

Do South African Bond Investors Care about Corporate Governance Issues

by

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Abstract

The study shows that in an emerging market setting characterised by high levels of institutional ownership and block holdings, the strength of corporate governance systems does not get incorporated into the bond prices. The study is based on a sample of 61 bond issues listed in South Africa over the period 2003-2013. Using multiple linear regression, this paper did not find a significant relationship between the level of institutional ownership and the number of independent directors with the cost of debt proxies of bond yields and credit ratings. These findings contradict the notion that bondholders in general care about corporate governance issues, as determined in developed markets.

Keywords: Corporate Governance, Institutional Ownership, Independent Directors, Bond Yields, Credit Ratings

1. Introduction

This study investigates whether bondholders are concerned about corporate governance issues. Prior studies on this subject can be categorised along three dimensions, depending on the dependent variables used. The first group of studies used bond yields as the dependent variable (e.g. Anderson et al. 2004; Klock et al, 2005; Cremers et al, 2007; Funchal et al, 2008), while Ashbaugh-Skaife et al (2006), Weber, (2006), Durate et al (2008), Opperman (2009) used credit ratings and Bhojraj and Sengputa, (2003) examined both bond yields and credit ratings. Overall, the studies found corporate governance issues to have a significant effect on bond ratings and yields. They found that effective corporate governance practices to have an effect in lowering bond yields and attracting higher or better credit ratings. However, the majority of these studies focussed on developed markets, most notably the United States of America (USA). Relatively little research focused on emerging markets, specifically South Africa. The study by Opperman (2009) is the only exception, as it is the only study which focused on South Africa.

Given the uniqueness of South Africa in terms of the institutional setting and corporate governance systems, examining the subject in South Africa might yield different results in relation to those reported from developed countries like USA, where the majority of prior studies focused on. The corporate governance system in South Africa is guided by the King III code, which was introduced in 2010 to supersede the King II of 2002. The King III code is based on the “comply or explain” principle and it places great emphasis on considering the interests of, not only shareholders but all stakeholders of the company including customers, employees, the environment and bondholders. On the other hand the USA corporate governance system follows a statutory approach to corporate governance, guided by the Sarbanes-Oxley Act (SOX). The guidelines of these

corporate governance codes, the SOX and King III, and the institutional settings in these two countries differ in ways that affect how bondholders react to corporate governance issues. For example the King III requires the board to have a majority of non-executive directors while the Sarbanes-Oxley Act does not give a recommendation on the proportion of non-executive directors (IOD, 2010). In addition, the bond markets from USA and other developed countries are characterised by relatively larger, more liquid and more efficient bond markets as compared to emerging markets (Viviers et al., 2008).

This study examines whether bondholders in South Africa care about corporate governance issues. To achieve this objective, we answer the following research question, what is the relationship between corporate governance and bond yields in South Africa; secondly, what is the relationship between corporate governance and credit ratings. Our study is similar in spirit to the one by Opperman (2009). However, our study is unique in several aspects. The study by Opperman (2009) is based on the King II guidelines, while this study analyses corporate governance issues from a King III perspective. Opperman (2009) studies the relationship between corporate governance and the cost of capital in the 20 largest listed companies in South Africa using credit ratings as the proxy for the cost of debt. This study uses a larger sample size of 61 companies. In addition we use both bond yields and credit ratings as proxies of cost of debt. The approach in this study also differs with regard to the measures of corporate governance. Opperman (2009) uses the G-Index designed and developed by Abdo and Fisher (2007) as a broad measure of corporate governance disclosure. This is similar to the governance index constructed by Gompers et al., (2003) which was used by a number of prior studies in developed countries (Klock et al., 2005; Cremers et al., 2007; Durate et al., 2008; Funchal et al., 2008). However, the G-Index has the disadvantage of averaging out all the corporate governance components and as such there is no way to tell which of the components has the most influence. In our study, we would like to see the impact of two specific and important components of corporate governance as opposed to using the G-Index.

The contributions of this paper can be summarized along three dimensions. (i) we confirm the findings of Opperman's (2009) and we show that in a developing country such as South Africa, where the bond market is relatively smaller, illiquid and less efficient (Adelegan & Radzewicz-Bak, 2009; Mu, Phelps & Stotsky, 2013), bond investors do not care about corporate governance issues. We find that there is no relationship between corporate governance and the cost of debt financing implying that bondholders do not care about corporate governance issues. This is a contradiction to the results reported from developed markets like the USA (Ashbaugh-Skaife et al., 2006; Weber, 2006; Durate et al., 2008) (ii) we add to the South African literature by focussing on two widely used measures of corporate governance which include institutional ownership and the proportion of the board that consists of independent directors. The impact of these two variables on bond yields and credit ratings have never been investigated in South Africa. (iii) We add to the literature by focusing on a setting which is unique in terms of corporate governance codes and principles.

Next, Section 2 discusses the theoretical framework of the study. Section 3 describes the sample and data used and outlines the research methods used. Section 4 reports and analyses the results. Finally, Section 5 concludes.

2. Theoretical framework

Bondholders should be concerned about corporate governance issues because they have the potential to affect their ability to recoup their investment from the bond issuer. Weak corporate governance systems imply poor monitoring of the managers, which consequently results in agency problems like, opportunistic behaviour and misallocation of company resources by management, investing in unprofitable investments with a short term focus in an attempt to increase the size of the firm and their personal compensation (Adams, 1994). The overall impact of the problems is to impair a firm's financial position, thereby increasing the probability of default by the company and consequent losses for the bondholders (FitchRatings, 2004).

On the other hand, strong governance structures imply improved, improved monitoring and to reduced agency problems. This reduces the probability of default, consequently reducing risk and bond yields (Bhojraj and Segupta, 2003). If a company has good corporate governance practices in place, this would decrease the probability of default and therefore give provide bondholders and credit rating agencies with a positive perception of its ability to pay its debts.

3. Empirical evidence and hypothesis development

Prior studies that investigated how bond investors react to corporate governance issues can be categorised into two. The first strand defined corporate governance using a composite measure (G-Index) of several variables like proportion of independent directors, board size, and ownership structure and shareholder rights. The second strand didn't use a composite measure but they analysed the subject using single and individual variables.

3.1 Studies that used a Governance-Index (G-Index) as a corporate governance measure

Klock et al. (2000), Durate et al. (2000), Ashbaugh-Skaife et al., (2006), Abdo and Fisher, (2007), Funchal et al., (2008) Opperman (2009) investigated the relationship between corporate governance factors and the reaction of bond investors. These studies used the G-Index as their measure for corporate governance. The G-Index is a broad measure of corporate governance that averages out a various number of corporate governance components into an index. Prior studies that used this approach in measuring corporate governance all found that there is a relationship between corporate governance and the cost of debt capital. These studies found that there is a negative relationship between the corporate governance and bond yields and a positive relationship between corporate governance and credit ratings. Although these studies all used the G-Index, they used different components of corporate governance to make up the index for their specific studies.

The study by Ashbaugh-Skaife et al., (2006) used the G-Index developed by Gompers et al., (2003) as the independent variable. They include financial transparency, number of block holders, board independence, board stock ownership, board expertise and CEO power as some of the components that make up the index for their study. They find a positive relationship between credit ratings and the corporate governance. Their study shows that governance mechanism implemented in a company will be beneficial to bondholders. These findings are similar to the study by Anderson et al., (2004) which includes board independence, board size and audit committee size and meeting frequency as some of the components that make up their index. They equally find that corporate governance as measured by their index has a positive relationship with credit ratings and also show that it has a positive relationship with bond yields.

Funchal et al., (2008) in their study investigate the manner in which corporate governance is related to both bankruptcy law and the companies cost of debt financing. They used the Brazilian Corporate Governance Index (BCGI) and included governance measures on the basis of disclosure, ownership structure, board composition and shareholder rights as the components that made up their index. Funchal et al., (2008) concluded that dimensions of the BCGI had influential power and directly impacted the levels of commitment from management. This increased commitment from management would thus lead to reduced agency costs which has an impact on the cost of debt financing (Jensen, 1976). Thus, they found that that better corporate governance results in a lower cost of debt and generally relates to firms with higher amounts of debt.

A study by Klock et al., (2005) considered a governance index that is comprised of antitakeover provisions and shareholder protection provisions to examine the extent to which bondholders care about corporate governance issues. Their study segmented the based on companies with strong antitakeover provisions which are in the form of management having stronger rights as compared to shareholders. On the other hand, they had data based on companies that had weak antitakeover provisions in which case shareholders had stronger rights compared to management. In a similar study, Cremers et al., (2007) investigate the extent to which the impact of strong shareholder governance on bondholders depended on the nature of the governance mechanisms that a firm had in place. Their study was focussed on shareholder control and takeover defences as components of their governance index to investigate the manner in which bondholders are affected by different governance mechanisms. They attempted to show how shareholder governance is related to bond risk and how bond yields are affected by the governance mechanisms a firm has in place.

Klock et al., (2005) found that companies with strong antitakeover provisions and hence corporate governance mechanisms in place are associated with a lower cost of debt whereas companies with weak antitakeover provisions are associated with a higher cost of debt. This suggests that bondholders care about antitakeover provisions and view them as beneficial to their interests although they are unfavourable to shareholders. Cremers et al., (2007) equally found that shareholder control is associated with high yields if the firm is exposed to takeovers and low yields if protected from takeovers. They find that the likelihood of takeovers is increased with stronger shareholder control which is coupled with weaker takeover defences. Hence, they suggest that strong shareholder governance increases the risk of takeovers as well as the concerns of bondholders. Although literature shows that a number of prior studies have used the G-index as their measure of corporate governance, its use has been widely criticized (Donker and Zahir, 2008).

The G-Index is designed as a broad measure of corporate governance and has a number of drawbacks. One of the major disadvantages of using the G-Index is that it averages out the various components of corporate governance that make up the index thereby diminishing their effect (Abdo and Fisher, 2007). The index further makes it difficult to distinguish the specific effect that one of the individual components of corporate governance has leaving the particular effect it has unknown. Ashbaugh-Skaife et al., (2006) in their study evaluate a broader set of governance variables in contrast to Bhojraj and Sengupta (2003) who restrict their analysis to a limited set of variables. They acknowledge that using a broader set of governance variables as a measure of governance is less definitive compared to using a limited set of variables.

3.2 Studies that used a single and individual corporate governance variables

A couple of studies have used individual corporate governance variables in their studies as a measure of corporate governance (Sengupta, 1998). Institutional ownership and the number of independent directors have been widely investigated as to the influential role they play in corporate governance. These variables have been used as part of the components that make up the G-Index of some prior studies and have also been used independently as a measure of corporate governance in some studies. Research has shown that these two factors play a vital role and are the most influential in reducing both agency risk and information risk through their monitoring of managements actions.

Studies which considered institutional ownership as a measure of corporate governance show that it would lead to a decrease in agency risk and consequently bond yields (Klock et al., 2005; Cremers et al., 2007). Bhagat and Bolton, (2008) argue in favour of 'active monitoring hypothesis' which says institutional owners have the incentive to attentively monitor the performance of the companies they are invested in due to their large stockholdings. Cremers et al., (2007) focussed on the control that institutional owners have with regards to take over defences. Their study finds that lack of institutional ownership and control exposes companies to hostile takeovers which leads to higher bond yields. On the other hand, the presence of institutional ownership and control leads to lower bond yields as the company would be protected and shielded from any attempts of hostile takeovers. McDaniel (1986) also finds that institutional ownership decreases the likelihood of takeovers and shows how bondholder covenants reduce this risk

Other studies used the number of independent directors as a proxy of corporate governance. Literature suggests that independent directors provide the most effective monitoring and control of a firm in that the independent directors contribute their expertise objectively (Klein, 2002). The effective monitoring by independent directors would reduce the influence of long standing directors as well as CEO's that also serve as the chairman of the board and with this lead to lower bond yields. Sengupta, (1998) used the proportion of independent directors and found it to exhibit a negative relationship with cost of debt (Sengupta, 1998). The studies highlight that companies with a larger number of independent directors would provide better control and monitoring over management leading to more efficient and effective decisions by management. This would increase the performance of the company and make it more profitable which would be rewarded with lower cost of debt financing hence lower bond yields (Kyereboah-Coleman, 2007).

From the above discussion, empirical evidence from prior studies is shows that the better the corporate governance the lower the bond yields and the higher the credit ratings. Hence we hypothesize the following:

H1: There is a negative relationship between good corporate governance and bond yields

H2: There is a positive relationship between good corporate governance and credit ratings

4. Data and research methods

4.1 Data

The study covers a 10-year sample period from 2003-2013. Our data set includes corporate governance variables, bond yields and credit ratings. For bond yields and credit ratings we collect details of bonds listed on the Bond Exchange of South Africa, over the sample period. Our initial data collection yielded a total of 7617 different types of bonds. To be consistent with prior studies (e.g Hibbert et al 2011; Avramov, Jostova & Philipov 2007) we focus on fixed rate bonds. After eliminating all bonds with additional features like collability, floating rates and inflation linked bonds, we remain with a final sample of 105 bonds. We then dropped 44 bonds which had no credit ratings, to remain with a final sample of 61 companies

We use two measures of corporate governance, institutional ownership and the proportion of independent directors, as done by Bhojraj and Sengupta (2003). Data on corporate governance variables was collected from Bloomberg database and Inet-BFA database and was based on information from the annual reports published during 2003-2013.

4.1.1 *Dependant variables*

In this study we use both the bond yield spread and credit ratings as proxies for the cost of debt and these are our dependent variable. We used both these proxies to ensure the robustness of our results. The bond yield spread is computed as the difference between the yield of a corporate bond and the yield of a comparable government bond. We match the maturity periods of corporate bonds and treasury bonds. Average daily bond yield data for SA government bonds was collected from the South African Reserve Bank website. The yields are grouped for different bonds depending on the term of the bond with rates for 3-5 years, 5-10 years as well as 10 years and longer.

The credit ratings variable represents the ratings obtained from the Global Credit Ratings Company (GCR) using their International Long Term Debt Rating Scale. GCR is the leading emerging market focussed ratings agency, rating the full spectrum of security classes. Not all the companies in our sample had GCR credit ratings available nor other credit rating agency ratings. For ease of use we convert the ratings symbols to numerical values using the methodology of Klock et al., (2005). Triple A rated bonds (AAA) are assigned a value of 18 and LD/DD bonds are assigned a value of 1.

4.1.2 *Independent variables*

This paper is consistent with Bhojraj and Sengupta (2003) in using two widely used measures of corporate governance, institutional ownership and the proportion of independent directors. Institutional ownership (InstOwn) is calculated as percentage of shares held by institutional owners while the proportion of independent directors (IndepDir) is calculated as the number of non-executive directors to the total board size.

4.1.3 *Control Variables*

Our control variables include firm and bond specific variables that affect credit ratings and bond yields, these were drawn from prior studies. We control for the following; firm size measured as natural log of market capitalisation (Klock et al., 2005); firm profitability, measured as the return on assets (Klock et al., 2000); leverage, measured using the long-term debt to total assets ratio as at the calendar year ending 31 December 2014 (Klock et al., 2005); firm volatility, measured as the standard deviation of stock returns. We also control for bond specific variables which include bond convexity, duration, bond maturity and seniority.

4.2 Empirical Models

To determine the relationship between the bond yield as a proxy for the cost of debt and the measures of corporate governance. In order to test the hypothesis developed, we apply a linear regression model. The regression models used are as follows:

Equation 1

We use equation one below to test the first hypothesis, which states that there is a negative relationship between good corporate governance and bond yields.

$$\text{BYield} = B_0 + B_1 (\text{InstOwn}) + B_2 (\text{IndepDir}) + B_3 (\text{FirmSize}) + B_4 (\text{ROA}) + B_5 (\text{Leverage}) + B_6 (\text{Volatility}) + B_7 (\text{SGrowth}) + B_8 (\text{LoanSize}) + B_9 (\text{Convexity}) + B_{10} (\text{Duration}) + B_{11} (\text{Maturity}) + B_{12} (\text{Senior}) + e \quad (1)$$

Equation 2

The second equation, shown below, test the second hypothesis which states that there is a positive relationship between good corporate governance and credit ratings.

$$\text{CredRat} = B_0 + B_1 (\text{InstOwn}) + B_2 (\text{IndepDir}) + B_3 (\text{FirmSize}) + B_4 (\text{ROA}) + B_5 (\text{Leverage}) + B_6 (\text{Volatility}) + B_7 (\text{SGrowth}) + B_8 (\text{LoanSize}) + B_9 (\text{Convexity}) + B_{10} (\text{Duration}) + B_{11} (\text{Maturity}) + B_{12} (\text{Senior}) + e \quad (2)$$

Where BYield is the bond yield Spread, CredRat is the credit rating, InstOwn is institutional ownership, IndepDir is independent directors, ROA is firm profitability, SGrowth is the sales growth and LoanSize is the loan size over the period of the study.

The two regression were run using STATA, the first with bond yields as the dependent variable and the second with credit ratings as the dependent variable. The control variables for the firm-specific and security-specific categories were consistent in both our regressions.

5. Research findings

5.1 Descriptive Statistics

Table 1 below presents a statistical description for the variables used in our analysis. We measure the mean, median, standard deviation for the dependent variables: Bond yield spread (BYield) and Credit Ratings (CredRat); the governance measures: institutional ownership (InstOwn) and independent directors (IndepDir); the firm-specific measures: size (FirmSize), profitability (ROA), leverage, volatility, sales growth (SGrowth); and security specific measures: loan issue (LoanSize), duration, convexity, maturity and debt seniority.

Table 1 Descriptive Statistics for the dependent variables, governance measures and control variables

Variable	Mean	Median	Std. Deviation	Min	Max
Dependent Variables:					
BYield	4.571	1.937	4.876	-0.018	7.970
CredRat	10.967	10	2.008	9	17
Governance Measures:					
InstOwn	76.793	83.897	25.887	2.401	142.613
IndepDir	60.484	61.541	15.442	33.332	91.667
Firm-Specific Measures:					
FirmSize	29.813	29.659	1.034	28.496	32.587
ROA	8.971	6.905	11.612	-4.664	77.986
Leverage	4.567	2.522	4.772	1.038	19.515
Volatility	30.701	27.991	8.905	20.215	62.382
SGrowth	15.492	9.782	29.469	-4.083	217.241
Debt-Specific Measures:					
LoanSize	19.388	19.807	2.102	12.429	23.342
Duration	3.419	3.473	1.132	1.832	5.527
Convexity	15.570	14.043	10.273	4.2474	37.920
Maturity	13.541	9	14.043	3	91
Senior	0.408	0	0.495	0	1

Table 1 above shows that there is slightly more variability in the credit rating variable than in the bond yield variable, with the mean credit rating being higher than the mean bond yield. From the table, we see that the mean bond yield spread is about 4.6% and the mean credit rating is about 11. The wide range in credit ratings implies that South African companies are considered to be significantly different with regard to their probability of defaulting on loans. The variation of the bond yield has a range of about 8 with a standard deviation of about 4.9.

The data reveals a mean and median for institutional ownership of about 77% and 84% respectively and a mean and median for the percentage of independent directors of about 60% and 62% respectively. The lowest percentage of independent directors was about 33% with a maximum of about 92% which indicates that a majority of the companies in the sample lie within a range of having a good number of independent directors on their boards.

A correlation matrix was created as shown in Table 2 below to assist us with assessing the degree of relationship that exists between the dependent variables and the governance measures, firm-specific variables and security-specific variables. The results do not show any significant linear relationships between the dependent variables and the governance measures nor the firm-specific and security-specific measures.

5.2 Regression Analysis

In conducting our analysis, we run two regressions: the first regression was run with bond yields as the dependent variable and the second used credit ratings. The independent variables in the two regressions were institutional ownership and the proportion of independent directors. The coefficients of the slopes for each variable are displayed on Table 3 below together with their p-values in brackets for each of the two regressions. The R-squared which measures the goodness-of-fit for each regression is also displayed on the table.

Table 3 Regression Output

	Dependent BYield	Variables CredRat
Constant	24.759 (0.007)	11.787 (0.213)
Governance Measures:		
InstOwn	0.013 (0.262)	-0.004 (0.737)
IndepDir	-0.002 (0.918)	0.027 (0.184)
Firm-Specific Measures:		
FirmSize	-0.708 (0.016)	0.341 (0.264)
ROA	0.017 (0.616)	-0.015 (0.672)
Leverage	-0.014 (0.829)	-0.015 (0.831)
Volatility	0.001 (0.997)	0.031 (0.414)
SGrowth	0.005 (0.685)	0.004 (0.779)
Debt-Specific Measures:		
LoanSize	-0.041 (0.752)	0.208 (0.132)
Duration	0.067 (0.957)	1.564 (0.233)
Convexity	-0.005 (0.972)	-0.164 (0.256)
Maturity	0.019 (0.322)	-0.021 (0.285)
Senior	-0.022 (0.971)	-1.33 (0.044)*
R Square:	21.68%	18.19%

*Significant at the 10% level

**Significant at the 5% level

Neither of the two corporate governance measures; institutional ownership or independent directors have a statistical significant relationship with each of our cost of debt proxies; bond yields and credit ratings. The coefficients of the corporate governance measures were insignificant showing

that investors do not care about corporate governance issues and this is contrary to the theory that bondholders would not be concerned about the effect that unfavourable governance mechanisms have on their investments and interests. The results are consistent with between the corporate governance measures and the cost of debt which is consistent with the Opprman's (2009) which also focused on South Africa. However our findings differ from the findings of prior papers in developed countries (Anderson et al., 2004; Klock et al., 2005; Cremers et al., 2007; Funchal et al., 2008; Ashbaugh-Skaife et al., 2006; Weber, 2006; Durate et al., 2008; Bhojraj and Sengputa, 2003) which all found a significant relationship between corporate governance and the cost of debt. The consistent results from the two South African studies vis-à-vis the contradictory results from developed countries confirms the need to analyse this subject from different geographical perspective. This is in light of different institutional settings, bond market settings in terms of size, liquidity and efficiency, different corporate governance codes, all of which affect how bondholder react to corporate governance issues.

6. Conclusion

This paper investigated the relationship between corporate governance and bond yields; and corporate governance and credit ratings. Corporate governance variables are represented by institutional ownership and the proportion of independent directors. The sample was drawn from South African companies listed on the JSE over the period from 2003-2013. We found no evidence of a significant relationship between the corporate governance measures and the cost of debt which is consistent with Opprman's (2009) study. These results suggest that bondholders in South Africa do not care about corporate governance issues. The findings contradict with those of prior papers from developed countries (e.g Anderson et al., 2004; Klock et al., 2005; Cremers et al., 2007; Funchal et al., 2008; Ashbaugh-Skaife et al., 2006; Weber, 2006; Durate et al., 2008; Bhojraj and Sengputa, 2003) which all found a significant relationship between corporate governance and the cost of debt. They reported a significant negative relationship between the implementation of better measures of corporate governance and the costs of debt capital, in the form of lower bond yields and higher credit ratings. The principles and codes governing corporate governance differs across countries, this has the effect on the weight that bondholders in these different markets place on the corporate governance measures and practices implemented by companies. The difference in the size and efficiency of the markets affect the speed and the extent to which bondholders respond to corporate governance, in inefficient markets the effect may not be not reflected at all (Rossouw, 2005). The South African bond market is relatively small, illiquid and inefficient while the bond markets from developed markets like USA are relatively large, more liquid and efficient.

We recommend that further studies look into why bond investors in emerging markets do not care about corporate governance issues in South Africa. It is intuitively expected that bond investors should care about corporate governance issues as theory and prior studies in developed countries show that they do. Thus, our results were counter-intuitive and therefore potentially contentious. In circumspect, it may well be that bond investors in developing countries do in fact care about corporate governance issues but that the inefficiency and size of the bond market fails to incorporate these effects into the results obtained. One of the limitations of our study was the sample size used and we thus recommend future research to use a bigger sample.

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