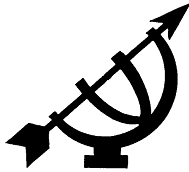

Business ethics and corporate governance in the Second King Report: Farsighted or futile?

G.J. (Deon) Rossouw
Department of Philosophy
Rand Afrikaans University
JOHANNESBURG
E-mail: gjr@lw.rau.ac.za

Abstract

Business ethics and corporate governance in the Second King Report: Farsighted or futile?

The relationship between corporate governance and business ethics has always been ambiguous. Does corporate governance per definition have an ethical nature or is it merely self-interested? Is business ethics an integral part of corporate governance or is it marginalised or even excluded by the debate on corporate governance? Does corporate governance also include the governance of ethics?

This article will focus on the relationship between corporate governance and business ethics from the perspective of a developing country. More specifically, it will look at a recent development in South Africa where the Second Report on Corporate Governance for South Africa (IOD, 2002), also known as the Second King Report, gave particular prominence to business ethics. The motivation for its emphasis on business ethics as well as its guidelines for the corporate governance of ethics will be explored and, in conclusion, critically reviewed.

Opsomming

Besigheidsetiek en korporatiewe beheer in die die Tweede King Verslag: versiende of futiel?

Die relasie tussen korporatiewe beheer en besigheidsetiek was nog altyd onduidelik. Het korporatiewe beheer per definisie ’n etiese aard, of is dit bloot gerig op korporatiewe eiebelang? Is besigheidsetiek ’n integrale deel van korporatiewe beheer, of word dit na die kantlyn geskuif en selfs uitgesluit van die debat oor korporatiewe beheer? Impliseer korporatiewe beheer ook beheer oor korporatiewe etiek?

In hierdie artikel word vanuit 'n ontwikkelende ekonomie-perspektief gefokus op die relasie tussen korporatiewe beheer en etiek. Daar word spesifiek gekyk na 'n onlangse verwikkeling in Suid-Afrika, waar die Second Report on Corporate Governance for South Africa (IOD, 2002), ook bekend as die Tweede King Verslag, besondere prominensie aan besigheidsetiek verleen het. Die motivering vir hierdie beklemtoning van besigheidsetiek, asook die riglyne wat vir die korporatiewe beheer van etiek verskaf is, word in die artikel ondersoek en daarna in die konklusie van die artikel krities geëvalueer.

1. Introduction

Corporate governance has enjoyed unprecedented attention around the globe over the last decade. There are various reasons for its recent prominence. These reasons are very context-specific. In some (mostly developed economy) contexts its prominence was driven by the agency problem (Collier & Robberts, 2001:67) and investor activism (Rossouw, 2002:137), whilst in other (mostly developing economy) contexts it was driven by the desire to attract foreign investment and to gain national and international legitimacy (Chernoff, 1999:2).

The relationship between corporate governance and business ethics has always been ambiguous. Does corporate governance per definition have an ethical nature or is it merely self-interested? Is business ethics an integral part of corporate governance or is it marginalised or even excluded by the debate on corporate governance? Does corporate governance also include the governance of ethics?

This article will focus on the relationship between corporate governance and business ethics from the perspective of a developing country. More specifically, it will look at a recent development in South Africa where the Second Report on Corporate Governance for South Africa (2002), also known as the Second King Report, gave particular prominence to business ethics. The motivation for its emphasis on business ethics as well as its guidelines for the corporate governance of ethics will be explored and, in conclusion, also critically reviewed.

2. Corporate governance and ethics

A distinction can be drawn between corporate governance in the broad and in the narrow sense of the word (James, 2001:236; Rossouw *et al.*, 2002). In the broad sense of the word corporate governance refers to control over companies externally exerted. For example, the state and the judiciary exercise this external control over companies (Coffee, 1998:69; Romano, 1998:144). The state may also opt for delegating some of its control functions over companies to regulatory bodies.

Alternatively, parties with a stake in the activity of companies can form self-regulatory bodies and seek statutory status for themselves. All of these arrangements combine to form the landscape of broad corporate governance. The purpose of such controls over the operations of companies is not only to set ground rules that will ensure the protection of all stakeholders in corporate action, but also to prevent the market as such from failing due to malpractices (Romano, 1998:148).

Corporate governance in the narrow sense of the word is concerned with the internal governance of companies. The Cadbury Report on corporate governance in the UK introduced a brief and widely used definition of corporate governance in this narrow sense of the word: "the system by which companies are directed and controlled" (Smerdon, 1998:1). This article will focus on corporate governance in this latter sense.

The responsibility for corporate governance lies with the board of directors and usually implies four functions: strategic direction, executive action, supervision and accountability (Reinecke, 1996:11). The board of directors is consequently held responsible for determining the strategic direction of the company as well as for taking those decisions that will steer the company in that direction. As the managers of the company are carrying out the board's decisions, the board of directors also has the added responsibility of supervising the management function of the company to ensure that it serves the chosen strategic direction. In all of this they need to be accountable to the stakeholders of the company and be able to assure them that the actions taken by the board are serving their best interests.

The relationship between corporate governance and business ethics is an ambiguous one. If by "ethical" we mean that one should not only consider what is good for oneself, but also consider the good of others, then the question arises whether corporate governance by its very nature is premised upon moral obligations. The four core values of corporate governance, viz., fairness, accountability, responsibility and transparency at least create the impression that corporate governance imposes ethical obligations upon corporations. The ethical nature of corporate governance is, however, largely determined by how "*stakeholders*" are defined within corporate governance. In this regard one can distinguish between exclusive and inclusive definitions of stakeholders. When stakeholders are *exclusively* defined as shareholders, corporate governance only has a very restricted ethical nature. In that case directors are regarded as the agents of shareholders and in that capacity they have to direct and control the company to the benefit of the shareholders. Although the four pillars of corporate governance: fairness, accountability, responsibility and transparency still apply, they are restricted in their application to the

interests of shareholders. They do not apply to the interests of other stakeholders of the business. Thus the only ethical dimension that can be indicated in this respect is the limited ethical responsibility of directors towards shareholders. Collier and Roberts (2001:68) state in this respect: "The only ethical imperative at work here is a Friedmanesque dictum to pursue profit maximization". By restricting moral obligations to shareholders only, the interests of other stakeholders are only considered insofar as they have strategic or instrumental significance for shareholders. When the interests of non-shareholding stakeholders do not have any strategic impact on shareholder interests, they can be neglected in terms of an exclusive stakeholder approach. In an attempt to remedy the obvious exclusion of the interests of other stakeholders inherent in this approach, some argue that stakeholders other than shareholders, for example employees and local communities, will automatically benefit, in trickle-down fashion, from the profit-optimisation of shareholders (Maitland, 2001:140).

When stakeholders are more *inclusively* defined as all parties who are affected by or who affect the company, then corporate governance gains a distinctively ethical character. Within this notion of corporate governance, directors take on a stewardship role and consequently have to be fair, accountable, responsible and transparent towards all stakeholders of the company. The interests of shareholders are not excluded, but are balanced with the interests of other stakeholders. This does not imply that profit-optimisation is abandoned as a corporate objective. To the contrary, within the corporate governance debate, Germany and Japan are often cited as examples where more inclusive stakeholder approaches resulted in improved financial performance and profit-optimisation. This of course does not prevent others from expressing grave concerns about the viability of these more inclusive stakeholder approaches, as they fear that responsibility towards all stakeholders can result in a lack of corporate focus and ultimately in financial disaster (Halpern, 2000:49; Maitland, 2001:129).

Besides the question whether the concept of corporate governance has an ethical nature, there is a further question: Does corporate governance exclude or include the governance of company ethics? Does corporate governance imply that directors should also take responsibility for the ethics strategy, the execution of ethics, the supervision of ethics and the accountability of the companies' ethics they serve? Or should directors merely be concerned about the implications of the core values of corporate governance, namely fairness, accountability, responsibility and transparency for matters such as board composition, executive remuneration, disclosure etc.?

Once more, judging from corporate governance codes around the globe, opinions are divided on this question. This difference of opinion does not coincide with the divide between exclusive and inclusive definitions of stakeholders discussed above. Countries that opt for inclusive definitions of stakeholders do not necessarily regard the corporate governance of ethics as a board responsibility.

In the remainder of this article, I will discuss and review the corporate governance code of a developing country that not only opted for an inclusive stakeholder approach, but also opted for directors to take responsibility for the corporate governance of ethics. This country is South Africa, where the Second Report on Corporate Governance for South Africa was published in March 2002.

3. The Second King Report on corporate governance for South Africa

The King Report on Corporate Governance for South Africa 2002 (also known as the Second King Report), named after the chairperson of the committee who drafted the report, Judge Mervyn King, is the successor code to the King Report on Corporate Governance for the South Africa of 1994.

3.1 Inclusive stakeholder approach

The Second King Report not only opts for an inclusive stakeholder approach (referred to as a "participative corporate governance system" in the report, p. 7), but also assigns responsibility for the corporate governance of ethics to the board of directors. In a section of the report titled, "Integrated Sustainability Reporting", it discusses the responsibilities of the board of directors with regard to the social, ethical and environmental performance of the corporation. The report makes it clear that the social, ethical and environmental performance of the corporation crucially determine whether the corporation will be able to sustain its financial performance. By social performance the report implies the moral obligations of corporations towards social transformation issues such as black economic empowerment and human capital development. By ethical performance it refers to the standards of corporate behaviour or integrity, and by environmental performance it alludes to the obligation to protect the natural ecology. This detailed and explicit emphasis on social, ethical and environmental obligations has been hailed as a "world first" for corporate governance reports (KPMG, 2001).

A close reading of the Second King Report reveals that the report is informed by the contemporary theoretical discourse on corporations and

their moral obligations. The view of the corporation that underlies the report is one that contradicts Friedman's idea (1970) that corporations have no other moral obligations than making profits for their shareholders. It rather supports French's view (1979) that corporations can and should be regarded as moral actors. Like Evan and Freeman (1993) and Goodpaster (1991), it contends that corporations have moral obligations to a wide range of stakeholders.

This stakeholder notion of the corporation is reflected in the report's option for an inclusive stakeholder approach as well as in its recommendation that the board of directors should take responsibility for the corporate governance of ethics. The following considerations that are explicitly mentioned in the report confirm this value orientation:

- Sustainability
- License to operate
- Social power
- Good corporate citizenship
- Societal values
- Corporate reputation

Each of these motivations will subsequently be discussed in some more detail.

3.2 Value orientation

3.2.1 Sustainability

The thinking behind the Second King Report's commitment to an inclusive stakeholder approach seems to be guided by the ideal of corporations with "sustained business success and steady, long-term growth in shareowner value" (IOD, 2002:8). Stakeholders are defined in the report as "those upon whose co-operation and creativity it [the corporation] depends for its survival and prosperity" (IOD, 2002:98). This implies that the ideal of sustainability can only be achieved when a company succeeds in gaining and retaining the support of its various stakeholders. Their ongoing support of the company will ultimately determine whether it will be able to continue as a "going concern". The dependence of companies upon their stakeholders is formally recognised in the Second King Report through its recommendation that boards of companies should engage regularly with stakeholders. The report advises boards to identify their key stakeholders and determine what expectations these stakeholders have of the company. Boards should

also give an account of how they have catered for the interests of these key stakeholder groups and then disclose regularly to these stakeholder groups how the company has acted in their mutual best interest.

3.2.2 License to operate

The Second King Report further recognises that a company needs more than legal approval to continue its operations. It also needs to be legitimised by its stakeholders and the community in which it operates. The ongoing process of being legitimised by its stakeholders, is referred to as the company's "license to operate" (IOD, 2002:8). The "licence to operate" is earned through responsible behaviour that demonstrates to its stakeholders that the company's existence is to the mutual benefit of the company and all its stakeholders. According to the Second King Report, the stakeholders from whom the company receives its license to operate includes, among others, groups like the state, investigative media, ethical pressure groups, consumers, employees and communities. In order to secure its license to operate, the report recommends that boards of companies engage regularly with these stakeholder groups.

3.2.3 Social power

A further motivation for the inclusive stakeholder approach adopted by the Second King Report is based upon the social power and influence of corporations in society. The report recognises the fact that modern corporations often have a more immediate presence and a more immediate impact on citizens than the state. They often determine, to a greater extent than the state, the quality of individual and community life. This increased social power and influence of corporations yield added responsibilities for the boards of companies. Although not explicitly stated, the Second King Report hints that if boards of companies do not take explicit charge of the added responsibilities that go with their social power, they will either be forced by the state to take that responsibility, or they will have to bear the brunt of the resentment of special interest groups, the media or local communities. The report therefore opts for a pro-active approach where boards of directors willingly take responsibility for their social impact and engage with their stakeholders in order to ensure that the interests of all who are affected by the operations of the company are catered and cared for. In this regard the report sounds a warning to boards that "in the age of electronic information and activism no company can escape the adverse consequences of poor governance" (IOD, 2002:10).

3.2.4 Good corporate citizenship

The option for an inclusive stakeholder approach is also motivated by claiming that it is imperative for companies to act as good corporate citizens within society. Good corporate citizenship does not only entail respecting laws and human rights and refraining from discrimination and exploitation. It also entails strengthening and developing the societies in which companies operate. This implies that companies should become involved in the most pertinent developmental issues in the contexts where they operate. Those issues that have a direct bearing on the success of companies should be addressed specifically. Within the South African context the report identifies at least three such areas that should figure prominently as part of the social responsibility of companies. They are:

- *Black Economic Empowerment*: the inclusion of black people in the mainstream of economic activity in order to facilitate a more equitable distribution of wealth. Affirmative action is considered an important aspect of this process.
- *Health*: HIV/AIDS is singled out as a challenge since “current indications show that over 20% of South Africa’s economically active population will be directly affected within the next five years” (IOD, 2002:109).
- *Human development*: The development of human capital is considered a high priority, not only because of educational deficits caused by Apartheid, but also because enterprises are in need of well educated and trained employees.

The commitment to good corporate citizenship advocated in the Second King Report thus stems from the conviction that strong sustainable companies require strong sustainable societies to survive and prosper. This is evident when the report justifies its option for an inclusive approach to corporate governance in contrast to an exclusively share-owner approach by stating that “any company’s long term commercial success is inextricably linked to the sustainable development of the social and economic communities within which it operates” (IOD, 2002: 98). Constructive responses to these developmental needs of the society require that companies should form partnerships with communities, local and national governments and other stakeholders in order to be effective. Once more the report implies that this responsibility for good corporate citizenship lies with the board of directors.

3.2.5 Societal values

A further motivation provided to justify an inclusive stakeholder approach revolves around the societal value system within which corporate governance is designed and practised. Underlying this motivation is the assumption that there is no one universally valid corporate governance system. To the contrary, corporate governance systems should reflect the uniqueness of the societies in which they originate. Specific reference is made to value system that Africans across the African continent embrace. This African value system is sometimes captured under the term *Ubuntu* which signifies a commitment to co-existence, consensus and consultation (IOD, 2002:19, also see Shonhiwa, 2001a & 2001b:19). By affirming these African values the report seems to suggest that corporate governance systems of African countries should reflect this value orientation. Such an orientation would render an exclusive focus on shareholders' interest impossible, as it would fly in the face of values such as co-existence, consensus and consultation.

3.2.6 Corporate reputation

A final motivation for the Second King Report's inclusive stakeholder approach is based upon the importance of corporate reputation. This argument is based on the obligation of directors to protect company assets. These assets do not only include physical assets, but also the symbolic assets of companies. Prominent among the symbolic assets is the reputation of the company as this not only impacts on its market valuation, but also on its ability to attract investment, clients and talented staff. Reputation is described in the report as "a function of stakeholder perception of a company's integrity and efficiency" (IOD, 2002:98). By implication this means that boards need to engage regularly with stakeholders in order to gauge what their current perceptions of the company are.

Unlike the previous five arguments that all maintained a balance between the interests of the company and those of its stakeholders, the last argument is merely concerned about the company's reputation in order to protect its own assets. Despite its lesser orientation on the interests of stakeholders, it nevertheless serves as a motivation for adopting an inclusive stakeholder approach to corporate governance.

The above six arguments all double as a justification for the report's recommendation that the board should take responsibility for the corporate governance of ethics. It seems as if the authors of the report assumed that board commitment to an inclusive stakeholder corporate governance system automatically also implies that the board should take responsibility for translating that commitment into a system that will

ensure that all employees of the company honour this commitment to serve the best interest of all stakeholders.

The report recommends that boards implement a best practice model for the corporate governance of ethics that consists of the following aspects:

- Determining stakeholder perceptions and expectations of the company
- Codifying ethical standards of the company
- Institutionalising ethics on the strategic and system levels of the company
- Monitoring ethics performance
- Communicating about and training on ethics
- Rewarding ethical conduct and/or disciplining unethical conduct
- Providing safe systems for reporting unethical or risky behaviour
- Accounting and auditing ethics performance
- Disclosing ethics performance to stakeholders

3.3 Farsighted or futile?

The Second King Report's inclusive stakeholder approach combined with its recommendations on the corporate governance of ethics discussed above extends these two dimensions much further than most other corporate governance reports around the globe. The question that I want to pose and answer in this concluding part of the paper is whether the corporate governance model proposed by the Second King Report is farsighted and should therefore be taken seriously in at least other developing economies, or whether it is a futile approach that does not warrant serious attention.

The main argument for the futility of the Second King Report's approach to corporate governance most probably is the one that states that the purpose of developing good corporate governance in developing economies is to enable companies "to compete for capital in a global market" (Chernoff, 1999:2). In order to compete successfully for capital, developing countries need to simulate the corporate governance systems and approaches of those developed economies where capital is most likely to come from. In the case of Africa that means that the Western-style corporate governance models and practices of the USA and EU need to be adopted. Because institutional investors from that part of the world are comfortable with and prefer these corporate governance standards they will be more likely to invest in economies where they see

the same corporate governance standards being adhered to. Since the existing corporate governance models in at least the Anglo-American world are premised upon an exclusive shareholder approach, the Second King Report's option for an inclusive stakeholder approach might not be palatable to Western institutional investors. It might therefore be suggested that the Second King Report's approach to corporate governance defeats the purpose of the exercise and is therefore an exercise in futility.

This argument is flawed in a number of ways and contradicts recent findings in comparative corporate governance research. In concluding this paper, this argument will be dismissed by exposing three flaws in it.

The *first flaw* in the above argument relates to the implied notion that there is a universally accepted best standard of corporate governance. This flies in the face of evidence that indicates that corporate governance is always context-specific. These findings are also emphasised in the OECD guidelines for corporate governance, where one of the guiding principles states that "International guidelines must recognize the international differences in governance systems" (Berglöf & Von Thadden, 2000:300; OECD, 1999:10). The distinction between market and control models of corporate governance emphasises why corporate governance models need to differ according to the context in which they apply. The diagram below highlights the differences between the two models.

Market model	**Control model**
Shareholder environment • Dispersed ownership • Sophisticated institutional investment	**Shareholder environment** • Concentrated ownership • Family, bank & public finance
Capital market liquidity • Active private equity market • Active take-over market	**Capital market liquidity** • Under-developed new issue market • Limited take-over market

(Adapted from KPMG, 2001)

The above diagram demonstrates that the institutional landscapes differ considerably between the two models. Whereas the market model (which is typical of the Anglo-American context) is characterised by companies

that are widely owned, the control model (which is more typical of developing economies) is characterised by concentrated ownership by families, banks and the state. Similarly the market model is characterised by high take-over activity, whilst take-overs are relatively limited in the control-model. These differences between the two models suggest that corporate governance systems designed for contexts with widely owned companies and active take-over markets could hardly be appropriate and relevant for contexts with concentrated ownership of companies and limited take-over markets.

This is confirmed by recent comparative corporate governance research that indicates that the widely held firm with dispersed shareholders is a rare phenomenon outside the Anglo-American world (Berglöf & Von Thadden, 2000:277; Sarkar & Sarkar, 2000:161). It therefore does not surprise that Halpern (2000:3), despite his stated preference for market model corporate governance systems, concludes that "the market-based system [of corporate governance] is not a viable alternative [for developing countries] in the short or medium term".

Admitting differences like the ones above should not, however, amount to admitting that good corporate governance is only possible within market model contexts. Good corporate governance is possible within both, even though the models themselves differ in many important respects. What matters is not the form of the corporate governance system, but whether it is true to the core values of good corporate governance, namely fairness, accountability, responsibility and transparency.

The *second flaw* in this argument is the suggestion that good corporate governance systems need to be exclusively shareholder orientated. There are both solid empirical and theoretical grounds for believing that an inclusive stakeholder approach can be as effective as an exclusive shareholder approach. The empirical evidence is provided by inclusive stakeholder corporate governance systems in developed countries with strong economies like Germany, France and Japan. In these countries at least employees are included in the corporate governance systems without adverse effects on the corporation (Jenkins-Ferrett, 2001:24).

The theoretical ground for an inclusive stakeholder approach is provided by the investment-argument advocated by Etzioni and others (Etzioni, 1998; Berglöf & Von Thadden, 2000:287-289). The investment argument is based upon the belief that investors should be rewarded for their investment in companies. This reward is not only in the form of benefits that accrue to them, but also the right to have a voice in the governance of the companies in which they have invested. This right to voice is

described by Etzioni (1998:683) as being "entitled to form a relationship with the users of their resources to help ensure that the usage will be in line with their interests and values". In the case of shareholders this right to voice is exercised by voting for the appointment or removal of directors responsible for directing and controlling the companies they have invested in.

If investment is defined as "the outlay of money, time or other resources, in something that offers (promises) a profitable return" (Etzioni, 1998: 682), then other stakeholders should also be considered as investors. Employees for example can be regarded as investors, since they have committed their talents and energy to the firm. This is especially true in the case of long-serving employees who have been asked to make sacrifices to help a company survive or to reach higher targets. In similar fashion other stakeholder groups like local communities and creditors can also be regarded as investors and should therefore be equally entitled to benefits and voice.

These empirical and theoretical arguments for the justification of an inclusive stakeholder approach can further be supported by a moral argument. The moral case for an inclusive stakeholder approach has, however, already been made earlier in this article and consequently will not be repeated here.

A *third flaw* in the argument under discussion relates to its neglect of the specific conditions that often prevail in developing economies. By insisting that corporate governance systems of developed economies should also apply in developing economies, it neglects important social differences between the two contexts. In developing economies, companies often need to take on responsibilities that are not normally considered the responsibility of companies in developed economies. In order to ensure stable and strong communities in which they can operate, companies in developing economies need to involve themselves in matters such as eradicating backlogs in education, training, health care etc., developing human capital and resourcing and reinforcing the legal system and its enforcing mechanisms. Attending effectively to these and other social and developmental needs requires a wider corporate governance agenda than in developed economies where the same responsibilities either do not exist or where it can be delegated to the state or organs of civil society. Neglecting these issues of crucial importance to developing countries could in fact constitute poor corporate governance as it might be considered a lack of corporate vision and control by the board of a company. Such lack of vision and competent governance can ultimately undermine the steady growth in

value of shareholder (and stakeholder) investments and the long term feasibility of the corporation itself.

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Key concepts:

business ethics
corporate citizenship
corporate governance
Second King Report on Corporate Governance
stakeholders

Kernbegrippe:

belangehouers
besigheidsetiek
korporatiewe beheer
korporatiewe burgerskap
Tweede King Verslag oor Korporatiewe Beheer