

MAKING SENSE OF THE DISCLOSURE OF LATENT DEFECTS IN FINANCIAL STATEMENTS AND COMPANY ACQUISITION CONTRACTS

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Abstract

This paper analyses the statement made by the South African Appeal Court Judge Holmes in the *Phame v Paizes* (1973) case and, using economic and unique South African legal principles, it examines the true legal nature of a contract to regulate company acquisitions.¹ Two solutions are offered for financial managers in South Africa: (1) the contract to regulate company acquisitions is a forward contract and (2) the difficulty in identifying latent defects should not be grounds for reducing the price paid for a company or enterprise in the South African legal system.

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Focus of the study

The main focus area of this paper is the term 'latent defect', generally known as a 'defect'. In the South African legal system, a defect is defined as an 'imperfection' or a 'shortcoming'. In order to rectify the imperfection or shortcoming, the aggrieved person employs actions or remedies (Hiemstra & Gonin, 2000). Depending on the severity of the defect, the aggrieved person uses either the *actio redhibitoria* (action or remedy to cancel a sale transaction) or *actio quanti minoris* (action for the reduction of the purchase price paid for something) (Van Zyl, 1977). The initial development of these ideas came from *Phame v Paizes* (1973), and propounds the criterion that there should be no legal difference between tangible or intangible things. The focus of this paper is on *quanti minoris* defects relevant to company acquisitions (intangible things), and it is argued that the *quanti minoris* defects should be avoided from an economic perspective.

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Research methodology

Within the framework established by the *Phame v Paizes* (1973) (that is, assuming there is no legal difference between defects relevant to tangible and intangible things), reference will be made to financial statements (balance statement and income statement) to illustrate the problem of how to record value within an accounting perspective relevant to company acquisitions. Finally, there will be a brief mention of new disclosure initiatives to rectify the shortcomings of financial statements. The disclosure of the shortcomings is currently known as non-financial indicators.

3

Introduction

The contractual or legal nature of company acquisitions has until recently not attracted much legal or economic interest in South Africa, nor has it been the subject of any deep controversy, because company acquisitions are generally regulated by the Securities Regulation Code on

Take-overs and Mergers ('the code'). The code has the force of law, which means, for example, that any company or enterprise must comply with the code in the event of an acquisition. However, the code does not acknowledge the use of economic terminology associated with future uncertainties as to company acquisitions (Kilian, 2009). The reason for this is the unwillingness of the courts or judges to develop or to establish the relevance of economic terminologies in the legal system because the use of economics to solve legal problems has been characterised as 'unsystematic', and 'confusing' (Bouckaert & De Geest, 2001). In this paper, a new approach to company acquisitions will be viewed as an attempt to reformulate and systematise the traditional Roman law principles to make them applicable to contemporary company acquisitions. Many first attempts to deal with latent defects will be considered. Examples of such attempts include the contractual nature of company acquisitions and how to disclose additional information in financial statements.

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Traditional legal approach to defects

Researchers have identified the traditional approach to defects as having originated in 367 BCE in the Roman law as Aedilitian actions. The actions were named after the public officials who invented them, namely the *Aedilis Curulis*. The word *Aedilis* derives from the word *Aedes*, which means a building (develop) and *Curulis* means legal authority (Van Zyl, 1977). In its simplest translation, *Aedilis Curulis* means 'the authority to develop the law'. The *Aedilis Curulis* regulated the selling of defective objects or things in the commercial world through the constant development of the Aedilitian actions (Daube, 1959). In Roman law, the buyer who had been prejudiced by a defect could not claim a reduction in the purchase price under all circumstances. In classical law, this action was intended to cover situations in which defective animals or slaves were acquired in a public market. In the post-classical period, or under Justinian law, the usefulness of these actions developed to other defective things (Mostert,

Joubert & Viljoen, 1972). In its South African development, the Court of Appeal had to consider whether the value or quality of a fixed asset differed from a share. It is all too clear that a fixed asset is a tangible thing, whereas a share or a company is an intangible thing and exists largely in electronic format. Appeal Court Judge Holmes stated the following in *Phame v Paizes* (1973):

To preserve the mercantile usefulness of the actions, I do not consider that the word should be given a restricted meaning. When one speaks of company shares of good quality, a relevant consideration is the percentage return after deducting expenses from income. If one speaks of buying 9 per cent shares, I consider that it can be said to relate to their quality.

If the latter is observed, then actions are considered a major premise in resolving disputes about what amounts to value for tangible or intangible things. It is clear from the above statement that intangibles may be awarded value in two general ways: income less expenses or buying 9 per cent shares. To disprove this technical statement, which I argue is inaccurate, it is necessary to analyse what features, if any, constitute the good or bad qualities of intangible things in an economic reality.

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Tangible and intangible things in an economic reality

Not surprisingly, if a contract of sale is of true legal nature when buying or selling a house or a share, then the actions are relevant to solving any disputes regarding the true value or quality of the thing purchased. For example, a house with defects is of far less value than a similar house without any defects (Daube, 1959). All that is required in terms of actions to claim a reduction on the price paid for a defective house should be that such a defect was undetectable by the purchaser or seller at the time the purchase was made (Hiemstra & Gonin, 2000). The same principle applies to shares. A listed share, for example, exists largely in electronic form. Despite the apparent conclusion on

the impossibility of identifying a defect, it is intriguing that an aggrieved buyer of a share can make use of the Aedilician actions. The Appeal Court Judge Holmes indicated that the value or quality of a share in a legal reality depends on income less expenses, or when buying 9 per cent shares. The economic reality is that a share has value in terms of the financial statements expressed in an appropriate ratio (Walsh, 1996).² To illustrate the difficulty in earnings per share as a ratio, the following example is relevant.

Enterprise A owns a fixed asset of R200 000. This asset is located in a high-crime area which negatively affects the turnover of the

enterprise. Enterprise B possesses a fixed asset in a low-crime area, valued at R450 000. Let us say that Enterprise A swaps its fixed asset with that of Enterprise B because B prefers to conduct business in a high-crime area. On the balance sheet of A, the fixed asset would be indicated as R200 000, because A is the owner of the fixed asset, even if A is not making use of the asset to produce turnover or net profits, as indicated in Table 1 (Anthony, 2004:47, 49). By making use of a financial ratio (earnings per share) the comparison between turnover and the fixed asset (R200 000) could convince any purchaser to enter into a contract with the seller to purchase shares in the enterprise.

Table 1

Extract from income statement after asset swap

Asset swap	
Turnover	R100 000
Net profit	R20 000
Issued shares	2000
Earnings per share	R10

Extract from balance statement after asset swap

Fixed asset	R200 000
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Table 2

Extract from income statement before asset swap

No Asset swap	
Turnover	R50 000
Net profit	R10 000
Issued shares	2000
Earnings per share	R5

Extract from balance statement before asset

Fixed asset	R200 000
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The tangible thing (fixed asset) for A and B is R200 000 and R450 000, but, because A is the owner of the fixed asset valued at R200 000, it is the only value that can be disclosed in the financial statements (Ernst & Young, 2006). This is owing to relevant accounting principles to record fixed assets in the balance sheet (Anthony, 2004). If company or enterprise A is sold as a result of its impressive net profitability or a share is sold as a result of its impressive

earnings per share ratio, the new owner of the enterprise or purchaser of the share may find himself in a serious situation, as indicated in Table 2. Indeed the new owner of the enterprise must use similar business acumen (i.e. asset swap), to maintain similar net profitability in the future and the same rationale applies to earnings per share (Vintcent, 1999). Is it possible to claim a reduction in the purchase price paid for the enterprise or share based on

the Aedilitian actions, owing to the fact that, in many ways, undisclosed business acumen had an impact on the future profitability of the enterprise (Black, Wright & Davies, 2001). It is obvious that enterprise A is not able to produce the same earnings per share or profitability after the acquisition. Holmes's statement is thus relevant to reducing the price paid for the enterprise or share. The question arises whether business acumen counts among actions owing to the difficulty or even impossibility of viewing undisclosed asset swap as a shortcoming.

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Complexity of intangible things in a legal reality

A listed share, for example, exists largely in electronic form. Despite the apparent conclusion on the impossibility of identifying a defect, it is again intriguing that the aggrieved buyer of a share can make use of the Aedilitian actions. The reason for the latter is that in recent years advocates have begun replacing defect with praises (Kerr 2002). In Table 1 and 2, the earning per share is R10 and R5, and it is obvious that the value of the share depends on asset swap. Regardless of whether the seller praises the shares (R10 per share) deliberately or innocently, he is nevertheless bound to make good what he has negotiated (Visser et al., 1997). For example, in the *Phame v Paizes* (1973) an agent misrepresented the annual municipal rates as R4 646 instead of R14 736 per annum, the difference being R10 090. The praise in that case was to negotiate income less R4 646, instead of income less R14 736. The agent therefore had to make good what he had praised, which was to repay R10 090 to the purchaser, as originally negotiated. How does this apply to our example of an asset swap? Cilliers et al. (2000) emphasise that, although the result of profitability depends on the financial statements, such statements have a downside to their effectiveness because they make use of generic terminology, e.g., 'fixed asset'. Under South African law, undisclosed generic terms for details or those that are presented vaguely may possibly be interpreted as innocent misrepresentation or praises (Mostert,

Joubert & Viljoen, 1972). Consequently, several recent key projects have been undertaken to address these shortcomings in financial statements. These will be discussed later in this paper.

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Roman law in contemporary times

It seems that the conclusion in *Phame v Paizes* (1973) is correct, owing to the difficulty in discerning any shortcomings in the financial statements (Daube, 1959). However, Roman law jurists (lawyers) indicated that there are certain things in the commercial world which do not possess true value, that is, things whose quality or value constantly fluctuates because of future uncertainties. With respect to the latter, Pomponius, a lawyer in ancient times, wrote the following (in Mommsen & Kruger, 1954):

Sometimes, indeed, there is held to be a sale even without a thing, as where what is bought is, as it was (sic), a chance. This is the case with the purchase of a catch of birds or fish or of largesse showered down. The contract is valid even if nothing results, because it is a purchase of a hope.

And Kerr (1996), explaining the relevance of Pomponius's statement to modern times, observes

...generations of [law]³ students have learnt that one can buy hope...and have wondered about the relevance of their newly acquired knowledge because no-one nowadays hears of anyone throwing largesse or buying the hope of a fisherman's or fowler's catch... .

To understand Pomponius's explanation in a contemporary context, one should rather ask whether largesse or a fowler's catch can be the main business of a company. The answer is in the affirmative. Also, if you buy hope, can it still be a contract of sale? Kilian (2005) explains that the word 'sell' is synonymous with the word 'buy' as far as the elements of a contract of sale are concerned, but 'buy' is also applicable to different kinds of contract. Considering that generations of students have wondered about the relevance of Pomponius's

statement, for a financial or economic analyst this extract contains the characteristics of a forward contract. This is a contract to pay a current price for a future thing, where the future value of the thing may be higher or lower than the current price (Arnold, 2005). The economic viewpoint is that company value is determined by future uncertainties rather than historic profit or earnings per share calculations. Table 2 illustrates hope without any asset swap, rendering the company lower in value when compared to Table 1. To avoid the application of undisclosed asset swap as a defect, the following paragraph is also relevant.

8 Other important factors in determining the future value of a company

Steiner (1998) and Vintcent (1999) have pointed out that the degree of future uncertainty as to whether a company is able to produce future profits is an element not to be ignored by the purchaser. A company that is able to produce future value is far more expensive than a company that is incapable of producing such value. Different methods (formulae) may be applied to calculate the future value of a company or enterprise (Black, Wright & Davies, 2001), one of which (i.e. shareholder value added) allows for an opportunity whereby the parties may agree on certain economic elements necessary to forecast the future value of the company over its economic life or case law may limit the economic elements necessary to calculate future value. In *Salisbury Portland Cement Co Ltd v Edwards Timber & Lime Industries (Private) Ltd* (1962), the court held that, if an arbitrator sets a current price for a company, this must be calculated on the principles of fairness and reasonableness. This decision, with respect, is vague because economic formulae deal with future uncertainties and do not constitute an exact science, making reasonableness or fairness as confusing as *Alice in Wonderland* (Vigario, 2007; Kilian & Du Plessis, 2005). An apposite example is to be found in *Steyn v Davies (1927)*, where the parties used the following simple

formula to determine the value of the dairy enterprise, as indicated in Table 3.

Table 3

24 cows and a bull	£850
6 calves	£30
Utensils etc.	£60
Goodwill	£160
Total (current price)	£1100

During the negotiations the seller did not disclose the fact that four cows were in the process of calving. This meant that for some time to come the purchaser would not be able to sell the quantity of milk that had been negotiated. On this basis, the buyer used the Aedilician actions to claim a price reduction in the purchase price on the grounds that four calving cows were currently unable to give milk. The court held that the plaintiff or purchaser did not consider the future profitability of the company and therefore the Aedilician actions were relevant to this legal difficulty. With all due respect, the future or added profitability was, in fact, negotiated and paid for – goodwill £160. The rationale behind any economic formula (even one as simple as that in *Steyn v Davies (1927)*) is whether the enterprise/company has the ability to create future goodwill within a fixed future period, for which the purchaser is willing to pay, and should not be seen as a defect when the company is unable to equal the future goodwill. The reason for the latter is simply that in the future there would be four additional cows to give milk, and the calving, or reduced milk production, was temporary in the economic life-cycle of the dairy.

8.1 Future value relates to economic life

In order to explain more clearly the relationship between future value and the economic life of a company in a financial context, Walsh (1996) uses the following example. A computer has a practical life of 25 years, but only five years of economic life. Today, a computer probably has an economic life of 24 months, 12 months or three months. If the value depended on 24 months, obviously the computer would have more value than if it had three months. Similarly,

in *Steyn v Davies* (1927), the aggrieved party did not consider the economic life of the dairy, which is possibly doing business today, fulfilling the bargain of goodwill acquired in 1927.

The underlying principle in the previous paragraph is not difficult to reconcile with the *Phame v Paizes* (1973) either. With respect, this court did not consider the concept of the economic life of the company acquired in the transaction, and the firm might still be doing business 30 years later. The main business being conducted in *Phame v Paizes* (1973) was the rental of fixed assets. Rent to be paid is not dependent on the value of the fixed assets: it can be either lower or higher than the market value of the fixed assets, depending on the relevant economic circumstances. In view of the uncertainty attached to company value and to avoid confusion over terminology, a forward contract should be used to describe company acquisition contracts (Kilian, 2005; Hurter, 1988). It is a less drastic judicial solution to conceptualise the value of future hope. However, this approach cannot be followed for fixed assets or tangible things. The value of fixed assets or tangible things is not as volatile as that of shares or company profits. A fixed asset seldom decreases in future value. However, a defective asset is always less expensive and the aggrieved purchaser should be allowed Aedilician relief.

8.2 A suitable method to disclose, inter alia, an asset swap or future profits

Transparent financial reporting or voluntary financial disclosure is a widely debated topic in accounting and academic circles (Havenga, 1997; Du Plessis, McConvill, & Bagaric, 2005; Ernst & Young, 2006). These leaders recognise that the current financial reporting methods focus primarily on historical financial transactions (balance, income and cash flow statements), and that these methods provide limited guidance on the future value of a company (Bloomfield, 2000). As a result, several recent key projects have been undertaken to address these shortcomings.

8.2.1 Recent key projects

The Global Reporting Initiative (GRI) (2009) represents an international effort to create a

common framework for voluntary reporting on non-financial issues. This framework includes, but is not limited to, the economic, environmental and social impact of organisational activities. The GRI, in partnership with the United Nations Environment Program (UNEP) and the Coalition for Environmentally Responsible Economies (CERES), is attempting to evaluate the sustainability of company reporting. The GRI also incorporates the active participation of hundreds of diverse stakeholders (inter alia, company people, human rights activists, accountants, labour lawyers, governmental organisations) worldwide in designing a common framework for sustainable company reporting. This framework is also referred to as the 'Sustainability Reporting Guidelines', and is used by more than 50 international companies in shaping their disclosure practices.

The Inspired Task Force (ITF) (2009) comprises the Security Exchange Commission and examines current company disclosures in order to assess economic value. ITF also investigates governmental and company organisations and makes suggestions for improving on company disclosures. Since value is driven by a company's expected future profits and cash flow, investors are looking for information that will help them to project both (such as operating performance measures, company model descriptions and forward-looking data). ITF believes that this 'business model' should become mandatory over time, as more and more companies seek credibility and uniformity in the business world.

Extensible Company Reporting Language (XBRL) (2009) is a computer software program that automates the mechanical aspects of reporting and analysis as an information supply chain in order to exchange relevant financial information (such as financial statements, general ledger information, and audit schedules). XBRL is licensed free and facilitates the automatic exchange of financial information which is compatible with various other software applications in the world.

The World Business Council for Sustainable Development (WBCSD) (2009) consists of 200 international companies and is complementary to the GRI. While the GRI defines key non-

financial performance indicators, the WBCSD designs a process for disclosing these key indicators. The aim of the WBCSD is to develop a guide on how to report publicly on sustainable development and how to decide which key non-financial indicators should be disclosed in the financial statements of companies, such as political changes or environmental abuse.

8.3 An example of political changes in South Africa as shortcomings

What would be a suitable South African model for disclosing non-financial information, taking into account apartheid and the period beyond? The transition from an apartheid to a post-apartheid state has created various democratic and social rights for all South African citizens, which are characterised by, but not limited to, trade union power as opposed to employer power. As an example, BMW South Africa is disclosing political changes in their financial statements, as a way of explaining why the company suffers fewer industrial actions.

8.3.1 Performance delivery agreement

BMW South Africa concluded a Performance Delivery Agreement with a BMW trade union, which stated the following (in Webster & Van Holdt, 2005):

In an ever-changing environment of cost pressures, fluctuating requirements for global production capacity, as well as increased competition locally and internationally, as well as the inherent disadvantage of our plant's location in relation to our markets, all associates need to contribute to make a positive contribution in ensuring an ongoing future for the company BMW, South Africa.

Thus, BMW avoids the conflict that can be created by a trade union, for example, strikes, by identifying a common goal for both of them – to be equal company partners. The term 'company partner' represents an attempt to change the identity and subjectivity of the employees so that they identify themselves with the company by shaping their attitude and behaviour to work with commitment. It is therefore highly unlikely that the trade union would order strikes or participation in an industrial action to impose economic pressure (i.e. demands for higher salaries) on BMW. This agreement is a public document and is available to any interested person as a non-financial indicator.

8.3.2 Working hours

South Africa (1995) stipulates a maximum working week of 45 hours. BMW has developed a bank hour account whereby their company partner can bank overtime as the global demand for BMWs increases or the company partner withdraws his or her banked hours when global demand for BMWs decreases. Webster and Van Holdt (2005) indicate that, in their 2000 Annual Report, BMW disclosed this business model voluntarily to the outside world as a non-financial indicator. This model allows for greater transparency concerning the causes of an increased operating profit because the company did not pay overtime remuneration.

8.4 An example of market volatility as a shortcoming

To illustrate the importance of voluntary disclosure from a financial perspective more clearly, the following example is relevant, as illustrated by Table 4.

Table 4

Extract from income statement

	2001	2000	1999	1998
Top line	2 193	2 319	2 292	1 016
Operating profit	250	195	296	-56

Share price statistics

End	2001	R4.00 per share
End	1998	R18.00 per share

Extract from balance statement

	2001	2000	1999	1998
Total assets	710	679	552	187
Debt to equity	0.25	0.29	0.54	0.51

Source: McGregor's (2002)

It is sometimes difficult to understand why a particular company enjoys a very high share price when its operating profit is very low, as indicated in Table 4. In our income statement it can be seen that operating profit is at its lowest when the share price is at its highest. Surely a poor operating profit would influence the supply and demand side of shares (Vintcent, 1999)? Many financial analysts analyse the share price movements in relation to profitability or operating profit to form an economic opinion of the economic environment in which the company operates, so as to justify the share price movements. Instead, shareholders or stakeholders appreciate more the opinion of the company on why it experienced the share price movements, owing to the correct identification of non-financial indicators, that is, the company explains its current company strategy (Steiner, 1998; Vigario, 2007).

8.5 Other methods of avoiding *quanti minoris* defects

If the parties are unable to reach consensus on an appropriate method of calculating future value for a company or enterprise, the seller could provide a written guarantee that the enterprise would be able to produce future value within a specific economic period. It is interesting that financial analysts consider a written guarantee to be an absolute forward contract (Correia et al., 2007). The positive aspect of a guarantee is that the seller would possibly disclose the kernel of his business acumen (an asset swap, as discussed earlier) so that the purchaser could attain at least the same economic results in the future.

9

Conclusion

This overview of the law and economic literature on intangible defects was fortunately not a selective selection. As far as the question of whether *quanti minoris* defects should be similar for tangible or intangible things in the law is concerned, an article by Hurter (1988) came nearly 15 years after the *Phame v Paizes* (1973) judgment, in support of which this contribution has analysed defects from the economic and legal perspectives (Mommsen & Kruger, 1954). This required the study of economic textbooks in which authors referred to forward contracts (Correia et al., 2007). Such contracts indicate that an intangible thing cannot have true value because the value of intangible things depends on future uncertainties. In addition an asset swap or the future production of milk as a future uncertainty is used to illustrate how the value of a company fluctuates, rendering the *quanti minoris* defects inappropriate for reducing the price paid for a company. One point of further research is the possibility of integrating future uncertainties into financial statements through the development of new disclosure policies. One of those policies is the World Company Council for Sustainable Development, which could be used as a guideline on how to report voluntarily on non-financial indicators (future uncertainties).

Endnotes

- 1 I am grateful to Dr. David Levey and two anonymous referees for useful and helpful comments on an earlier draft of this contribution.

- 2 The quality of a company is observed by means of reliable financial methods or ratios which are capable of being compared with those of other companies in the same economic sphere. Bloomfield (2000) states that these methods or ratios must be universally acclaimed, otherwise good company qualities become just another synonym for hoodwink. Steiner (1998) indicates that these methods usually make use of profitability to calculate investment attractiveness.
- 3 My inclusion.

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