Australian directors define corporate governance

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Increasingly there is a call for refining and defining what is understood when using the term corporate governance. The research reported on here provides a definition constructed from the language used by directors of public listed companies in Australia. Analysis of the definition reveals a departure from the traditional language that was reflective of agency theory and reliance by directors on language that is consistent with the underlying principles of stakeholder theory. Furthermore the provision for multiple and varied stakeholders in a constantly changing environment aligns with the principles of complex adaptive systems theory.

The onset of the new millennium saw a series of corporate collapses around the globe. In Australia there was HIH (Chenoweth & Hepworth 2001) and in the United States giants such as Enron, Tyco, World-Com (Carter & Lorsch 2004). Each of these examples has raised questions that concern the performance of Boards of Company Directors (BOCD). While the general reaction to these events meant an increased focus on regulations for corporate governance activities (Leung & Cooper 2003). Newly introduced legislation drew attention to the fact that there were organisations where significant improvements were being made (Carter & Lorsch 2004). This study explores the views held by practitioners of corporate governance, directors of public listed companies. The study provides an insight into how directors articulate their understanding of what corporate governance is.

In this study forty five directors of public listed companies in Australia provide their own definition of corporate governance. The definition that participating directors provide poses questions about stakeholder interests and the way in which the organisation interacts with its environment. This is demonstrated in the language used by participating directors and reflects elements of stakeholder theory supported by the theory of complex adaptive systems.

This article is organized as follows. The research design is presented, stakeholder theory is discussed followed by complex adaptive systems theory. The definition that emerged from the interview data is introduced followed by a discussion relating the aspects of the definition to the relevant literature with reference to complex adaptive systems theory followed by the conclusion. Throughout the paper the convention (…/) is used to acknowledge direct quotes from interviews with participating directors.

Research Design

The study reported on in this article examines directors' perceptions of best practice in Corporate Governance in Australia at the dawn of the 21st century. It is argued that in the business setting (Glaser & Strauss 1967; Strauss & Corbin 1990; Whiteley 2000) the process of institutionalisation has laid the basis for conceptualisation to a degree that contaminates the use of pure Grounded Theory (Glaser & Strauss 1967). This qualitative study was conducted within the constructivist paradigm using a modified grounded research approach (Glaser & Strauss 1967; Strauss & Corbin 1990; Whiteley 2000).

The interview schedule developed for the collection of primary data was the result of an exploratory process involving development, trial, analysis, modification, and retrial with each step dependent on the outcome of the last. The research makes use of the generative aspects of Grounded Theory (Glaser & Strauss 1967) using both theoretical sampling and content analysis. The analytical approach includes the development of theoretical sensitivity and the comparison of data allowing for numerous iterations. The iterative process permits meaning to be arrived at via discovery and emergence in such a way as to be 'provisional, capable of reforming and reshaping as interaction proceeds' (Glaser & Strauss 1967; Strauss & Corbin 1990; Whiteley 2000). Principal findings are based on the categories of meaning drawn from the interview data as a result of the iterative process.

Stakeholder Theory

Rowley (1997) claims there is evidence of stakeholder concepts in the orthodox theories of systems theorists and corporate planners. He describes stakeholder theory as a 'handmaiden theory' whose concepts are used to support the arguments for other theories. The break with established thinking comes with Freeman's (1984) seminal work on stakeholder theory. Freeman integrated stakeholder concepts into a coherent construct giving stakeholder theory a focus for its own development. The term 'stakeholder' was originally used to describe the 'stockholder' as the only group to whom management needed to be accountable (Freeman 1984). The current use of the word, based on Freeman's work (1984) includes all those who have a stake in the objectives of the company (Sternberg 1997).

An assumption underpinning stakeholder theory is that persons or groups with intrinsic and legitimate interests in substantive aspects of the corporate activities of an organisation are stakeholders (Donaldson & Preston 1995) even though Freeman (1984) proposed that there are situations where one can identify illegitimate stakeholders. The ability of stakeholder groups or individuals to take action is the over-riding concern in the power theory proposed by Pfeffer (1972; 1977; 1978) and is also reflected in Hawley and Williams' (1997) political model. Further development of the power/dependence concepts within the framework of stakeholder theory has allowed for the integration of network analysis with resource dependence theory (Rowley 1997). Implementation of any of the four types of stakeholder influence strategies - direct withholding, indirect withholding, direct usage and indirect usage - (Frooman 1999 p. 191) is determined by the power relationship that exists between the stakeholders and the firm.

Donaldson and Preston (1995 p. 65) propose that stakeholder theory contains three distinct but mutually supportive theories i.e. descriptive/empirical, instrumental and normative. These theories ask the questions: 'what happens? what happens if? and what should happen?' respectively (Jones 1995). Donaldson and Preston claim that of these three theories it is the normative base that is fundamental. Jones takes the instrumental theory as identified by Donaldson and Preston and further examines the underlying assumptions of the instrumental theory as a synthesis of the stakeholder concept, economic concepts, behavioural science and ethics. The normative ethics approach to the stakeholder theory emerges consistently as fundamental to stakeholder theory (Jones 1995).

While Eisenhardt (1989) argues for compatibility between agency theory and stakeholder theory, Francis (1997) sees the differences between the two as being located in the foundational paradigm of each. Debate continues with writers such as Jones (1995), Donaldson and Preston (1995), Jones and Wicks (1999) and Freeman (1999) contributing to the further exploration of ideas that flow from the implications of stakeholder theory.

Complex Adaptive Systems Theory

The science of complexity (Chia 1998) has provided a suitable metaphor (Tsoukas 1998 p. 305) for those attempting to determine some of the less predictable aspects of organisational behaviours, systems and processes (Stacey 1996a).
Stacey (1996b) describes the theory as follows,

> *Complex adaptive systems consist of a number of components, or agents that interact with each other according to sets of rules that require them to examine and respond to each other's behaviour in order to improve their behaviour and thus the behaviour of the system they comprise. In other words, such systems operate in a manner that constitutes learning. Because those learning systems operate in environments that consist mainly of other learning systems, it follows that together they form a coevolving suprasystem that, in a sense, creates and learns its way into the future (Stacey 1996b p. 10).*

Drawing on the physics of non-linear chemical systems Stacey (1996b) describes the workings of the complex adaptive systems as a dissipative system that imports energy and information from the environment in which it operates. These energies and information are permitted to dissipate through the system bringing about changes resulting in the system reorganising itself in response to the energies and information that have now become an integral part of itself.

> *A dissipative system is essentially a contradiction or paradox: symmetry and uniformity of pattern are being lost but a structure still exists, the dissipative activity occurs as part of the process of creating a new structure. A dissipative structure is not just a result, but a system or process that uses disorder to change. It is an evolving interactive process that temporarily is manifested in globally stable structures (Stacey 1996b p. 63).*

Stacey (1996b) identifies ten characteristics of the complex adaptive system. A complex adaptive system does not conform to a predetermined structure. Rules or schemas are multiple and can change. Agents' behaviour may have individual schemas or may be conditioned by common shared schemas. Schemas may consist of simple reaction rules, more complex rules requiring formation of expectations and taking anticipated action, performance evaluation rules, and rules for evaluating schema rules themselves (Stacey 1996b). The capacity to be self-generating and an ability to demonstrate fluidity and diversity are organisational features that encompass Stacey's ten characteristics of a complex adaptive system.

Table 1: Characteristics of a complex adaptive system

A Complex Adaptive System	
1	Has a basic purpose of performing tasks and surviving.
2	Consists of networks of large numbers of interacting agents.
3	Interacts with an environment consisting of other complex adaptive systems and therefore coevolves.
4	Interacts in an iterative non-linear manner.
5	Discovers, i.e. acquires information about the systems constituting its environment and information about the consequences of its own interaction with those systems by employing feedback.
6	Chooses, i.e. exercises a kind of free will to identify and select regularities in the feedback information it acquires and then condenses those regularities into a schema or model of its world, in effect selecting one of a number of competing models that might 'explain' the regularities and yield effective rules of behaviour for coping with that world.
7	Acts according to its schema rules in relation to the systems that are its environment.
8	Discovers the responses its action provokes, as well as the consequences of those responses.
9	Uses this information to adapt its behaviour, that is to perform simple or single loop learning.
10	Revises its schema so as better to adapt, that is, to perform complex or double loop learning.

Source: Stacey, 1996b

Comments from participating directors were inclusive of the language that describes complex adaptive systems theory.

…/ you have got to constantly keep reinventing your self…/ conditions change and you have got to respond…/ being proactive and intertactive…/ prepared to challenge, to provoke, to stimulate…/ interacting with its environment…/

Stacey comments on what the human dimension brings to the complexity model.

What the peculiarly human features do seem to add is potential complexity; they make the operation of human systems more complex and unpredictable rather than less so (Stacey 1996b p.114).

Corporate Governance-a definition-in-use

The definition-in-use is dependent on ideas expressed by participating directors throughout their interviews. Using content analysis (Glaser & Strauss 1967) words and phrases were extracted from the interview data and combined to construct the following definition. A phrase by phrase analysis of the definition follows providing further insights making use of supporting statements offered by participants as well as relevant literature.

Corporate governance is the ongoing independent exercising of professional judgement by the board as custodian of the company's assets, in the best interests of a variety of stakeholders including shareholders, employees, customers, with a commitment to demonstrate integrity, responsibility and accountability.

Independent exercising of professional judgement

Ongoing independent exercising of professional judgement - The word 'independent', as used by the participants, presents two levels of meaning. Initially it appears to convey the ideas associated with the preferred model for Australian boards, a board structure comprised of 'a majority of non-executive directors with an appropriate mix of skills and experience' (Bosch 1993 p. 12). Hilmer's (1993) recommendation was that no less than a third of the board should be genuinely independent. Directors talked about what was required to satisfy the requirement to demonstrate independence as part of the board structure.

…/ a true non-executive director is a fairly rare breed in some senses, in that he doesn't have, or she doesn't have, any other relationships with the company, or never had…/ my definition of an independent director is one who does not represent a major shareholder, a major supplier or someone who is involved in giving professional advice or trading with the company and does not have through any of those stakeholder roles an opportunity to significantly influence decisions of the company.../

As well as encompassing the concepts that pertain to the structure of the board (AIMA 1997; Donaldson 1993) the term independent also includes the board's activities with regard to deliberation and making judgement (Bosch

1993; Wymeersch 1998). This was what directors referred to as independence of mind or independent thinking.

> */ the ongoing independent exercising of professional judgement in the best interests of the shareholders…/ you somehow need to make the directors more independent in a real sense as well as in the structural definitional sense.../*

For some directors the dilemma of independent thinking was seen to be greater for executive directors. They pointed to the fact that when a proposal is brought to the board by the executive it has already been thrashed out within management. As one of the participants explained,

> *…/ another executive director in the board meeting cannot get a second bite at the cherry and say well I know that is what the boss is bringing but I disagree. That is tantamount to handing in your resignation…/*

Despite this, participants believe that an independence of mind is a necessary attribute for any director whether executive or independent. Directors connected to management also need to demonstrate independence of mind.

> *…/ I mean the person who is on the board has to have an independence of mind …/ I want every body to have an independence of mind…/*

However pragmatism dictates that those who have both independence of income and status more easily demonstrate this type of independence of thought. As one participant suggested,

> *…/ it is conceivable that you would have somebody there as a representative of a large shareholder who was an independent thinker but the probability would be less just as the probability that a retired executive would be independent, would be less …/*

Pease and McMillan (1993 p. 29) point out that maintaining a strong independent view should not compromise the need to also maintain 'a sufficient and 'interested' knowledge of the company'. As Bosch (1993 p. 12) points out this can be addressed by ensuring that independent directors provide 'an appropriate mix of skills and experience'. Overriding both the need for adequate knowledge and diversity of skills is the need to bring 'independent judgement to tasks where there is a potential for conflict of interest' (Directorate for Financial Fiscal and Enterprise Affairs 1999 p. 9).

In the framework of agency theory boards of directors, acting on behalf of shareholders should be independent of management (Bosch 1993; Hilmer 1993; Renton 1994; Norburn et al. 2000). Donaldson (1993 p. 82) argues that research evidence does not necessarily support this to be the position. Francis (1997 p. 100) agrees and describes the director as having a dual role - one is self-regulatory and the other managerial. The managerial role is seen as an intrinsic part of the board's attention to the company's performance in the marketplace.

Underlying directors' use of the term *professional judgement* there is an assumption that in a truly professional manner all sides of the situation can be considered.

> *…/ the independent director also will bring to that board table his experience in other industries or other companies, which might even be a company in the same industry…/ a lot these non-executive directors have an involvement in other spheres of life that all help to provide a better background to decision making in the company…/*

Demonstrating professional judgement is an extension of the requirement that directors are able to demonstrate independence in their thinking. Included in this assumption is a requirement that the board has access to all relevant information. Bain and Band (1996 p. 88) discuss this as a recently developed requirement resulting from the fact that directors are 'increasingly required to understand not only their own organisation, but also its industry, its competitive environment, prospective management successions, and its short, medium and long-term strategies.'

Traditionally management was the principal provider of information to BOCDs. In the view of participants this remains for many the model for non-executives to access critical information.

> *…/ as a director you are absolutely at the mercy of the Chief Executive and the management and you rely on them enormously to give you the information that you need .../*

While the practice of appointing independent directors does not necessarily arise from the logic of agency theory (Nowak & McCabe 2001) the dependence of independent directors on management as the principal source of information does. Management are the agents appointed by the owners to operate the company. In this position management is in control of the operational information pertaining to the day-to-day running of the organisation. Directors are dependent on management for this information. In this study directors discussed the problems associated with accessing information they needed.

> *…/ Chief Executives want to, even the good ones … tend to want to control the flow of information to the board…/ if people putting up the information on the proposals have the power, it is difficult to get around that…/*

If management is the principal supplier of information the extent to which the BOCD is dependent on management is conducive to a highly predictive arrangement. Solutions tend to be those proposed by and sought by management. This has the capacity to restrict the potential for innovation and change. Stacey (1996b)defines this situation as simple and linear. Simple linear lines of communication restrict discussion and produce highly predictive outcomes (Griffin, Shaw & Stacey 1998). If X is the case then Y is expected (Jones 1995).

The trend towards information being accessed freely from within the organisation and also from external sources (Francis 1997) does not fit within the predicitive model and has potential for far less predictable outcomes. A non-linear way of operating is complex and enables dynamic interaction to produce emergent solutions (Griffin, Shaw & Stacey 1998). This is a characteristic of complex adaptive systems theory (Stacey 1996b). Such a framework allows independent contributions with regard to deliberation and the making of judgement. BOCD members are encouraged to bring innovative and challenging ideas to the board room.

Custodial Function

As custodians of the company's assets - The custodial concept highlights the fact that the BOCD is appointed by the shareholders as an internal check to ensure that there are sanctions and checks against management acting in its own interests. Agency theory (Gomez-Mejia & Balkin 1992) emphasises the role as a contractual commitment principally to the interests of the owners or shareholders. In the words of one director the custodial role is,

> *…/ the responsibility that directors have to the shareholders as custodian of the company's assets …/*

Within the framework of agency theory the custodial function of the BOCD is seen to provide shareholders with protection against management acting from a position of self-interest (Worsham, Eisner & Ringquist 1997). Having a BOCD in place is not sufficient in itself to ensure that shareholders interests are protected. Experiences of the shareholders of companies facing financial disasters over recent decades have provided ample evidence that more than a structure is required. Some such cases include HIH (Chenoweth & Hepworth 2001), Adelaide Steamship Company (Francis 1997), Bond Corporation (Bosch 1995) as well as the case that became the catalyst for governance reform in Australia, AWA (Norburn et al. 2000).

The earlier discussion surrounding the concept of independent judgement indicates directors see themselves operating increasingly in a non-linear or emergent model of multiple realities (Griffin, Shaw & Stacey 1998). This view of the BOCD recognises that interaction with boards is not restricted to the linear dimensions of two players. There is recognition by the board that all organisational players influence and are influenced by events rather than simply the BOCD and shareholders. This is a key element in the principles underpinning stakeholder theory (Freeman 1984; 1999). In the following quote one of the directors expands on the non-linear and societal view of the custodial role of the BOCD.

> *…/ at a more subjective level, the question then becomes, is the board …, as custodians of the vision and hopefully the moral driver of the company, are they discharging that responsibility? …/*

Within stakeholder theory the custodial role requires an awareness and appreciation of value systems at work within the organisation as well as a commitment to shared values (Whiteley 1995).

Best Interests of Stakeholders

In the best interests of the shareholders, employees, customers and a variety of stakeholders - Directors who were interviewed held the view that the responsibility of the BOCD with regards to performance of the organisation is not exclusive to shareholders but should be inclusive of all stakeholders.

> *…/ guide the corporation to do the right thing for all its stakeholder groups over time …/*

One definition provided by directors describes stakeholders as follows.

> *…/ all the active community groups who feel that they are stakeholders and they want their views taken account of…/*

In embracing a variety of stakeholder groups directors have adopted the social entity of the organisation in preference to the property entity (Francis 1997).

Jones' (1995) definition of the firm as 'characterized by relationships with many groups and individuals' that have the power to influence the firms performance as well as having a stake in the firm's performance, recognises that groups and individuals not holding a monetary interest in the organisation, such as illegitimate stakeholder groups (Freeman 1984) can be in a position to influence decision making within it.

With membership of some stakeholder groups overlapping at times, and relationships between groups and individuals varying both in formality and specificity, predictability is lessened. In this complex arrangement there is a need for decision makers to rely on information and energy that is found in the environment supporting the operational context (Stacey 1996b). For the BOCD it requires an ability to continually read the environment, gaining both information and energy, enabling it to renew itself through self-organisation (Stacey 1996b).

As a normative theory Freeman (1984 p. 210) claims that the stakeholder approach does not prescribe a particular moral stance from within a predicitive model (Griffin, Shaw & Stacey 1998) but provides a framework that invites 'a host of differing moral views' for consideration. This view is closely aligned with Griffin's (1998) emergent model where effective management of conflicting positions contributes to the shared understanding of values (Whiteley 1995) of various players. This allows for the emergence of a position that is not exclusive to one or other of the stakeholder groups.

Central to the application of stakeholder theory is the identification of stakeholders in the organisation (Luoma &

Goodstein 1999). The question 'who are those groups and individuals who can affect and be affected by the achievement of an organisation's purpose?' (Freeman 1984 p. 54) has raised questions concerning groups that previously were not considered. In Freeman's (p. 53) view there are illegitimate stakeholder groups such as terrorists that must also be taken into account if strategic plans are to be implemented. Certainly this is borne out in the wake of the events of September 11, 2001 (Romei, Eccleston & Shannahan 2001). More than a month after terrorist attacks in New York and Washington, Dr Alan Greenspan, chairman of the US Federal Reserve reported to a congressional committee that economic growth and productivity were suffering the effects of terrorism and it was too soon to gauge the prospects of recovery (Hartcher 2001). Taking up Freeman's claim that terrorists are stakeholders to be reckoned with it can be argued that ignoring terrorists as a stakeholder group in the course of developing strategy reduces the prospect of victim organisations and those associated with them recovering in a timely fashion. By not having provided for unseen contingencies an organisation can unwittingly contribute to its own demise.

The fortune/misfortune of any one group with interests in the organisation has a flow on effect for the entire range of groups associated with the company and possibly those associated with any number of those groups. As observed by directors,

> *…/ you see you have got to get everything in harmony and synergy …/ most biological organisms try to live in symbiotic relationships which expose them least to stress. Boards do the same thing. As the wick gets turned up, whoever is turning the wick up, society, shareholders, the industry you are in …/*

Stakeholder theory (Freeman 1984) supported by the theory of complex adaptive systems (Stacey 1996a) provides a framework for the BOCD when working towards a shared understanding of all stakeholder interests.

Commitment to Accountability

With a commitment to demonstrate integrity, responsibility and accountability - First stage analysis of the interviews with directors indicated that directors believed that conformance activities were directed and controlled by regulation (McCabe & Nowak 1997). Further analysis revealed that directors believe that while these activities are controlled and monitored within a regulatory framework they should be driven by integrity. Bosch (1993) expresses a similar sentiment,

> *In an economy run on market principles, the freedom allowed by society to the producers of goods and services is dependent on the degree to which the public has confidence in the integrity of the participants. The lower the standard of behaviour, the more regulations are needed (Bosch 1993 p. 32).*

Integrity is deemed by directors to underpin all that a director is called upon to do as a member of the BOCD.

> *…/ that the other directors on the board have integrity and have good reputations and you feel comfortable in working with them…/ decent people loaded with integrity …/ the characteristic that you are looking for in boards and management if it comes to that, is integrity…/ Am I going to be on a board with people of integrity?…/*

Some participants promoted the other side of the argument claiming that an over reliance on a regulatory approach promoted a culture where people would test the system and experiment with what they could 'get away with'.

> *…/ I think sometime that changes in the law, changes in accounting methods really encourage people to be a bit cute about how they do things rather than to be absolutely transparent…/.*

In 1996 Listing Rule 4.10.3 was introduced in Australia as a measure to promote the idea that corporate governance was not simply about government regulation but about directors, management and shareholders being responsible for the fate of the company (Factor 1996). The call by directors in this study for directors to demonstrate accountability and responsibility with integrity can be interpreted as indicating that there is a belief among directors that conformance matters should be driven by an ethical rather than regulatory position (McCabe & Nowak 1997). This position is further supported by Leung and Cooper (2005) when they argue that competence, objectivity, integrity and honesty are demonstrable features of accountability within corporate governance.

There is an assumption underpinning directors' comments, suggesting that integrity as an attribute of a value system is perceived and understood to be valued in the same way universally. This is an assumption that is open to challenge. Etzioni (1988) highlights the significance of moral factors within corporation and the workplace and insists that shared commitments and values are a result of extensive and continued moral dialogues (Etzioni 1996). Leung and Cooper (Leung & Cooper 2003) p. 514 have engaged in the moral dialogue and propose that meaningful change in corporate governance structures and practices will only be achieved if the 'religion of materialism is recognised and addressed.'

Conclusion

This definition adds yet another definition to the variety that can be found in the literature. The language and ideas contained in the definition are grounded in the experience of practitioners in corporate governance and reflect the ideas about corporate governance held by a group of directors in Australia. The definition includes defining features of the board, in particular its independent structure and its decision making role. It also includes the custodial role of the board and the driving principles for dealing with conformance and performance issues conducted from a platform of integrity. The analysis here supports the position that the definition is underpinned by an acceptance of stakeholder theory, recognising the corporation as a social entity. The provision for multiple and varied stakeholders in a constantly changing environment aligns with the principles of complex adaptive systems theory.

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