poor's 500
SMF	Stock Exchange of Mauritius
USD	United States Dollar
VAR	Vector Autoregressions
WFE	World Federation of Exchanges

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**TAX 02: The Hand Which Reaches Beyond the Grave: Reasons  
for and against the abolishment of Estate Duty in South Africa  
using Australia as a benchmark**

Authors:

Patrick Dunton, Riley Carpenter,  
Riyaan Mabutha (University of Cape Town)

Contact: [riyaan.mabutha@uct.ac.za](mailto:riyaan.mabutha@uct.ac.za)

**ABSTRACT**

This paper analysed the current position of the treatment of death as a taxable event in South Africa and Australia, by means of a high level overview. Greater detail of the reasons and arguments for and against Australia's abolishment of its death duties in 1978 were considered, and the relevant current literature regarding South Africa's Estate Duty Act. This paper then sought to determine whether the reasoning offered during the deliberations over Australia's abolishment could be applied in a South African context to the Estate Duty Act, by taking the Australian arguments, both for and against abolishment of death duties, and analysing the literature on South Africa's estate duty and whether any points or facts from the South African literature could be linked to the arguments presented during Australia's abolishment of death duties deliberations. The study found that some arguments drawn from Australia's abolishment of death duties could potentially be applied to estate duty in South Africa. However the results were not conclusive, several similarities were highlighted and potential arguments that could be applied in a South African context were evident.

Key words: Estate duty, capital gains tax, death taxes, double tax

## INTRODUCTION AND RESEARCH OBJECTIVE

The treatment of death as a taxable event in South Africa has been under considerable scrutiny since the introduction of capital gains tax in 2001. This is evidenced by the South African Treasury delegating to a committee the task of determining “the continued relevance of Estate Duty” and also focusing on the “interaction between CGT and estate duty” in 2013 (The Davis Tax Committee, 2015).

Much has also been written about the current South African position on death as a taxable event, with some questioning the value of the Estate Duty Act and some defending the use of the legislation. (Muller, 2010; Roeleveld, 2012, Thorpe 2015).

Roeleveld (2012) proposed an argument that either death should not constitute a capital gains tax event, or that estate duty should be abolished altogether. The reason for this argument was that estate duty and capital gains tax are levied on the same assets, and it was further elaborated that capital gains tax could essentially fill the role of estate duty and there was therefore no need for estate duty as an additional tax.

In order to analyse these concerns further, in particular the relevance and merits of estate duty and the perceived double tax that arises on death, this paper analyses the treatment of an individual's assets on death from a South African tax perspective. This is then contrasted to Australia, considering whether the reasons for and against the abolition of Australia's death duties can be applied to a South African context with regards to the Estate Duty Act

### Comparable Country Selection of Australia

In order to compare South Africa's treatment on death against that of another country, certain criteria would have to be met in order for the study to carry value. Australia was determined to be the country that came closest to meeting the necessary criteria for the following reasons:

- Australia previously had a form of death tax that was abolished. This allows for the analysis for the reasoning of the abolishment, and whether that reasoning could be applicable to South Africa, a country which still has a form of death tax, that being estate duty. It also allows for a control variable in the comparison that would not necessarily be available from a country which never had a form of death tax or currently still has a form of death tax in force.
- South African Income Tax legislation was derived from Australian source legislation. The first Income Tax Act of South Africa (The Income Tax Act No. 28 of 1914) was derived from the New South Wales Act of 1895 (Haupt, 2014). This allows for a necessary degree of comparability that may not be viable from another country where the legislation is derived from a completely different source, and has no similarities or origins, and therefore, no comparability.

- When Australia abolished its death duties it was considered to be very controversial, as it resulted in Australia being the first member country of the Organisation of Economic Cooperation and Development (OECD) to not have any form of tax on capital appreciation. This resulted in much literature being written on the topic by academics and social commentators. This large amount of literature provides greater understanding and completeness to the study that one does not necessarily achieve with other countries (Pedrick, 1982).
- Australia had death duties as a taxing mechanism at a federal and state level. This had the effect of an asset being subject to tax at these two different levels on death, resulting in what was effectively a double taxation on the asset. South Africa currently has a similar situation with estate duty and capital gains tax, which enhances the comparability between the two countries.

The following was considered to be a limiting factor of using Australia as the comparable country:

It could be considered that South Africa has a greater degree of inequality and poverty than Australia. Although this limitation cannot be disregarded, its effect on the comparison is expected to be minimal due to the abatement (essentially up to R3.5 million of the net value of the deceased's estate is tax free from estate duty) provided by the Estate Duty Act (section 4A), therefore effectively ruling out a significant portion of the South African population, and minimising to a limited extent the effects of the differing levels of inequality on the comparison

## RESEARCH METHOD

A literature review was performed on the various types of death taxes applicable in South Africa and Australia. The literature review included a survey of the literature for and against the abolishment of Australia's death duties. The paper then analyses the reasons for and against the abolishment of Australia's death duties against literature on South Africa's estate duty. It is in turn determined whether they have some relevance or can be applied currently to South African context with regards to estate duty. This paper then concludes considering recent developments in South Africa as it relates to estate duty including the work of the various tax review commissions established in South Africa.

## SOUTH AFRICAN TAXES PAYABLE ON DEATH

In South Africa, there are several forms of taxation that are applicable to individuals, the most relevant being, for the purposes of this paper, estate duty and capital gains tax which is levied at death.

### Estate Duty:

Estate duty is governed by the Estate Duty Act of 1955 and applies to all individuals who are ordinarily resident in South Africa on the date of their death, or who are not ordinarily resident but owned assets in the Republic on the date of their death (section 2(2)). The



provisions of the Estate Duty Act apply to all property held worldwide by residents and the definition of property is very broad and includes items which are deemed to be property (section 3(3)). The Estate Duty Act requires that a duty be levied at a flat rate of 20% on the total net value of assets that form part of a deceased South African resident's estate, subject to certain exemptions and deductions.

#### Intention of Estate Duty in South Africa:

Estate duty is first and foremost a wealth tax, as only individuals who own assets of a high enough value will be subject to it. This is achieved by the Estate Duty Act allowing the deceased to apply a R3,5 million abatement (section 4A) against the net value of their estate.

In South Africa, where just under 60% of the population are deemed to be living in varying forms of poverty (Statistics South Africa, 2015), the abatement rules out a vastly significant portion of the population from ever being subject to estate duty, therefore, only a wealthy minority will be subject to the tax.

Estate Duties usefulness in generating tax revenue is very limited. In 2014, estate duty only contributed to 0.1224% of total tax revenue (South African Revenue Service & National Treasury, 2014).

#### Capital Gains Tax:

Capital gains tax is governed by the Income Tax Act of 1962 and came into effect in 2001. The Eighth Schedule of the Income Tax Act stipulates that any gains in the form of capital appreciation that arise on disposal of assets owned by a South African resident, or fixed property of a non-resident, will be subject to an inclusion, at a rate of 33.3% in the calculation of a natural person's taxable income. For the purposes of this paper, capital gains effecting companies are disregarded, as companies do not attract death taxes.

The Eighth Schedule in the Income Tax Act requires that for capital gains tax to be triggered, there must be a disposal, "death" is included in the definition of disposal. The implications of this is that when a resident of the Republic, or a non-resident who owns qualifying property in terms of the Eighth Schedule, becomes deceased, the deceased disposes of all their property, at a value equal to the prevailing market value on the date of their death.

#### Intention of Capital Gains:

Capital gains tax is intended to be a mechanism for the SARS to tax capital appreciation that would not normally fall in the scope of the income tax net due to the appreciation being capital in nature, this was intended to "strengthen the ideals of fairness and impartiality" of the South African tax system (Thorpe, 2015). The total amount of revenue generated by capital gains tax in 2014 was R11,603 million which equated to only 1,28% of total tax revenue (Thorpe, 2015).

### Recent Developments on South African Taxes on Death

Three committees have been set up to review the tax structure of South Africa, these were the Margo, Katz and Davis Commissions, and each highlighted particular insights and issues relating to estate duty. The Margo and Katz commission were held before the introduction of capital gains tax and therefore their relevance with regard to this paper is limited and are therefore only dealt with briefly.

The Margo Commission was tasked with reviewing the state of the South African tax system in 1987, and by virtue of this detailed particular insights into Estate Duty Act.

The Margo Commission suggested that a pure form of capital gains tax was not required, but rather that a capital transfer tax be implemented and that this would take the place of estate duty, allowing for it then to be abolished (Margo Commission, 1987). It has been suggested that the transfer tax that was proposed is very similar to the capital gains tax that was implemented in 2001 (Roeleveld, 2012). The fact that the commission suggested that the capital transfer tax, which as stated, is very similar to the current capital gains tax legislation, take the place of estate duty, is relevant because it is evident that the commission specifically wanted to avoid the scenario where there are two forms of taxation on capital appreciation.

The Katz Commission (1994) supported the view that there was a need for a wealth tax. It adjudged, based on the reasons above, that some form of wealth tax was necessary in the South African tax legislation. It identified that it would want to implement a wealth tax that would yield approximately 1-1.5% of total tax revenue, and wanted to avoid high administration costs of implementing this tax. The commission also raised the point that it did not want savings and capital accumulation to be adversely affected by such a tax (Katz Commission, 1994).

Having taken the factors discussed above into account, the Katz Commission (1994) concurred with the Margo Commission and also favoured a capital transfer tax that would encompass estate duty and donations tax, but did not recommend that it be implemented immediately, but rather after more consideration and study.

The Davis Commission was established in 2013 and released a report in early 2015 dealing exclusively with estate duty, in particular “the role and continued relevance of estate duty” and the “interaction between CGT and estate duty” (The Davis Tax Committee, 2015). The Davis Tax Commission (2015) suggested that South Africa is currently underperforming with regards to revenue generation from estate duty relative to other countries’ death duties revenue generation and suggested that there is “scope to improve performance in this regard” (The Davis Tax Committee, 2015). Stemming from this low revenue generation, the Davis Tax Committee (2015) identified certain issues regarding the current Estate Duty Act:

- It is inefficient.
- It displays various aspects that are inequitable. This point was justified by pointing out that the wealthy are “easily able to plan and implement estate duty planning mechanisms” (The Davis Tax Committee, 2015).
- It is overly complex, time consuming and inconvenient.
- It lacks transparency due the wealthy’s ability to mitigate their tax liability through adequate planning.

Based on the shortfalls discussed above, the Davis Tax Committee (2015) concluded that the following was action that could be taken

- Abolish the Estate Duty Act completely, “moving away from treating death as a taxable event” (The Davis Tax Committee, 2015). This is an option also suggested by Rooleveld (2012).
- Amend the Estate Duty Act to correct its flaws.
- Replace the present Estate Duty Act with a new form of wealth tax.

The Davis Tax Committee (2015) suggested that because of the significant inequality currently in South Africa, it would be difficult to motivate the abolishment of the only tax tool that is a direct tax on the wealthy in South Africa.

Having ruled out the other two options, and utilising several arguments against abolishment put forward by the Katz Commission, the Davis Tax Committee (2015) recommended that the estate duty legislation should remain in place and with appropriate amending, could “achieve many of the objectives” (The Davis Tax Committee, 2015) that it is intended to achieve

## AUSTRALIAN TAXES PAYABLE ON DEATH

### Death Duties

Australia currently has no death tax, it was abolished at a federal level in 1978 and eventually at a state level in all six states of Australia in 1982 (Grossman, 1990). The movement towards this abolishment was mostly due to the view that death duties “weighed heavily on even very modest estates, with inflation exacerbating the problem of low exemptions” (Gilding, 2010). Australia was seen to be relatively progressive with this move, as it was the first of the OECD countries at the time to make this type of tax reform (Pedrick, 1982), being no tax on capital appreciation, as capital gains tax was only introduced into Australian legislation in 1985 (Flynn & Stewart, 2010).

In 1975, the Asprey Commission was formed to review the Australian taxation system and to make any recommendations that were required to update the Australian tax system (Commonwealth Taxation Review Committee, 1975). The Death Duties Act of Australia received considerable focus, as it had not been reviewed since the 1950’s (Gilding, 2010). The commission made several recommendations regarding death duties but never considered abolition as a solution to the legislation’s shortcomings. (Commonwealth Taxation Review Committee, 1975).

Even before the Asprey Commission, the trajectory towards abolition of death duties in Australia had begun to gain momentum. The initial pressure was mostly generated from the general public, as Australian citizens began to believe that the tax was inherently unfair. (Duff, 2005; Pedrick, 1982). Right wing political parties took advantage of this public sentiment to generate support, by proposing the abolition while focusing on the economic merits for the Australian citizen of doing so, this was especially prevalent at a state level (Grossman, 1990).

The following reasons were raised in favour of abolition:

- *Undue harshness*- Some of the perceived harshness was partly attributed to the fact that exemptions were very low, with a basic exemption of AUS\$40 000 at a federal level, and sometimes as low as AUS\$20 000 at a state level, depending on which state the deceased was resident in (Pedrick, 1982). The insufficiencies of these exemptions are illustrated when contrasted against the net value of estates taken from a sample in 1973. In the sample of 16 734 estates, 87 percent of these estates were greater than the value of AUS\$20 000 and approximately 44 percent of these estates had a value greater than the AUS\$40 000 exemption provided at a federal level, approximately ten percent of estates were considered to have a greater value of AUS\$120 000 as of 1973 (Commonwealth Taxation Review Committee, 1975). An explanation for these inadequate exemptions was that they had not been adjusted adequately for inflation over the years (Pedrick, 1982). Low exemptions detracted from Australia's death duties being primarily a wealth tax, as it would even "apply to relatively modest estates", therefore not necessarily being a tax on wealth (Duff, 2005).
- *Duplication of the tax at Federal and State Level*- Death duties were effective at a federal and state level in Australia, with all residents of Australia being subject to the federal tax and each state instituting its own form of death tax at a state level, with its own provisions and exemptions. This had the unpopular effect of duplicating the tax payable on the estate of the deceased.

This duplicative system of wealth tax increased compliance costs for all estates but the relative burden was "likely higher for small and medium sized estates" (Duff, 2005). Several recommendations were made to allocate the revenue from death duties to either the Commonwealth or the state level but the double tax remained until the final abolition of death duties at the federal level in 1978 (Duff, 2005).

Queensland was the first Australian state to fully abolish its state death duties in 1977. The loss of revenue anticipated was AUS\$25 million, but the attractiveness for citizens of other states to invest their assets or even relocate to Queensland in order to evade the state duties in their current state was expected to be very high and bring an inflow of investment and citizens to Queensland as a result of the newly acquired competitive position of the state (Grossman, 1990). The expectations proved to be

correct, with AUS\$11 million transferred in a single year between Tasmania and Queensland alone (Pedrick, 1982).

The other states, fearing the exodus of capital and pressure to also abolish their death duties or risk unhappiness of its citizens, eventually all followed Queensland's suit in the move to abolish its state duties (Duff, 2005). Tasmania was the last state to abolish their death duties in 1982 (Pedrick, 1982).

The political popularity by Queensland's move to abolish death duties was correctly recognised as a potentially powerful political tool at a federal level and therefore the attractiveness to support federal abolition in order to garner political strength was potentially a significant consideration taken into account when considering the abolition decision (Duff, 2005).

- *Complexity*- The Asprey Commission (1975) acknowledged that the system of death duties at a state and federal level lead to many complexities, for both the taxpayer and receiver. The complexities resulted in great difficulty in administering the tax, resulting in large costs being incurred by the Australian Tax office in order to try and enforce the tax, as well as determine the value of assets which did not actively trade. This proved contentious and problematic (Commonwealth Taxation Review Committee, 1975). The Asprey Commission noted that due to the complexity that resulted in a very small net revenue yield due to the costs that resulted, many factions in Australia believed it was best to do away with the tax altogether (Commonwealth Taxation Review Committee, 1975).
- *Ease of Avoidance*- Individuals with a high enough level of tax knowledge were able to avoid the tax liability of death duties significantly as a consequence of the many loopholes found within the Death Duties Act. The Asprey Commission (1975) acknowledged this significant shortcoming in its report by stating the following: "It is certainly at present a tax which can be avoided by well-advised persons with ease, and which might almost be said to be paid principally from the estates of those who died unexpectedly or who had failed to attend to their affairs with proper skill" (Commonwealth Taxation Review Committee, 1975). Several of the recommendations made by the Asprey Commission were directed towards removing several of these loopholes.

A common example of avoidance was the use of a discretionary trust. This had the effect of deferring payment of death duties from generation to generation into perpetuity if the estate planning was maintained and the property remained in the trust (Duff, 2005).

The arguments against abolition were the following:

- *Part of modern fiscal system-* As mentioned above, Australia was considered to be very progressive with regard to the move to abolish their death tax, as it was considered an integral part of a modern fiscal policy, and to abolish it was considered somewhat of an anomaly (Gilding, 2010). The main arguments behind this point was that without death duties, there would be no tax at all in Australia on capital appreciation of assets, and that Australia would stand unique in the industrialised Western world because of this. Death duty therefore formed a “quite essential role to play in the tax structure as a whole” (Pedrick, 1982). When Australia did finally make the decision to abolish death duties it was the only country of the 21 OECD countries to not have a tax on capital appreciation (Pedrick, 1982).
- *Tax revenue-* At a federal level, between 1977-1978, the Australian death duties produced AUS\$100 million, and at a state level produced a significantly higher AUS\$240 million. It can therefore be seen that death duties were more valuable as a fiscal tool at a state level than a federal level in terms of revenue generation (Grossman, 1990). Total tax revenue generated by Australia during this period was AUS\$21.428 million, of which death duties contributed 1.59% (The Treasury of Australia, 2012). This is in line with the prevailing trend at the time that death and gift duties contributed approximately 1-3% towards tax receipts (Pedrick, 1982).

An issue began to arise with revenue yield produced by the death duties, as a result of the low exemptions offered. As more estates became subject to death duties due to the low exemptions, the administration costs of the death duties legislation increased at a greater proportion than the additional revenue produced by the smaller estates that now fell in the death duties scope. This greatly hampered the revenue yield of the Death Duties Act (Duff, 2005).

It was argued at the time, that even though the amount raised was not a significant amount, it was still useful when the government was engaged in special projects which required this additional revenue, and the loss of this revenue through abolition would have to result in other forms of tax becoming more onerous in order to recoup the lost revenue (Pedrick, 1982).

- *Equity through the tax system/Against accumulated wealth-* During the 1970's in Australia there was a significant amount of wealth concentration (Pedrick, 1982). A study conducted in the year that the death duties in Australia were abolished, 1978, suggested that the top one percent of the Australian population held approximately 22 percent of the country's wealth, and that the top five percent of Australians held fifty percent of the country's wealth (Raskall, 1978).

Being a wealth tax, death duties was seen as a form of taxation policy that could look to rectify this large concentration of wealth and bring greater equity to the residents

of Australia. If it were to be abolished there would be no tax mechanism in place to confront this. However, the effectiveness of its ability to do this was highly disputed due to the growing increase in wealth concentration in Australia from the 1960's to the 1970's (Katic & Leigh, 2015).

It was felt that the role of death taxes served as a symbol to the Australian people that the legislation was committed to bringing equality to the people of Australia and providing equal opportunity through the redistribution of significant wealth (Pedrick, 1982). In essence, it was felt that the Death Duties Act was a symbol of Australia's commitment to progressive equality, and to abolish it would be tantamount to signalling that wealth distribution and equal opportunity was not a priority in Australia.

### Capital Gains Tax

Australia introduced capital gains tax in 1985 in an attempt to generate some form of tax revenue from capital appreciation of a taxpayer's assets. The appreciation in value of these assets had not been subject to any form of taxation since the Australian authorities made the move to abolish its Death Duties Act in 1978 (Flynn & Stewart, 2010).

It was originally planned that when capital gains tax was introduced into Australian law, death would result in a deemed disposal of the deceased's assets and the capital appreciation of these assets would therefore be realised and fall into the capital gains net. The government at the time, however, decided against instituting it, as they feared it would be seen by the general public as a form of death tax being incorporated into income tax law (Flynn & Stewart, 2010).

The final decision regarding capital gains tax and its implications with regards to death was that the appreciation in value of the asset and the associated liability that would arise from such appreciation, in the form of capital gains, would be passed on to the successors or the inheritors of such assets, through various rollover provisions, and would only fall into the income tax net when such entity had sold or disposed of it themselves (Flynn & Stewart, 2010). These collective rollover provisions only apply when the assets of an Australian resident will still be subject to Australian tax once they have been bequeathed. In the case where assets are bequeathed to an entity which will render the assets not subject to Australian tax (such as an asset foreign to Australia being inherited by a non-resident), the gain will be subject to capital gains tax and included in the deceased's final tax return (Flynn & Stewart, 2010). This exception to the rollover rules are in place to ensure that Australia will not lose out on revenue that could be derived from capital appreciation by bequests taking certain assets out of their tax jurisdiction.

From this it can be seen that death in itself does not lead directly to capital gains, and by virtue of that, income tax implications.



### Recent Developments on Australian Taxes on Death

Since Australia's introduction of capital gains tax in 1985, the need for a death tax has been greatly reduced as there is now a mechanism to tax capital appreciation in Australia. There have still been, however, occasional calls for the reintroduction of a death tax as many public finance economists and tax policy experts believe it is a valuable tax mechanism (Flynn & Stewart, 2010).

A review into the Australian tax system was recently conducted and reported in 2010. Prior to the release of the final report, drafts made reference to the benefits that a wealth tax, such as death duties, can have, by stating that a tax on wealth "may help to promote equality of economic opportunity by taxing large fortunes handed down from generation to generation and by limiting the acquisition of wealth without personal effort" (The Treasury of Australia, 2009). The report, however, counters this sentiment soon after by stating that "bequest taxes may fall disproportionately on families where a death is unexpected" (The Treasury of Australia, 2009).

In the final report it is acknowledged that a bequest tax is an "economically efficient way of raising revenue" and the tax "could have a progressive element." This suggests that most of the revenue that could be raised from a bequest tax could be generated by the top 10% of households in Australia (The Treasury of Australia, 2010). Despite this, due to Australia's "controversial" history with regards to past wealth taxes, the report does not recommend the reintroduction of a wealth transfer tax, but rather suggests that there should be "full community discussion and consideration of the options available" in this regard (The Treasury of Australia, 2010).

Based on this report it appears unlikely that Australia will revise its stance on death and wealth taxes in the immediate future, but may do so in the medium to long term.

### ANALYSIS

Using the reasons described above for and against the abolishment of Australia's death duties each reason is analysed against literature on South Africa's estate duty. It is then considered whether this can have some relevance or can be applied currently to the South African context with regards to estate duty.

#### Reasons for Abolishment:

##### Undue Harshness

Australian death duties was seen not to provide adequate relief in the form of exemptions to the estates that were subject to it, and in particular it was severely harsh on the surviving spouse of the deceased, with inter-spousal relief only coming into effect briefly before the decision for abolishment was enacted (Duff, 2005; Pedrick, 1982).

The Estate Duty Act of South Africa, in contrast, does provide sufficient inter-spousal relief as all assets left to the surviving spouse are deducted from the value of the deceased's estate and are therefore not subject to estate duty (section 4(3)(IA)). The abatement of R3.5



million provided could potentially be seen to be more generous than the rebates provided in Australia purely due to the fact that the abatement provided has not drawn as much, if any, criticism or discussion over its sufficiency relative to the Australian abatements. Australia's abatements were the subject of severe criticism and were considered so insufficient that the Asprey Commission felt a particular need to focus on their harshness (Commonwealth Taxation Review Committee, 1975; Pedrick, 1982).

South Africa's abatement is also subject to frequent revisions, having been increased from R1 million to R2.5 million in 2005 and finally to R3.5 million in 2007. The Davis Tax Committee has also recommended that this abatement be increased to R6 million in its 2015 Report (The Davis Tax Committee, 2015). This is contrasted against Australia where one major problem was that the death duty's exemptions had not been adjusted for inflation as frequently as was deemed necessary (Duff, 2005).

Muller (2010) suggested that wealth taxes, such as estate duty, only enhance the progressivity of the tax system when they are imposed on the very wealthy. Granting adequate exemptions ensures this. When these exemptions are not adjusted appropriately for inflation, less wealthy individuals begin to fall into the scope of the tax as a result of the inflation, and not through increases in real wealth. This leads to social unrest and unpopularity of the tax. It's progressivity is also then undermined as a result (Muller, 2010). It has been put forward however that to abolish the tax would be much more detrimental to equity in society than the slight inequity that arises due to not adjusting the exemptions, therefore highlighting the need for the tax to bring equity to society (Graetz, 2010).

It would not be appropriate to draw conclusions over the generosity of the abatements in South Africa and the exemptions in Australia offered under each tax system based on proportionate revenue generated. These numbers have the potential of being distorted by pieces of tax legislation that apply to one country but not the other, hence reducing the comparability.

It is therefore evident that this argument would not necessarily be as strong an argument against estate duty as it was against Australia's death duties.

#### Duplication of tax at a state and federal level

Although in the South African context death duties is not replicated at a provincial and national level, it is evident that the tax on capital appreciation is replicated through capital gains tax and estate duty, effectively resulting in a similar effect that produced this argument against Australia's death duties. It is therefore considered possible to potentially advance the argument given during Australia's deliberations over abolishment towards South Africa's Estate Duty Act, due to assets being subject to two taxes.

An example (Appendix 1) which illustrated that poor estate planning could result in an excessive tax charge on death, largely as a result of the double nature of the taxes, and evidenced the "confiscatory" nature that having two transfer taxes on capital can have (Roeleveld, 2012). The term "confiscatory" is assumed by this paper to allude to the fact

that generally the assets that the taxes are placed on have to be sold by the beneficiary in order to generate the cash to satisfy the tax liability that arises on the death of the deceased. This is suggested as being contrary to the objective of estate duty of creating an equitable situation, as having a double tax on assets could be considered “unfair and punitive” (Independent Green Voice, 2006). To elaborate further on what the paper is suggesting, any tax should not be unduly heavy or harsh on a particular taxpayer in order to try and create an equitable situation for other citizens, and society in general, because in doing so, it creates an inequitable or unfair situation for the original taxpayer (Thorpe, 2015).

The Davis Tax Committee did not concur with Roeleveld (2012) that there is a need to rectify the double nature of tax that arises on death. The reasoning behind this rejection is that Roeleveld (2012) bases the conclusion it reaches on the premise that capital gains tax and estate duty are both “wealth taxes” and the Davis Tax Committee stipulates that capital gains tax is an income tax, hence the rejection (The Davis Tax Committee, 2015). Although, the Davis Tax Committee (2015) disputes the validity of the double tax argument in South Africa, there is still sufficient concern from the general public for it to still carry significant weight (Muller, 2010; Roeleveld, 2012). This point was also evident in Australia where the Asprey Commission did not believe that the double tax that arose at a state and federal level needed to be rectified but public sentiment drove the movement towards abolishment (Commonwealth Taxation Review Committee, 1975; Pedrick, 1982).

The fact that the duplication is not a verbatim copy of the same tax at differing legislative levels as was in Australia, does not appear to harm the argument in anyway if it were put forward in South Africa, as the argument’s premise was based on the capital being taxed twice as opposed to arguing against the medium through which it was taxed.

### Complexity

The Estate Duty Act of South Africa does not appear to be a very complex tax relative to Australia’s death duties. This is shown by the lack of any significant case law that would presumably have arisen if it were a contentious tax as a result of complexity (Roeleveld, 2012). The fact that it is not administered at a national and provincial level, in South Africa, also appears to have the effect of avoiding the main source of complexity that arose in the Australian instance.

The Katz Commission, however, identified that as the net value of the dutiable estate is based on the market values of the assets at the time of death, these market values could be contentious, as many of the assets would not necessarily be trading on an active exchange. Therefore, a degree of complexity could potentially play a part in determining the net value of the estate. A similar issue was raised by the Australian Asprey Commission with regards to the valuing of assets (Commonwealth Taxation Review Committee, 1975). The Margo Commission and Davis Tax Commission both stated that estate duty was “complex” (Margo Commission, 1987; The Davis Tax Committee, 2015). They did not, however, elaborate further on this point.

Therefore, the point of complexity as an argument could potentially be substantiated with reference to the difficulty in determining market values. This is significantly undermined by very little case law dealing with this point in South Africa.

### Ease of avoidance

The Asprey Commission noted that the Australian death duties legislation was riddled with loopholes and therefore could easily be avoided by individuals with a high enough level of tax knowledge (Commonwealth Taxation Review Committee, 1975). Those with sufficient tax knowledge were also able to mitigate their death duties liability substantially through the use of trusts (Duff, 2005). Loopholes do not appear to be an issue with South Africa's estate duty legislation as there are several provisions in place which bring assets that were disposed of before death into the estate duty net. The Margo Commission did, however, note particular instances where individuals would make provisions to avoid estate duty (Margo Commission, 1987). The Davis Tax Committee also noted that individuals were able to mitigate their tax liability by implementing "estate duty planning mechanisms" (The Davis Tax Committee, 2015).

The repercussions of avoidance in South Africa are not as severe as they would have been in Australia, as individuals would generally still be subject to capital gains in their attempts to avoid estate duty, albeit at a lower rate.

This therefore seems not to be a sufficiently significant argument for abolition.

## Reasons against Abolishment

### Part of Modern Fiscal system:

In 1978, when Australia's death duties were abolished, as mentioned previously in the study, it was seen as a very controversial decision. This is because Australia was the first nation of the OECD countries to not have any tax on capital appreciation (Pedrick, 1982) and the death duties mechanism was seen as an important and powerful fiscal tool (Gilding, 2010).

In order to determine whether death duties is still considered a valuable fiscal tool, it is worth analysing what other countries' approaches and policies regarding death taxes are currently. Many modern Western countries have made the move to either abolish their death taxes all together or to limit the importance and application of such. Eleven countries and two tax jurisdictions have abolished their death duties since 2000 (Appendix 2), seven of which are OECD countries. Furthermore, no country has moved to implement death taxes since 2000 (Cole, 2015).

Furthermore as of 2004, an example of this trend is further evidenced by thirty of the American states having effectively eliminated death taxes since 1976, and many others having made moves to reduce them (Conway & Rork, 2004). As of 2014, only 19 of America's 51 state's still retained a form of death taxes, but eight of these states were in the process of reviewing their legislation over death (Ebeling, 2014). At a federal level in America, the House of Representatives voted to abolish death taxes in America in 2015, a

vote seen to be a significant step towards federal level abolishment (Goodman, 2015). The reason why America's changing policy to death taxes has been especially highlighted is that it currently has the fourth highest death tax rate in the world, and there has been much written on the topic, making it particularly useful to analyse (Cole, 2015).

As is evidenced by the above, there appears to be a strong movement or consensus towards abolishment of death taxes. This therefore undermines the importance of death taxes as a part of a country's modern fiscal system, as it can be seen that the "fiscal benefits of levying such a tax are eventually outweighed by the administrative, political and economic costs" (Cole, 2015).

It would therefore not be unreasonable to conclude that this argument against abolishment of South Africa's estate duty would not be a valid one.

### Tax Revenue

South Africa's estate duty brings in a much smaller proportion of total South African tax revenue, being only 0.1224%, compared to what Australia's death duties brought in in 1978, being 1.59% of the total Australian tax revenue (South African Revenue Service & National Treasury, 2014; The Treasury of Australia, 2012). Therefore it could possibly be perceived that this argument against the abolishment of estate duty would hold much less weight as it did when it was put forward in Australia, as a result of this much lower proportional amount of revenue generated, being approximately a thirteenth of the proportional amount that was generated in Australia.

The revenue argument itself was not necessarily a strong one when initially presented in Australia due to the relatively minor amount of revenue it did generate (Gilding, 2010). Despite this, it did carry some weight, as death duties was the only mechanism with which the Australian Treasury had in place with which to generate revenue from the accumulated wealth of individuals.

This point would also carry very little weight in an argument in favour of the retention of estate duty as capital gains tax in South Africa renders the point redundant.

### Equity through the Tax System and Breaking down of Accumulated Wealth

As death duties were the only form of tax on capital appreciation in Australia in 1978, it was essentially the only tool that could be used to break down accumulated wealth and provide equity through the tax system, although its effectiveness at doing this has been disputed (Katic & Leigh, 2015).

Roeleveld (2012) presented the argument that having both estate duty and capital gains tax in place was counterintuitive to bringing equity through the tax system, due to the confiscatory effect that arose as a result of having two taxes in place over the same assets (Appendix 1) as discussed above.

The Davis Tax Committee disputed the validity of capital gains tax being a “wealth tax” and propositioned that since estate duty is currently the only wealth tax in South Africa, “it would be hard to justify a repeal” as it is the only taxing mechanism that is geared to the redistribution of wealth (The Davis Tax Committee, 2015). Muller (2010) further highlighted that the purpose of estate duty was a means to bring equity to society. Both papers do concede, however, that the current estate duty legislation does require revisions in order for it to effectively achieve its objectives (Muller, 2010; The Davis Tax Committee, 2015).

The need for estate duty to bring equity to society is therefore a potentially valid argument against the abolishment of estate duty in South Africa. The current form of the estate duty legislation, however, in combination with capital gains tax, does not appear to achieve its objectives. This was also highlighted by Roeleveld (2012) and the need for revisions in order to achieve its objectives, highlighted by Muller (2010) and the Davis Tax Committee (2015), supports this point.

## **SUMMARY OF RESULTS**

The above analysis shows that there are reasonable grounds to advance some of the arguments for and against the abolishment of death duties in Australia towards the Estate Duty Act in South Africa (Appendix 3). The argument which carried significant weight and was most applicable to estate duty was the duplication which arises as a result of capital gains tax and estate duty being levied on the same assets. The importance of this argument is slightly undermined by the Davis Tax Commission not viewing it as a major concern (The Davis Tax Committee, 2015), but there is strong public sentiment in South Africa to rectify this (Muller, 2010; Roeleveld, 2012).

The arguments of complexity and ease of avoidance are also applicable to estate duty as issues have been raised in South Africa, mainly through the various tax commissions, which highlighted these as problem areas. The problems may not be at the same significance level that was present in Australia, but they are still applicable and carry weight in South Africa currently.

The arguments put forward against abolition of death duties in Australia were significantly weaker when applied in a South African context. Death duties, and by association, estate duty, is no longer viewed as an important fiscal tool in a South African or global context and therefore is a weak argument against abolition of death taxes worldwide, and in South Africa.

The revenue argument is critically undermined in South Africa as a result of capital gains tax effectively neutralizing the argument that death duties is the only means to generate revenue from capital appreciation. The amount of proportional revenue generated in South Africa from estate duty is also significantly less than what the proportional amount in Australia was from death duties.

Finally, the need for estate duty to break down accumulated wealth and bring equity to society is greatly disputed in South Africa. There is clearly a need for a mechanism to bridge the inequality gap and provide equity, but it is very questionable as to whether estate duty

achieves this goal. Based on this sentiment, it is inconclusive as to whether this could be provided as an argument against the abolition of estate duty in South Africa. After the revisions suggested by the Davis Tax Commission have been enacted, this argument could potentially become a strong argument against abolition of estate duty, if such revisions do in fact allow the estate duty legislation to better achieve its objectives.

### **SUGGESTED SOLUTIONS TO REMEDY 'DOUBLE TAX'**

As the results above suggest, there is reason to believe that there could potentially be a more effective method of how death is treated as a taxable event, some of these alternatives are presented below.

In order to resolve the double tax situation, there appear to be three reasonable actions to take; either to abolish estate duty; disregard death from the capital gains tax net, in order to solve the inequitable situation that arose from the double tax; or keeping estate duty and implementing variation to the base cost determination for capital gains system on death.

The first option, as suggested by Ger (2012), was to abolish estate duty altogether. The first point raised in favour of this option was that the revenue raised by estate duty was not worth the cost of administration. Estate duty only raises approximately 0.1224%, as mentioned earlier, of total tax revenue and raising this revenue can prove to be a costly exercise, resulting in a negligible yield (Roeleveld, 2012). However, it has also been suggested that the existing collection structure through the Master's offices requires very little administration and is therefore cost efficient (Muller, 2010).

Regardless of its expenses to administer, the intention of estate duty is clearly not geared towards revenue generation but rather the breaking down of condensed wealth. The point of its low revenue generating ability, therefore, may not be considered a viable argument. A potential counter-argument to this is that because the separate piece of legislation only generates insignificant amounts, would it not prove more efficient and potentially less costly to abolish estate duty altogether and amend the capital gains legislation to recoup any revenue that would have been lost through the abolishment?

The next significant point raised in the argument in favour of the abolishment of estate duty and the retention for capital gains tax is that capital gains tax is the superior tax. Several points to support this claim are listed below:

- The definition of a "disposal" has been given a very wide meaning. This is a significant point because from this it can be seen that capital gains tax draws all assets that would be subject to estate duty into its tax net due to its broad disposal definition therefore very little or no amendment would be required.
- Capital gains tax is an easier tax to collect due to being aggregated/integrated into an individual's taxable income (Ger, 2012).



- Using a sliding scale of tax, as is the case with capital gains tax, creates a much more equitable situation than a case where an individual is taxed at a flat rate, as with estate duty (Mccaffery, 1999). This may not be considered equitable as there is not a single class of wealth, but rather several different brackets of society that would be classified within “wealthy”. The actual wealth of the individuals in these brackets varies substantially from wealth bracket to wealth bracket (Roeleveld, 2012).
- An important advantage of keeping capital gains tax as opposed to estate duty is that capital gains tax is covered by most existing double tax agreements that South Africa has in place with other foreign countries (South African Revenue Service, 2015). This is not the case with estate duty because many other foreign countries do not have a form of death taxes and therefore death model treaties are not common in these countries (Roeleveld, 2012). The problem with this is that South African residents may not get total relief if the asset in question is taxed both in South Africa, under estate duty, and a foreign tax jurisdiction.

The second alternative to the current treatment of death as a taxable event presented by Thorpe (2015) would be to disregard death as a capital gains tax event. This would be done by altering what constitutes a deemed disposal in paragraph 40 of the Eighth Schedule to exclude death. It is suggested that adopting this approach will have the lowest impact on the revenue generated on the death of an individual, as the current capital gains tax legislation already provides several provisions, such as roll-over relief on the death of a spouse and a primary residence exclusion (Roeleveld, 2012). Issues arise with this approach because the administration effects that would need to be implemented in order to amend other legislation to avoid tax inefficiencies would be significant (Roeleveld, 2012).

Van Jaarsveld (2013) suggested a third possibility of keeping estate duty as is and rather implementing a variation of the capital gains system on death. The proposed variation is either using a “stepped-up” approach, which means the asset’s base cost is revised up to market value at death and no capital gains is payable, or a “carry-over” approach, which means the beneficiary who receives the asset essentially takes the place of the deceased and no capital gains is payable until the asset is subsequently disposed of. (Van Jaarsveld, 2013). The amendments were suggested to try and rectify the double tax situation that arises on death.

Roeleveld (2012) concludes that capital gains tax on death should be retained, and that estate duty should be abolished, as capital gains tax is “far reaching and more beneficial to the fiscus”. Thorpe (2015) also highlighted that South Africa was one of a very few number of countries that had implemented a form of double taxation on death and this needed to be addressed and potentially resolved through the abolishment. Muller (2010) concurred that the double taxation that arises, while not feasible, should not merit abolition, but rather an alternative or legislative change which rectifies the double tax situation be found.

## CONCLUSION AND AREAS FOR FUTURE RESEARCH

The paper has detailed current literature that exists for South Africa and Australia with regards to their respective positions on death as a taxable event, with the focus primarily being on death taxes. The research question was not conclusively answered as instances arose where some arguments put forward for Australia's abolishment proceedings were supported in a South African context and other instances where the arguments put forward were not. The paper however has illustrated that there are some arguments that could potentially be drawn from Australia's motivations for their abolishment of their death duties in 1978 for the abolishment of estate duty in South Africa. Perhaps even more significant from the results is that the arguments put forward opposing the abolishment in Australia are generally either not applicable or their importance is greatly diminished in a South African context. This could be seen to further promote the position of abolishment due to the weak nature of the counter-arguments. The Davis Tax Commission's recommendations could potentially align the Estate Duty Act with its supposed objectives and correct the double tax situation that arises on death, the paper also presents several potential alternatives or adjustments to estate duty that have been suggested by academics. If this is done the calls for abolishment will surely diminish, until that time however, this paper has determined that there are currently potentially valid arguments for the Estate Duty Act to be abolished in South Africa, or the treatment of death as a taxable event to at least be revised.

The study has provided some useful analysis but could be improved by expanding the number of countries in the comparison. This could potentially improve the analysis of how South Africa treats death as a taxable event relative to other countries, and whether any of those approaches adopted would be applicable or potentially preferable in a South African context. The study could also focus on past cases of other countries which had two independent taxes in place, which taxed the same capital appreciation and the reasoning as to why this situation existed and the deliberations which took place to resolve it.



## APPENDICES

### Appendix 1

(The illustrative example of the confiscatory nature of South African taxes on death in Roeleveld (2012) has been kept the same albeit updated with the latest amendments to South African Tax legislation for year of assessment ending 29 February 2016)

### Example

A person dies, leaving only one income-generating property with a market value of R6 million to his child. The property had been donated to the deceased many years previously when the market value was R1 million and it had a base cost of R800 000 for the donor. There are no other assets of worth in the estate and because of assessed losses built up in the past the deceased's current year's taxable income is nil. There is no surviving spouse. The taxes on death are as follows (Roeleveld, 2012):

Capital Gains Tax			Estate Duty		
Proceeds		6m	Value of Estate		6m
Less: Base Cost		(1m)			
Total Capital gain		5m	Less: Income Tax liability		(0.586250m)
Less Annual Exclusion		(30k)	Less: S4a Abatement		(3.5m)
Net Capital Gain		4.97m	Net Value of Estate		R 1 913 750
Inclusion Rate of 33.3%		1.65501m	Estate Duty liability @ 20%		R 382 750
Tax Per Tables		R 599 607			
Less: s6 Primary rebate		R -13 257			
<b>Income Tax Liability</b>		<b>R 586 350</b>			
Total Tax payable by Deceased Estate (Estate duty + Income tax liability)		<b>R 969 100</b>			

In order to satisfy this liability, the executor will most probably have to sell the property as it is highly unlikely the child who inherited the property will have the funds to pay such a significant amount, the family unit is therefore harmed as a result of this confiscatory effect. The total tax liability is 121% of the original cost of the home to the family, and a significant 16.15% of the current market value of the home.

The damage to the family unit of losing the family home and the significant amount of the windfall that is lost on the sale of the home as a result of satisfying the tax liability could be seen to bear unfairly or inequitably on the child of the deceased, this simple example therefore illustrates the "confiscatory nature" (Roeleveld, 2012) of the current tax situation in South Africa.

Original Source: Roeleveld 2012

**Appendix 2**

Countries which have moved to abolish death duties or inheritance tax since the year 2000

<b>Country or Jurisdiction</b>	<b>Year of Repeal</b>
Macau	2001
Portugal	2004
Slovak Republic	2004
Sweden	2005
Russia	2005
Hong Kong	2006
Hungary	2006
Singapore	2008
Austria	2008
Liechtenstein	2011
Brunei	2013
Czech Republic	2014
Norway	2014

Original Source: Cole 2015

**Appendix 3**

Table illustrating the results of the study at a high level.

Points Raised in Australia	Can Points Raised be Applied to estate duty in South Africa?					
Arguments for Abolition	Reason 1	Applicable to SA?	Reason 2	Applicable to SA?	Reason 3	Applicable to SA?
Undue Harshness	Low Exemptions	NO	Significant burden on surviving spouse	NO		
Duplication of tax at State and Federal level	Duplication of tax on same asset	YES	Strong Public Sentiment	YES		
Complexity	Complexity at federal and state level	NO	Difficulty in valuing assets	YES	Tax Commissions cited it as "complex"	YES
Ease of Avoidance	Easily avoided by those with tax knowledge	YES	Significant Loop holes	NO		
Arguments Against Abolition						
Part of Modern Fiscal System	Death Duties was regarded globally as important fiscal tool	NO				
Tax Revenue	Only means to generate revenue from capital appreciation	NO				
Equity through the tax system and breaking down of accumulated wealth	Only tool to tax accumulated wealth	Disputed				

Source: Authors own construction

## REFERENCES

1. Cole, A. (2015). *Estate and Inheritance Taxes Around the World*. Retrieved from <http://taxfoundation.org/article/estate-and-inheritance-taxes-around-world>
2. Commonwealth Taxation Review Committee. (1975). *Final Report*. Retrieved from <http://adc.library.usyd.edu.au/view?docId=law/xml-main-texts/p00087.xml>
3. Conway, K. S., & Rork, J. C. (2004). Diagnosis murder: The Death of State Death Taxes. *Economic Inquiry*, 42(4), 537–559. <http://doi.org/10.1093/ei/cbh080>
4. The Davis Tax Committee. (2015). *Estate Duty: A Discussion Document*. Pretoria.
5. Duff, D. G. (2005). The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia and New Zealand. *Pittsburgh Tax Review*, 3(72), 72–120. Retrieved from [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=719744](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=719744)
6. Ebeling, A. (2014). Where Not to Die in 2015. Retrieved from <http://www.forbes.com/sites/ashleaebeling/2014/09/11/where-not-to-die-in-2015/>
7. Flynn, M., & Stewart, M. (2010). Death as a Taxable Event and Its International Ramifications. *Cahiers de Troit Fiscal International*, 97–120.
8. Ger, B. (2012). Time for Estate Duty to go. *De Rebus*, 59–60.
9. Gilding, M. (2010). *The Abolition of Death Duties in Australia: A Comparative Perspective*. Retrieved from <https://www.tasa.org.au/wpcontent/uploads/2011/01/Gilding-Michael.pdf>
10. Goodman, J. (2015). Why Do We Have a Death Tax? Retrieved July 15, 2015, from <http://www.forbes.com/sites/johngoodman/2015/04/27/why-do-we-have-a-death-tax/>
11. Graetz, M. (2010). It's Fair, and We Need the Revenue. Retrieved June 21, 2016, from <http://www.wsj.com/articles/SB10001424052748704358904575477593075638722>
12. Grossman, P. J. (1990). Fiscal Competition Among States in Australia : The Demise of Death Duties. *Publius*, 20(4), 145–159. Retrieved from [http://www.jstor.org/stable/3330297?seq=1#page\\_scan\\_tab\\_contents](http://www.jstor.org/stable/3330297?seq=1#page_scan_tab_contents)
13. Haupt, P. (2014). *Notes on South African Income tax* (33rd ed.). Roggebaai: H & H Publications.
14. Independant Green Voice. (2006). ABOLISH THE DEATH TAX. Retrieved June 21, 2016, from <http://www.sovereignty.org.uk/features/articles/manifesto07/iht.html>
15. Katic, P., & Leigh, A. (2015). Top Wealth Shares in Australia 1915-2012 \*. *Review of Income and Wealth*. <http://doi.org/10.1111/roiw.12177>
16. Katz Commission. (1994). *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa*. Pretoria.
17. Margo Commission. (1987). *Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa*. Pretoria.
18. McCaffery, E. J. (1999). Grave Robbers: The Moral Case against the Death Tax, (353). Retrieved from <http://www.cato.org/sites/cato.org/files/pubs/pdf/pa353.pdf>
19. Muller, E. (2010). *A Framework For Wealth Transfer Taxation in South Africa*. University of Pretoria. Retrieved from <http://repository.up.ac.za/bitstream/handle/2263/28572/Complete.pdf?sequence=8&isAllowed=y>

20. Pedrick, W. H. (1982). Oh, to Die Down Under! Abolition of Death and Gift Duties in Australia. *Western Australia Law Review*, 6(August), 438–48. Retrieved from <http://heinonline.org/HOL/LandingPage?handle=hein.journals/uwatlw14&div=29&id=&page=>
21. Raskall, P. (1978). Who's Got What in Australia: The Distribution of Wealth. *The Journal Of Australian Political Economy*, (2), 3–16. Retrieved from <http://search.informit.com.au/documentSummary;dn=800220684;res=IELAPA>
22. Roeleveld, J. (2012). An Argument for Either Excluding Death as a Capital Gains Tax Event or Abolishing Estate Duty. *South African Journal of Accounting Research*, 26(1), 143–164. Retrieved from <http://www.tandfonline.com/doi/abs/10.1080/10291954.2012.11435167?journalCode=rsar20#.Vbj7>
23. South African Revenue Service. (2015). Summary of all Treaties for the Avoidance of Double Taxation. Retrieved July 27, 2015, from <http://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-DTA-2013-01 - Status Overview of All DTAs and Protocols.pdf>
24. South African Revenue Service, & National Treasury. (2014). *Tax Statistics Database*. Retrieved 29 April 2015 from [www.oecd-ilibrary.org](http://www.oecd-ilibrary.org)
25. Statistics South Africa. (2015). Stats SA. Retrieved April 29, 2015, from [http://www.statssa.gov.za/?page\\_id=739&id=1](http://www.statssa.gov.za/?page_id=739&id=1)
26. The Treasury of Australia. (2009). *Australia's Future Tax System - Consultation Paper*. Retrieved from [http://www.taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/Publications/Papers/Consultation\\_Paper/index.htm](http://www.taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/Publications/Papers/Consultation_Paper/index.htm)
27. The Treasury of Australia. (2010). *Australia's Future Tax System - Final Report Part 2-Detailed Analysis-Volume 1*. Retrieved from [http://www.taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/Publications/Papers/Final\\_Report\\_Part\\_2/index.htm](http://www.taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/Publications/Papers/Final_Report_Part_2/index.htm)
28. The Treasury of Australia. (2012). *Mid-Year Economic and Fiscal Outlook 2012-13*. Retrieved from <http://www.budget.gov.au/2011-12/content/myefo/html/prelims.htm>
29. Thorpe, L. L. (2015). *Is it time to abolish estate duty in South Africa? A comparative look at global trends in levying death taxes and the feasibility of suggested changes to South Africa's current regime*. University of Cape Town. Retrieved 7 June 2016 from <http://hdl.handle.net/11427/15186>
30. Van Jaarsveld, J. (2013). *The Levying of Capital Gains Tax at Death*. University of Johannesburg. Retrieved from <https://ujdigispace.uj.ac.za/handle/10210/8595>

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**TAX 03: The effect of electronic commerce on the erosion of  
tax bases – Developing appropriate taxation laws in South  
Africa**

Authors:

Amy Wilson, Shaun Parsons and Riley Carpenter

University of Cape Town

E-mail: [riley.carpenter@uct.ac.za](mailto:riley.carpenter@uct.ac.za)

**Abstract:**

In response to concerns about the erosion of tax bases caused by a lack of adequate taxation laws to govern the digital economy, this paper considers the issues that have arisen around the taxation of electronic commerce.

Significant issues relating to classification, residency, permanent establishment and source of income that arise from the presence of technology and electronic commerce are identified and explored, though analysis of the considerations, discussions and actions of the Organisation of Economic Co-operation and Development as well as countries around the world. The relevance of issues are then applied to a South African context.

This study recommends that South Africa continue to follow the actions of the Organisation of Economic Co-operation and Development, along with those of the United Kingdom, the United States, New Zealand and Australia, in order to appropriately respond to this growing sector of the economy.

## **1. Introduction**

In the past two decades, the world has seen massive growth in electronic commerce (e-commerce). Not only has e-commerce become a useful tool through which to conduct business, for some businesses it has become an essential part of their income earning structure. E-commerce has created a new trading platform and has introduced an entirely new economy, the digital economy. Some industries have been forced to completely transform the way they conduct business. For example, the magazine and newspaper industry has seen a trend towards the discontinuation of traditional print media and the launch of digital versions of these products online.

Tax authorities around the world have considered the issues that have arisen from the introduction of e-commerce that have been caused by the unfamiliarity of e-commerce transactions. Since these transactions do not fit perfectly into the current tax regimes, they challenge certain concepts and sometimes fall outside the reach of laws, causing transactions to go untaxed by any jurisdiction (Cox, Doernberg, & Hinnekens, 2013).

Not only does this issue have the potential to significantly erode the tax bases of countries all around the globe, but it also could have the effect of causing inequality within industries, thus challenging the concept of a free market. This arises when transactions over the internet offer the same products as 'traditional bricks and mortar' stores. If the online transactions are not taxed, but the traditional traders are, there is an opportunity for price differentiation between these two businesses as online retailers could charge a price proportionately lower than their competitors since they do not have to incorporate tax into the price. This unfair competitive advantage contradicts the concept of tax neutrality, which implies that all substantially similar transactions should be taxed equally (Chan, 2000).

In 1998, the US government signed a law introducing the Internet Tax Freedom Act (ITFA), which placed a temporary moratorium on the introduction of new taxes on e-commerce transactions. The rationale behind this was to promote the endless potential that the internet offered and encourage growth in this industry (Bruce, Fox, & Murray, 2003). Since then the digital economy has grown to a size where continuing to allow these transactions to remain untaxed could lead to a large opportunity cost of lost tax revenue. The Davis Committee, an advisory tax panel in South Africa, recently released an article identifying the fact that South Africa needs to create policies around the taxation of e-commerce in order to seize the opportunity to increase tax revenue in the Republic (Estor, 2014). These policies are necessary to 'level the playing field between local and international companies dealing with electronic goods and services' (Estor, 2014).

## **2. Literature Review**

E-commerce presents a unique problem to tax authorities for many different reasons. These challenges arise because the nature of e-commerce transactions differs significantly from traditional transactions around which tax authorities have based their rules (Lau & Halkyard, 2003). Beyond the administrative and technical problems of taxing e-commerce, there are also several other issues around the current tax rules upon which the tax laws are based, namely, issues around income classification, residency, permanent establishment and source (Azam, 2007). These issues are discussed below.

### **2.1 Why electronic commerce presents a unique problem**

According to the Organisation for Economic Co-operation and Development (OECD), e-commerce is defined as 'the sale or purchase of goods or services, conducted over computer mediated networks', narrowly defined as 'internet transactions', with the main network being the internet (OECD, 2002). These transactions can occur between any two parties that have access to the internet, regardless of their location around the globe, thereby transcending territorial boundaries (Azam, 2013). This ability to trade without the confines of geographical borders creates a world that undermines the legitimacy and feasibility of the tax laws that were created around the concept of the physical separation of countries (Cox et al., 2013). The internet creates a mobility of capital and almost real-time availability of information that causes volatile changes in taxable resources (Lau & Halkyard, 2003). This, along with the increasing mobility of intangible assets, users and business functions, has posed challenges to tax authorities all around the world (Cox et al., 2013). The taxation of these cross border transactions is becoming increasingly difficult, especially if state and country tax laws are not uniform (McClure, 2015).

E-commerce has fundamentally changed the way business is conducted on a national and international level. The presence of a virtual business platform has allowed businesses to create innovative ways to streamline core business functions over the internet and to obtain resources in a manner that is more efficient (Lau & Halkyard, 2003). The growth in the digital economy has caused a convergence of resources making technologies cheaper, more powerful and widely standardised. This enhances innovation across many business sectors. For example, retailers can gather and analyse customer information from online sales in order to improve their reach to the target markets, the financial services industry can provide its customers with the ability to manage and track returns online, and the news and media industry has had to adapt to the rapid expansion of non-traditional mediums through which to communicate news while user participation has increased through the use of social networks and user-generated content (Cox et al., 2013). These innovations, together with the high mobility of capital through e-commerce, could see resident companies migrating to low tax jurisdictions by incorporating offshore companies through which business is performed (Cox et al., 2013).



The matters presented above create challenges around the administration and enforcement of tax on e-commerce transactions. The ability of tax authorities to collect tax is dependent on the identification, location, and verification of taxpayers and their corresponding taxable transactions (Young, 2012). The increasing level of anonymity created by the internet has caused complexities to arise around merely identifying the appropriate taxpayer (Azam, 2013). Furthermore, with the global increase in information security and confidentiality, tax authorities may need to find a balance between the various privacy laws and regulations and the need to ensure tax compliance (Lau & Halkyard, 2003). However, the virtual nature of online transactions makes monitoring and controlling e-commerce transactions across borders difficult. Additionally, tax authorities need to consider the appropriate country in which certain taxpayers will be taxed. This may pose a problem when companies lack substantial physical presence in any country but are virtually present in multiple countries (Azam, 2007).

Another administrative challenge would be developing an efficient mechanism for tax collection from sellers, in particular remote sellers and non-residents (Lau & Halkyard, 2003). Some remote sellers may be burdened by the administrative cost of registering for tax and may not be able to meet the tax burden on top of other costs such as shipping and handling costs and time costs due to delivery lags (Bruce et al., 2003). Although compliance costs may seem to be disproportionately higher for smaller businesses, Bruce et al. (2003), discuss how the difference between local and remote sellers should continuously erode as the internet grows and online transactions become an increasingly important component of consumer life.

A further issue arises from the creation of different payment methods such as the use of e-wallets or cyber-wallets that are charged in advance with credits and used online as an alternative to a credit card (OECD, 2014). This is enhanced by the creation of virtual currencies, such as Bitcoin (Cox et al., 2013). Bitcoin is defined as the use of 'peer-to-peer technology to operate with no central authority or banks' (Bitcoin Foundation, 2015). The lack of a central authority makes it seemingly impossible to track every transaction made by each individual owner of the currency in order to impose tax on these (Cox et al., 2013). Furthermore, individual taxpayers may abuse the anonymity of Bitcoin ownership and transactions by not declaring related income (Parsons, 2014).

In order to approach these challenges tax authorities should consider the benefits that have been created from the internet and the administrative advantages that can be extracted from this medium. An opportunity has arisen where a new range of tools is available to be used in order to ensure compliance with legislation and other tax rules as well as assist with the collection of taxes and improve taxpayer services (Lau & Halkyard, 2003).

## **2.2 Important issues identified around the taxation of e-commerce**

The unique problem e-commerce presents to tax authorities arises because the nature of these transactions creates room for warped interpretations of certain areas of current tax legislation. Transactions of a virtual nature put pressure on certain tax concepts that require physical presence for distinct classification (Azam, 2007). The main areas of concern are income classification, residency, permanent establishment and source rules.

### **2.2.1 Income Classification**

The introduction of information technology has created numerous new products, services and methods of doing business. These products and services can sometimes blur the lines of income classification (Azam, 2007). Traditionally tax authorities have imposed different types of tax regimes on different classes of cross-border income. The transmission of digital goods and services, however, may not provide a clear indication as to what is actually being transferred, whether a good has been delivered, a service performed or an intangible asset licensed (Cockfield, 2006). The digital revolution has made it possible to record multimedia forms of interactive sounds and images that are of a high quality. This has created an opportunity to sell the same item in both tangible and intangible forms. For example, instead of purchasing a physical CD, one can purchase the mp3 version and download it from the internet (McLure, 2015). Additionally, new business models, such as cloud computing, have arisen relying on the new digital economy and these models have made the ability to classify certain income even more challenging (Cox et al., 2013).

### **2.2.2 Residency**

Many countries worldwide use a residence-based tax system where, if a taxpayer is a resident of the country, the taxpayer will be taxed on worldwide income regardless of its source. Generally, a universal perspective is taken that for a company to be classified as a resident, generally, there are two tests, namely, the 'place of incorporation' test and the 'place of effective management' test (OECD, 2001).

Under the 'place of incorporation test', if a company is incorporated in a country, it is considered a resident of that country, regardless of where the major economic activities take place (Cockfield, 2006). The justification for this system is that the company should compensate the country in which it was incorporated as this country contributes to the abilities of the company to produce income through providing resources and services (Azam, 2013). Since this test does not require the company to maintain economic presence within the country of incorporation, residency can change simply by changing the country of incorporation (OECD, 2001). The mobility and flexibility of the internet and other computer-mediated networks has removed most of the challenges around managing a company's operations from an offshore

country (Lee, 2006). As a consequence, the 'place of incorporation test' could be used as a tax avoidance opportunity if internet companies were to incorporate in low tax jurisdictions, such as Ireland, or in tax havens, such as Bermuda, and escape taxation altogether (Cockfield, 2006).

Under the 'place of central/effective management and control test', the place where a company's major economic decisions are made is deemed to be that company's country of residence. This generally involves analysing where the company's board of directors meet on a regular basis and where the head office of the company is situated (Cockfield, 2006). However, the internet has created the ability for directors, employees and business partners to communicate seamlessly while maintaining physical presence in their various countries of personal residence (Lau & Halkyard, 2003). This gives rise to a possible manipulation of the residence-based taxation system in order to achieve tax avoidance (Azam, 2007).

### 2.2.3 Permanent Establishment

A company could be a non-resident of a country but may still have to pay tax in that country on a portion of its income. This is required if the company establishes and operates through a permanent establishment in the country. The tax payable would be imposed on the income attributable to that permanent establishment (Chan, 2000). The permanent establishment concept has been the basis on which to determine whether a particular country has the right to tax the profits made by a non-resident transacting in the country. The digital economy, however, is placing pressure on the concept of a permanent establishment, dependent as it is on a substantial physical presence in the country (Cox et al., 2013).

Article 5 of the OECD Model Tax Convention addresses the concept of permanent establishment and provides a definition on which many tax laws rely when considering this concept (Laursen, 2010). Article 5 states that 'the term permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on' (OECD, 2003). The word 'permanent' does not require the company's presence in a country to be forever. Laursen (2009) discusses how in most cases, a period of six months is usually sufficient to constitute a permanent nature in terms of the permanent establishment concept. The definition alludes to the fact that to be considered a permanent establishment, the place must be a 'fixed' place and must be a place through which business is carried on. Paragraph 2 includes especially a place of management, a branch, an office, a factory, workshop or a mine (OECD, 2003). This supports the court-determined definition of 'nexus', which requires substantial physical presence by a company before being defined as a permanent establishment or being obligated to pay tax on a portion of its profit (Bruce et al., 2003).

E-commerce challenges the concept of a permanent establishment because it gives a company the potential ability to have digital presence in a country without having the burden of paying tax because of the lack of substantial nexus (Cadesky, Rinninsland, & Lobo, 2014). This is because internet transactions and other digital platforms reduce the need for physical presence in a country in order to transact and conduct business in that jurisdiction. This places questions around the assumption of the need for physical presence in order carry out value-generating economic activities within a country and suggests that the digital economy has caused this concept to become outdated (Cox et al., 2013). A company could potentially be present in hundreds of different countries around the world at one time in a purely virtual manner (Azam, 2013).

This concept can be demonstrated further by using as an example. Google's mission is to 'to organize the world's information and make it universally accessible and useful' (Google, 2015). In pursuit of this, Google maintains more than 180 domains in countries around the world but only operate offices in 40 of these countries. While more than half of Google's revenue is generated outside of the United States of America, the ability to classify the proportion of revenue generated in each individual country in order to share fairly all pieces of the tax pie, is almost impossible. This process is made more challenging in the countries where Google has no physical office or presence of any type, other than in the computer servers that feed the domains within each country (Azam, 2013).

From this, one can see that the introduction of internet transactions, there may be an opportunity for a company to achieve double non-taxation due to the lack of nexus in the source country together with the lack of taxation in the resident country arising from a double taxation agreement (Cox et al., 2013).

The lack of physical presence needed for generating income in any economy and the rise in the ease of cross-border commercial transactions has been enabled by the use of computer servers. A computer server is a computer that has been networked to the internet and, in some cases, eliminates the need for traditional business intermediaries such as retail stores (Cockfield, 2006). The current legislation does not adequately consider the issues around the virtual and independent nature of a server. A server has the potential to perform integral economic activities within the business without requiring any human involvement (OECD Committee on Fiscal Affairs, 2000). Furthermore, since virtual distance is not proportional to physical distance, the actual location of each server could be challenging to pinpoint. This shows the challenges that arise from the digital economy and may indicate that the concept of a permanent establishment may be outdated and in need of revision (Lau & Halkyard, 2003).

#### 2.2.4 Source

If a company is a non-resident, the general rule is that the company will be taxed in a jurisdiction on income that is derived from a source within that specific jurisdiction. The rationale behind source-based taxation is that the source country provides the company with infrastructure and other facilities that contribute to the income-generating ability of the business (Azam, 2007). The source country usually takes precedent over the resident country and although both countries may impose tax on the company, generally, double taxation agreements lead to a credit being issued by the resident country, leaving the final tax benefit with the source country (Chan, 2000).

E-commerce makes the identification of 'what is done in which country' and the original cause of the income significantly more challenging and exposes a potential weakness of the current source-based rules (Lau & Halkyard, 2003). All types of e-commerce transactions have some sort of virtual aspect to them, as physical existence outside the internet may be limited or non-existent. This makes it difficult to identify the specific geographical location of an e-commerce transaction as the technical location of the transaction could be 'on the internet', making the identification of the source of the income more challenging (Azam, 2007).

Additionally, determining the source of e-commerce transactions is made more challenging as the existence of a virtual trading platform causes certain income to be linked with several countries, with no clear indication of a country that provides a dominant contribution (Azam, 2013). As the internet has provided almost instantaneous access to a large volume of information, companies can use this to gather information and generate data on consumers, competitors and target markets within the industry. This causes the attribution of taxable profits to a particular source country to become particularly challenging as the value is derived from the generation of information that is collected from digital goods and services from sources around the world. The ability to separate each bit of information and determine a value attached to that specific piece of information may prove to be nearly impossible (Cox et al., 2013).

These challenges around the enforcement of source rules cause a number of possible tax avoidance opportunities to arise and may lead to avoidance becoming widespread and easy for many companies participating in information generation and other trades (Azam, 2013). This suggests that special attention toward source-based rules may be required by tax authorities before the growth in e-commerce causes a significant erosion of tax bases around the world (Azam, 2013).

### **2.3 Current considerations and responses by the OECD and other countries on the taxation of electronic commerce**

The issues discussed above has been cause for consideration for the past two decades by authorities such as the OECD, the US National Treasury and other tax authorities around the globe (Cox et al., 2013).

#### **2.3.1 The OECD actions and recommendations**

Throughout the last few decades, the OECD has considered the issues around the taxation of e-commerce. The Ottawa Ministerial Conference on Electronic Commerce was held in 1998, where leaders from both member and non-member countries participated in a discussion around the promotion and development of e-commerce around the world. At this conference, a set of tax principles was established on which the OECD and other tax authorities would base their considerations around the taxation of the digital economy (OECD, 2014). This framework provided that taxation between different forms of commerce must be neutral and equitable, achieving effectiveness and fairness while remaining simple and certain. The compliance and collection costs must be efficiently minimised as far as possible as well as have the ability to keep up with the flexible and continuously evolving technologies in the digital economy (Cockfield, 2006).

After the Ottawa conference, the Committee on Fiscal Affairs created Technical Advisory Groups, consisting of business, scientific and governmental representatives from around the globe, to discuss further the issues surrounding the digital economy and present possible recommendations (OECD, 2014). In 2013, the OECD launched an Action Plan on Base Erosion and Profit Shifting, followed by a discussion draft on Action 1: Address the tax challenges of the digital economy, released in April 2014. Some of the considerations and recommendations that have arisen are discussed below.

**Residency:** There was a proposal to amend the determination of residency under the 'place of central/effective management and control test'. If the taxpayer's activities indicate more than one country, or indicate no clear country of residence, the place of effective management would be determined by considering three options. The place of effective management would be either the country in which the taxpayer substantially makes use of the economic, financial, physical and legal resources of the country; that in which the activities performed by the taxpayer are the most substantial and relevant; or the country in which the clear majority of decisions by the Board of Directors are made and the location of the head offices of the corporation (OECD, 2002). This amendment would eliminate the challenges around identifying the resident country of a taxpayer through the 'place of central/effective management and control test', thereby decreasing the opportunity to escape the imposition of taxation.

**Permanent Establishment:** The OECD established certain guidelines around the definition of a permanent establishment, including an amendment of the commentary on Article 5 of the Model Tax Convention (OECD Committee on Fiscal Affairs, 2000). The clarification on the application of the permanent establishment definition in e-commerce considers separately whether computer equipment, websites and servers could constitute permanent establishments. It also considers the issues around Internet Service Providers (ISPs). The responses around these issues are as follows:

- *Computer equipment:* A permanent establishment may exist in a location where computer equipment is used regardless of whether the location requires human presence or not. If the equipment carries out core functions of the business that are substantial and significant, a permanent establishment will exist. However, if the activities carried out by the computer equipment are preparatory or auxiliary, further evidence would be needed in order to determine whether the equipment constitutes a permanent establishment (OECD Committee on Fiscal Affairs, 2000).
- *Websites:* The commentary on Article 5 states that a website, in itself, does not constitute a permanent establishment. This is because the website is an intangible item that cannot be classified as 'computer equipment' and therefore does not fall into the above category (OECD Committee on Fiscal Affairs, 2000).
- *Servers:* According to the OECD Committee on Fiscal Affairs (2000), a server, if owned or leased by a non-resident company, could classify as a permanent establishment as it is equipment with a physical location. The server will constitute a permanent establishment if it performs an integral part of the cross-border transactions of an enterprise and is in a fixed location for an adequate period of time (Cockfield, 2006).
- *ISPs:* If an enterprise's website, through which business is conducted, is hosted on the server of an ISP, the enterprise usually does not have control over where the server is located. Therefore the only presence the enterprise has in a country is through its website, which, as seen above, will not constitute a permanent establishment (OECD Committee on Fiscal Affairs, 2000).
- *Nexus:* A new nexus rule was proposed where a resident transacting with a non-resident would be required to withhold tax from the payment that has been made from the resident bank to the non-resident company (OECD, 2014).
- *Virtual Permanent Establishment:* As an alternative to the new nexus rule, a proposal was made to amend or extend the definition of a permanent

establishment. This would allow for servers and specific virtual presence of a company to be considered a permanent establishment, thus eliminating the possible avoidance of tax imposition through a lack of substantial physical presence (OECD, 2014).

Countries around the world, both members and non-members of the OECD, have been following the OECD's commentaries, and implementing reactions in order to adequately deal with this taxation issue (Cockfield, 2006). The responses of the United States (US), Australia, New Zealand, Canada and the UK have been considered and analysed below. The analysis will occur on these specific countries because of the sophisticated taxation systems along with the presence of a fair amount of e-commerce in each of these developed economies.

### 2.3.2 The United States

The US established the Digital Economic Task Force (DETF) in September 2013, which seeks to promote a balanced analysis of the taxation of the digital economy. Although there was little support from the DETF on the implementation of a 'virtual permanent establishment' definition, the task force does recognize the complexities around the taxation of e-commerce. Along with an organisation of worldwide in-house corporate tax executives (the Tax Executive Institute), the DETF suggests inequitable taxation implications could occur from an improper application of tax initiatives. This could lead to multiple tax impositions on the same transaction. The groups suggest that the appropriate response to these issues may be achieved through the proper application of the existing taxation rules (Cadesky et al., 2014). Although very little action seems to have taken place in addressing this issue, the US, in all its agreements with various countries, maintains that taxation of e-commerce should be clear, consistent and non-discriminatory (Cockfield, 2006).

### 2.3.3 Canada

Initially, the Canada Revenue Agency maintained a status quo on both the direct and indirect taxation of e-commerce transactions. Canada used an approach that consisted of examining the place of contracting and the location of physical assets of a business (Ault & Arnold, 2004). The country's tax authority did not deal with issues around service providers and servers and deemed these not to be permanent establishments as they were not physically located within Canada. Therefore no tax was imposed on these transactions on a physical presence basis.

However, from 2013 onwards, the Canada Revenue Agency has issued tax and reporting requirements for corporations, partnerships and self-employed individuals who earn income from one or more internet webpages or websites. Corporations are required to submit a 'Schedule 88, Internet Business Activities' report along with their corporate tax returns. Partnerships are not yet required to report the above income



and self-employed individuals are required to report an 'Internet Business Section' of a specific tax form and submit it with their income tax and benefit returns (Canada Revenue Agency, 2015).

#### 2.3.4 The United Kingdom

In 2000, after considering the OECD's release of the Clarification of Article 5 of the Model

Tax Convention and the discussion within that indicated when servers, computer equipment and websites could be considered a permanent establishment, Her Majesty's Treasury (HM Treasury) issued a press release on the matter. The stance that the HM Treasury took was that servers in themselves will never constitute a permanent establishment of a non-resident (HM Treasury & HM Revenue & Customs, 2014) .

In March 2014, the HM Treasury issued a report showing its support of the OECD's Task Force on the Digital Economy. The HM Treasury's view is that fair and consistent tax treatment must be applied to digital enterprises as well as traditional enterprises that have incorporated digital technology into their business operations. The HM Treasury has considered the revised definition of permanent establishments and states that it will need to be applied to all companies, not just those that are digital.

The ultimate approach of the HM Treasury is to continuously follow the work done by the OECD and 'propose supplementary rules to tackle specific issues raised by digitisation if progress on updating the existing international framework fails to materialise' (HM Treasury & HM Revenue & Customs, 2014).

#### 2.3.5 Australia

Australia's tax jurisdiction usually revolves around two doctrines, namely, the benefit doctrine and the economic allegiance doctrine. The benefit doctrine places taxation rights based on the benefits derived, by residents and non-residents, from Australia, whereas the economic allegiance doctrine uses the relationship between the income generating ability of the taxpayer and the country. The Australian Treasury notes that these doctrines may be inadequate to determine taxation rights relating to the digital economy, and is considering the concepts of source, residence and permanent establishment (The Australian Government Treasury, 2013).

The Australian Treasury has identified a number of different responses to the risk of base erosion and profit shifting caused by the digital economy. One response is to improve the enforcement of existing tax laws by increasing the exchange of information through expanded networks and providing the necessary training for tax auditors. Another response is to improve tax transparency by requiring large

corporate entities to disclose certain tax information. However, a cost-benefit analysis may be necessary before this takes place. Furthermore, the Treasury recommends that a review of Australia's bilateral and multilateral agreements with other countries should be performed at least once a decade to ensure that the terms of the agreements continue to be for the national benefit and fairness to the taxpayer (The Australian Government Treasury, 2013).

### 2.3.6 New Zealand

New Zealand has continuously provided guidance on the issue of cross border taxation and internet transactions. The Inland Revenue Department of New Zealand (Te Tari Taake, referred to as the 'Inland Revenue') has stated that e-commerce transactions will be treated within the current laws and interpretations of New Zealand (Inland Revenue, 2004).

According to the Inland Revenue (2004), New Zealand has followed the OECD's recommendations of determining whether a server is a permanent establishment, as discussed earlier, provided all the facts and circumstances are assessed on a case-by-case basis. This shows how the Inland Revenue has taken the OECD's comments and recommendations into account and applied some of these responses to their local tax laws.

## **2.4. Identification of arguments opposing the taxation of the digital economy**

In 1998, the US government signed a law introducing the Internet Tax Freedom Act (ITFA). This ITFA was created, and extended until 2003, in order to promote and preserve the commercial, educational and informational potential that the internet provided by placing a moratorium on taxing internet transactions. States were allowed to apply current tax laws to e-commerce transactions but were prohibited from creating any new or discriminatory laws explicitly targeted at internet sales (Bruce et al., 2003). In 2003, the ITFA Coalition proposed the introduction of a permanent ITFA, stating that it would 'benefit America's consumers and innovators and ultimately lead to higher economic growth and job creation'. This argument was based on the premise of tax neutrality and suggested that this would protect the internet from unfair taxation (ITFA Coalition, 2015).

The ITFA was developed when most online sales were by remote sellers in the US and therefore fueled the argument that a tax differential between remote and local sellers would be an incentive to purchase remotely, thereby fostering the growth and development of remote purchasing mechanisms such as the internet (Bruce et al., 2003). This argument, however, has gradually become less sound as internet transactions and globalisation has become a large part of the business world today (Bruce et al., 2003).

Zodrow (2003) explains how the implementation and development of separate tax laws dealing with the internet may have compliance and cost issues. The costs of

developing sound laws, communicating them to all companies, including remote sellers and collecting the tax may prove more costly than the benefit arising from the extra tax revenue received from these transactions (Zodrow, 2003). A cost-benefit analysis may need to be performed on the issues mentioned above in order to ensure that the costs do not outweigh the benefits. This may be an area for further research.

Many countries are in co-operation to develop a fair and efficient method of taxing the digital economy. Some countries may be slightly more hesitant or less equipped to implement changes at the moment but should still be participating in the discussions and suggestions of the OECD (Cockfield, 2006). There are many different approaches that have been implemented by different countries around the world and these are continuously monitored alongside the actions of the OECD.

### **3. Research Methodology**

Analysis of the literature has identified issues relating to income classification, residency, permanent establishments and source of income as well as compliance and administration concerns and costs. The reactions of the United States of America (US), the United Kingdom (UK), Australia, Canada and New Zealand, along with that of the OECD were explored. These issues will be applied to a South African context and a recommendation will be developed from the findings.

### **4. Research Question: How should South Africa approach the taxing of e-commerce?**

While South Africa is not a member of the OECD, it is one of the many non-member countries with which the OECD has a working relationship. South Africa has generally recognised and adopted the OECD Commentary on its Model Tax Convention (Jardine, Owens, & Sanger, 2014). In 2007, the OECD adopted a resolution to strengthen its relationship with South Africa among other non-member countries. This brings about a relationship of mutual advantage as 'South Africa is Africa's largest economy, and typically the 'prime mover' for OECD activities... especially on taxation, investment and competition policy' (OECD, 2015).

#### **4.1 South Africa's reactions to date**

In 2000, the Department of Communications of the Republic of South Africa issued a report titled 'The National Green Paper on Electronic Commerce'. This was neither academic literature nor a government policy statement but was a platform on which to translate topical issues around e-commerce into government policy. The paper was of a discursive nature and dealt with many of the unconventional issues that e-commerce brought into the marketplace (Department of Communications Republic of South Africa, 2000).

The paper established the underlying principles towards the development of e-commerce policy, which were similar to those established by the OECD in 1998.

These goals supported the principles of flexibility of regulation and governance, technological neutrality and international benchmarking. The paper continues to analyse certain issues that needed to be considered by the policy makers, including how to recognize e-commerce transactions, the threats that arise from the existence of cyber cash and multilateral trading systems. The ultimate objective of the green paper was to develop a policy that equitably imposed tax on e-commerce transactions, considering administration and compliance issues, as well as ensuring the citizens of South Africa's rights to privacy (Department of Communications Republic of South Africa, 2000).

Since then, the Value Added Tax (VAT) Act has recently been amended to incorporate the compulsory registration for VAT of foreign suppliers of e-commerce. The South African Revenue Service (SARS) has amended the VAT Act in order to account for the lack of VAT levied on e-commerce between foreign suppliers and South African customers (Strydom & Hare, 2014).

#### **4.2 Analysis of the Income Tax Act and other legislation**

A revision of the Income Tax Act No. 58 of 1962 (The Income Tax Act) dealing with the taxation of e-commerce transactions and the digital economy has yet to be implemented. The current income tax laws in South Africa show that South Africa's current approach is similar to that of the OECD. An analysis of the Act should indicate whether it is currently adequate to deal with the issues of taxing e-commerce.

Presently, e-commerce transactions between two residents of South Africa do not pose a unique threat to SARS' tax collection on these revenues. This is because if a taxpayer is a resident, the taxpayer is taxed on worldwide income, which will incorporate all income, regardless of the source. However, when a South African resident transacts with a non-resident, several issues arise. These concerns are similar to those already identified, being residency, permanent establishment and source of the income arising from e-commerce transactions.

##### **Residency:**

A resident is defined in section 1 of the Income Tax Act as any natural person who is ordinarily resident in the Republic or, if not, meets specific requirements of a 'physical presence test'. For a company, the Income Tax Act defines a resident as 'any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic (Income Tax Act, 2015).

The term 'place of effective management' is not defined in the Income Tax Act therefore SARS looks to the ordinary meaning of the words, while considering international precedent and interpretation. The term 'effective management' does not

have a universal meaning and countries around the world, as well as the OECD, attach different interpretations to the word. SARS has issued an interpretation clarifying that, while considering all the relevant facts and circumstances on a case-to-case basis, the general approach will be that 'the place of effective management is the place where the company is managed on a regular or day-to-day basis by the directors or senior management of the company, irrespective of where the overriding control is exercised, or where the board of directors meets' (South African Revenue Services, 2002).

Although the interpretation of the place of effective management differs slightly from that of the OECD and other international interpretations, some of the underlying issues that arise from e-commerce are still present in both interpretations. However, the ability to avoid being defined as a place of effective management, by using technologies such as video conferencing, has been hindered by this interpretation (Cox et al., 2013). This is because the day-to-day, routine transactions generally need to be made where the operations of the business are occurring. However, the virtual nature of internet companies could still cause the artificial avoidance of being defined as a permanent establishment due to lack of physical presence in the Republic.

#### **Permanent establishment:**

The issues around establishing a permanent establishment are identical to those identified by the OECD. This is because a permanent establishment is defined in section 1 of the Income Tax Act (2014/2015) as 'a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation of Economic Co-operation and Development'.

#### **Source:**

Section 9 of the Income Tax Act (2015) determines which receipts and accruals are derived from a source within South Africa as well as stipulating those derived from a source outside South Africa. Section 9(2)(a)-(l) describes amounts received by or accrued to the taxpayer that are from a source within South Africa. These define the source relating to the income received in the form of: local dividends; interest; royalties; payments for imparting scientific, technical, industrial or commercial knowledge or information; payment for services rendered on behalf of certain resident employers; receipts of any lump sums, pensions or annuities in respect of services rendered within South Africa; sale of immovable property; sale of assets other than immoveable property and exchange differences (Income Tax Act, 2015).

If certain income does not fall within these sections in the Act, a taxpayer must look to case law in order to determine the source of the income. Under the case of CIR v Lever Brothers and Unilever Ltd 1946, in order to determine the source of income, the taxpayer must first establish the *quid pro quo* given in return for what the

taxpayer has supplied. The source of the income is then determined by identifying the originating cause of the income is and then determining where that originating cause is located (The Appellate Division, 1946). The *Black v CIT* case indicated that the source of the income is determined by considering where the dominant or main or substantial cause of income originated (Young, 2012).

When applying the principles established by these cases to e-commerce transactions, neither the issue around income classification nor around source is solved. This is because the originating cause of the income could be from a service provided over the internet or an intangible good supplied. Therefore determining the location of this cause may be a challenge, as the internet has no specific location.

There are no other interpretation notes to the Income Tax Act that reference the internet. There are also no cases regarding source or residency relating to the internet (South African Revenue Service, 2015). This suggests that South Africa needs to look towards developing an approach to this issue, either by adopting the views of the OECD or developing an independent approach.

#### **4.3. Davis Committee opinions and suggestions**

The Davis Committee recognises the need for South Africa to address the issues of base erosion and profit shifting. The committee has issued an interim report regarding the OECD's action plan on Base Erosion and Profit Shifting (BEPS). The report does not specifically deal with the taxation of the digital economy, but rather considers the entire BEPS action plan in a South African context. The taxation of the digital economy is action one of fifteen actions in the plan (OECD, 2013). The committee identifies the challenges that arise around the amendment of taxation policies. This is because tax policy changes could produce unintentional distortions on cross-border trade, which could disadvantage domestic businesses (Jardine et al., 2014). The committee also recognizes the OECD's warning to be wary of taking unilateral action that may lead to multiple taxation, causing South Africa to become a less attractive country for foreign direct investment (Jardine et al., 2014).

The Davis Committee notes that although South Africa is not a member of the OECD, Section 233 of the Constitution states 'when interpreting legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law' (Jardine et al., 2014). This suggests that South African law should consider the views of the OECD and other international policies when creating policy regarding the issue of the taxation of the digital economy. The Davis committee emphasizes that South Africa needs to be aware of its position in the global market as an emerging economy and create tax policies that will allow the country to be a good platform for future economic growth, development and investment into South Africa and the rest of Africa (Jardine et al., 2014).

#### **4.4 The total size and stage of development of the virtual economy in South Africa**

Director of the International Telecommunication Union (ITU), Brahima Sanou, states that 'technological progress, infrastructure deployment, and falling prices have brought unexpected growth in ICT [information and communication technologies] access and connectivity to billions of people around the world' (International Telecommunications Union, 2015). According to the ITU world facts and figures of 2015, the number of internet users in developed countries has increased from 300 million users in 2005 to 1 billion in 2015, whereas the internet users in developing countries has increased from 100 million to 2.2 billion, respectively (International Telecommunications Union, 2015). This demonstrates the immense growth of the digital world and its infiltration into the world's population and business processes. Since 43% of the world's population has access to the internet, there is still potential for growth in the digital economy in the future (International Telecommunications Union, 2015).

According to Internet Live Statistics (2015), 46.88% of South Africa's population has access to the internet, representing growth of 14% from 2013. The largest growth in internet penetration in a country from the year 2013 to 2014 was 17% in countries such as Uganda, Angola and Zimbabwe and 16% in countries such as Kenya, Mozambique and Madagascar (Internet Live Statistics, 2014). This shows the degree of internet penetration that gives the South African population access to e-commerce transactions and the significant growth of this in developing countries in Africa. This suggests that the size of the e-commerce market in South Africa is continuing to grow and the digital economy is potentially becoming of greater importance to policymakers within South Africa. Therefore, even if e-commerce transactions have not eroded South Africa's tax base immensely in the past, there is great potential for this to become a large issue in South Africa, and may cause the country to forgo an opportunity to increase its tax revenue.

#### **5. Area for future research**

As stated above, implementing and developing separate tax laws could create a greater burden on compliance and an increase in costs (Zodrow, 2003). An analysis on the cost-benefit of developing the laws, communicating them to taxpayers, including remote sellers and collecting the tax could be performed.

#### **6. Conclusion and recommendations**

Some countries automatically adopt the OECD views, while others either adopt an independent view that parallels that of the OECD, intentionally elect an alternative route or believe their current system to be adequate to deal with the issues under consideration. The US, Australia and Canada have elected not to follow the view of the OECD. The US believes that more stringent enforcement of their current tax laws should be adequate to tackle the issue. Canada has not taken much action towards

solving the issues of digital taxation, its only action being an update of the legislation around declaring income from certain internet businesses. Australia intends to review its existing laws and improve enforcement of its current tax system. Both New Zealand and the UK have each chosen to implement systems that use the OECD as a guide, but are independent of the OECD's views, focusing on different aspects of both current and new laws.

South Africa's approach, to date, has been to follow that of the OECD, adjusting its approach to suit the SA environment more appropriately (Jardine et al., 2014). South Africa's green paper issued in 2000 shows its commitment to keep up with worldwide policymakers regarding this issue. South Africa's reactions to the issues around the taxation of the digital economy have been similar to those of other countries such as New Zealand and the UK. South Africa has followed the views and changes of the OECD, almost automatically adopting its views around some issues in the digital economy.

It is recommended that South Africa continue to follow the actions of the OECD, as well as those of the UK, US, New Zealand and Australia, in order to develop a sound understanding of the issues around the taxation of e-commerce, as well as to keep constantly updated with new developments. By closely following the actions of the OECD and constantly commenting on these developments, South Africa can slowly start to develop policies that will be consistent with the goals of the country's taxation policies. South Africa should not rush the development of these policies that could create a unilateral response to the issue, causing a strain on competition and a disadvantage for local businesses, but should rather consider the value that could be created by developing an internationally coordinated approach (Jardine et al., 2014).

In line with the OECD's Model Tax Convention, South Africa should continue to update its interpretation notes and other tax legislation in order to slowly integrate the taxation of the digital economy into tax policies. Although this may be a slow approach to tackling this issue, it will allow e-commerce to contribute to the tax base of the country in the medium to long term, as well as encourage entrepreneurship and development of industry.

If South Africa considers its options, in line with developments from the OECD, and creates an approach in cooperation with other international countries, the issue of taxing the digital economy can be addressed, while also creating new or strengthening old relationships with countries in the worldwide economy.



## **References**

- Ault, H. J., & Arnold, B. (2004). *Comparative Income Taxation: A Structural Analysis* (2<sup>nd</sup> ed.). The Hague: Kluwer Law International.
- Azam, R. (2007). E-commerce taxation and cyberspace law: The integrative adaptation model. *Va. JL & Tech.*, 12, 1..
- Azam, R. (2013). Global Taxation of Cross-Border Ecommerce Income. *Virginia Tax Review*. 31(4).
- Bitcoin Foundation. (2015). Bitcoin is an innovative payment network and a new kind of money. Retrieved May 29, 2015, from <https://bitcoin.org/en/>
- Bruce, D., Fox, W., & Murray, M. (2003). To tax or not to tax? The case of electronic commerce. *Western Economic Association International*, 21(1), 25–40.
- Cadesky, M., Rinninsland, R., & Lobo, K. (2014). The U.S. View on BEPS. Presented to AOTCA 2014 Conference October 2014, (October).
- Canada Revenue Agency. (2015). Reporting Internet business activities. Retrieved May 29, 2015, from <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/cmm/ncm/wbncm-eng.html>
- Chan, C. W. (2000). Taxation of Global E-Commerce on the Internet: The Underlying Issues and Proposed Plans. *Minn J Global Trade*, 9, 233.  
<http://doi.org/http://www.winthrop.com/Portals/0/PDF/claytonchan.pdf>
- Cockfield, A. J. (2006). The Rise of the OECD as informal “World Tax Organization” through national responses to e-commerce tax challenges. *Yale Journal of Law and Technology*, 8(1), 137–187.
- Commissioner for Inland revenue vs Lever Brothers & Unilever Ltd 1946 AD 441
- Cox, N., Doernberg, R., & Hinnekens, L. (2013). Addressing Base Erosion and Profit Shifting in South Africa. *Davis Committee Interim Report*, (2001), 1–56.
- Department of Communications Republic of South Africa. (2000). *Green paper on electronic commerce for South Africa*. Retrieved from <http://www.info.gov.za/view/DownloadFileAction?id=68917>
- Estor, L. (2014). BDLive - SA must not miss out on e-commerce tax revenue, says Davis Committee.pdf. *BDLive - Print Article*, 1–2.
- Google. (2015). About Google. Retrieved May 30, 2015, from <http://www.google.com/about/>
- HM Treasury, & HM Revenue & Customs. (2014). *Tackling aggressive tax planning*

*in the global economy : UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting.*

- Income Tax Act, No 58 of 1962, as amended. (2016). *SAICA Student Handbook 2015/2016*, Vol. 3. Cape Town: LexisNexis.
- Inland Revenue. (2004). E-commerce and income tax. Retrieved May 29, 2015, from <http://www.ird.govt.nz/ecommerce-tax/ecommerce-incometax/>
- International Telecommunications Union. (2015). *Facts & Figures*.
- Internet Live Statistics. (2014). Internet users by country (2014). Retrieved July 18, 2015, from <http://www.internetlivestats.com/internet-users-by-country/>
- ITFA Coalition. (2015). About the Internet Tax Freedom Act Coalition. Retrieved May 30, 2015, from <http://itfacoalition.org/>
- Jardine, M., Owens, J., & Sanger, C. (2014). Addressing Base Erosion and Profit Shifting in South Africa. *Davis Committee Interim Report*, 1–39.
- Lau, C., & Halkyard, A. (2003). From E-Commerce to E-Business Taxation. *Asia-Pacific Tax Bulletin*, (January 2003), 2–13.
- Laursen, A. N. (2010). Permanent Establishment – an Analysis of Article 5 of the OECD Model Tax Convention, 94(2009).
- Lee, S.-H. (2006). Price Competition between online and offline firms in an electronic commerce market and discriminatory taxation. *Hitotsubashi Journal of Economics*, 47, 37–49.
- McClure, C. E. (2015). National Tax Association. *National Tax Journal*, 50(4), 731–749. Retrieved from <http://www.jstor.org/stable/41789713>
- OECD. (2001). *The Impact of the Communications Revolution on the Application of “Place of Effective Management” As a Tie Breaker Rule*. Retrieved from <http://www.oecd.org/ctp/treaties/1923328.pdf>
- OECD. (2002). *Measuring the Information Economy*. Retrieved from <http://www.ingentaconnect.com/content/oecd/16080270/2002/00002002/00000014/9202151e>
- OECD. (2003). Articles of the model convention with respect to taxes on income and on capital. *OECD Model Tax Convention*, (January).
- OECD. (2013). Action Plan on Base Erosion and Profit Shifting. *OECD Publishing*, 43. Retrieved from <http://doi.org/10.1787/9789264202719-en>
- OECD. (2014). Public Discussion Draft BEPS action 1: Address the tax challenges of

the digital economy. *Public Discussion Draft*, (April). Retrieved from <https://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf>

OECD. (2015). South Africa and the OECD. Retrieved July 18, 2015, from <http://www.oecd.org/southafrica/south-africa-and-oecd.htm>

OECD Committee on Fiscal Affairs. (2000). *Clarification on the application of the Permanent Establishment definition in E-Commerce: Changes to the Commentary on the Model Convention on Article 5*.

Parsons, S. (2014). What is Bitcoin? The potential tax consequences of transacting in virtual currency in South Africa. *Southern African Accounting Association 2014 annual conference*.

South African Revenue Service. (2002). *Interpretation Note: No.6: Resident: Place of effective management (persons other than natural)* (Vol. 1962).

Strydom, B., & Hare, R. (2014). South Africa's VAT changes: the impact on e-commerce, (February), 16.

The Australian Government Treasury. (2013). *Risks to the Sustainability of Australia's Corporate Tax Base*.

Young, N. (2012). The Effect of Global E Commerce on Taxation Legislation and The Permanent Establishment Concept in South Africa. *International Journal of Economics and Finance*, 3, 10–12.

Zodrow, G. R. (2003). Network Externalities and Indirect Tax Preferences. *Kluwer Academic Publishers*, 79–97.

**2016 Southern African Accounting  
Association (SAAA)  
National Teaching and Learning and  
Regional Conference Proceedings**

ISBN number: 978-0-620-74761-5



---

**TAX 04: Has the changing research and development  
taxation legislation affected research and development  
output in South Africa?**

**Riley Carpenter  
University of Cape Town**

**ABSTRACT**

National Treasury and the South African Revenue Service introduced section 11D into the Income Tax Act No. 58 of 1962 in the 2007 Taxation Laws Amendment Act, effective from November 2006. This section incentivises investment in research and development through an attractive tax regime for qualifying expenditure. Since section 11D's introduction into the Income Tax Act, it has undergone multiple amendments. These amendments have attempted to meet the section's objective of higher domestic productivity, economic growth, increased employment levels and better skills development through creating a more robust definition of research and development, improving the innovative nature of research and development and shifting the focus to more scientific and technological pursuits. The objectives as defined in the Explanatory Memorandum on the Taxation Laws Amendment Acts have been met, but evidence from the Department of Science and Technology and the South African Revenue Service indicate that research and development output has increased only marginally, and may have been significantly lower had there been no tax incentive.

**Keywords:** income tax, taxation, research and development, section 11D, innovation, National Survey of Research and Experimental Development, Department of Science and Technology

## INTRODUCTION AND RESEARCH OBJECTIVE

Section 11D<sup>33</sup> of the South African Income Tax Act No. 58 of 1962 (“the Income Tax Act”) has been a topical issue over the past few years. This is due to the potentially large tax incentive for research and development (“R&D”) that it affords the taxpayer, the number of amendments the section has undergone since it was introduced into legislation and its relevance to the general shift in business towards a more knowledge-based economy.

The changes that have occurred in the last few amendments to the Income Tax Act affect the operation of the tax incentive regime and shed clarity on issues where the intention of the legislation was not coming to pass in practice. The R&D Tax Incentive is supposed to support economic growth through innovation promotion and competitiveness enhancement (Department of Science and Technology, 2016b).

But have the objectives of the tax incentive regime been met and is there a greater output of R&D expenditure since its introduction?

There are reports which provide information regarding the R&D output in South Africa. These reports could be used to provide further insight into R&D.

The annual survey results from the National Survey of Research and Experimental Development, conducted on behalf of the Department of Science and Technology by the Centre for Science, Technology and Innovation Indicators at the Human Sciences Research Council provide some insight into whether the broader economic objectives of the legislation are being met.

The Tax Statistics, an annual joint publication between National Treasury and the South African Revenue Service (“SARS”), provides clarity on how companies’ profitability is forever changing (South African Revenue Service, 2016). This includes the statistics of the companies in the research and scientific institutes sector.

The annual Report to Parliament on the Performance of the Research and Development Tax Incentive Programme provides statistics on the uptake of the R&D tax incentive programme, tax revenue forgone, expenditure on R&D and the number of R&D personnel (Department of Science and Technology, 2015).

---

<sup>33</sup> All references in this paper to sections refer to sections of the South African Income Tax Act No. 58 of 1962 (as amended)

## RESEARCH METHOD

A literature review was performed on section 11D of the Income Tax Act and its specific amendments. These amendments are then assessed as part of a doctrinal study to determine whether they are in line with the objectives of the legislation.

The success of any tax incentive is difficult to measure. The section 11D R&D Incentive was introduced into the Income Tax Act, on 2 November 2006.

The reports mentioned above were analysed to identify the changes in R&D output over time:

- The National Survey of Research and Experimental Development, from 2007 to 2014<sup>34</sup>,
- The Tax Statistics, from 2007 to 2014<sup>35</sup>, and
- The Reports to Parliament on the Performance of the Research and Development Tax Incentive Programme, from 2007 to 2015.

## LIMITATIONS OF THE RESEARCH

This paper focuses on section 11D of the Income Tax Act (as amended). Its predecessor, section 11B was effective for years of assessment commencing on or after 1 January 2004 until it was repealed when section 11D replaced it on 2 November 2006. Section 11B applied to R&D performed by the taxpayer.

The R&D Tax Incentive measures analysed are focused on the increase in R&D, and not for what reason the incentive and expenditure is being used. The types of research output have not been specifically identified.

Had there been no tax incentive, businesses may not have incurred the expenditure on R&D. The paper does not investigate whether the business expenditure on R&D would have remained the same had there been no tax incentive. No research on this topic has been performed in South Africa to date (Köhler, Laredo, & Rammer, 2012).

---

<sup>34</sup> The latest R&D Survey, published on 24 May 2016.

<sup>35</sup> The 2015 Tax Statistics, published in November 2015, includes data up till the 2014 tax year.

## THE LEGISLATION

### Definition

The section 11D R&D Incentive was introduced into the Income Tax Act, in 2006 to replace the previous R&D rule that existed in terms of section 11B.

The Taxation Laws Amendment Acts promulgated in 2011 and 2013 contained several changes and enhancements to the legislation with respect to the R&D incentive that is available to taxpayers. A pre-approval process for R&D activities undertaken after 1 October 2012 was included. Prior to this date, only retrospective approval could be given.

One of the main objectives of the amendments to section 11D was to ensure that the definition of R&D is more robust, and requires the activities that qualify for the incentive to be innovative in nature (National Treasury, 2013). This was reflected in the various additions to the definition, as well as the stylistic changes and reorganisation of the subsections within section 11D, as detailed below.

The definition of R&D in section 11D(1) is three-fold, with the first part relating to discovery, creation or development, the second relating to improvements and the last part to medical research (creating or developing a product or conducting a clinical trial). The newer versions of the definition have introduced the requirement of “systematic investigative or systematic experimental activities of which the result is uncertain...” (National Treasury, 2013) to be applicable to both parts of the R&D definition as opposed to only the first part as it was in the 2011 amendment. The Taxation Laws Amendment Act (2013), promulgated on 12 December 2013, contained medical research subsections 11D(1)(d) and (e) which included the creating or developing of a multisource pharmaceutical product and conducting a clinical trial.

R&D activities should lead to the creation or development of an invention, functional design, computer program or knowledge essential to the use of these items. The latter activity has been clarified to exclude “creating or developing operating manuals or instruction manuals or documents of similar nature...” (National Treasury, 2013) to ensure that the outcome of the R&D is not only an integral part of the intellectual property that has been created, but also that such intellectual property should be intended for a more expansive use than the internal business operations of that entity or a connected person (Taxation Laws Amendment Act, 2013).

Both of the above amendments to the definition show an increased emphasis on innovation for the purpose of the incentive, as well a move towards R&D activities which have a scientific or technological focus.

## Research and development exclusions

In previous amendments, expenditures which were disallowed for the purpose of the R&D deduction were detailed in section 11D(8). The revised definition of R&D in section 11D now encompass these exclusions within the *proviso*, with two minor changes. The exclusions now forming part of section 11D(1)'s *proviso* indicate that the expenditure should be viewed by the taxpayer as falling outside the scope of the definition of R&D as opposed to a prohibition of a deduction.

The section 11D(1) *proviso* (b) relating to the development of internal business processes has now been expanded to clarify that no deduction shall be allowed for such expenditure unless those business processes are intended for use by persons "who are not connected parties in relation to the person carrying on that research and development" (Taxation Laws Amendment Act, 2013). This further emphasises the intention of the legislature to incentivise the creation of intellectual property which is intended for sale to or use by third parties in relation to the taxpayer that carried out such R&D.

The other change relates to overhead and indirect costs which may be incurred in the process of R&D, such as financing and administrative costs, are not included in the *proviso*'s but disallowed in terms of section 11D(2)(b)(ii). Such expenditures do not form part of an activity that is outside the scope of the definition, but are instead a denial of the deduction as detailed in that subsection, and thus the movement.

## Research and development deduction

Prior to the promulgation on 12 December 2013 of the Taxation Laws Amendment Act of 2013, section 11D(2) provided for an automatic deduction of 100% of qualifying expenditure that is incurred by the taxpayer in respect of R&D. This deduction could be claimed by such taxpayer without pre-approval provided that the expenditure is incurred solely and directly in respect of R&D activities which are undertaken in the Republic, are incurred in the production of income and in carrying on of any trade (National Treasury, 2012). Taxpayers could then potentially receive an additional deduction of 50% of the original qualifying expenditure if the expenditure is approved by the adjudication committee of the Department of Science and Technology, and the expenditure was incurred in respect of R&D activities that were undertaken on or after the date of receipt of the application for approval by the Department of Science and Technology (National Treasury, 2012).

An objective of the revised incentive regime, as stated in the Explanatory Memorandum on the Taxation Laws Amendment Bill (2013), is to align the previously separate 100% and 50% deductions. It was noted during the approval process that taxpayers had taken the view that expenditure which met the definition



of R&D in section 11D(1) would automatically receive the 50% additional deduction, while it was intended that the approval process for the uplift (additional deduction) should require further effort on the part of the taxpayer to ensure that the R&D activities which ultimately are subsidised by the government are those which would not have occurred in the ordinary course of business (National Treasury, 2013). To this end, there have been numerous changes to the wording of the subsections which deal with the available deductions under the incentive. Importantly, there is no longer an automatic deduction, and section 11D(2)(a) of the new amendment to the Income Tax Act requires that the taxpayer apply and receive approval from the Department of Science and Technology in order to be afforded a deduction of the full 150% of qualifying expenditure incurred on R&D activities which are undertaken after the date of successful application (National Treasury, 2013). The requirements that the expenditure be incurred directly and solely in respect of R&D activities undertaken in the Republic, in the production of income and in the carrying on of any trade have remained unchanged in section 11D(2)(a).

### **Disallowed deductions**

The 2011 amendment to section 11D made no reference to items which are capital in nature and the potential deduction available in respect of such expenditures. As it stands, all expenditures on R&D activities are thus deductible provided that they meet the requirements within section 11D. While it is understandable that R&D activities which may culminate in a capitalised asset are deductible (since entities may undertake R&D for the purpose of developing an intangible asset that will be sold to, or the right of use granted to, third parties), this left open the possibility that capital assets such as plant, machinery and immovable property could qualify for the deduction under section 11D notwithstanding that they are provided for in sections 12C and 13(1) of the Income Tax Act.

While R&D expenditure that is of a capital nature is still deductible in terms of the 2013 Tax Laws Amendment Act, the proposed relief has dealt with the capital assets ambiguity in section 11D(2)(b) which states explicitly that no deduction is allowable under the section for “expenditure incurred in respect of immovable property, machinery, plant, implements, utensils or articles excluding any prototype or pilot plant...” (Taxation Laws Amendment Act, 2013). This section also disallows any deduction for financing, administration, compliance and similar costs. These costs were previously dealt with under the list of excluded items in section 11D(8), which have now been incorporated into the definition of R&D as discussed above.

## **Accelerated capital allowances under section 12C and section 13(1) of the Income Tax Act**

Given that section 11D(2)(b) has disallowed the deduction of plant, machinery and immovable property and related expenditure, the taxpayer is only allowed to seek relief in the other sections of the Income Tax Act where accelerated capital allowances for these items are provided for, namely section 12C and section 13(1). There had been some ambiguity in the rates applicable in section 12C, but this was remedied in the 2013 amendment. Section 12C(1) *proviso* (d) provides for an accelerated allowance of 50%, 30% and 20% in three successive years.

Section 13(1)(b), (d), (dA) and (e), through the inclusion of the R&D option on top of a process of manufacture, permits the taxpayer an allowance on buildings used for R&D.

## **Third party funding of research and development activity**

The requirements and allowable deductions in section 11D(4) for taxpayers who incur expenditure to fund R&D of another entity who undertakes such R&D on behalf of the entity that provides the funding has not changed, in effect, in the last two amendments to the section.

In the last three amendments of the legislation, the party who funds the R&D is entitled to the deduction allowable (i.e. 150%) provided that the R&D activities are approved by the Minister of Science and Technology, the expenditure is incurred by the party who receives the funding to undertake such R&D activities after the date of receipt of a successful application by the Department of Science and Technology, and to the extent that the party who carries out the R&D is exempt from normal tax under section 10(1)(cA) or is a company forming part of the same group of companies as defined in section 41, which has not claimed the deduction itself.

To the extent that the party that undertakes the R&D forms part of the same group of companies that funds such R&D, the deduction available to the funding company is limited to 150% of the expenditure actually incurred by the party undertaking the R&D, directly and solely for the purpose of R&D (National Treasury, 2012). This effectively eliminates the possibility of the funding party deducting any profit element which is charged to them by the party who carries out the R&D activities. This section 11D(2)(a) has been amended in the latest amendment of the legislation in order to align all deductions and allowances with the 150%. The previous percentage under section 11D(3), which has since been deleted, was 50%.

Given that section 11D(2) grants the taxpayer who undertakes R&D the potential deduction under the incentive, and section 11D(4) grants the deduction to the party

who funds the R&D in the event that it is carried out by another party on behalf of the funder, section 11D(6) has clarified which party shall be considered the party to undertake or carry out the R&D activities.

A person who is carrying on R&D is the person who has control over the R&D process by virtue of possessing the ability to determine or alter the methodology in terms of which the R&D is carried out (Köhler et al., 2012).

The section 11D(6)(b) amendment has broadened the scope of the above by allowing the Minister of Science and Technology to designate certain categories of R&D by way of government regulations which will be published in the Government Gazette (Taxation Laws Amendment Act, 2013). While the above rule regarding the research methodology will provide sufficient guidance in most circumstances, there are certain instances where complexities arise, and it is submitted that it is for this reason that the legislature has afforded the Minister of Science and Technology this outlet (Department of Science and Technology, 2016b).

The amendment to section 11D(6)(b) has also made it clear that while the incentive is only available for R&D activity undertaken within South Africa, the activities that are taking place within the Republic must have some level of significance to the R&D endeavour as a whole (National Treasury, 2013). This speaks to the overall intention of the taxation legislation, noting that it is intended to encourage local skills development, and this can only occur if some significant activity occurs in South Africa (National Treasury, 2013).

There may be some exceptions to the above in the pharmaceuticals and Information and Communications Technology (ICT) sectors given the nature of the operations of these sectors (National Treasury, 2013). This further highlights the necessity to amend the section to allow the Minister of Science and Technology the power to prescribe criteria by which one can evaluate which types of R&D will be eligible for the incentive. It is expected that more guidance will be provided in the regulations regarding the pharmaceuticals and ICT sector specifically (National Treasury, 2013).

### **Government and quasi-governmental funding**

In terms of previous legislation, where an amount was received by way of a government grant, such amount was not eligible for a deduction under the additional uplift incentive (the extra 50%) provided for in section 11D. This is intended to prevent double dipping by virtue of the grant being exempt in the hands of the recipient while still allowing an additional deduction to the taxpayer (National Treasury, 2012).

Given that the purpose of the introduction of the incentive regime was to encourage private sector funding of R&D activity, the application of this limitation in respect of government grants was thought to be too narrow (National Treasury, 2013). The 2013 amendment thus broadened this provision to be applicable to not only exempt government grants, but also funding received from any quasi-governmental agency such as a public entity which is listed under schedule 2 or 3 of the Public Finance Management Act No. 1 of 1999 or a municipality. Under the current legislation, which has not changed for section 11D(7), should funding be received from any of the above entities, the 150% deduction shall not be available to the taxpayer to the extent of such funding.

### **Withdrawal of approval**

Under previous legislation, section 11D(10) allowed for the withdrawal of the approval that has been granted in terms of section 11D if the taxpayer had failed to disclose any material facts that may have had an effect on the approval process if they had been known at the time it was granted, or if the taxpayer should fail to submit any of the reports that are required under section 11D.

The 2013 amendment extended the criteria for withdrawal of approval to include the following circumstances: “the taxpayer on that R&D is guilty of fraud, or misrepresentation or non-disclosure of material facts which would have had the effect that approval under section 11D(9) would not have been granted” (Taxation Laws Amendment Act, 2013).

### **Administrative provisions**

There have been various changes to the administrative subsections of section 11D. Section 11D(9) deals with the approval process of the R&D Incentive, and has been amended to allow a person who has been appointed by the Minister of Science and Technology to approve the applications as opposed to this being the responsibility of the Minister alone. Previously, the Minister of Science and Technology would consider the innovative nature of the R&D, the extent to which it will require specialised skills and other criteria which is prescribed by them in making the decisions regarding approval. These aspects have been encompassed within a more robust definition of R&D and the Minister of Science and Technology (or appointed individual) must consider whether the R&D complies with the criteria that is set out in the definition of R&D under section 11D(1), or alternatively the criteria which has been prescribed by the Minister of Finance in consultation with the Minister of Science and Technology.

Section 11D(13) requires that the taxpayer who has been granted approval report to the committee (as required by section 11D(11)) on an annual basis, within 12 months of the end of the year of assessment of the taxpayer, to present the progress of the R&D Incentive to date. In addition to this requirement, section 11D(13) requires that the approval report to the committee should also detail “the extent to which that research and development requires specialised skills” (Taxation Laws Amendment Act, 2013). This requirement was previously consideration for the granting of approval, and again speaks to the intention of the legislation to enhance skills development in the Republic (National Treasury, 2012).

Section 11D(14) has been amended to allow the Commissioner for SARS (Commissioner) to disclose to the Minister of Science and Technology any information in relation to the R&D activities of a taxpayer, if that information is material with regard to either the granting of approval for the tax incentive or the withdrawal of approval by the Minister.

Section 11D(16) has been amended to allow a person appointed by the Minister of Science and Technology (in addition to the Minister) to provide written reasons for the approval or withdrawal of approval, as well as to service the Commissioner with information regarding the granting of approval, the withdrawal of approval and the date on which such events take effect.

The other changes that have been made to section 11D are stylistic and grammatical in nature.

## **THE OBJECTIVES OF SECTION 11D**

Through an analysis of the amendments to taxation legislation as stated in Explanatory Memorandums on the Taxation Laws Amendment Bills, an assessment can be made as to whether the theoretical objectives of the R&D Incentive have been met. The improvement in R&D in the South African economy must then be measured and an assessment of whether the overall objective of the introduction of section 11D into legislation has been met can be made.

The overriding objectives of section 11D are higher domestic productivity, economic growth, increased employment levels, increased taxable income and better skills development. The Department of Science and Technology introduced the 150% deduction incentive to motivate R&D in the business sector to help promote national competitiveness (Department of Arts, Culture, Science and Technology, 2002).

While all of these still hold, the Explanatory Memorandum on the Taxation Laws Amendment Bill (2013) states the following:

*“The existing research and development tax incentive regime has been revised to achieve the following main objectives:*

1. *To align the 100% and the 50% deductions.*

*The additional uplift was intended to force the taxpayer to put in extra effort to obtain the additional allowance through an application process, and not assume an automatic uplift if the definition was met. Since this was not occurring as intended, the application must now be for the full 150%.*

2. *To ensure a more robust definition of research and development, requiring that research and development for the purpose of the incentive will be innovative in nature.*

*This was necessary as the prior policy of the 50% uplift potentially allowed for the claiming of expenditure which was never intended to fall within the ambit of the section.*

3. *To simplify and streamline the legislation for ease of use.”*

The first stated objective has been met. The change in the wording of the legislation will ensure that it is achieved by forcing taxpayers to apply for the full 150% deduction. The revision of the definitions in section 11D(1) as well as the other changes previously discussed have the potential to ensure that R&D activities that are undertaken are more innovative in nature. However, given this amendment's recent date of promulgation (12 December 2013) and the lack of research survey data, there is no evidence on which to base an assessment of this issue. Therefore, a limited assessment of whether or not the latest amendment has been simplified and streamlined must be performed.

There are recurring issues in the previous legislation that were considered pitfalls of section 11D from the perspective of the taxpayer. These include the following:

- The interpretation and implementation of section 11D requires extensive knowledge of not only tax law but also intellectual property law (Strauss, 2011).
- There is contention with regards to the application of the section to the development of computer programmes. This is related to the fact that SARS is of the view that computer programmes which automate internal business processes or create management efficiencies do not qualify for the deduction even if such programmes are for sale to third parties. This excludes most software development companies from the claiming the deduction (Strauss, 2011).
- Interpretation Note 50, released by SARS in 2009, on the topic of R&D (and which was needed by taxpayers due to the difficulty in interpretation and implementation as mentioned above) has been highly criticised (Strauss, 2011). It has been said that it is at odds with the Frascati Manual issued by

the Organisation for Economic Co-operation and Development (OECD), and widely accepted as best practice on the subject. The interpretation note has also been criticised for misinterpretations of well-established legal principles, particularly with regard to the concept of “novelty” (Strauss, 2011). The first issue has been specifically addressed in the new taxation amendment, and given the changes to the definitions and arrangement of the section it is possible that the interpretation of the section will be less onerous. The definitions and details pertaining to software development have also been updated in the new amendment, although some of the issues regarding internal business processes are likely to remain. Finally, there has not been an updated interpretation note on R&D, but the concept of novelty has been removed from the latest amendment to the section.

## **MEASURING RESEARCH AND DEVELOPMENT**

Prior to the introduction of section 11D, the applicable legislation in respect of R&D was contained within section 11B, which has since been repealed. The initial draft of the original section 11D was proposed in October 2006, enacted in February 2007, and came into operation on 2 November 2006. As discussed above, it has been amended numerous times since the date it was passed into law, with the first amendment occurring in February 2007. This is expected to continue until the objectives of the section have been met (Strauss, 2011). The intentions and objectives of the introduction of the section can be assessed through review of the National Surveys of Research and Experimental Development, published by the Department of Science and Technology.

### **The overall objective of the introduction of section 11D**

It is recognised that innovation and technological advancement are key factors in the pursuit of higher productivity within a country. South Africa is no different, and with enhanced productivity, there is the potential for higher economic growth and improved competitiveness on an international level (National Treasury, 2013). While many European and Asian countries have established themselves as specialists in various scientific and technological fields, South Africa has had to pay royalties to these foreign nations as a result of the lack of innovation and advancement on its own shores (Williams, 2012). These are contributing factors which have caused National Treasury and SARS to incentivise investment in R&D through an attractive tax regime for qualifying expenditure.

In addition to the tax incentives provided by the government for R&D, there are currently a number of direct subsidies which will aid this cause. However, it is noted that the main objective of the current tax regime is to encourage private sector funding and expenditure on R&D (National Treasury, 2012). With this private sector



undertaking, South Africa hopes to encourage spending on R&D that would not have otherwise occurred in the normal course of business (National Treasury, 2013). Thus the effect of the incentive on the growth of R&D in the country can be measured by enhanced domestic productivity, economic growth, job creation, skills development and taxable income (National Treasury, 2013).

Section 11D(17) states that “The Minister of Science and Technology must annually submit a report to Parliament advising Parliament of the direct benefits of R&D in terms of economic growth, employment and other broader government objectives and the aggregate expenditure in respect of such activities without disclosing the identity of any person”. It is these reports by the Department of Science and Technology that will be analysed in determining the success of the incentive since its introduction in 2007.

According to the reports issued by the Department of Science and Technology, the National Survey of Research and Experimental Development is undertaken annually, and provides information on the sources of R&D funding, the amount of expenditure on R&D in institutional sectors as well as information regarding the human capital that is involved in these R&D activities (Department of Science and Technology, 2013). The survey is carried out in terms of the principles which have been set out in the Frascati Manual Guidelines (Organisation for Economic Co-operation and Development, 2002), which was developed by the OECD and is widely considered best practice on the subject matter (Department of Science and Technology, 2011). The primary data in the survey is sourced from various public and private sector organisations. In the public sector, data is collected from universities, science research councils as well as department based research institutes. Public sector institutions are normally not taxpaying entities anyway, so would not qualify for section 11D. In the private sector, the primary data providers are both non-profit organisations and profit making firms (Department of Science and Technology, 2008).

One of the key indicators that is calculated in the R&D report is the gross expenditure on R&D (GERD), and GERD as a percentage of Gross Domestic Product (GDP). Per the R&D report, the target of GERD:GDP reaching 1% by 2008 was set, however a new target of 1.4% by 2015 was set (Department of Science and Technology, 2008), and the new legislature intended for the amended R&D Incentive to help attain this goal.

Section 11D came into operation at the end of the 2007 fiscal year. While the amendment would have been known prior to this, it is submitted that the effect of the incentive would have had a minimal impact in 2007 and that growth in R&D from 2008 must be assessed and compared to the results of the latest available survey, being 2013/2014.



## The National Survey of Research and Experimental Development results

### Key indicators

TABLE 1: KEY R&D INDICATORS, SOUTH AFRICA, 2013/14 WITH COMPARATIVE FIGURES FOR 2007/08

KEY INDICATOR	VALUE	
	2007/08	2013/14
Gross domestic expenditure on R&D (GERD) (R million)	18 624	25 661
Gross domestic product (GDP) at current prices (R million)	2 002 580	3 534 326
GERD as a percentage of GDP (%)	0.93	0.73
Total R&D personnel (FTE)*	31 352	37 957
Total researchers (FTE)#	19 320	23 346
Total R&D personnel (FTE) per 1 000 in total employment	2.4	2.5
Total researchers (FTE) per 1 000 in total employment	1.5	1.6
Total R&D personnel (headcount)	59 344	68 838
Total researchers (headcount)	40 084	45 935

\* FTE = Full-time equivalent

# Following OECD practice, doctoral students and post-doctoral fellows are included as researchers

*Data source: South African National Survey of Research and Experimental Development, 2007/08, and South African National Survey of Research and Experimental Development Statistical Report, 2013/14*

### GERD

TABLE 2: GERD IN CONSTANT 2010 RAND VALUES

Year	Amount
	(R million)
2007/08	23 174
2008/09	24 057
2009/10	22 286
2010/11	20 254
2011/12	20 824
2012/13	21 213
2013/14	21 515

*Data source: South African National Survey of Research and Experimental Development Statistical Report, 2013/14*

GERD amounted to R25.661 billion in 2013/14. This represents an increase of 37.78% from R18.624 billion in 2007/08. R&D expenditure has been increasing nominally between 2001/02 and 2012/13 (Department of Science and Technology, 2013). However, as can be seen in Table 2, at a constant 2010 Rand value, GERD has decreased slightly (Department of Science and Technology, 2016a). Statistics South Africa (2014) revised and adjusted the GDP figures to 2010 Rand values. GERD has yet to reach its highest value, recorded in 2008/09 (Department of Science and Technology, 2016a).

### **GERD as a percentage of GDP**

For an international comparison, GERD expressed as a percentage of GDP can be used to compare countries' R&D. GERD as a percentage of GDP in South Africa was 0.73% in 2013/14. This ratio increased from 0.60% in 1997/98 and peaked at 0.95% in 2006/07 (Department of Science and Technology, 2011). However, there is no indication as to whether this movement was due to any tax incentives. GDP has increased at a higher rate than the nominal value of GERD until 2010/11, indicated by the decrease in GERD as a percentage of GDP. The rate has stayed relatively constant since 2010/11.

This indicates that the incentive objective did not come to pass in the 2007/08 period, which is in line with the expectation that a change in legislation will take time to filter to the economy. In light of the positive economic results discussed above, Mrs Naledi Pandor (the Minister of Science and Technology at the time) stated the following: "It does appear, from the R&D survey results, that both the investment in R&D and the growth in the number of researchers lagged these important developments. This observation requires careful analysis to determine appropriate policy responses in the future" (Department of Science and Technology, 2009). It is possible that these results were the driving force behind the numerous amendments that have followed since the inception of the tax incentive regime.

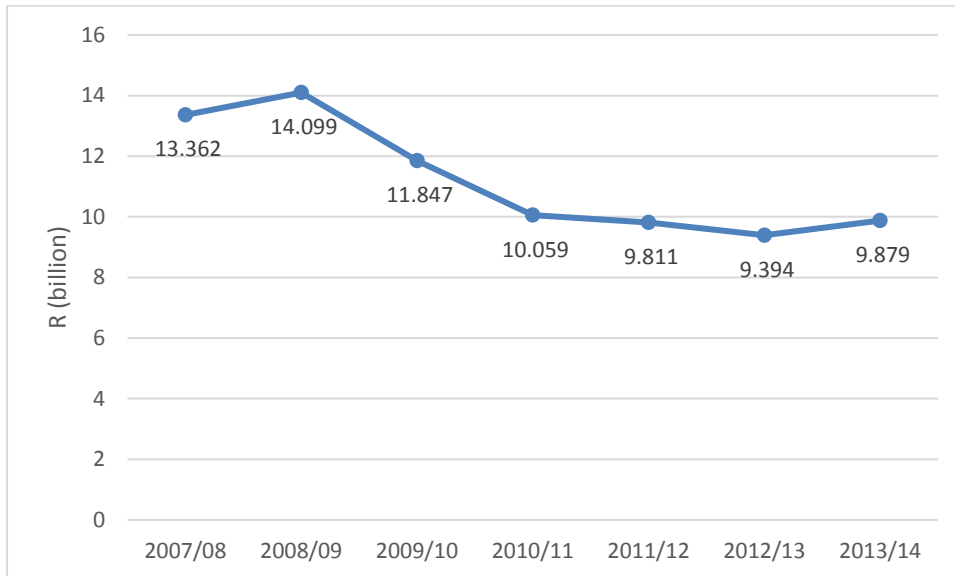
### **GERD by sector**

The National Survey of Research and Experimental Development reports GERD by five sectors: Government, Science Councils, Higher Education, Business and Not-for-profit (Department of Science and Technology, 2016a). The business sector is the only sector that would be affected by the R&D tax incentive.

Business expenditure on R&D amounted to R11.783 billion in 2013/14, equivalent to 45.9% of GERD. This is a 10% nominal increase from the R10.739 billion recorded

in 2007/08. This sector has remained the largest contributor to R&D expenditure in South Africa, in both nominal and constant 2010 Rand value terms.

FIGURE 1: BUSINESS EXPENDITURE ON R&D (R BILLION), SOUTH AFRICA, 2007/08 TO 2013/14 IN CONSTANT 2010 RAND VALUES



*Data source: South African National Survey of Research and Experimental Development, 2007/08 to 2013/14*

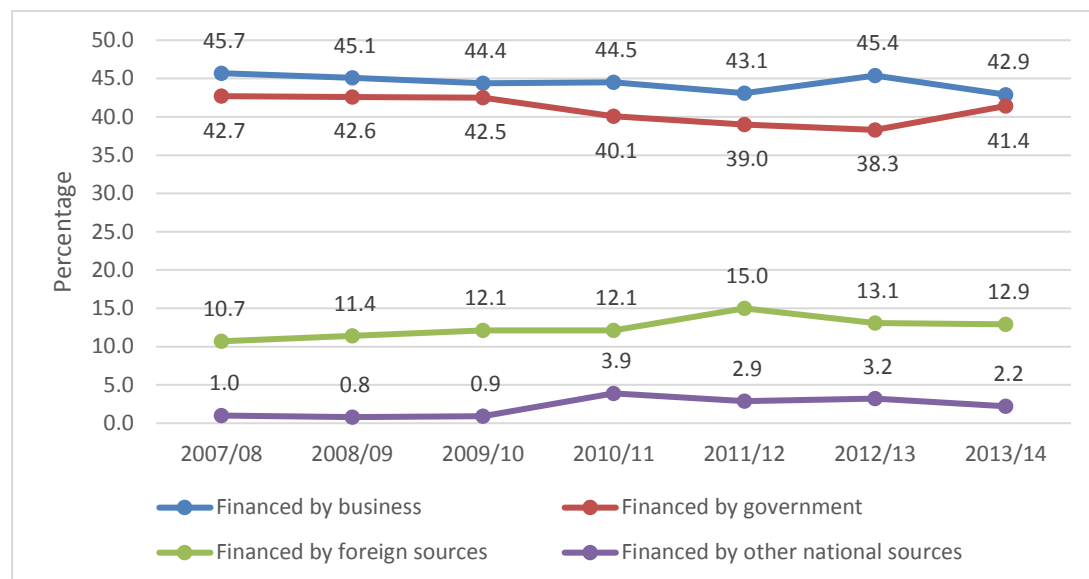
Figure 1 illustrates that in constant 2010 Rand value, Business expenditure on R&D has decreased 26% from R13.362 billion in 2007/08 to R9.879 billion in 2013/14.

The R&D Tax Incentive is supposed to change the behaviour of taxpayers, by stimulating additional investment over and above had there been no incentive (Guellec & De La Potterie, 2003). To the authors own knowledge, no published research has been performed in South Africa to determine whether the business expenditure on R&D would have remained the same had there been no tax incentive. International literature (Köhler et al., 2012) has indicated opportunity losses when government does not support private sector R&D, whereby short term tax revenue forgone is more than offset by long term economic benefits and efficiencies.

### GERD by sources of funds

R&D expenditure in South Africa is funded by business, government, foreign sources and other uncategorised South African sources. Government-funded R&D included all public funding for R&D received by the higher education, science councils, business and government departments.

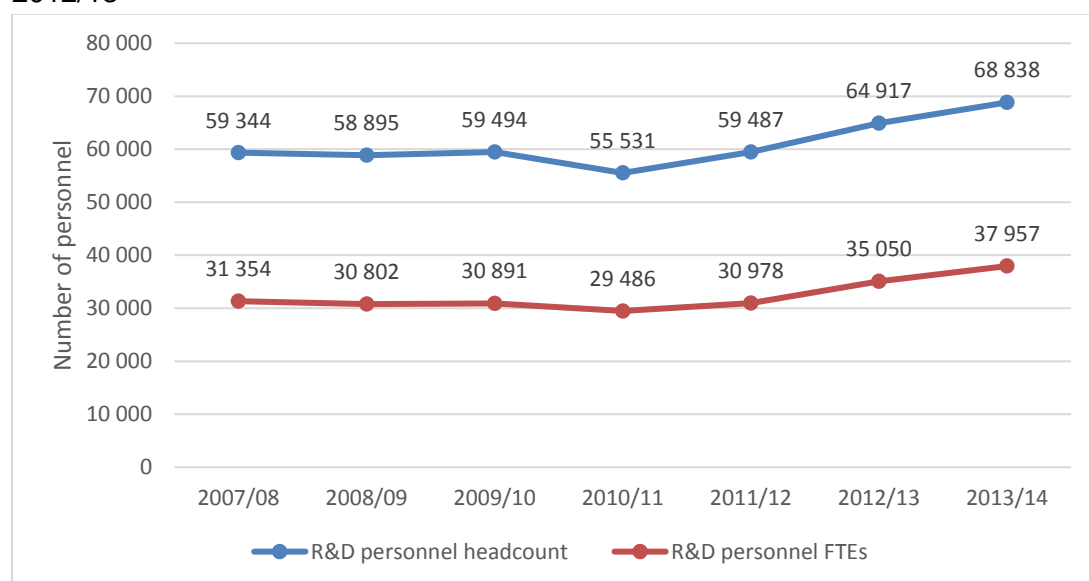
FIGURE 2: GERD BY SOURCE OF FUNDS (PERCENTAGE), SOUTH AFRICA, 2007/08 TO 2013/14



Data source: South African National Survey of Research and Experimental Development, 2007/08 and 2012/13

Government and business enterprises have consistently funded the largest proportion of GERD in South Africa. Government funding has exceeded all other enterprises, local and foreign, including business funding since 2007/08. The proportion of R&D funds from foreign sources and other national sources increased in 2013/14 from 2007/08, while the proportion of funds from government and business decreased. **Research and development personnel**

FIGURE 3: R&D PERSONNEL (HEADCOUNT AND FTEs), SOUTH AFRICA 2007/08 TO 2012/13



Data source: South African National Survey of Research and Experimental Development, 2007/08 and 2012/13

R&D personnel headcount totalled 68 838 in 2013/14, which is an increase of 9 494 since 2007/08. Note that as per OECD practice, doctoral students and post-doctoral fellows are counted as researchers. R&D personnel (Full-time equivalents) have also increased.

## The Tax Statistics

The General Assembly of the United Nations adopted a resolution to endorse the Fundamental Principles of Official Statistics on 29 January 2014 (United Nations, 2014). Government agencies use these principles as best practice for the publishing (and generation) of statistics. SARS and National Treasury jointly publish tax statistics annually, generated from SARS' registers of taxpayers and from tax returns (South African Revenue Service, 2016).

TABLE 3: ASSESSED INDIVIDUAL TAXPAYERS WITH BUSINESS INCOME IN THE RESEARCH AND SCIENTIFIC INSTITUTES SECTOR, 2007 – 2014

TAX YEAR	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)
<b>2007 [97.1% assessed]</b>	13 796	– *	572
<b>2008 [95.9% assessed]</b>	4 098	– *	176
<b>2009 [94.5% assessed]</b>	4 463	899	196
<b>2010 [94.7% assessed]</b>	1 542	407	116
<b>2011 [93.3% assessed]</b>	1 431	363	110
<b>2012 [90.8% assessed]</b>	1 393	423	125
<b>2013 [85.2% assessed]</b>	1 329	474	130
<b>2014 [74.9% assessed]</b>	1 379	564	145

\* No data available

*Data source: Tax Statistics, 2008 to 2015*

The number of individual taxpayers with business income in the Research and Scientific Institutes sector (table 3), appears to have decreased. However, the large decrease in taxpayers from 2007 to 2008 and again from 2009 to 2010 is due to a change in classification of the composition of individuals in the Research and Scientific Institutes sector, and not necessarily as a result of a decrease in the number of taxpayers. No adjusted data was available for those years.

The comparable data from 2010 indicates that there was a slight decrease in 2011, but that the numbers have been constant since then. Additionally, the assessed tax, while increasing slightly, does not indicate a significant increase.

TABLE 4: ASSESSED COMPANIES IN THE RESEARCH AND SCIENTIFIC INSTITUTES SECTOR, 2007 – 2014

TAX YEAR	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)
<b>2007 [104.3% assessed tax]*</b>	1 195	-318	89
<b>2008 [102.2% assessed tax]</b>	1 472	-289	103
<b>2009 [98.7% assessed tax]</b>	1 666	-638	126
<b>2010 [99.2% assessed tax]</b>	1 804	-1 088	119
<b>2011 [100.5% assessed tax]</b>	1 751	-820	146
<b>2012 [99.5% assessed tax]</b>	1 466	-748	189
<b>2013 [93.3% assessed tax]</b>	1 057	-619	214
<b>2014 [44.5% assessed tax]</b>	759	62	158

\* as a percentage of provisional tax

*Data source: Tax Statistics, 2008 to 2015*

The number of companies in the Research and Scientific Institutes sector increased until 2010, and thereafter decreased. Once all 2014 returns have been assessed, the number may reach 2012 levels.

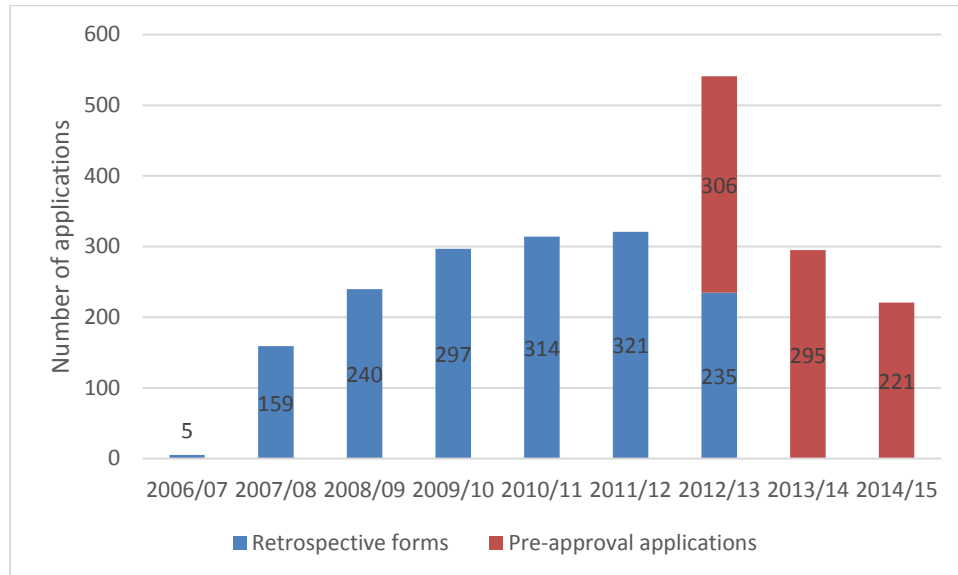
There has been a steady increase in the tax assessed from 2007 (with a small decrease in 2010) and this is expected to continue in 2014 after all returns are assessed.

### **Reports to Parliament on the Performance of the Research and Development Tax Incentive Programme**

The reports follow the activities of the R&D Tax Incentive on an annual basis, using certain identified performance indicators, including uptake, participating company profiles, tax revenue forgone, amounts of R&D expenditure incurred and budgeted and estimated companies' results achieved from supported R&D (Department of Science and Technology, 2015).

## Number of applications

FIGURE 4: NUMBER OF RETROSPECTIVE FORMS AND PRE-APPROVAL APPLICATIONS RECEIVED BY THE DST, 2006/07 TO 2014/15



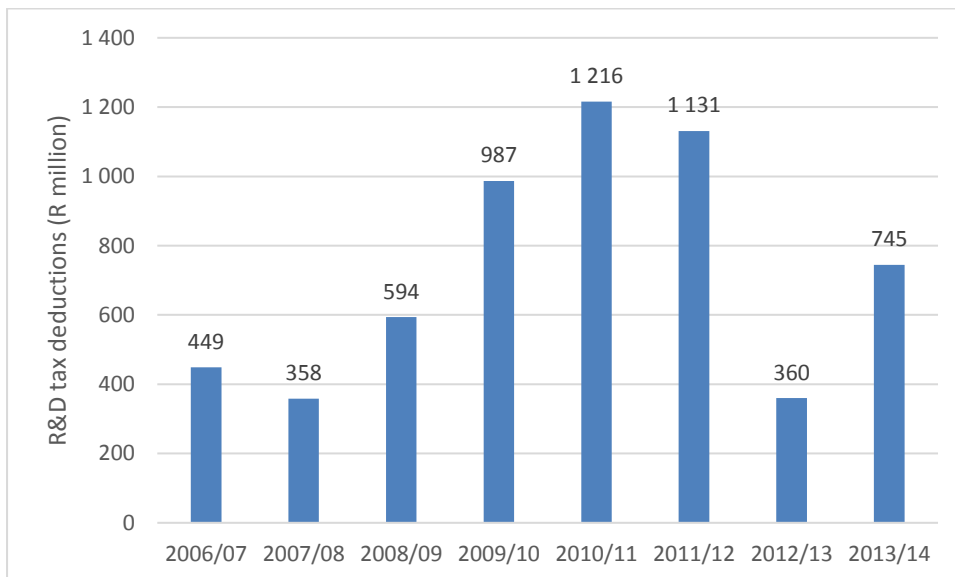
*Data source: Report to Parliament on the Performance of the Research and Development Tax Incentive Programme, 2007 to 2016*

Figure 4 illustrates an increase in the number of retrospective forms received by the DST for the R&D Tax Incentive from 2006/07 to 2011/12. In 2012/13, the DST received both retrospective forms and applications for pre-approval, following the change in the approval process. Thereafter, there is a decline in the number of applications.

However, this decline could be attributed to the change in the administrative procedure. After the change in the approval process, companies could submit applications with projects spanning multiple years, rather than an application each year (Department of Science and Technology, 2016b).

## Tax Revenue Foregone

FIGURE 5: TAX REVENUE FOREGONE 2006/07 TO 2013/14



Data source: South African National Treasury Budget Review, 2007 to 2016

National Treasury has estimated that roughly R5.5 billion in tax revenue has been foregone through the section 11D R&D Tax Incentive. Figure 5 indicates the revenue foregone per annum. Note the large decrease of 70% in 2012/13, and 38% in 2013/14 compared to 2010/11. This was due to the change in the application process for the allowable deduction, where taxpayers needed to have their expenditure pre-approved. There were administrative delays and backlogs that developed (National Treasury, 2016).

## ASSESSMENT OF FINDINGS

This paper defines a successful R&D tax incentive as an incentive that increases:

1. R&D expenditure,
2. The number of research personnel,
3. The number of taxpayers, and their taxable income in the Research and Scientific Institutes sector,
4. The volume of incentives granted by SARS, and/or
5. The tax revenue foregone.

There are various factors which impede the ability to draw conclusive findings based on the above data. It is difficult to determine the period it takes for the various sectors within the country to begin making use of a tax incentive once it becomes available. Different implementation times amongst sectors may skew conclusions.

Given that the period under review was one which experienced an economic recession, and the trends seen indicate fluctuation, albeit on an upward trend,



making it difficult to determine the extent to which the results can be attributed to the tax incentive regime as opposed to other external factors.

Notwithstanding this, and bearing in mind the original objective of higher levels of R&D which lead to innovation that yields positive externalities for the economy of the country, there are trends that can be noted.

TABLE 5: SUMMARY OF FACTORS INFLUENCING WHETHER THE R&D TAX INCENTIVE HAS BEEN EFFECTIVE

Factor	Effect
<b>GERD</b>	Decreased since 2007/08, but has been increasing in constant 2010 Rand values since 2010.
<b>GERD as a percentage of GDP</b>	Decreased since 2006/07.
<b>Business Expenditure on R&amp;D</b>	Decreased since 2007/08, although a slight improvement in 2013/14.
<b>GERD by sources of funds</b>	Government is funding more GERD, and business less than past years.
<b>Personnel</b>	Both headcounts and FTEs have increased.
<b>Companies in the Research and Scientific Institutes sector</b>	The number of companies has steadily decreased, although the tax assessed has increased.
<b>Applications for s11D</b>	Increased until 2012/13, then decreased (but due to change in admin process).
<b>Tax revenue forgone</b>	Increased until 2010, thereafter decreasing.

*Source: Authors' own construct*

The decrease in business expenditure on R&D, coupled with the increase in GERD, indicates that the South African economy is not growing in terms of R&D. However, once the backlog of applications for section 11D have been processed, this may filter into business expenditure.

The South African government was the largest funder of R&D expenditure since the 2007/08 fiscal year, with the business sector following. While the business sector made a small contribution to funding in the higher education sector, it showed a decrease in funding provided to the science councils (Department of Science and Technology, 2013). The business sector displayed steady positive growth in the funding within its own sector. Given that an objective of the tax incentive was to increase private sector funding of R&D activity, this trend indicates a positive result from the perspective of the objectives set out by the legislature.

The increase in personnel is a clear indication of an increase in research, but contradicts the decrease in business expenditure. The authors could not find any literature providing a reason for this incongruity.

While the number of companies in the Research and Scientific Institutes sector has decreased (with tax assessed increasing), these companies are not all the companies performing R&D in the economy. The increase of tax assessed is promising, and hopefully extrapolates into the whole population, even though business expenditure on R&D decreased.

The applications' decreasing as much as they have is mainly due to a change in the administration process. Taxpayers were uncertain of how to apply for R&D tax incentives and whether they would receive approval. However, the change in the process from a retrospective application to a pre-approval was more taxing administratively and resulted in a large backlog of claims (Department of Science and Technology, 2015).

The Department of Science and Technology (2016b) suggests simplifying the administrative process through a revised application form, improved information, assisting all stakeholders in understanding the incentive and helping them throughout the process. Additionally, a hybrid model of approval, once demonstrable R&D has been performed, may be another option.

The decrease in tax revenue forgone since 2012 is affirmed by the backlog and additional administration required by the approval process.

Overall, there appears to be a decrease in R&D rather than an increase. This goes against the objective of a R&D Tax Incentive. As stated previously, no research on whether R&D would have remained the same had there been no tax incentive has been performed in South Africa to date (Köhler, Laredo, & Rammer, 2012). However, it may be prudent to recommend changes to the R&D Tax Incentive. These changes could include international considerations and expanding the allowable R&D, both in terms of scope and attraction.

## CONCLUSION

Section 11D of the Income Tax Act has undergone multiple changes since it was introduced into legislation in 2006. It can be seen that most of the changes were to ensure that the original intention of the legislature is effected, and many of the new additions to the section have been promulgated with the view to placing an emphasis on R&D that is scientific and technological in nature.

In looking at the objective of the latest taxation laws amendment, it was noted that conclusive findings cannot be drawn based on the fact that it is not yet in operation.

Some of the issues that plagued the previous versions of the section have been addressed in the new amendment, while certain others are likely to remain contentious.

Based on the results obtained from the National Survey of Research and Experimental Development, the Tax Statistics and the Reports to Parliament on the Performance of the Research and Development Tax Incentive Programme, there is evidence of a marginal decrease in R&D in South Africa. However, had the R&D Tax Incentive not been in existence, it is possible that there would be significantly less expenditure on R&D.

Improvements to both the legislation and administrative process would help increase the level of R&D in South Africa.

## References

- Department of Arts Culture Science and Technology. (2002). *National Research and Development Strategy*. Pretoria.
- Department of Science and Technology. (2008). *National Survey of Research and Experimental Development, High-level key results, 2006/07*. Pretoria.
- Department of Science and Technology. (2009). *National Survey of Research and Experimental Development, High-level key results, 2007/08*. Pretoria.
- Department of Science and Technology. (2011). *National Survey of Research and Experimental Development, 2007/08*. Pretoria.
- Department of Science and Technology. (2013). *National Survey of Research and Experimental Development, High-level key results, 2009/10*. Pretoria.
- Department of Science and Technology. (2015). *Performance of the Research and Development Tax Incentive Programme, Report to Parliament 2013/14*. Pretoria. Retrieved from <http://www.dst.gov.za/index.php/services/41-rad-tax-incentives-programme/1288-reports-to-parliament-20132014>
- Department of Science and Technology. (2016a). *National Survey of Research and Experimental Development, Statistical Report, 2013/14*. Pretoria.
- Department of Science and Technology. (2016b). *Report of the Joint Government Industry Task Team on the Research and Development Tax Incentive*. Pretoria. Retrieved from <http://www.dst.gov.za/index.php/services/the-rad-tax-incentives-programme>
- Guellec, D., & De La Potterie, B. V. P. (2003). The Impact of Public R&D

Expenditure on Business R&D. *Economics of Innovation and New Technology*, 12(3), 225–243.

Köhler, C., Laredo, P., & Rammer, C. (2012). *The Impact and Effectiveness of Fiscal Incentives for R&D. NESTA Compendium of Evidence on Innovation Policy Intervention*. Retrieved from <http://www.innovation-policy.net/compendium/>

National Treasury. (2012). *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011*.

National Treasury. (2013). *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013*.

National Treasury. (2016). *Budget Review 2016*. Pretoria. Retrieved from [http://www.treasury.gov.za/documents/national budget/2016/review/default.aspx](http://www.treasury.gov.za/documents/national%20budget/2016/review/default.aspx)

Organisation for Economic Co-operation and Development. (2002). *Frascati Manual: Proposed Standard Practice for Surveys on Research and Experimental Development. The Measurement of Scientific and Technological Activities* (6th ed.). France. <http://doi.org/10.1787/9789264199040-en>

Republic of South Africa. Taxation Laws Amendment Act No. 31 of 2013, Government Gazette (2013). Republic of South Africa. <http://doi.org/102GOU/B>

South African Revenue Service. (2016). *Tax Statistics 2015*. Pretoria.

Statistics South Africa. (2014). *Gross Domestic Product*. Pretoria.

Strauss, C. (2011). *An Analysis of Sections 11D(1)(a) and 11D(5)(b) of the Income Tax Act No. 58 of 1962 as Amended*. University of Stellenbosch.

United Nations. (2014). *General Assembly Resolution A/RES/68/261*. Retrieved from <http://unstats.un.org/unsd/dnss/gp/fundprinciples.aspx>

Williams, R. (2012). Research and development expenditure - the 150% deduction. *Pwc Synopsis - Tax Today*, (February 2012). Retrieved from <https://www.pwc.co.za/en/assets/pdf/synopsis-february-2012.pdf>