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**TOWARDS AN INTEGRATED CORPORATE
GOVERNANCE FRAMEWORK FOR
CONFORMANCE AND PERFORMANCE**

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Thesis presented in partial fulfilment for the degree of Masters of
Industrial Administration in the Department of Mechanical Engineering

MAY 2005

Plagiarism Declaration

I know the meaning of plagiarism and declare that all the work in the document, save for that which is properly acknowledged, is my own.

David Couldridge

May 2005

University of Cape Town

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TOWARDS AN INTEGRATED CORPORATE GOVERNANCE FRAMEWORK FOR CONFORMANCE AND PERFORMANCE

CHAPTER 1

Introduction

1.1.1 The struggle to build wealth

Individuals try to build wealth so that they can retire when they can no longer work, or when they choose not to work. This is done by direct investment in shares, property, cash or fixed interest securities. There are more exotic investment instruments, but they are ultimately exposed to the instruments mentioned. We can invest indirectly through insurance companies, unit trust management companies, other financial institutions or pension funds. When these investments do not perform according to our expectations or how we were advised they would, it puts us in a position where we cannot meet our personal investment objectives. Saambou, Regal Bank and Masterbond are examples of South African financial institutions that could not meet their commitments. Globally we have other examples such as Barings Bank, Allied Irish bank and National Australian Bank.

With our direct investments, shareholder value may also be totally destroyed or significantly reduced. Leisure Net's insolvency affected many investors and users of their services in South Africa. In 2001 the largest bankruptcy filing in the history of America took place. Debt that was hidden off Enron's balance sheet was consolidated in their financial statements causing a write off of more than one billion United States dollars. This caught the attention of the world.

1.1.2 The global response

Action to develop corporate governance took place in the twentieth century. At the beginning of the twenty- first century, the moderate corporate governance action to detect and prevent these type of events accelerated. The guidelines that were put in place, to steer governance, came under increasing scrutiny, particularly due to the massive destruction in shareholder value of Enron and also WorldCom in the United States of America (USA). There have also been other wakeup calls for investors around the world, with further frauds and company failures in USA, Marconi in the United Kingdom (UK) and Parmalat in Italy. This has forced government, together with regulators, to reassess the corporate guidelines and regulations that were in place. Swift action took place in the USA with the demanding requirements of The

Sarbanes - Oxley Act (2002) that has created global implications for companies and auditors. In the UK, the Combined Code on Corporate Governance (1998) issued by the Hampel Committee, came under close scrutiny. A revised Combined Code on Corporate Governance (2003) was introduced. Countries around the world moved to introduce corporate governance codes or to improve their guidelines. South Africa introduced the second King Report on Corporate Governance (2002).

In contrast to the stringent, rule - based, requirements of the USA, the UK, South Africa (SA), Australia, New Zealand, Canada, Europe and many other countries have developed corporate governance guidelines. These guidelines relate to listed corporations and are not generally reinforced with legislation like the local Companies Acts. They remain voluntary guidelines, to a large degree, but with the requirement that non - conformance is disclosed in the Annual Financial Statements. The hope is that capital markets will, over the long – term, force these companies to comply.

1.1.3 Destruction of shareholder value continues

It must be kept in mind that the frauds, company failure and resulting destruction in shareholder value has had negative influence on all stakeholders associated with these corporations. Employees have lost their jobs. Suppliers have gone out of business. One of the previous “big five” firms of global accountants, Arthur Anderson, no longer exists. Pensioners (strictly part of shareholders but who normally have minimal decision making power as they are represented by institutional shareholders) have suffered losses, in some cases, their life savings. Previous clients of the corporations have often been put in a difficult position, as the service or goods they received was suddenly no longer available.

Of course, we as individuals have been put in a position where we have become even more concerned with the risks of investment. We are very aware, that we not only have to concern ourselves with country risk, fiscal risk, monetary risk and industry risk, but that our direct or indirect investments may be in corporations that have poor systems of governance and therefore do not manage risk effectively.

Enron had a board of directors, audit and remuneration committees, internal and external auditors, all of which are required by the guidelines of most of the countries named above. If these corporate governance role – players were not enough to prevent what occurred at Enron, what confidence should stakeholders have in the guidelines in place around the world?

Corporate governance has been described in many ways. Sarah Teslik, Executive Director of the Council of Institutional Investors in the United States described it in her own, very practical way:

“It is almost comical to suggest that corporate governance is a new or complex or scary idea. When people own property, they care for it: corporate governance simply means caring for property in the corporate setting” (Ralls, 1997: 1).

The definition that appears to have stood the test of time is the definition that was included in The Cadbury Report (1992):

“Corporate governance is the system whereby companies are directed and controlled.”

It is the directors who are responsible for ensuring that the corporate governance system works. We, as shareholders, need to be satisfied that our investments are being protected and properly used. Therefore we must be satisfied that an appropriate corporate governance system is in place.

If one of the purposes of the system of corporate governance is to protect our investments, why has this not taken place? If directors are responsible for ensuring that the system of governance works, then directors around the world have a lot to answer for as we look back over the last decade.

The elements of corporate governance have been closely examined and changes have been made to the separate parts. For instance, studies have been made of audit committees in 2003 by a group in the UK led by Sir Robert Smith (Smith, 2003) and the role and effectiveness of non executive directors by Derek Higgs (Higgs 2003), but the same commitment has not been focused on how all the elements, or role players of corporate governance, can be integrated to ensure comprehensive corporate governance. The guidelines do not deal with the complexity of the current modern corporation and the powerful changing environmental forces that have huge influence on the risks of leading, directing, managing and controlling organisations.

Globalisation, technology and our modern society have had significant influence on the challenges and risks faced by corporations. Globalisation has intensified world- wide global relationships. Local action and events are influenced by events elsewhere in the world and global events are influenced by local action and thinking. We have an increasing perception of the world as a whole. Thinking and action is moving away from national and local to

international. Globalisation has been driven by technology that allows communication, knowledge and travel to flow and happen effortlessly. Society has quickly developed a global perspective and this has facilitated the rapid globalisation of corporations. Corporations have taken advantage of the opportunities that have opened up around the globe, but, at the same time their business has become more challenging, risky and messy.

The complexity of the global corporation creates many challenges for directors when they try to put in place a system of governance. The researcher's observations led him to be very concerned about the way directors around the world were trying to deal with this critical responsibility. Directors did not know enough about the financial, operational and regulatory risks of the corporation that they were directing. In most cases this critical responsibility was left in the hands of executive management. Executive management also struggled with this responsibility and therefore it was often given to consultants (normally the external auditors or other specialist consultants) to put an enterprise risk management system in place. Individuals were appointed to embed the system and the processes it relied on. These processes were never properly integrated with the overall governance processes. In addition, internal audit and external audit often continued to independently assess the adequacy and effectiveness of internal controls to manage risk. The results of this approach were sometimes disastrous. The independent action of executive management, management, external audit and internal audit left "huge holes" that created the opportunity for fraud and the manipulation of financial information.

Enormous efforts have focused on trying to improve the performance of directors. Directors competencies, independence of directors, committees to assist directors with their work, remuneration of directors, the relationship with external audit and assessing the performance of directors have all been put under the microscope and researched by many individuals and institutions. In spite of all this work and the important findings, the destruction of shareholder value continues.

The researcher is very concerned that until the "holes" in the corporate governance system are comprehensively dealt with, poor governance surprises will continue to disappoint and anger investors. This is the concern that has driven the researcher to conduct this work. He hopes that his passion, concern, experience and insights can be used to bring attention to this important aspect of governance that has received insufficient attention.

At the same time, the researcher recognises that modern day corporations are complex. The characteristics and behaviour of corporations, such as their human activity systems, require a

system of control that is different to simple engineered systems. The reliance on human beings with their unpredictable behaviour requires equivalent variety and responsiveness from intelligent control and monitoring systems.

Corporate systems are non – linear. Simple linear corporate models ignore the complexity, and increase risk to all stakeholders. In addition, traditional risk management and corporate governance approaches do not adequately deal with the important influence of power and culture on the overall risk environment.

The current simple, linear, guideline approach to corporate governance cannot deal appropriately with the complexity of the corporate situation, particularly when these guidelines are applied based on a “box ticking” exercise. “Box ticking” is the name that has evolved when corporations take the Code of corporate governance, and assess the effectiveness of their system of governance, by simply crossing off the provisions and principles the company complies with.

1.2 The concern

The guidelines have often been made use of in a “tick box” manner. This has prevented an integrated, systemic approach to the development of a system of governance. The researcher is concerned that the linear approach has resulted in “holes” in corporate governance systems that have allowed the destruction of shareholder value to take place. This destruction in shareholder value has had a negative influence on all stakeholders.

In order for the modern corporation to be governed successfully, it is necessary to develop an appropriate conceptual framework that allows for sufficient variety and responsiveness for modern, current complexity and risk, and which is supported by an acceptable theoretical foundation. The framework needs to be developed in a holistic, systemic way that reflects the reality of governance and ensures that light is cast on all the governance aspects.

1.3 The Research Question

Having briefly shown that corporate governance does not fully protect wealth building endeavours and specifically identifying the area of concern, it is now appropriate to develop a research question:

The general research context is corporate governance. The researcher's initial questions relating to this important discipline focused on the global destruction of shareholder value. The questions were as follows:

1. Are the global corporate governance guidelines adequate to prevent the destruction of value?
2. Can these voluntary global guidelines be improved to increase shareholder protection?
3. Should there be less emphasis on a code of good governance and more on market regulatory control?
4. How can boards, management and assurance providers be organised and integrated to ensure effective internal control environments in organisations, in spite of the increasing complexity of business?

When the above questions were combined, the fundamental research statement became:

Systemically develop a corporate governance framework that allows for sufficient variety and responsiveness for current complexity and risk, but at the same time encourages balance between control (or conformance) and performance.

1.4 Conclusion

The researcher has outlined the challenge of building wealth and the inadequate global response to this concern. Research questions were developed into a research statement to focus research effort on this concern.

CHAPTER 2

THE DEVELOPMENT OF CORPORATE GOVERNANCE

The researcher takes the reader on a journey that describes the development of corporate governance using the literature. The journey helps to describe the complexity of the challenge to guide corporations towards sound corporate governance practices and prevent the destruction of shareholder value.

The introduction and examination of the development of corporate governance, helps to build an understanding of the governance concern and the context from different perspectives.

2.1 Theory of corporate governance

Early company law was based on the *stewardship theory*. Directors were trusted to pursue their fiduciary duties to the company. They were expected to act as stewards of shareholders interests and place these interests above their own. Over the years an opposing theory emerged called the *agency theory*. This theory holds that given the chance, directors will pursue their own interests and cannot be expected to adopt a stewardship perspective unless appropriate checks and balances are put in place (Hampel, 1998).

The recent destruction in shareholder value of Enron, WorldCom, Allied Irish Bank, and in South Africa, Leisure Net and Regal Bank disasters, would persuade many that the agency theory is perhaps the more appropriate one in respect of the behaviour of directors, and senior executive management.

Professor J. Lorsch, Director of Research, Harvard Business School, was asked at the International Conference on Corporate Governance (2003) if the destructive greed related to "a few rotten apples in the barrel?" His response was very concerning; he felt it was not simply a few bad apples but that the barrel itself was rotten!

Agency theory has been challenged by what has become known as *stakeholder theory*. This theory claims that the corporation should serve the wider interests of stakeholders and not just the shareholders (Freeman, 1984; Blair, 1995). Stakeholders include employees, customers,

suppliers, communities and creditors. It is argued that they all affect the long-term success of the corporation and must be taken into account in the decision-making of the corporation.

The Hampel Committee (1998) in the UK dismissed the stakeholder notion. "Directors are responsible for relations with stakeholders, but are accountable to the shareholders." In the researchers personal experience this is the conventional wisdom in boardrooms in the UK and USA. German and Japanese governance structures are more aligned with stakeholder theory.

Letza, Sun & Kirkbride (2004) argue that the two extreme and opposite models cannot fully explain the complexity of corporate reality. They call for a new approach to the understanding of corporate practice to help the search for effective and efficient governance. Their work is effective in demonstrating that neither stakeholder nor agency theory perfectly aligns with the complexity and reality of the current, modern corporation. They do not suggest an approach that can practically deal with the many challenges identified but call for radical research.

King (2002) dealt with this important issue as follows:

*In governance terms one is accountable at common law and by statute to the company if a director, and one is responsible to the stakeholders identified as relevant to the business of the company. **The stakeholder concept of being accountable to all legitimate stakeholders must be rejected** for the simple reason that to ask boards to be accountable to everyone would result in them being accountable to no one. The modern approach is for the board to identify its stakeholders, including its shareowners and to agree policies as to how the relationship with those stakeholders should be advanced and managed in the interests of the company (King, 2002:7).*

King (2002) agrees with the Hampel Committee (1998) that the board is not accountable to all stakeholders, but does not simply accept agency theory where the board is accountable to shareholders alone. Instead King follows company law and states that the board is accountable to the company and responsible to identified stakeholders. This approach was called the "Inclusive Approach" and positions the company to undertake "triple bottom line reporting." This reporting ensures that the company expands its focus from only "bottom line reporting" to "triple bottom line reporting." This change embraces the economic, social and environmental aspects of the company's activities. In other words, the financial and non-financial aspects of a company's business, the effect on the environment of the product or the services produced by the company and the values, ethics and reciprocal relationships with stakeholders.

2.2 From Management emphasis to Governance

Corporate governance has actually been practised for over a thousand years, but the actual research and study of the subject is less than one hundred years old. We saw significant focus on management thought and theory in the twentieth century but corporate governance was not dealt with in the same way. In fact the term, “corporate governance” was only used in the 1980’s. Organisation theories have made great progress, but boards of directors and other governance role players did not seem to have received the same attention. Important theoretical insights were developed for the separate and specialist areas of finance, marketing etc. but not for corporate governance. There was almost a total preoccupation with management. Many were made out to be heroes through popular magazines like Time, Fortune, Harvard Business Review etc. These individuals were seen to be very powerful and indeed they were. The seeds of their destruction, and, unfortunately, the destruction in shareholder value were sown. This massive destruction in shareholder value has generated a huge wake up call:

“The new century promises to become an era of corporate governance – as the focus swings to the way in which power over corporate entities is wielded, made effective and legitimised” (Tricker, 2000: 289).

2.3 The Corporate Governance Journey

A comment of Adam Smith, as early as the eighteenth century, is often quoted to demonstrate that he understood the issue of corporate governance, even though the name did not exist:

“The directors of the company, being managers of other people’s money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own” (Adam Smith, 1776).

Berle and Means (1932) used data from companies in the United States to demonstrate the growing separation in power between executive management of public companies and their diverse and remote shareholders. They realised the significance of corporate power:

“The rise of the modern corporation has brought a concentration of economic power that can compete on equal terms with the modern state – economic power versus political power, each

strong in its own field. The state seeks in some aspects to regulate the corporation, while the corporation, steadily becoming more powerful, makes every effort to avoid such regulation.... The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but also possibly superseding it as the dominant form of social organisation" (Berle & Means, 1932).

This was the first significant work on corporate governance. It took forty years before this study was taken forward.

In the 1970's three significant developments occurred in corporate governance thinking:

- Independent directors and outside audit committees were emphasised.
- The two – tier board was promulgated in Europe
- Shareholder involvement was being robustly debated.

The two – tier board, which arose out of governance practised in Germany and Holland, replaced the unitary board in Europe. Here companies have two boards. An executive board runs the business and an upper supervisory board is responsible for monitoring and overseeing the work of the executive board. There is no common membership. The United Kingdom responded with a report by a committee chaired by Lord Bullock (*The Report of the Committee of Inquiry on Industrial Democracy 1977*).

This was the first serious study of corporate governance in the UK. The Committee proposed the continuation of the unitary board, but with the addition of directors who represented the workers. This was not well received. British business did not like the co- determination ideas practised in Germany. This was seen as almost a partnership between capital and labour.

The role of the corporation in society started to be questioned. The argument was that companies have a responsibility that goes beyond their shareholders. It was suggested that boards should be responsible and accountable to a range of stakeholders that would be affected by board decisions. These included employees, suppliers, customers, the community and government (Fogarty, 1975).

In the 1980's stakeholder concerns slipped into the background driven by the market-orientated economics of Reagan and Thatcher. The director's responsibility to increase

shareholder value was reinforced. Profit performance for shareholders was the basis for privatisation of state run entities.

Corporate governance started to receive significant attention in the UK, not because of academic research, but instead because of a number of corporate collapses and board and executive excesses. One of them related to Robert Maxwell. The Department of Trade inspectors had earlier in 1971 decided that he should never run a public company. Unfortunately, this advice was ignored and he was allowed to build a large media company. In 1988 the Mirror Group pensions scandal attracted global attention. Maxwell used the Mirror Group pension funds to try and support his failing businesses. This caused long-term damage to the public's trust in the probity and competence of boards and directors Garratt (2003).

In the 1990's major institutional investors realised they had enormous investor power. They became pro-active in corporate governance. The Californian State Employees Pension Fund (Calpers) produced Global Principles for Corporate Governance. In the UK Hermes is a stand-alone investment manager, wholly owned by the largest UK pension fund, BT Pension Scheme. Through its investments Hermes is exposed to under performing companies. Hermes understood the importance of sound governance practices for long-term shareholder value. As a result it has become a leader on issues of corporate governance and shareholder involvement.

In the UK, and then later around the world, a report by the committee chaired by Sir Adrian Cadbury (1992) on the financial aspects of corporate governance, had a significant effect on thinking on corporate governance.

The report emphasised:

- Importance of independent non-executive directors
- Audit committees

Some felt that the report went too far, as the emphasis on independent non-executive directors might, in a round about way, introduce the European two-tier board system. Others felt the report did not go far enough (Tricker, 2000).

Many countries followed this important lead by the Cadbury committee. Among them South Africa produced the first King Report (1994).

Cadbury had focused on conformance and compliance, whereas an Australian Committee on corporate governance (1993), headed by Professor Fred Hilmer, made a strong argument that governance is about **performance and conformance**.

The Australian report argued that the board's key role was to ensure that corporate management is continuously and effectively striving for above-average performance, taking account of risk (Hilmer, 1993).

The committee called their report "*Strictly Boardroom*." The name was derived from a film that was called "*Strictly Ballroom*." The film portrayed the world of competitive ballroom dance where originality and innovation had been sacrificed to inflexible and inhibiting rules and regulations. Hilmer's committee argued that corporate governance was going in the wrong direction if conformance and compliance overshadowed performance.

In 1998 a UK committee on corporate governance chaired by Sir Ronald Hampel reported on the Cadbury proposals and recommended a code of best practice that simply combined previous codes developed by Cadbury and Greenbury. Greenbury had focused on remuneration principles. The committee, consisting mostly of directors of major public companies, rather predictably, decided that there was no need to limit director's powers to make wide decisions or to make them more accountable.

The King Report (2002) on Corporate Governance was published in South Africa and is known as King 2. It replaced the first King Report (1994) and was effective for all affected companies from 1 March 2002. The committee recommended an inclusive approach with greater emphasis on sustainable or non-financial aspects of company performance. The so-called triple bottom line reporting. In addition, companies needed to be open to institutional activism.

Unfortunately, the most demanding driver of change in corporate governance, will probably be future corporate destruction in shareholder value because of the complexity of the modern corporation and the imbalance of director and executive management power:

"The telling driver of change in corporate governance is the dynamic, flexible new corporate structures, often global, that were replacing the stable, often regional, corporate groups of the post war years – massively complex networks of subsidiary companies and strategic alliances with cross-holdings of shares, cross-directorships, chains of leveraged (and often

public) funding, dynamic and ever changing operational and financial linkages throughout the added value chain. Networks that operated in multiple jurisdictions, cultures and currencies; groupings with voracious appetites for growth. Top management of major corporations around the world are now wielding enormous power. Whilst claiming to reflect owners' interests, directors were seen to be pursuing their own agendas and expecting huge rewards- privileges reserved in earlier generations for aristocrats and King (Tricker, 2000: 294)."

2.4 Conclusion

At the end of the twentieth and the beginning of the twenty-first centuries we have seen the emergence of a greater focus on corporate governance. This focus increased at the end of 2001 and early 2002 with the destruction of Enron and WorldCom shareholder value. Around the world, regulators, governments and large institutional shareholders, urgently tried to introduce, or improve, corporate governance guidelines. The USA introduced strict legislation.

In spite of this increased focus, the destruction of shareholder value continues. The Parmalat fraud received publicity at the end of 2003, and in 2005, we have taken note of the MG Rover and reinsurer difficulties. The complexity of the situation requires an integrated, systemic approach. This approach will help to reduce the opportunities for fraud and encourage corporate performance.

CHAPTER 3

INDIVIDUAL INQUIRY FRAMEWORK

Chapter 3 and Chapter 4 develop a theoretical framework for inquiry to focus on the research question. The purpose of the framework is to guide the research to deal with the problem situation identified in Chapter 1 and further developed in Chapter 2.

Chapter 3 incorporates the research objectives and a philosophy to inform and ground the inquiry.

3.1 Research Objectives

The researcher's overall purpose, is to develop a framework that can be used by directors, senior executives, external auditors, internal auditors and other important stakeholders, such as shareholders, to guide effective corporate governance. It should also be possible to use the framework diagnostically to identify poor governance. In addition, the researcher wishes to test the validity of the framework in practice so as to improve it, further enhance his understanding of effective corporate governance and to identify areas of research for the future.

This process will help him to learn about research enquiry and extend his knowledge of corporate governance. Achieving these objectives will ensure that the long research process will be personally rewarding.

3.2 The Research Framework

As researchers we endeavour to get closer to the "truth." In order to get closer to the truth it is important to have a framework to guide one on the "inquiry journey." This framework helps the researcher to apply a rigorous inquiry approach and to stay focused through the long process. It also helps communicate the rigour of the research process.

A theoretical framework for research inquiry has the purpose of further understanding the problem situation and guiding the research inquiry process. This framework will incorporate a philosophical stance that will then guide the selection of an appropriate research strategy or methodology.

The understanding of the problem and the appropriateness of the corrective action are limited by the researcher's perception of the situation, the knowledge relating to the situation and the value system of the researcher. It is, therefore, important to share openly the assumptions and beliefs that the researcher holds so that the reader can fully understand how these influence research decisions and actions. Crotty (1998: 17) described this process as follows:

“The long journey we are embarking upon arises out of awareness on our part that at every point in our research – in our observing, our interpreting, our reporting and everything else we do as researchers – we inject a host of assumptions. These are assumptions about human knowledge and assumptions about realities encountered in our human world. Such assumptions shape for us the meaning of research questions, the purposiveness of research methodologies, and the interpretability of research findings. Without unpacking these assumptions and clarifying them, no one (including ourselves) can really divine what our research has been or what it is now saying. “

At the beginning of the research process it is important to set out the researcher's assumptions about knowledge, reality and values. The three major fields of philosophy are epistemology, metaphysics and axiology. Respectively they deal with the question of knowledge, the nature of reality and the importance of values. By making plain the researcher's views and assumptions relating to these major areas of philosophy, it positions the reader to understand the philosophical perspective of the researcher as he endeavours to undertake the research process.

3.3 The Philosophical perspective

3.3.1 Epistemology

For the purposes of my research, the most important philosophical assumption is the epistemology that guides the research. Epistemology refers to the assumptions we hold about knowledge and how this can be obtained. It deals with the nature of knowledge; its possibility, scope and general basis (Crotty, 1998:8). “Epistemology is concerned with providing a philosophical grounding for deciding what kinds of knowledge are possible and how we can ensure that they are both adequate and legitimate (Crotty, 1998:8).” There is a range of epistemologies. The researcher has focused on objectivism and constructionism. Objectivistic epistemology holds that meaning and therefore meaningful reality exists apart from the operation of any consciousness. The tree in the forest is a tree whether anyone is

aware of its existence or not. When human beings recognise it as a tree, they are simply discovering a meaning that was there all the time (Crotty, 1998).

Constructionism rejects this view of human knowledge. There is no objective truth waiting for us to discover. Truth or meaning comes into existence through our engagement with the realities of the world. There is no meaning without a mind. Meaning is not discovered but constructed. Consequently different people may construct meaning in different ways, even in relation to the same phenomenon. This is the epistemology that researchers make use of when focusing on social issues and problems.

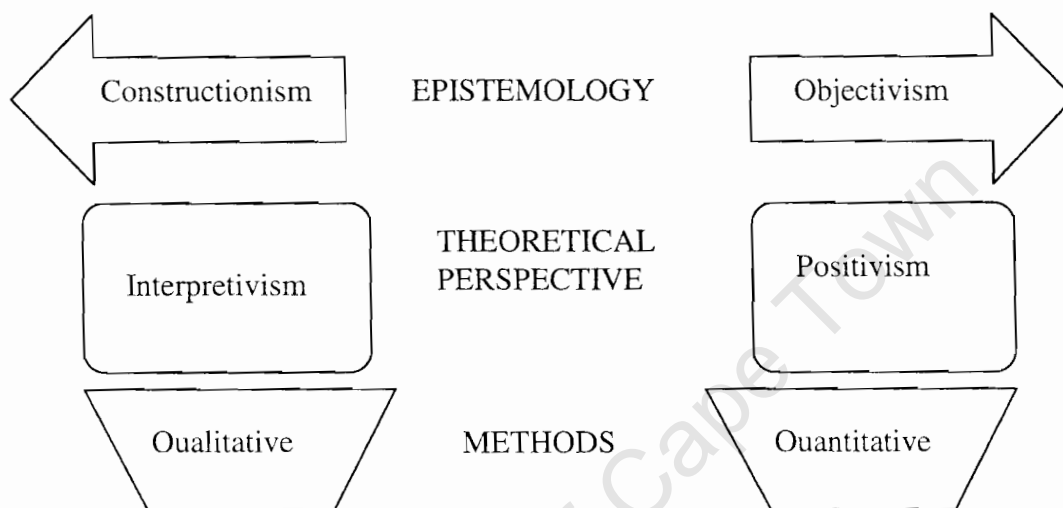


Figure 1 Research Approaches

The two different philosophical epistemologies lead to different research approaches and action. People make different assumptions about the world and as a result have different beliefs about it. This results in different approaches to the way in which they will undertake inquiry and develop knowledge of the world and truth. An interpretative research model is applied if the epistemological assumption is grounded in a constructionist philosophy and a positivistic research model is applied if the assumptions are grounded in an objectivist philosophy.

3.3.2 Theoretical Perspective

The theoretical perspective underpinning the methodology that the researcher will employ is interpretivism. Crotty, (1998) stated that the theoretical perspective provided a context for the research process and a basis for its logic and criteria. Interpretivism emerged to understand

and explain human and social reality. It looks for culturally derived and historically situated interpretations of the social life – world. (Crotty, 1998:67)

This interpretive approach to human inquiry has appeared in a number of guises. One of the labels was pragmatism. Pragmatism elevates the use of things above the knowledge of things (Misak, 1991). It encourages a practical approach rather than a purely theoretical one. This is the philosophical approach that the researcher requires to deal with the real world managerial and leadership issues of corporate governance.

3.3.3 From theoretical perspective to systems perspective

Annexure H is an introduction to systems thinking.

The designers of systems approaches will have incorporated, either consciously or unconsciously assumptions about systems thinking and the nature of social systems (or society) (Jackson, 2000:23). The researcher has adopted an interpretive social perspective that will affect the way he perceives systems and problem situations.

By viewing systems from an interpretive paradigm, the researcher views systems as the creative construction of human beings. Systems are understood by trying to understand the points of view and the intentions of the human beings who constructed them. To acquire information about the system the researcher must examine its activities. By having an informed understanding of such systems, prediction and control are facilitated (Jackson, 2000).

This systems perspective has been called an interpretive systems approach.

3.3.4 Interpretative systems approach

This is often referred to as “soft systems thinking” (Jackson, 2000:211). This theoretical perspective focuses on people. People with all their unpredictability, their different values, perspectives, beliefs and interests are considered seriously when this approach is followed. After all, people build systems, develop technology and create structure. It is important that we take into account their multiple perceptions of reality. People give meaning to their situations and understand corporations from their personal perspective. It is important that the beliefs and values of the organisation are shared to ensure corporate effectiveness and sustainability. Politics emerges from the different interests and different perceptions of situations. Systems from this perspective are not objective and independent from people.

Systems are seen as the creative constructions of human beings (Jackson, 2000). Soft systems thinking is built on this perspective and endeavours to understand the intentions of people who are part of the problem situation. People are seen to have a free will and therefore must be involved in changing and improving the systems that they create.

3.3.5 A metaphor to further clarify my assumptions

The researcher is aware that many have attempted to understand or describe the corporation by using metaphors. Skilled managers also use metaphors to enhance creative insight and to develop critical thinking (Jackson, 2000).

The interpretive approach used by the researcher has used *culture* and *political system* as metaphors to describe the organisation. The researcher builds on the *culture* metaphor. Through wide and deep experience of corporations and corporate governance, the researcher began to develop a mental model of corporate governance within corporations as a *fishing net*. This *fishing net* was viewed as being strongly influenced by the culture of the organisation. Where the culture of a corporation encouraged, sound, integrated governance, the *fishing net* had small holes. Here all the people of the organisation and the governance role players were aligned with the purpose of corporate governance and took integrated action to embed the processes. A unified culture was in place.

Where the culture of the organisation worked against a commitment to people, it did not encourage sound, integrated governance; the *fishing net* had huge holes. Here there was no unified culture. Positions for governance were identified, but embedded, integrated governance was not present.

3.4 The framework and corporate governance

The research enquiry area of focus is corporate governance. This is an area where human activity systems predominate and it is a “messy,” complex, environment.

The current situation relating to governance guidelines shows that they have been developed by the stakeholders, who have most to lose from reform, this being the directors and senior executive management. They have used a linear approach to develop guidelines.

With this backdrop and understanding of the context to the problem situation, it is necessary to consider the epistemological and theoretical perspectives which ground the research.

The epistemology that will be the foundation for the research journey is constructionism. Over time corporations build a unique culture. The power relations that are inherent in the organisations heavily influence them. A constructionist epistemology lends itself to an analysis of human activity systems. Knowledge, reality and meaning appropriate to the corporate governance question evolve and grow from the stakeholders that are part of the corporate governance processes. The goal is to develop a framework to guide executive management and the directors to improve corporate governance practice. It is not possible to achieve this goal by objectively and scientifically assessing separate corporate governance practices and guidelines that are in place. The corporate governance people/ role players are very much part of the corporate governance system and influence its overall effectiveness. This is where data will be found that can improve current practices. People develop corporate governance guidelines and create practices through the implementation of these guidelines. People, including all stakeholders that are influenced by corporate governance practices, have their views as to what is working and what is not working. This is where the rich data lies that needs to be collected, synthesised and understood to improve governance practices and develop an Integrated Governance Framework.

3.5 Using a pragmatic approach for inquiry

Now that a comprehensive philosophical foundation to undertake research is in place, it is important to ground the manner in which the research will be undertaken.

In the field of management it is important to develop an inquiry framework that can be applied practically to the problems and challenges of management.

Pragmatists contributed to the study of epistemology by attacking the notion of absolute, unchanging truth. In place of absolute truth, pragmatists developed a pragmatic theory of truth. Truth was hypothetical until tested by experience. We make truth happen through the action we take. In taking action in different ways, regarding an idea we have, we make the idea true or false for that action and any future action. Peirce's pragmatic account of truth states that a true belief is one that is fated to be agreed upon were we to inquire as far as we could (Misak, 1991).

Inquiry is thinking with purpose. Peirce first identified the importance of the "**method of science**," but it was Dewey who extended this view and made it popular among social scientists. Dewey (1933) wrote that inquiry was comprised of 5 phases. The phases of inquiry were set in motion when a person confronted a confusing situation:

1. Suggestions where the mind leaps to a possible solution
2. An intellectualisation of the difficulty into a problem to be solved.
3. The use of one suggestion after another as an idea or hypothesis to initiate observation and action
4. The mental elaboration of the idea or hypothesis
5. Testing the hypothesis

Dewey did not part from Peirce's logical depiction, but opened inquiry to both the expert and ordinary person.

Pragmatism, with regard to knowledge, elevates the use of things above the knowledge of things (Misak, 1991). It focuses on the practical aspects of knowledge rather than pure theory. It requires theory to ensure we have the understanding to achieve appropriate solutions to our problems.

The researcher has referred to the "method of science." The researcher chose to use this term as the term "scientific method" has sometimes been seen to be aligned with the positivistic view that treats the social world like the natural world (Hard, external and objective reality). The method is then used to search for universal laws which explain and govern the reality which is being observed (Burrell & Morgan, 1979). This positivist approach to the social world is not appropriate for the study of human behaviour in corporations with its immense complexity.

Before we continue with the development of the inquiry process it is important to deal in some detail with the method of science so that we understand how it has been used to drive inquiry:

3.5.1 The Method of Science

The method of science is used to pursue truth and drive inquiry.

The function of the method of science is:

1. Production of theories for explanatory purposes or to make predictions.
2. Comparing theories against evidence which then positions us to confirm or adjust our theories

The method is powerful as it is based on observation and tested in experience. This experience is the beginning of knowledge.

The start of this method is the observation of an unsatisfactory situation. Often this is where we experience an unexpected result. In a management context this tends to be when the manager is faced with a problem where the elements are difficult to identify. The manager desires to move from this situation (the result), through investigation to understand the cause. Taking into account current knowledge of the situation, (the rule) the manager develops a hypothesis (the case) to explain the situation (Yu, 1994).

This first stage is called abduction.

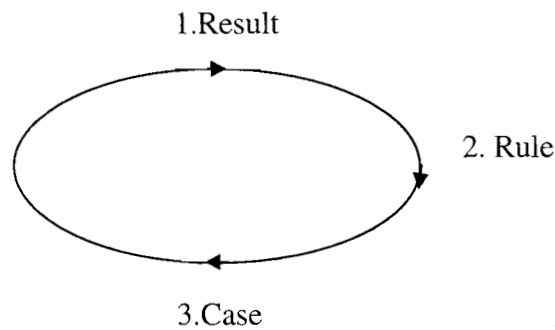


Figure 2 The abductive cycle

The abducted hypothesis/theory is used to make predictions about the results that will be generated by testing. Consequences are deduced from the hypothesis (Yu, 1994).

In this phase, experiments (rules) are developed for application to the situation (case). Predictions (results) are then made. It is essentially a stage where the value of the hypothesis is tested. This outcome is reached by experience (*Deduction*)

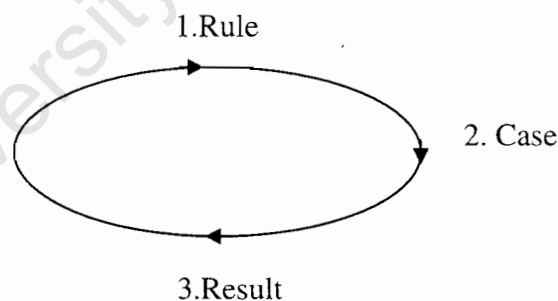


Figure 3 The deductive cycle

The results are compared to the results predicted by the hypothesis and in this way the truth content is established. The process of induction starts from the hypothesis (case) and the

results to the rejection or modification of the theory or hypothesis. The method reflects on the validity of the hypothesis.

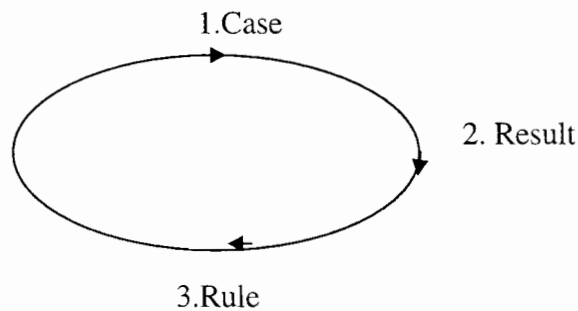


Figure 4 The inductive cycle

For Peirce, reasoning requires that a person should apply abduction, deduction and induction together to achieve a comprehensive enquiry (Yu, 1994).

Inquiry follows the cyclic process of abductive, deductive and inductive reasoning. The experiences and results generated through the cyclic process help us develop better hypothesis and theories. The method of science is therefore a valuable enquiry process to develop our knowledge, question our reality and adjust our values.

The inquiry into the development of an integrated corporate governance network will follow the method of science:

1. Through observation, the unsatisfactory situation relating to corporate governance was identified.
2. Based on these observations, experience and a literature review, the researcher will develop an integrated framework (Abduction reasoning process)
3. Testing the framework with action (Deduction)
4. Reflect on the results and compare the response with what was expected. Finally he will modify the framework where appropriate (Induction)

3.5.2 Approaching Truth

The pragmatic inquiry process of getting closer to the truth needs to be carefully considered. Inquiry is an approach that is used to better understand “truth.” This is of course essential to solve problems. The path of inquiry to get closer to the “truth” is therefore very important.

Peirce presented this path of enquiry as follows (Misak, 1991):

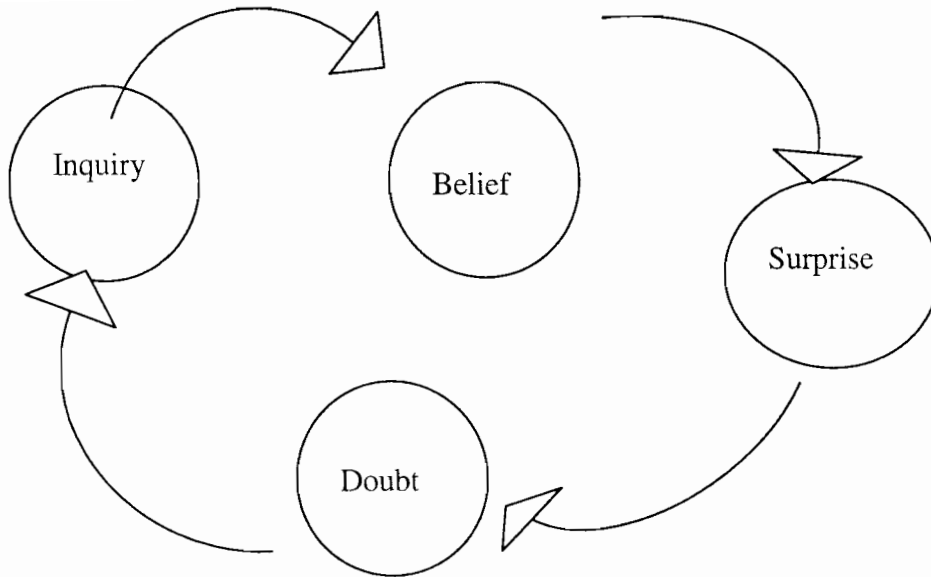


Figure 5 Adapted from Path of Enquiry Peirce (Misak, 1991).

Beliefs develop over a period of time. They are influenced and updated through a process that has been depicted in The Ladder of Inference that was developed by Chris Argyris (1992):

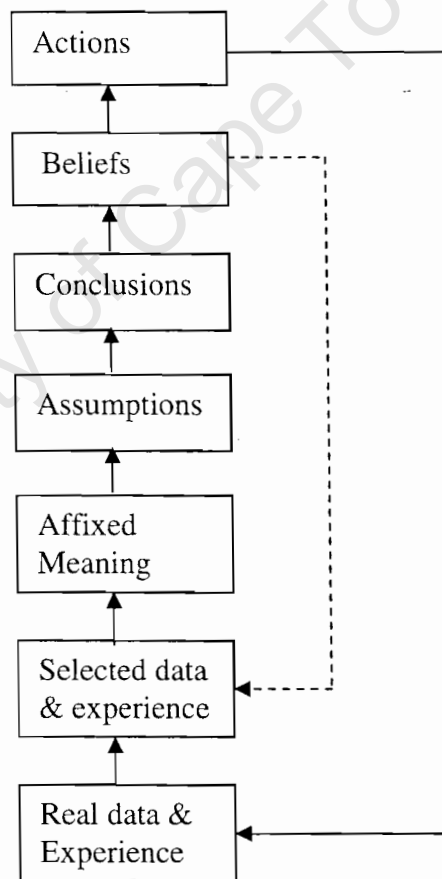


Figure 6 Ladder of Inference

Our beliefs influence the selected data and experiences we select and pay attention to. The tendency is to select and pay attention to data that supports our beliefs. The relevant question is how do we stop short-circuiting our search for truth and understanding because we are blinkered by our beliefs

As we immerse ourselves in a process of inquiry we position ourselves to be surprised by our findings and experiences. This surprise results in us experiencing self-doubt regarding our knowledge. We need to keep in mind the way in which we are tempted to short circuit the search for truth rejecting the data that conflicts with our beliefs. We need to struggle with the doubt to escape in order to regain belief. Doubt must push us to conduct further inquiry to eliminate the doubt. This action enables us to update our beliefs as we move forward again to conduct further inquiry. We continue the inquiry process until the doubt has been satisfactorily settled. Peirce attributes an eagerness to learning the truth to the dissatisfaction that doubt causes in man. Doubt has been described as:

“an uneasy and dissatisfied state from which we struggle to free ourselves and pass into a state of belief” (Misak, 1991, p53).

The individual will continue the enquiry process until doubt is satisfactorily settled.

This self-driven motivation can be added to the process of learning which Handy (1989) likens to a wheel of activities. As the wheel goes round we raise new questions and search for new answers. One set of questions duly answered, tested and reflected upon, leads onto another set. It is life’s special treadmill (Charles Handy, 1989).

Argyris (1992) developed the concept of double – loop learning. Individuals carry views and beliefs of the way in which the world functions. These beliefs can change as a result of our action and interactions with the world. The inquiry process updates our knowledge and the double- loop learning refers to the change that this brings to our beliefs

3.6 Conclusion

The aim of inquiry is to approach truth. We have to be aware of our in- built limitations in our journey to get closer to the truth. We have to allow new data and the surprise it brings to create doubt with our beliefs. We have to accept that the anxiety and doubt helps to push our knowledge boundaries and keeps us on the inquiry journey. Through the inquiry process,

where we take action and interact with the world, generating real data, we are constantly broadening the field of our knowledge, changing our perception of truth and adjusting our values or beliefs. Therefore truth is a concept that is inherently part of epistemology, metaphysics and axiology.

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CHAPTER 4

THE RESEARCH METHODOLOGY

The research process moves from examining the underlying philosophical perspectives that inform the research through to the methods of research. This Chapter focuses on the specific methods of research.

Constructionist epistemology, together with the interpretive theoretical perspective, require a qualitative approach to the research. There are many qualitative research tools and methods. The specific methods applied will be informed by the nature of the research and the philosophical foundations on which the research is built.

A research methodology is a strategy of inquiry that is contingent on the underlying philosophical assumptions. It deals with the research design and the collection of the data. The following research methods were incorporated into the overall research framework:

4.1 Action Research

The interpretive theoretical perspective encourages a process of inquiry involving collaboration between researchers and the people in the situation. Action research is an appropriate methodology that supports reflective learning in a social context.

Action Research requires the researcher to immerse him or herself in the problem situation as a participant, and to contribute to improving the situation. Checkland and Holwell (1998) developed a model of action research as follows:

1. One or more research themes
2. Researcher declares in advance a framework of ideas and embodies them in a methodology to be applied to an area of concern.
3. The researcher enters a real world situation and takes part in the change process.
4. The researcher reflects on experience and involvement in the situation.
5. Reflection can lead to learning in relation to the framework, methodology or area of concern.
6. Findings can be incorporated into the framework, methodology or area of concern.
7. The cycle may be iterated a number of times.

(Checkland and Holwell, 1998: 26)

Action Research is a process where change and understanding are pursued at the same time. It is cyclic with action and critical reflection taking place after the action. The reflection is used to review the previous action and plan the next action.

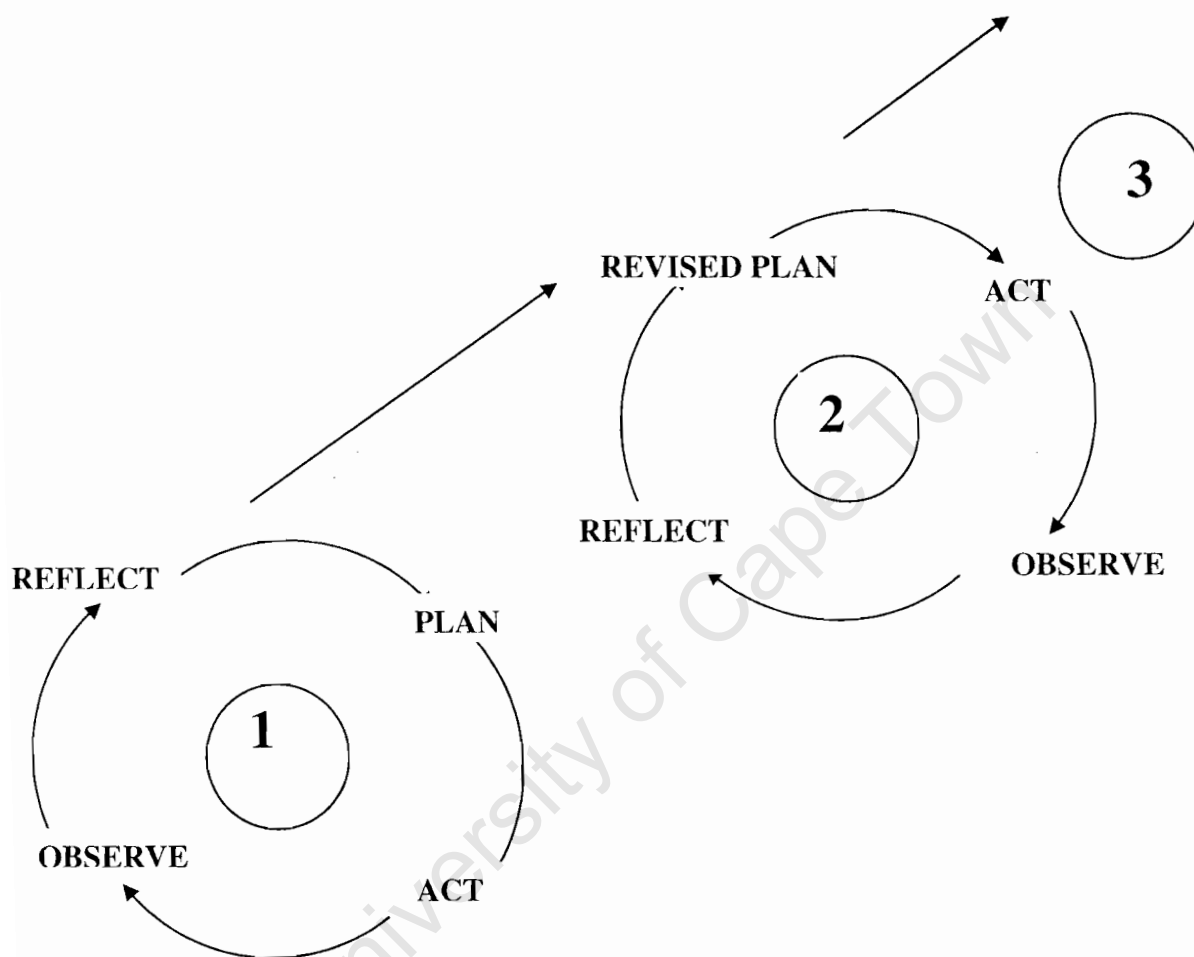


Figure 7 Action Research Spiral adapted from Ortrun Zuber-Skerritt (1995).

The researcher has identified a concern that is part of the topic of corporate governance. This concern has been linked to a situation or context and gives rise to a corporate governance practical problem that has been developed in Chapter 1. It is complex and the solution is not immediately obvious. The Action Research spiral above will help ensure rigour in the Action

Research. Rigour in Action Research (confidence in the data and interpretations) can be achieved through a number of methods (Dick, 2002).

The researcher intends to use the following:

- Two cycles of Action Research (Using a cyclic procedure as shown above).
- Multiple sources of data within each cycle.
- Combining data collection and data interpretation in each cycle.
- Different participants and informants.
- Literature as a source of disconfirming evidence.

4.2 Grounded Theory Method

In order to build an Integrated Corporate Governance Framework, the researcher required a method that would enable him to develop the theory for the Framework. Grounded Theory was ideal for this purpose as it is an emergent research process with certain similarities to Action Research.

Smith (2004) dealt with research methods for accounting and business studies and comments that Grounded Theory has been increasingly adopted as the preferred qualitative approach in accounting field study environments. In addition, Page & Spira (2004) used Grounded Theory as their research method to investigate the impact of the Turnbull Report and current developments in internal audit for the Research Committee of The Institute of Chartered Accountants of Scotland. They referred to the increasing acceptance of Grounded Theory within the accounting literature. Laura F Spira is Professor of Corporate Governance at Oxford Brookes University. Her research interests include aspects of governance and accountability.

Grounded Theory begins with a research situation. Within the situation, the task of the researcher is to understand what is happening and how the role players manage their roles. This is done through observation, conversation and interviews. After collecting data it is necessary to note down the key issues. Bob Dick (2002) calls this “note-taking”

Constant comparison is the heart of the process. A researcher will compare an interview to interview, or data to data. Theory emerges quickly from this process. The next stage is to compare the data to the theory that has emerged. The results of this comparison are written in

the margin of the notes as coding. The task is to identify categories (equivalent to variables) and their properties (in effect, their sub-categories)

As the categories and properties emerge they provide the theory. As this happens further notes are recorded about the theory (memoing). As the data collection and memoing proceeds codes and memos accumulate. When the categories are saturated it is time to move to sorting the memos in the order that makes the theory clear.

In summary, data collection, note-taking, coding and memoing occur simultaneously, from the beginning. Sorting occurs when all categories are saturated. Writing up the theory can now take place easily. The literature is accessed as it becomes relevant. It is not given special treatment Glaser (1998).

Grounded Theory has its own sources of rigour (Bob Dick, 1998). It is responsive to the situation in which the research is done. There is a continuous search for evidence that may invalidate the emerging theory. It is driven by the data in such a way that the final shape of the theory is likely to provide a good fit to the situation. Glaser (1998) provides two main criteria to judge the adequacy of the emerging theory: that it fits the situation; and that it works (It helps people in the situation to make sense of their experience and to manage the situation better.). The researcher suggests that this is a worthwhile goal as it is about making a real difference in the lives of people in problem situations. An Integrated Corporate Governance network has the potential to do this.

The Grounded Theory method is embedded as part of the overall Action Research methodology.

4.3 Data Collection

The data collection process required two stages: the first stage - the collection of data for the Integrated Governance Framework; and the second stage - testing the data.

The data for the development of the Framework was obtained from a wide variety of journals, web sites, articles, books, corporate governance case studies, international corporate governance conferences, discussions, informal interviews and personal experience. The development of the Framework from this data requires application of the Grounded Theory method. The inquiry framework and the systems approach guide this action.

Once the Framework is developed, it will be tested on a small sample of corporate governance experts. The target population will be the partners of the “big 4” firms of Chartered Accountants responsible for corporate governance in South Africa. These partners were selected for their wide and in depth experience of corporate governance in South Africa. According to Neuman (2000) *“A researcher may use purposiveness sampling to select members of a difficult-to-reach specialised population.”*

Purposive sampling is an acceptable kind of sampling for special situations; one of these is when specialisation is present (Neuman, 2000).

With purposiveness sampling the researcher does not know whether the case/ individual represents the population. It is used in field research to gain greater understanding and insight rather than trying to ensure a representative sample is obtained.

The data collection method will be in the form of unstructured interviews that will involve asking questions, listening, expressing interest and recording what was said.

In addition, the researcher intends to obtain an invitation to the 6th International Corporate Governance conference at Henley Management College to further test the framework with global experts from the industry.

The systems approach is used throughout the research process. It is not always specifically acknowledged, however, it influences the mental model or perspective the researcher uses.

The researcher has called the first cycle of Action Research Cycle 1.

The framework for cycle 1 is summarised in a diagram below:

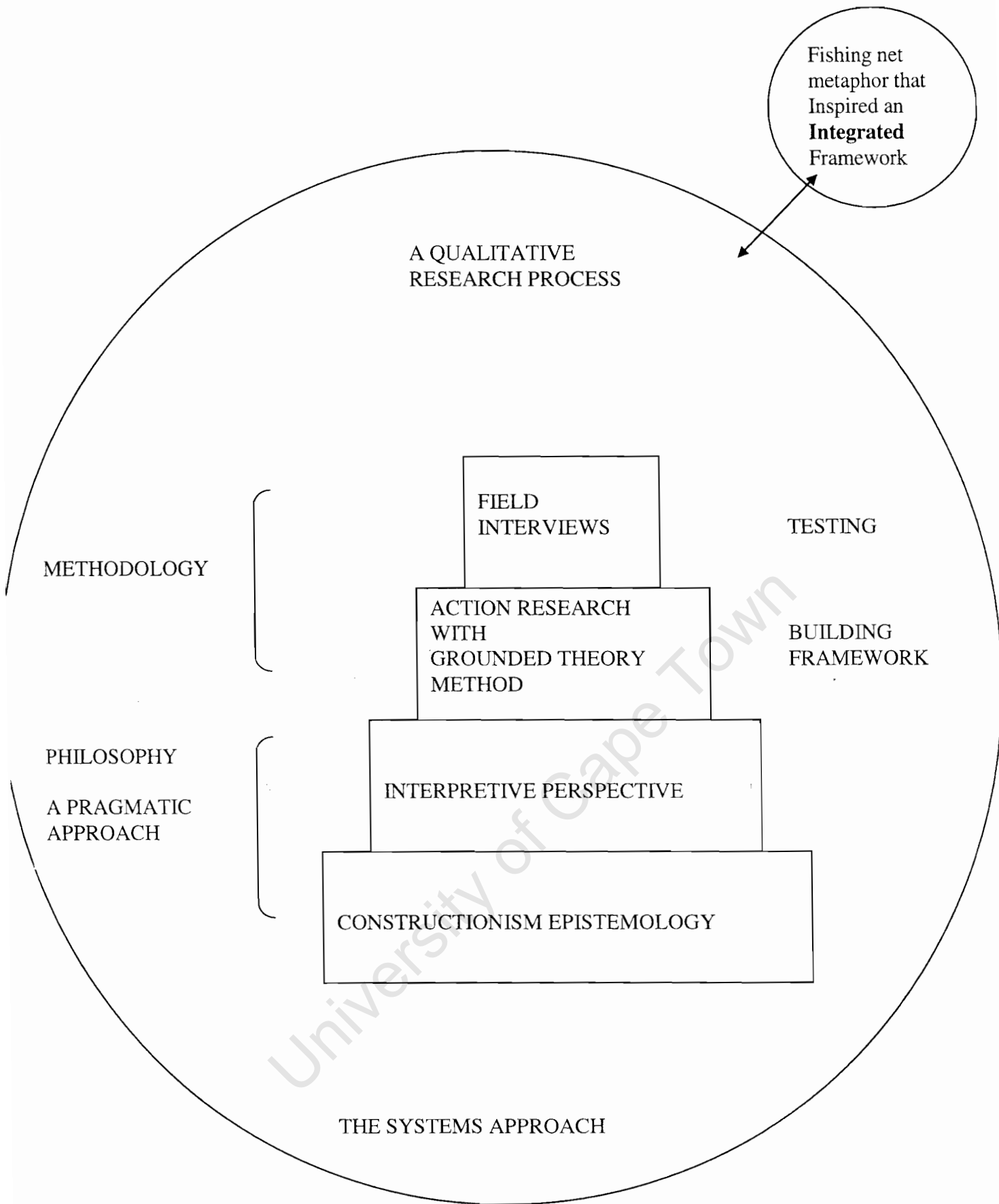


Figure 8 Research framework for Cycle 1

4.4 Conclusion

A framework has been developed to guide the research process. In the next chapter the researcher applies the research framework to the problem.

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CHAPTER 5

INTEGRATED GOVERNANCE FRAMEWORK - CYCLE 1

The purpose of this chapter is to apply the theory developed and embedded into the research framework described in Chapter 3 and Chapter 4, to the problem situation.

This chapter sets out the action taken to develop the Integrated Governance Framework. Certain categories developed through this process and embedded in the framework are explained. Variables, that are part of this Framework are also identified and described.

The final part of the chapter describes the testing process and the feedback data that was generated from it. This feedback was synthesised into 3 main challenges to the Framework set out at the end of the chapter.

5.1 Developing the Integrated Governance Framework

Through the interactive process of observation, discussion, informal interviews, literature review, and reflection, the researcher developed an Integrated Governance Framework.

Action Research was the research method, with the Grounded Theory method to identify the important categories and variables of corporate governance that emerged and were incorporated into the Integrated Framework. The Grounded Theory method also helped to identify the important interrelationships to ensure that the Framework is systemic and integrated.

5.1.1 Data Gathering and Analysis

The data for the development of the Framework was obtained from a wide variety of journals, web sites, articles, books, corporate governance case studies, international corporate governance conferences, discussions, informal interviews and personal experience. The development of the Framework from this data required application of the Grounded Theory method. The inquiry framework and the systems approach guided this action.

Detailed notes were maintained of the data obtained from the above sources. These detailed notes ensured that the researcher was fully grounded in the data. Preliminary analysis of this data was undertaken for a conference presentation. The researcher made use of an affinity

diagram to organise and analyse the vast amount of data for presentation purposes. This initial analysis identified the roles of directors, executive management, internal audit and external audit as being vital for sound, integrated governance practices.

The researcher created a table with columns for 'categories' and 'concepts.' This allowed the researcher to code the data into specific concepts. The researcher initially used the affinity diagram roles as the categories to start the data coding process. In carrying out this activity, and through the notes that the researcher made, he became aware that certain behaviour and action was required from these important governance role-players. He took the decision to use this insight to identify the categories. The concepts were organised to link to the categories that emerged from the theory building process. The categories were Awareness, Action, Assurance and Activism.

The initial table was very large as it was based on the original data. It was necessary in the final stage of the analysis to summarise the concepts in the table. This table is reproduced below.

Table 1 Categories and Concepts emerging from Grounded Theory Method

<u>CATEGORY</u>	<u>CONCEPT</u>
Awareness	1. Directors and executive management to change culture through changes in personal behaviour and "the tone at the top" to ensure all people understand the concept of integrated governance. The joint action and focus of the people become the greatest control in the management of enterprise wide risk.
Action	1. The Board develops a policy for the management of risk and risk tolerance criteria. 2. Executive management, together with the Board clarify the purpose of the company and develop an appropriate strategy which takes into account the external environment and capabilities of the company. 3. This strategy has to be monitored constantly, and, if necessary, changed. 4. Executive management documents the business model and value chain.

<p>Action</p>	<p>5. Executive management ensures that effective processes are put in place to implement the strategy.</p> <p>6. Executive management ensure the correct people are in place to implement the strategy and embed the processes.</p> <p>7. Executive management ensures that all the risks, which could prevent the objectives of the strategy being achieved, are identified. These risks should be linked to each process. The risks should be assessed and appropriate controls put in place to manage them. A monitoring process ensures the continuing effectiveness of the controls.</p> <p>8. Directors review the risk assessment and ensure they are comfortable that all risks have been identified. Executive management also needs to demonstrate that the controls are cost effective in relation to the risks managed.</p> <p>9. All risks must be covered. i.e. operational, financial and regulatory risks.</p> <p>10. Directors need to ensure that a senior executive is linked to each process and that he or she is accountable for the performance of the process and the effective management of the risks. (The Financial Services Authority in the UK requires senior executive accountability for each business process)</p> <p>11. All processes to be flow- charted to ensure a “picture” is available for all to understand the business and for business continuity.</p> <p>12. The documented processes and all related risks to be retained in a risk database.</p> <p>13. This risk database is to be used by all corporate governance role players. Management, external audit and internal audit.</p>
<p>Assurance</p>	<p>1. The risk database is to be used by management, external audit and internal audit.</p>

Assurance

2. Internal audit will use this database to develop a risk based audit plan. In terms of the assurance that internal audit provides the Board, it is important that they check independently for completeness of risk in the processes. They will also assess the adequacy of the controls against leading practice and ensure the controls are cost effective. Any report will integrate all internal audit work done relating to a specific process. This will require internal audit teams to be multi disciplinary to ensure financial, operational and regulatory risks are combined in one report. (Internal audit should be positioned to be as independent of executive management as possible. The head of internal audit is appointed by the audit committee and reports directly to the chairman of this committee. Funding for internal audit to be controlled by the audit committee)

3. External audit must assess the quality of internal audit work and rely on it, if the quality is appropriate. They will again look for completeness of risks and make use of the one database. If they are able to rely on the processes, due to the work of internal audit and executive management, they will be well positioned to report on the financial position and the results of the company for the financial year. All that will still be required is to verify the assets and liabilities.

4. Many companies have a separate risk management department. This is unnecessary, as it tends to create additional risk databases that are not well integrated into the day-to-day activities of the company. Rather risk experts should be part of the businesses and ensure the risk identification, assessment, management and monitoring processes are effective.

5. Companies have set up separate compliance departments. Often these departments are “toothless” as they normally report to the Chief Operating Officer. They normally have no functional responsibility and they are sometimes described as a “middle office” in asset management businesses. i.e. neither front office (portfolio managers and research), nor “back office” (processing, administration and accounting). Their role should be integrated into the processes with specific responsibility to identify any changes in legislation that will effect the business. They need to ensure processes and controls are in place in compliance with any regulatory requirement

Assurance	impacting on the business and to train process people to understand the regulatory requirements. The regulatory monitoring they carry out should be automated into the process. Exception reports should be generated when controls are not complied with and these should go to both the process owner and the Compliance Officer. (In terms of regulation, a Compliance Officer is required. To ensure appropriate independence, a qualified Compliance Officer should be part of the internal audit team or should report directly to the Board)
Activism	1. Shareholders to insist the Board and executive management embed integrated corporate governance. Shareholders need to be empowered to discuss integrated governance with external auditors and directors.

Versions of the Integrated Framework were developed from the categories and concepts in the above table. Affinity diagrams and Causal Loop Diagrams helped the process of framework building (Some of the versions are presented in the Annexures). The final Integrated Governance Framework emerged from this process. The categories, variables and the relationships between them, developed through the application of the Grounded Theory method, are embedded into the Integrated Framework shown in Figure 9.

5.2 The Integrated Governance Framework

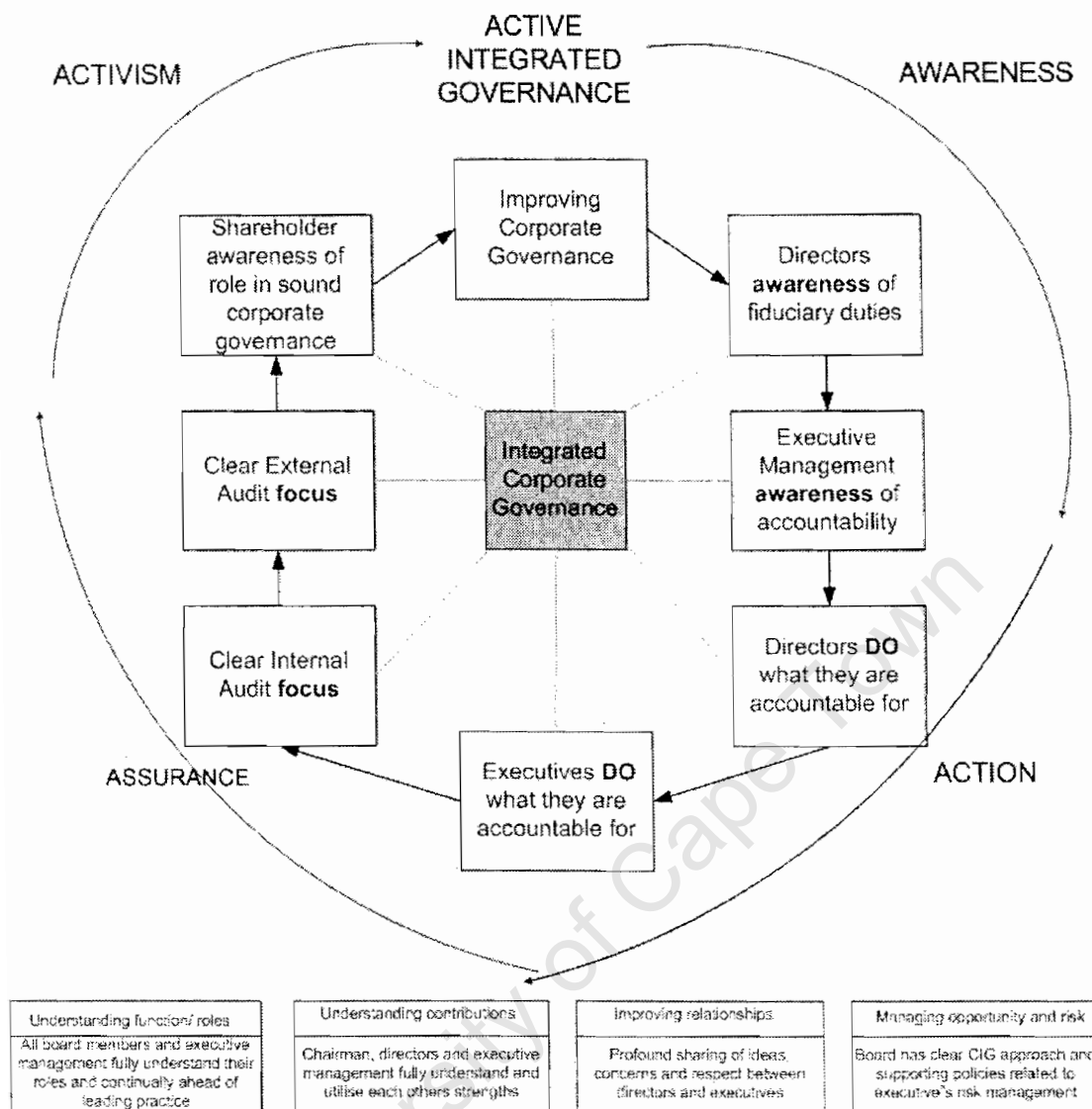


Figure 9 Integrated Governance Framework

The categories and variables are described below. The relationship between the variables ensures the integrated nature of the framework. The researcher first focuses on the variables.

5.2.1 Directors

The directors are responsible for the system of governance. They need to be aware of their fiduciary duties and ensure appropriate action is taken. They develop policy, the ground rules and the means of enforcing them. They identify all stakeholders and clarify purpose to ensure

there is focus to generate value for stakeholders and the company. They clarify business objectives and a strategic plan with executive management to ensure that these objectives are achieved.

Directors are responsible for developing risk management policy and to ensure risk management is embedded in the organisation. They will work with executive management to ensure the organisation's strategy is appropriate, taking into account the impact of the environment and the risks that the organisation faces.

Directors will receive information from executive management and the exception reporting management information system, to ensure the organisation is moving firmly towards its business objectives. If it is not, it may be necessary to adjust the business strategy or to change certain policies.

Directors will also receive information from their internal auditors and external auditors that provides them with assurance that the policies have been implemented and specifically that the risk policy ensures all material risks are identified and adequately managed. Exceptions must be brought to their attention immediately.

Directors must communicate with stakeholders, including shareholders to ensure they are aware of the performance of the organisation and the conformance with stakeholder policy. This communication and the management of the relationship are vital to building trust.

5.2.2 Executive Management

Executive management are responsible for implementing strategy and identifying the operational business units in alignment with overall strategy. A risk management system must be put in place to ensure the strategy is achieved

They are responsible for stability and making sure the business units work together in mutually beneficial ways that optimise their interactions. In addition, they must ensure that the business units can survive in a changing environment. They need to be aware that they are accountable for these responsibilities and that they do what they are accountable for.

The risk management system must ensure all risks are identified, assessed and controlled. The Enterprise Risk Management- Integrated Framework developed by the Committee of Sponsoring Organisations of the Treadway Commission (COSO, 2004) will act as a useful

guide for this critical activity. The purpose of this framework integrates neatly with the researcher's Integrated Governance Framework.

“The underlying premise of enterprise risk management is that every entity exists to provide value for its stakeholders. All entities face uncertainty, and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value. Uncertainty presents both risk and opportunity, with the potential to enhance or erode value. Enterprise Risk Management enables management to effectively deal with uncertainty and the associated risk and opportunity, enhancing the capacity to build value (COSO, 2004: 1).

The COSO framework also aligns with the Systems Thinking approach:

“Enterprise risk management is not strictly a serial process, where one component affects only the next. It is a multidirectional, iterative process in which almost any component can and does influence another” (COSO, 2004:4).

The risks identified and managed using the COSO disciplined process will be recorded in an appropriate risk register and linked to the business objectives. It is important that internal and external audit consult this register of risks, rather than developing new separate lists through their own processes. Unfortunately this happens in many organisations and leads to duplication of work, management frustration and audit not always focusing on high impact risks.

Executive management must have specific responsibility for all risks that are identified. They need to ensure that these risks are assessed and have adequate controls in place that are effective. They also need to consider the efficiency of the controls.

5.2.3 Internal Audit

Internal audit assists executive management with optimisation of the group interactions. They are effectively part of the management information system that reports exceptions to executive management. They ensure all risks have been identified and disclosed in the risk register, that the risks have been correctly assessed, and that there are adequate controls in place to manage the risks. In addition they need to ensure that the controls have been tested and found effective. Any exceptions are reported to executive management and the board.

It is vital that internal audit work intelligently with external audit to ensure an integrated assurance process is in place

5.2.4 External Audit

External audit ensures that a sound, integrated governance system is in place. In carrying out this role they need to ensure that the enterprise risk management process has identified all material risks and that they are adequately and effectively managed, directors and executives are aware of their duties and do what they are accountable for, internal audit is focused and effective, and stakeholder relationships are built so that they are positioned to be part of the system of governance.

They should, if appropriate, rely on the work of internal audit to help them develop their opinion on the financial position and the results of the corporation. If they cannot rely on internal audit work they should make this very clear to the board and insist on action being taken so that the costs of assurance to the board are optimised.

The internal audit work will help them to assess the accuracy and reliability of the management and statutory information processes. If strategic, financial, operational and compliance risks are soundly managed, external audit can confidently place reliance on these processes to ensure accurate statutory information is generated. It will position them to report confidently on the results of the operations and the financial position to the board and shareholders.

The researcher now focuses on the categories that emerged from the theory building process:

5.2.5 Awareness

Shareholders appoint directors to direct and control the organisation for conformance to policy and regulation. In addition, an important responsibility is to ensure performance of the corporation. The most senior management in corporations are referred to as executive management and are appointed into these positions by directors. Executive management is totally responsible for implementing strategy and performance of the business. The directors and executive management are the individuals who have the position, power and leverage to make a difference with regard to corporate governance. It is critical that directors are aware of

their fiduciary duties and that executive management is aware of its accountability for implementing strategy.

5.2.6 Action

In spite of the significant increase in awareness of directors and executive management duties, many continue to act in their personal interests. All respondents were concerned regarding the independence of directors and the limited, functional approach of senior executives to their responsibilities. Integrated governance requires independent, integrated action by directors and executive management.

The approach by directors to behave as if they were the all-knowing wise men or women, who were in the position of director simply to give advice when executive management requested it, became a widespread practice (Carver, 2001). The critical proactive leadership role of directors was absent. Directors were too thinly spread and could not, or chose not, to play the active leadership role with regard to both the performance of the organisation and compliance (Tricker, 2000).

Executive management, who were responsible for developing effective enterprise risk management strategies, was simply appointing individuals to be responsible for risk management, but did not follow through and ensure an integrated, effective risk management process was in place. In the same way, as directors were leaving the performance of the organisation to executive management, executive management was leaving risk management to more junior management. This level of management could not embed risk management so that it was part of the day-to-day business. Executive management simply allowed senior operational management to continue conducting business as usual. In many cases the risk assessment exercises remained once off exercises for compliance purposes with no follow through or integration to a system of governance.

Integrated action by directors and executive management is essential for integrated governance.

5.2.7 Assurance

Directors have significant responsibilities. One of these is to ensure there is a policy of risk management in place that is fully understood and embedded in the corporation. In order to be certain that risks have been identified, assessed, efficient controls are in place and that the

controls are adequate and effective, the directors require affirmation from the internal and external auditors. This affirmation is referred to as assurance.

Both external and internal auditors were in a difficult position. Executive management were controlling the work of internal audit in a number of ways:

- Internal audit normally reported to the CEO.
- Internal audit required the CEO to approve their budget and in many cases were put in the impossible position of negotiating funds from the underlying business units in order to carry out their work.
- All internal audit reports had to be cleared with operational executive management, prior to their clearance by executive management. Only after this had taken place could the internal audit reports go to the directors. Clearly, this should be an important quality control to ensure that data and facts are correct, however, in many cases it was executive management that used their power to influence the reporting process.

Executive management was also controlling the work of external audit in many ways:

- Although the board technically approved the audit fees, in practice, executive management was very much in control of the funds that were approved for audit and non-audit services.
- The primary external audit relationship was with executive management and not the board. External auditors built strong relationships with executive management, as this was where the real decision making power was. The board was seen to follow or “rubber stamp” the recommendations of executive management.
- External audit had to clear the final audit report with executive management. Their control over fees, as well as their holding the balance of power in the relationship, was sometimes used astutely by executive management to influence the final report.

Effective assurance requires internal and external audit to work together in an independent, strategic and intelligent way. Directors can assist by ensuring the head of internal audit reports directly to the board and that the directors are actively involved in the allocation of funds for internal and external audit.

5.2.8 Activism

One of the greatest sources of intangible value resides in the ability of a company to manage its relationships with its various stakeholder groups. Effective activism starts with the company identifying the stakeholder groups, developing policy to add stakeholder value, communicating the goals to the stakeholders and then reporting progress to them.

This positions shareholders and other stakeholders to be part of the critical process of improving corporate governance. Integrating stakeholders in this way is a powerful way of ensuring active integrated governance.

For directors and executive management to be fully aware of their responsibilities, to ensure that they take the right action, and for the auditors to work together in an independent, intelligent way and to give assurance to the directors, it is important for shareholders and stakeholders to be active. Unfortunately shareholders of international corporations tend to be distributed globally. Often they do not receive information aligned to their needs in time, or even care about the difference they could make.

Where shareholders understand the business purpose, (there is a mutual understanding of objectives) are aware of the shareholder or stakeholder policies of the organisation; where they pay attention to the plans of management and ask tough questions when these plans and policies are not carried through, directors, executive management and auditors are kept “on their toes.” This active interest then helps to ensure sound governance.

Reporting must focus on matters that are of interest to the major stakeholders. All communication must be based on the principles of openness, transparency, substance over form and accountability. The stakeholders, including shareholders, must be able to receive a full, fair and honest account of the performance of the organisation. At the same time, access to the corporate governance policies of the organisation, should give confidence that a sound system is in place to ensure conformance.

The categories and variables addressed above emerged from the grounded theory process. The relationships between the variables and their association with the categories, make up the Integrated Corporate Governance Framework. Now it is important to test the Framework.

5.3 Testing the Integrated Governance Framework

5.3.1 South African corporate governance audit partners

The researcher identified the partners in charge of corporate governance at the “Big Four” external audit firms in South Africa in order to share the Framework with them. He was able to meet with two of the partners due to the timing of the testing. Both of the partners were responsible for corporate governance, were males aged between 40 and 45 and had extensive local and international experience. Their position and experience ensured they had insight of governance practice across all industries.

The researcher shared the purpose of the framework, how he proposed the framework to be used and worked through three open – ended questions with them:

1. What are your views on corporate governance?
2. Do you believe that the corporate governance guidelines prevent the destruction of shareholder value?
3. Can the Integrated Framework guide directors and executive management to sound integrated governance that can help prevent the destruction of value and encourage performance?

Some of the detailed response is shown in Annexure F.

5.3.2 International Conference on Corporate Governance

The researcher managed to obtain an invitation to present his framework at the 2003 conference. (See Annexure I)

The researcher recorded all formal feedback including the informal interviews and discussions. (See Annexure G)

5.3.3 Putting the data together

All data was synthesised using the Grounded Theory method and the following categories or challenges emerged as gaps or areas for improvement:

- Action for performance.
- Power.
- An effective system of governance.

These specific categories are described below.

5.4 Adapting the framework

5.4.1 General

The researcher's framework originally did not include the processes to ensure that the role of the board requires it to balance conformance and performance. It is vital that the board ensures that the company performs as a whole and that the focus is not just on the past and conformance; directors need to leverage, with executive management, the various elements of sound corporate governance.

To a very large degree boards have focused on historical results and conformity rather than working with executive management on strategy to ensure it is actioned and that effective risk management is embedded so that risks which could get in the way of the business achieving its strategic objectives can be identified, assessed, managed and monitored. For directors to ensure that this takes place they have to move from passively attending board meetings, to proactively ensuring all the elements of corporate governance are in place and that the company has embedded processes that ensure strategy is developed, risks are identified and managed, performance is monitored and accurate timely information is provided to stakeholders.

This takes time and tenaciousness. The stakes are high. Directors need to demonstrate that they have carried out their fiduciary duties with due care and skill, nothing less will suffice. The interviews have shown that audit partners are concerned that many directors and executives have not adjusted to this requirement.

Leverage comes from the directors to ensure the system is integrated and that directors and executive management carry out their fiduciary duties and the responsibilities they are accountable for.

Action by the directors necessitates a focus on integrated conformance as well as a systemic understanding of what is required for outstanding performance. This will depend on collaboration between directors and executive management, and at the same time a very clear systemic understanding of what is required, so as to ensure the whole corporation is aligned for change, learning, development, growth and performance.

In the researcher's discussions with external audit partners and delegates at the International Conference on Corporate Governance (2003), a recurring theme came through in the open-ended interviews and discussions:

The Integrated Framework made it clear *what had to take place*. The Framework in itself would not *make this action happen*. Awareness had to escalate to action if the Framework is to achieve the goal of guiding directors and executive management to implement effective corporate governance.

The specific gaps or challenges that were identified through the testing are set out below:

5.4.2 Action for performance

There is significant focus on corporate governance in most organisations today. Unfortunately much of the activity is driven by a linear rather than an integrated systemic approach. This separate activity by the governance role players has actually, in some cases, created more risk as the directors are overwhelmed with paper and battle to cope with their conformance responsibilities and so cannot deal with the performance aspect. The influence of this discomfort, and governance exposure, has had a negative and stressful effect on the people working in these corporations. The challenge was to find a way to ensure all role players and stakeholders clearly understand the purpose of the corporation and their role for action to take place

5.4.3 Power

The directors have the power to ensure that sound corporate governance is implemented. This has not always happened. One of the corporate governance partners was very direct on this important point:

“Directors have the ability to leverage other corporate governance role players, but the will and drive is just not there”

The challenge is therefore, to ensure that directors are not only aware of their responsibilities but, more importantly, that their power is not abused, but used for the right action.

5.4.4 An effective system of governance

The generally accepted definition of corporate governance refers to a *system* to direct and control organisations. The researchers observations, experience, interviews and discussions confirmed that organisations generally do not have an effective system of governance in

place. The challenge was to identify a model that would help directors and executive management ensure that a sound system of governance was in place.

5.5 Conclusion

The researcher has completed the first cycle of development of an Integrated Governance Framework. Response in the interviews and informal discussions were mostly positive and encouraging. The feedback indicated that the Framework would make a positive contribution to guiding sound integrated corporate governance. Certain challenges have been synthesised into three specific categories. These challenges require attention to improve the effectiveness of the Framework.

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CHAPTER 6

ADAPTING THE RESEARCH FRAMEWORK - CYCLE 2

The research framework developed in Chapter 4 includes a process of Action Research. An important part of this process is reflection on the experience and involvement in the situation. This reflection can lead to learning in relation to the framework, the methodology or area of concern (Checkland & Holwell, 1998).

The process followed clearly led to learning about the area of concern. This was the effectiveness of the Integrated Corporate Governance Framework to guide directors and executive management to implement effective governance.

It was now necessary to consider whether the research framework and methodology needed to be adapted for the second iteration of research. Each of the Integrated Governance Framework challenges set out in Chapter 5 was carefully considered. Specific action to deal with these challenges was identified and incorporated into the framework for the second iteration of Action Research.

The systems perspective was slightly widened to deal with the influence of power on corporate governance. To this end critical systems thinking was introduced to the framework.

6.1 Reconsidering the Methodology

The researcher searched the literature for case studies and ideas that could improve the three concerns. In addition, the researcher carefully considered methodologies, methods and models that aligned with the interpretive theoretical perspective. Through this process the researcher was able to identify action that would be consistent with his philosophical stance, systems approach and Action Research.

Table 2 below sets out the specific methods that the researcher pinpointed to deal with the challenges that were identified from the first Action Research cycle. It is important to note that all methods are consistent with the underlying epistemology.

The significant influence of power on the corporate governance system encouraged the researcher to broaden his theoretical systems perspective, but to remain informed by the constructionism epistemology.

In 3.5.2 the researcher dealt with inquiry in the sense of approaching the truth. The inquiry framework directly motivated the consideration of a broader theoretical systems perspective. Through the Action Research, the data and the reflection process, it became necessary to push past the self-imposed interpretive perspective to deal with the doubt. Doubt led to the researcher questioning this limitation and to consider using the emancipatory systems perspective to continue the inquiry process and deal with the challenge of power.

6.2 Critical Systems Thinking introduced to research framework

Through the Action Research, a common challenge emerged. Directors have the awareness and the leverage to integrate and drive sound corporate governance, but for many perceived reasons, the necessary action is not taking place.

From the research process in cycle 1, the picture emerged that directors had over time built a significant power base (Chapter 5). Their power influenced their behaviour and decisions. Goergen (1998), in a study of institutional investors in the UK, revealed that although institutional investors were the most important category of shareholders, they tended to follow passive strategies. This passive stance increased the power of directors, who were the second most important category of shareholders, and allowed them to entrench their positions, in spite of action taken by other shareholders to restructure the board due to poor governance.

Jackson (1985) argued that there was a need for an appropriate systems approach for social systems in which there are great disparities of power and resources between participants, and that seems to have escaped the understanding of those who create the system and sustain it.

An emancipatory systems approach evolved for when some groups are seen to benefit at the expense of other groups in society (Jackson, 2000: 291).

“Sir Adrian Cadbury in the 1999 overview of corporate governance in the World Bank Report made it very clear that corporate governance had to be concerned with the interests of individuals, corporations and society and the way in which **power is balanced**:

*“Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals...the aim is **to align** as closely as possible the interests of individuals, corporations and society”* (King, 2002: 7).

Ulrich's *Critical heuristics of social planning* (1983), described for the first time a systems approach that responded to societies and organisations that were affected by the “**dominance of dominant voices**” (Jackson, 2000).

Ulrich's aim was to set out an appropriate philosophy for emancipatory systems thinking and to develop a methodology that could be used by planners and concerned citizens to reveal the underlying value assumptions, and the consequences for those who are affected by the system. Critical systems heuristics was designed as a practically oriented, emancipatory systems approach (Jackson, 2000: 316).

6.3 Methods to address the challenges

The methods set out in the table below will be used to adapt the Integrated Framework for the challenges that emerged through the testing in the first iteration.

After adapting the Integrated Framework, testing will again be required.

<u>Epistemology</u>	<u>Theoretical Perspective</u>	<u>Action Required</u>	<u>Method</u>
Constructionism	Interpretive	Build Integrated Governance Framework	Action Research with Grounded theory method.
Constructionism	Interpretive	Testing Framework	Action Research
Constructionism	Interpretive	No clear shared purpose to drive action	Literature search: Carver's Policy Governance (7.1)
Constructionism	Interpretive	No effective corporate governance system	Models: Beer's Viable Systems Model (7.2)
Constructionism	Emancipatory	Directors not taking action/imbalance of power	Critical Systems thinking (7.3)

Table 2 Action and Method informed by theoretical perspective

6.4 Data Collection

Data for the adaptation of the Framework will be obtained by Action Research, making use of the literature, experience and feedback from the first Action Research cycle. The Grounded Theory process will be applied in the same way as described for the development of the Framework in the first cycle.

In order to test the applicability and robustness of the Framework, the researcher's interpretive theoretical perspective requires him to use qualitative research methods and tools. When adopting the emancipatory perspective, the qualitative approach is still appropriate.

Once the Framework is developed, it will be tested on a small sample of experts. The target population will be corporate governance experts in South Africa. These individuals will be selected due to their wide and in depth experience of corporate governance in South Africa.

The researcher decided to use a direct interview method where he would create some structure by deciding on certain open-ended questions and then allowing flexibility in the interviews. The interviews will involve asking questions, listening, expressing interest and recording what was said.

The questions (in Annexure A) will be used to build a foundation of understanding of the expert's views on corporate governance. This foundation will position the expert to talk openly and widely about improving corporate governance and to obtain their views on the appropriateness of the Framework to guide directors and executives to implement sound corporate governance.

Cycle 2 strategy is shown below:

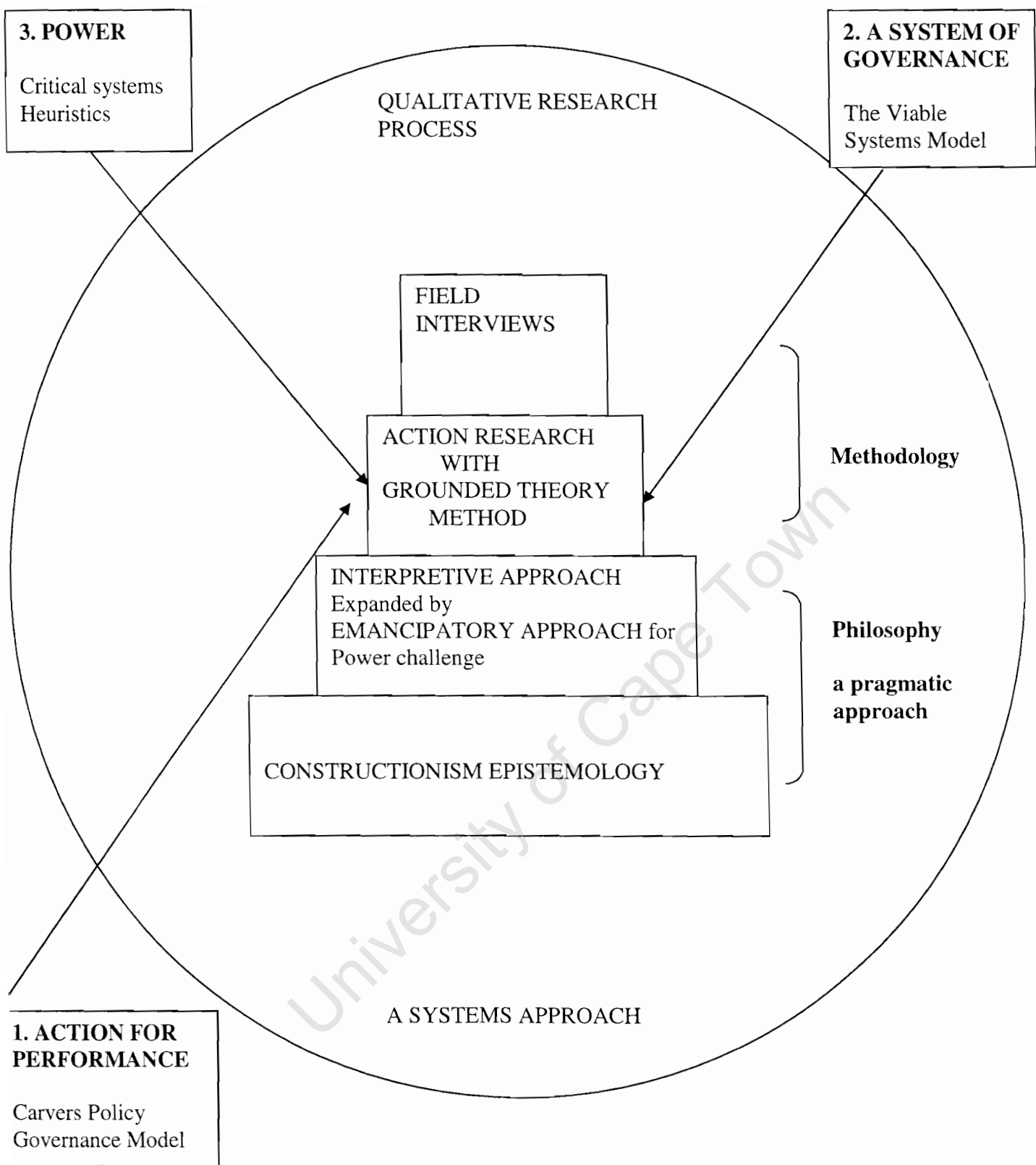


Figure 10 Research framework for Cycle 2

6.5 Conclusion

The researcher reviewed the research framework that was made use of in the first iteration of action research (Cycle 1). The reflection resulted in the adaptation of the methodology to specifically focus on the three challenges that arose from the first testing cycle. The framework for Cycle 2 emerged and is applied in Chapter 7.

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CHAPTER 7

ADAPTING THE INTEGRATED GOVERNANCE FRAMEWORK - CYCLE 2

This chapter begins with descriptions of the methods and models to deal with each challenge emerging from cycle 1 (Table 2, Chapter 6) of the action research process as shown below.

1. **Action** for performance: addressed by Carver's Policy Governance (7.1)
2. An effective **system** of governance: addressed by Beer's Viable Systems Model (7.2)
3. **Power**: Critical Systems Thinking (7.3)

Each of these challenges is carefully considered and the ability of these models and methods to deal with the specific challenge is argued. The Integrated Governance Framework is adapted for these changes and presented in this chapter as the Inclusive Integrated Governance Framework.

7.1 Action for performance

7.1.1 Purpose

When there is no clear, shared purpose in a corporation, resources and people are not focused for performance. It is necessary that the foundation of corporate governance is clear about the purpose to align the corporation for overall **performance**.

There are many definitions of corporate governance. Perhaps the one most recognised is the Cadbury Committee's (1992) definition: "*The system through which companies are directed and controlled*" This definition leaves the researcher with the question - Directing and controlling for what purpose? Applying thought to purpose, the Code of Best Practice for Corporate Governance (Germany), known as the Cromme Code, helps to provide the logical focus.

"Governance is a set of tools aimed at making corporate managers and controllers responsible and orientated towards the creation of value"

(The Cromme Code, 2002).

If we then ask the question, the creation of value for who? The Italian corporate governance code, known as Prema Code, helps guide us:

“Corporate governance is a set of rules according to which a company is managed and controlled. The aim of corporate governance is the creation of value for shareholders” (The Prema Code, 2002).

If we are to follow the “inclusive approach” per King 2 (2002), the researcher argues in 7.3, using critical systems thinking, it is necessary to widen board representation to include stakeholders that the company has a significant responsibility to. This representation will help to ensure that the interests of these stakeholders are always seriously considered. If the interests of the stakeholders are carefully considered then sustainable value will be created over time for all significant stakeholders, and not just the shareholders.

King (2002) refers to research that has demonstrated that an inclusive approach drives shareholder value.

“A wealth of evidence has established that this inclusive approach is the way to create sustained business success and steady, long-term growth in shareowner value” (King Committee, 2002:8).

Consequently, stakeholder value, inherent in the inclusive approach, drives shareholder value. It is therefore reasonable to suggest that the aim or purpose of corporate governance should be *the creation of value for stakeholders*.

The researcher’s definition of corporate governance would then be:

*Corporate governance is the system through which companies are **directed and controlled** to create value for the stakeholders.*

Linking the purpose of corporate governance to creating value for stakeholders does not imply, or require, the directors to anchor their governance philosophy on stakeholder theory. The researcher is not moved from the King (2002) inclusive approach. This approach requires directors to be accountable to the company and responsible to stakeholders. This inclusive approach leads to stakeholder value being generated by the business activities and consequently shareholder value.

The complex organisation of today creates many challenges for those who are entrusted with managing and leading them. All too often insufficient time is focused on the vital activity of clarifying purpose and then developing a strategy with appropriate action plans to carry it out. If this vital activity is carried out properly, a powerful foundation is developed for wide communication and building of understanding and clarity about the processes and skills that are required to identify risks that can prevent the attainment of the objectives and overall purpose. This forms a sound foundation for corporate governance.

If this does not take place, the organisation is not positioned, in the best possible way, to add value for all stakeholders. In order to add value it is vital that all managers and employees are aligned with the overall purpose and strategy of the organisation. Their efforts and action need to be focused to produce maximum performance for all stakeholders.

The researcher has argued that the overriding objective of corporate governance is to add value for all stakeholders. It, therefore, follows that it is essential for the organisation to have a clear purpose. In terms of the researcher's Framework of Integrated Governance, clear purpose will help clarify awareness of responsibilities for all levels of management. Espejo and Schwaninger (1993) refer to three levels of management:

Levels of Systemic Effectiveness

Logical Levels of Management

Goals

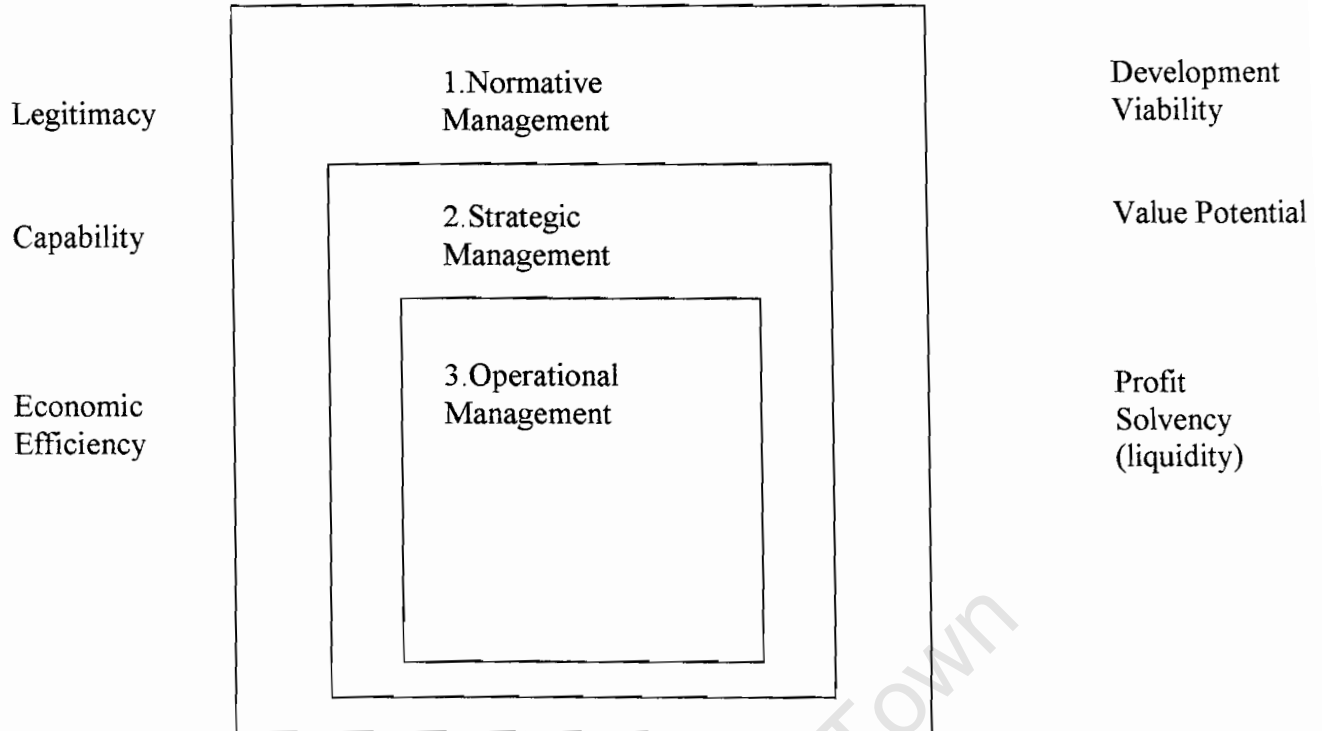


Figure 11 Three levels of organisational fitness/ systemic effectiveness (based on Schwaninger, 1989).

The above figure makes it clear that the categories of management are not detached subsystems. Each higher level envelops those below it. At the three levels, different criteria of organisational fitness or systemic effectiveness apply as shown above. At the normative level it is shown as Legitimacy. This is defined as *the potential to fulfil the claims of all relevant stakeholders*. This is an additional reinforcement of the purpose to focus on stakeholder value. Espejo and Schwaninger (1993) refer to the duty of management to meet all three requirements shown in figure 11.

*“In other words the challenge consists in assuring that the corporation is successful in operational terms, intelligent – that is to say, on course – in strategic terms and a **valuable contributor** to the larger whole in normative terms”* (Espejo & Schwaninger, 1993: 55).

It is clear, that the purpose, Espejo and Schwaninger present for senior executive management, is aligned to the purpose the researcher has put forward for corporate governance, i.e. to add value for stakeholders. This gives a clear target to focus on. This clear focus creates a strong foundation to enable directors, executive management, internal auditors

and external auditors to integrate and align their governance work, as effectively as possible, around this central purpose.

The overall clarity of purpose then positions the directors to have clear focus in carrying out their responsibilities and to delegate with clarity. They can state their expectations and insist on delivery and accountability.

Ensuring clear purpose is turned into focused action and performance is dealt with below when the researcher introduces John Carver's Policy Governance model. Specific principles, aligned to purpose, embedded in the model, encourage directors and executive management to develop policy that delivers results and, therefore, *performance*.

7.1.2 Policy Governance for awareness and action

The overall responsibilities of directors are split between conformance and performance. Drawing on data from participant observation in a number of contexts (refer annexure J for details), case studies, literature and feedback from the first action research cycle, directors have largely focused on conformance, and past performance rather than future performance. They have generally abdicated this important responsibility to the Chief Executive Officer and rubber stamped the future strategy developed by him or her and the executive management team. Clear purpose and building an overall context has not been well done by directors and has influenced the exploding complexity of organisations.

Dr. John Carver has done some important work in this field, in developing the Policy Governance® model. The Policy Governance model helps to focus directors minds on the purpose of the organisation and the director's priorities. It was designed to empower boards of directors to fulfil their obligation of accountability to the organisations they govern. The Integrated Governance Model, presented in this dissertation, demands director and executive management **awareness** of their responsibilities and real **action**. Intelligent focus on purpose, and clear communication through the organisation, positions the organisation so that director and executive management awareness, accountability and action are present and take place. Carver's Policy Governance model is built around this vital issue:

"The explosion of commentary deals extensively with committee structure, balancing inside and outside directors, combining the CEO and chair roles, mergers, acquisitions, using directors as customer contacts and countless other aspects of the board role. What is missing,

however, is a theory of the governance job itself. How to do the job is important, of course, but the first question is to define just what the job is” (Carver, 2001: 1).

Carver states that his model, when applied in business, answers one question: “How can a group of peers, on behalf of shareholders, see to it that a business achieves what it should (normally in terms of shareholder value) and avoids unacceptable situations and actions?” (Carver, 2001: 2).

Carver anchors his model on the board being accountable to the shareholders. Shareholders hold the board accountable for the company achieving what it should and avoiding what is unacceptable. He sees this shareholder-board relationship as one of principal –agent nature.

“Contrary to the antiquated, imprecise language of corporate law, directors’ moral duty is to the shareholders, not to the company-particularly since “ the company” so easily comes to mean current company management and, in any event, can actually conflict with one’s obligation to shareholders” (Carver, 2001:6).

Carver sees the board as owner representative in fact, not merely in rhetoric. It has no responsible alternative but to exercise the authority of the role.

“There can be no authority exercised within the company that does not flow initially from the board. As the supreme authority (after shareholders), the board must be in full control of its own job before presuming to control anything else” (Carver, 2000:2).

He states that the board exists to govern. While this is not disputed, he points out that there is a practice that is widespread that the board exists primarily to advise. If the board is to form the accountability link between owners and operators, the board’s job is fulfilled only if it properly defines expectations and demands achievement. He says the central challenge is to ensure that management is optimally empowered, yet challenged at the same time. In order to achieve this balance Carver argues that it is necessary for directors to control corporate “ends”, in an affirmative, prescriptive way, and to control corporate “means” in a limiting proscriptive way. He defines corporate “ends” as the intended results for various shareholder classes, along with their relative priority. The “ends” are the outcomes for which the corporation exists. “Ends” refer to what the company is for, rather than what it does. He defines “means” as any decisions or realities that are not “ends.” The “means” are controlled in a limiting and proscriptive way by the board expressing to the CEO boundaries around acceptable managerial decisions. The board does not tell the CEO how to do the job, but how

not to do it. In other words the board tells the CEO what to achieve (ends) and what to avoid (unacceptable means).

Carver believes that his approach achieves a vital balance enabling the board to control what it must, (not all that it can) hereby fulfilling its accountability to shareholders while empowering management.

“Define-and –demand as a governance approach beats not only the stultifying, intrusive effects of poke-and –probe, but the fecklessness of react-and-rubberstamp as well” (Carver 2001: 5).

Boards have not been effective in their critical role of building a clear purpose to ensure all people and resources available to the organisation are focused on strategic business objectives. This clear focus positions the organisation for performance. The lack of purpose is evident from the tendency to focus on management or operational issues rather than normative or board responsibilities. Observation of 20 board and audit committee meetings revealed that in practice:

- Management (on behalf of senior executive management) developed the agenda and controlled the meetings
- Data was generated and selected by management
- The boards did not specify criteria for success or what they required.
- Typically took place 4 times a year with directors having to go through very large board packs, which they only received a few days before the meeting.
- Board packs contained what management thought the board required.

In an interview with the most senior finance executive of a large financial services organisation, he revealed that “there should be no surprises in a board meeting.” Board meetings were in fact management meetings and not fulfilling obligations of board meetings. At no time did the board specify the criteria for success and specify what it required.

Hours were spent by internal audit and management to put the data together for the meeting and responding to the questions of senior executive management. Executive management appeared to be trying to come to terms with the data and its implications for the organisation for the first time. Often reports were “massaged” many times by internal audit and management before going to the board. In spite of this time consuming, morale destroying

process, the reports were sometimes not acceptable to the board. Management and internal audit had to go through the draining process again.

The Policy Governance model avoids this wasteful process and ensures that the board receives information that communicates whether the specific requirements of the board are being achieved. Management and internal audit has clarity as to what is required by the board. The monitoring process then becomes simple for both management and the board.

Management does not control board meetings. The board meetings are undertaken to carry out the work of the board. Management must be clear about what is required at these meetings. A board meeting is to do the work that the board is responsible for. It is possible that management may be asked to attend the meetings, but it is very clear that the board is in control and management is accountable to deliver on the requirements of the board.

Carver's Policy Governance model has been developed to ensure directors are not only aware of their fiduciary duties but that they focus on the right action that supports this duty.

Carver makes a clear link between shareholders and directors. He is of the opinion that the directors are the agents of shareholders (Agency theory obliges directors to act primarily for the benefit of shareholders). The researcher's view is that company law does not support this neat, simple association. Company law has been developed around the premise that the business is incorporated as an independent legal entity, separate from its shareholders whose liability for the debts of the company is limited to the amount of equity capital they have agreed to subscribe to. A corporate veil is drawn around the company. The company has a life of its own. It has an existence independent of the shareholders who can transfer their shares to others. The directors have a fiduciary duty to the company and have a duty of care in carrying out their responsibilities. Therefore in company law the directors are obliged to carry out their responsibilities in the interests of the company and not exclusively for shareholders. The King Report on Corporate Governance is very specific on this important point:

"The logic has been that shareholders are entitled to expect directors to run the company in their sole interests. This approach has been rejected by the Courts in various jurisdictions, because on incorporation the company becomes a separate persona in law and no person whether natural or juristic can be owned. Courts have also held that shareowners have no direct interest in the property, business or assets owned by the company, their only rights being the right to vote and a right to dividends. Shareowners also change from time to time while, as the owner, the company stays constant. Consequently, directors, in exercising their

fiduciary duties, must act in the interest of the company as a separate person. (King, 2002:11).

This is extremely important for company law and corporate governance. In reality, shareowners have little or no protection. The quality of corporate governance, is therefore, extremely important to shareholders. It is, of course, important to other stakeholders as well.

The researcher concurs with Carver that clear purpose is essential for sound governance, the empowerment of management and corporate performance. Clear purpose allows directors to focus on the corporate “ends.” This clear purpose does not necessitate a principal – agency link between shareholders and directors. A broader theory of governance is required. A theory that is built from stewardship, agency and stakeholder theory. The King Report on Corporate Governance proposes the “inclusive approach” (King, 2002). This approach recognises that the company is a separate legal persona and that the directors must act in the interests of the company. The directors are also responsible to the stakeholders and this requires the development of policies and an approach that integrates the interests of stakeholders with the interests of the company (The Inclusive Approach).

This approach appears to be sound from a legal point of view, and, at the same time, fulfils balanced interests by requiring the directors to be responsible to stakeholders, but not to be accountable to them. The approach requires further comprehensive research. For the purposes of the researcher’s Framework, he is comfortable that it is a sound approach and is appropriate in terms of his philosophy that has its foundation in the importance of people, society and the environment.

Carver’s Policy Governance model is a powerful model that “sits” easily with the “inclusive approach,” in spite of the agency theory bias to the model. Carver anchors his model on shareholder priorities. The researcher has argued that a broader range of stakeholders should be taken into account and aligns himself with the King Committee (King, 2002) that focuses on an “inclusive approach.” In spite of this important difference, the Carver model can still be used to guide directors to ensure the purpose of the corporation is clear and communicated to all and that executive management has specific responsibility for “ends”, or business objectives.

This clear link from purpose to specific responsibility for business objectives will drive awareness, action and encourage performance. The Policy Governance model, therefore, neatly aligns the purpose of the corporation with the purpose of corporate governance and

corporate performance. This holds true whether an agency, stakeholder or inclusive approach is used as the underlying theory of governance.

7.2 An effective system of governance

German governance guidelines (Cromme, 2002) refer to *a set of tools*, and Italian guidelines (Preda, 2002) refer to *a set of rules*. The researcher does not consider either appropriate. Rules are broken and require a regulatory enforcement process. We have seen the results of a rule driven process in the United States of America. The constant risk of litigation in this society has been largely responsible for a rule-based approach. The reaction to Enron and other corporate catastrophes has resulted in the costly Sarbanes – Oxley Act (2002).

The recent KPMG & Economist survey (2005) makes it clear that corporate executives around the world are concerned that regulation driven by the Sarbanes- Oxley Act (2002) has become too invasive and costly.

Whereas **rules** appear to drive cost, **tools** can be misunderstood, or inappropriately used. Conversely *a system* can be organised and controlled.

The second challenge that the researcher needed to address *was to identify a model that would help guide directors towards a system of governance*. The Viable Systems Model (VSM) is a whole systems theory that is a model and not a methodology. The model is normally used for diagnosis and design for improving the performance of organisations. (Refer to 7.2.2 for an overview of the model)

In the researcher's review of the literature, to identify models that could guide directors and executives towards a system of governance, the researcher identified an Action Research project undertaken in Australia by Tepe & Haslett (2002). The authors required a *corporate governance system* for Occupational Health and Safety (OHS) in a large, complex government department. They found that VSM could be a useful model for a corporate governance system for several reasons:

1. VSM deals with information flow. Corporate governance requires clarity of policy and feedback on performance against policy from the whole organisation.
2. VSM's recursive nature allows all levels in the organisation to take responsibility for their performance and to report on it.
3. The audit function of VSM allows for independent feedback to management on policy implementation.

In their conclusion they were very supportive of VSM being used as a model for a corporate governance system:

“In short, VSM seems like the ideal structure to provide corporate governance in a large, complex organisation” (Tepe & Haslett, 2002:516).

In 7.2.2 the researcher introduces the model and integrates it into the Corporate Governance Framework to guide directors and executive management towards sound, effective governance.

7.2.1 Complexity and the need for a system of governance

Corporations today are very complex. Many have global clients and operate in many countries around the world. Apart from the operational and logistical complexity of running these businesses, the different regulatory requirements, language and customs make the modern global corporation very challenging to direct and control.

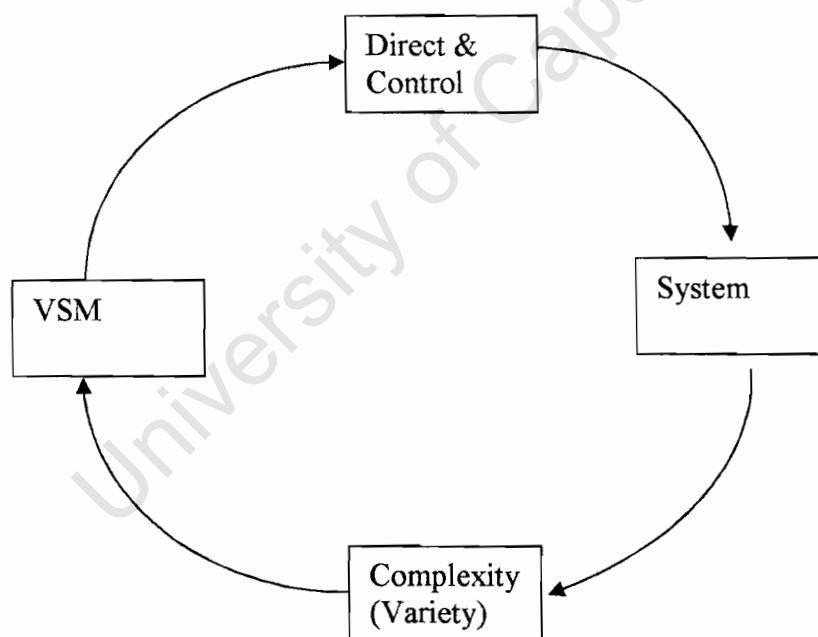


Figure 12 System to regulate complexity

The parts of a system have to be in balance. In organisational terms this concerns ensuring the capabilities of the system that regulate are sufficient to deal with the complexity of the

problems which have to be dealt with. Variety is used to measure complexity. Variety is simply the number of states in which a system can exist. If a system is complex it has a large variety. If it is simple the variety is low. The variety of anything can be theoretically measured and, therefore, there are no limits to its applicability. All work with variety looks at the complexity of one system relative to the complexity of the system with which it interacts.

The complexity of a steam engine is defined as the number of possible states in which it can exist. This will be the different speeds at which it can run. In designing a regulator, the regulator must be able to respond to every state of the engine. It would not work if it reached a particular speed that the regulator could not respond to. Hence Ashby's law of Requisite Variety:

The variety of the regulator must be at least as large as the system it regulates (Ashby, 1956).

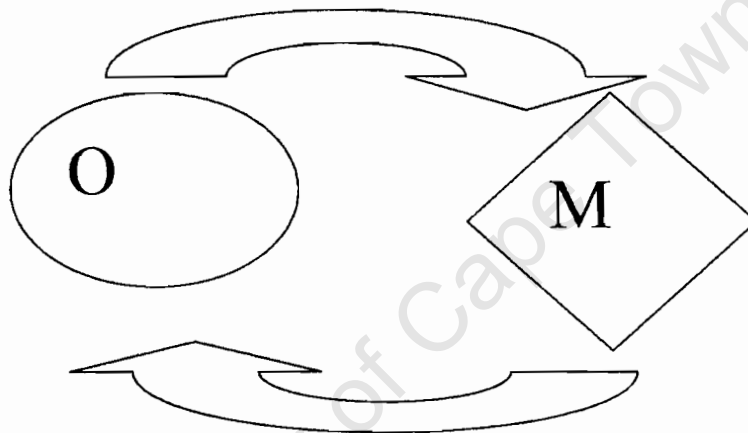


Figure 13 Balancing variety (Operation and Metasystem in balance)

The Figure 13 above represents a diagram where the Metasystem has enough variety to ensure balance. For every state of the operation the Metasystem can respond. It can be said that the Metasystem has enough “requisite variety.”

In organisations that experience a break down in control, the variety of the Operation exceeds the variety of the Metasystem. The Metasystem does not have the capacity to respond to every state of the Operation.

The only way to deal with this is to ensure that the varieties are rebalanced. This can be done by increasing the variety of the Metasystem or decreasing the variety of the Operation.

Instead of following the normal management path of restricting the operational workers (O) and increasing the power of management (M), new ways can be considered that balance the varieties. Coaching and developing the people to limit their own variety by encouraging the people actually doing the work to deal with the problems themselves, is a powerful way to reduce variety and improve control. In addition, ensuring the Metasystem can deal with the information by cutting down the information flow and reporting only important changes. i.e. exception reporting. These actions will help to ensure the variety balance is restored. A well-designed information system can be used as an alternative to authoritarian control. It can enhance self-managed, autonomous individuals. Huge quantities of variety are absorbed by intelligent behaviour at the operational level. Reduction of variety in the way described is an important part of a sound governance system.

“Managerial, operational and environmental varieties should be designed to balance with minimal damage to people and to cost”
 (Beer, 1979:97).

7.2.2 Balancing the whole system with the environment

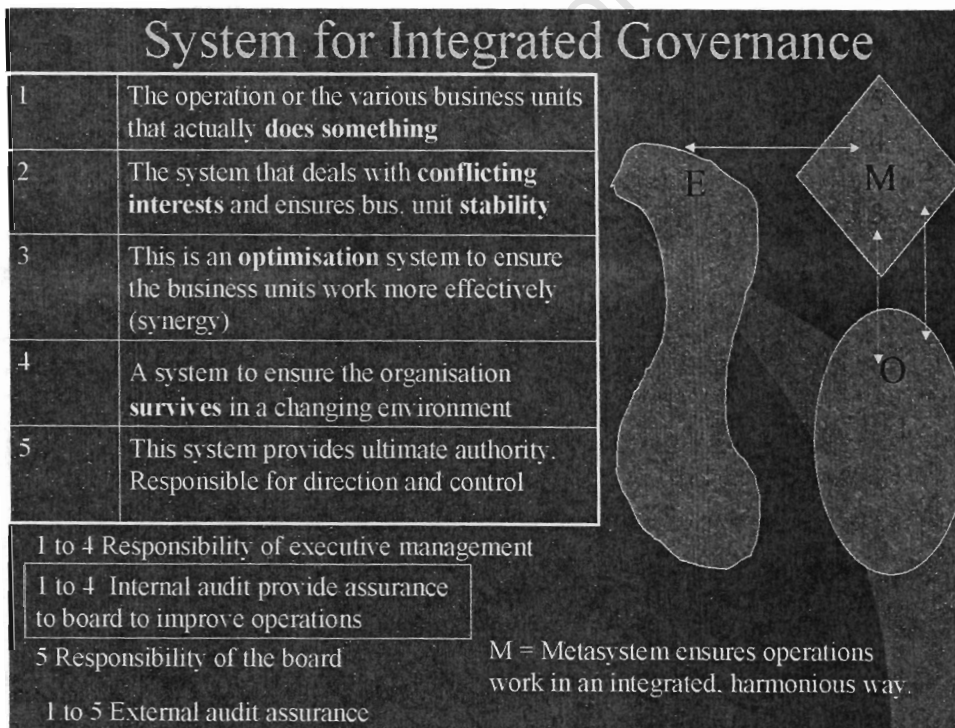


Figure 14 The Viable Systems Model & Integrated Governance

VSM considers the organisation as a whole system that must be in balance with its environment. The design of the Metasystem depends upon the particular conditions within the

Operation. As the environment changes, the organisation must respond. This normally requires a change in the Operation to balance the environmental changes. This change requires the Metasystem to adapt, as it has to be in balance with its Operation (The VSM guide: Cybernetic eyes, n.d.).

The Viable Systems Model is composed of three elements: E, O and M. O and M further subdivide into 5 interacting systems. They were originally derived from Beer's thinking about the management of the muscles by the brain and the nervous systems. The functions of the 5 systems are general enough to make the model applicable to all discrete systems. These 5 systems come together to create an integrated whole system.

1. The Operation or the part of the system that actually **does something**. In an organisation it is those parts that carry on the various business activities. This system is called S1.
2. S2 is the system that deals with conflicting interests and ensures **stability**. Conflict of interests in an organisation are inevitable.
3. When the interactions of System 1 are stable, it is essential to optimise these interactions. System 3 (S3) works with an overview of the entire complex of interacting System 1 (S1) business units to ensure they work more effectively. This is called synergy. S3, therefore, regulates S1. It has an **optimisation** function.
4. When the organisation has optimal, stable business units it is necessary to ensure that it can survive in a changing environment. System 4 (S4) looks at the outside world for threats or opportunities and then produces plans to **ensure long-term viability**.
5. The business units of the organisation must **function within an overall context (purpose)**. All business units and people must be going in the same direction. System 5 (S5) provides the ground rules and the means of enforcing them to ensure that the system is complete. S5 provides the ultimate authority.

One of the very powerful strengths of the model is its generality. The model does not prescribe a particular structure. Instead the model focuses on a system's essential organisation. It is concerned with what defines a system and helps it to maintain its identity, rather than with the variable relations that can develop between components, integrating particular systems. VSM has been found to be applicable to small organisations, large firms, training programs, industries, local government and national government. The model is also capable of dealing with organisations whose business units or parts are both vertically and horizontally interdependent. The notion of recursion enables VSM to cope with vertical

interdependence in global companies. The fact that VSM is applicable at different system levels acts as a great variety reducer for managers, executives, directors and auditors.

The strength of the VSM model that was particularly important to the researcher's philosophy, that all people are important and there is a need for a balance of power to ensure effective governance, is that the source of control in VSM is spread throughout the architecture of the system. The self-organising tendencies in all complex systems can be employed. Problem solving takes place as close as possible to the point where the problems occur. This frees management to focus on the important Meta – system functions and increases the motivation of the employees who service the clients, or solve other problems.

A fishing net metaphor has always guided the Framework development. The governance system in a corporation can be likened to a fishing net. If the holes are large it is easier for governance lapses to slip through. If the holes are small and close together the system is positioned to detect and prevent governance lapses. Merging the VSM model into the Integrated Framework significantly assists in ensuring all employees in the corporation are aligned to the overall purpose of the governance system.

The restrictions on autonomy imposed by the Meta-system are essential. This constraint facilitates liberty rather than limiting it. If less control were exercised the result would be greater freedom for the parts, but anarchy (Beer, 1979: Chapter 7). Jackson reinforces this point:

“We do not regard laws against assault and theft as infringements of our liberty because they increase our freedom to go about our normal business unhindered. The degree of autonomy granted to the parts by VSM is the maximum possible if the system as a whole is to continue to exist” (Jackson, 2000: 173).

Beer encourages decentralisation of control in alignment with the law of requisite variety. With the modern, global, complex organisation, decentralisation of control is essential. If the parts of the organisation were not given autonomy, it would not be possible for management, executive management, directors and auditors to absorb the massive environmental variety. The Model promotes organisational efficiency but also encourages the development and growth of human potential. This was a very powerful reason for the researcher to use the Model to guide directors and executives to implement a sound system of governance.

In the same way as VSM encourages a high level of human autonomy, it is also important to keep in mind that Carver's Policy Governance model requires directors to identify the "ends", or as the researcher has referred to them, the business objectives. The "means" of achieving the "ends" is left to the CEO, the executive team and the people of the organisation. Democratic involvement encourages the parts to be convinced that the system is also serving their purpose.

The board, as well as looking after the shareholders, also embodies the power of its workforce and its managers, of its customers and of the society that sustains it. The board metabolises the power of all such participants in the enterprise in order to survive (Beer, 1985:12).

This encourages the researcher that the VSM model is appropriate to guide a corporate governance system that has the purpose of adding value for all stakeholders. The directors start with the overall purpose, they then use the Purpose Governance approach to identify the business objectives and the policies to guide the organisation. These policies are embedded as part of System 5 in the overall system of governance. VSM helps to ensure that a sound system of governance is in place, throughout the organisation, with only essential constraints on individual autonomy.

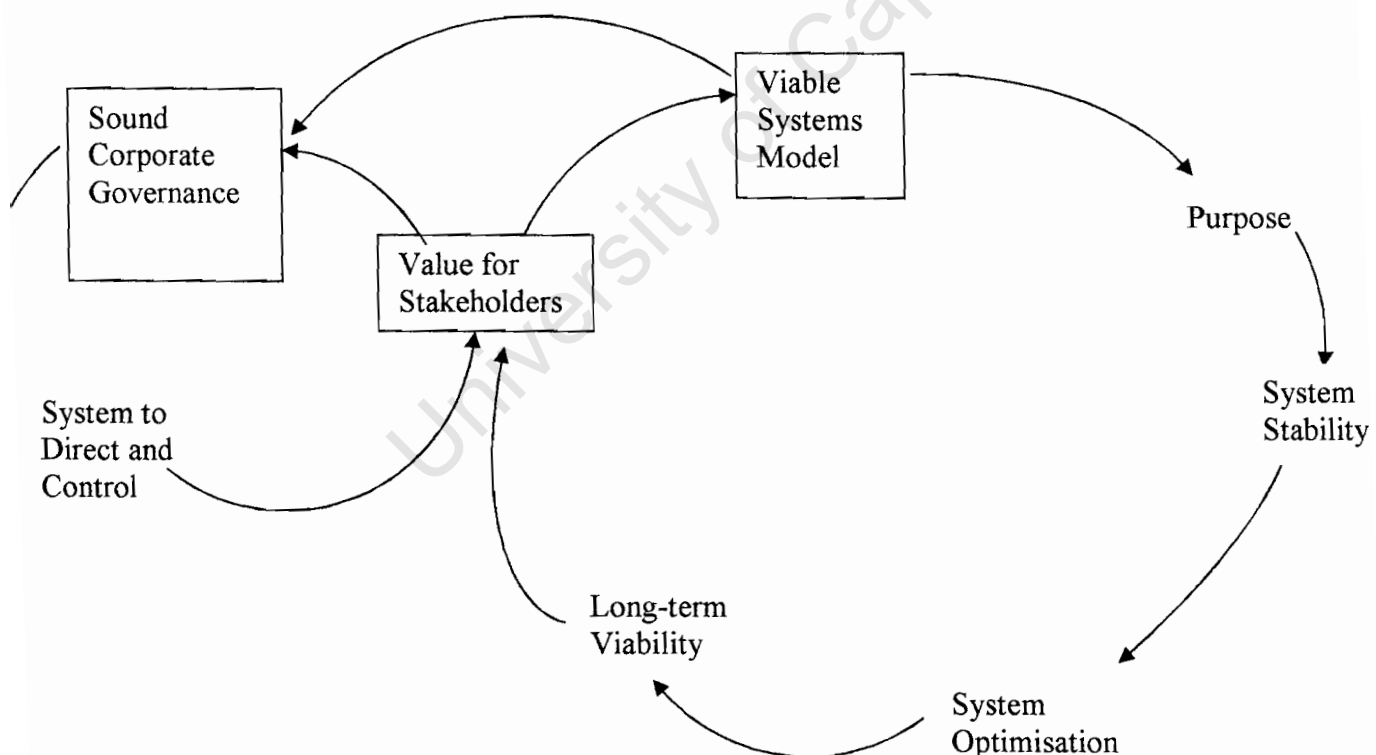


Figure 15 Causal loop diagram – VSM and corporate governance

7.2.3 Corporate governance role-players and VSM

The corporate governance role-players, set out in the Integrated Governance Framework, include directors, executive management, external auditors and internal auditors. If we are using VSM to guide the design of our corporate governance system, how do these role players fit into the five systems?

Directors

The directors are responsible for the System 5 (S5). They need to be aware of their fiduciary duties and ensure appropriate action is taken. They develop policy, the ground rules and the means of enforcing them. They identify all stakeholders and clarify purpose to ensure there is focus to generate value for stakeholders and the company. They clarify business objectives or the “ends” and a strategic plan with executive management to ensure that these objectives are achieved.

Directors are responsible for developing risk management policy and to ensure risk management is embedded in the organisation. They will work with S4 executive management to ensure the organisation’s strategy is appropriate, taking into account the impact of the environment and the risks that the organisation faces.

Directors will receive information from S3, S2 and S1 executive management and the exception reporting management information system, to ensure the organisation is moving firmly towards its business objectives. If it is not, it may be necessary to adjust the business strategy or to change certain policies.

Directors must communicate with stakeholders, including shareholders to ensure they are aware of the performance of the organisation and the conformance with stakeholder policy. This communication and the management of the relationship are vital to building trust.

Executive Management

Executive management are responsible for identifying the operational business units, in alignment with overall strategy, and putting the Metasystem in place. The Metasystem ensures **stability** and makes sure the business units work together in mutually beneficial ways and **optimise** these interactions. In addition, it ensures that the business units can **survive** in a changing environment. Executive management are responsible for S1, S2, S3 and S4.

In carrying out the above it will be necessary to ensure all risks are identified, assessed and controlled. The Enterprise Risk Management- Integrated Framework developed by the Committee of Sponsoring Organisations of the Treadway Commission (COSO, 2004) will act as a useful guide for this critical activity. The purpose of this framework integrates neatly with the researcher's Inclusive Integrated Governance Framework.

The risks identified and managed using the COSO disciplined process will be recorded in an appropriate risk register and linked to the business objectives. It is important that internal and external audit consult this register of risks, rather than developing new separate lists developed through their own processes. Unfortunately this happens in many organisations and leads to duplication of work, management frustration and audit not always focusing on high impact risks.

Executive management need to have specific responsibility for all risks that are identified. They need to ensure that these risks are assessed and have adequate controls in place that are effective. They also need to consider the efficiency of the controls.

Internal Audit

Internal audit assists executive management with **optimisation** of the interactions (S3). They are effectively part of the management information system that reports exceptions to executive management. They ensure all risks have been identified and disclosed in the risk register, that the risks have been correctly assessed, and that there are adequate controls in place to manage the risks. In addition they need to ensure that the controls have been tested and found effective. Any exceptions are reported to executive management and the board.

External Audit

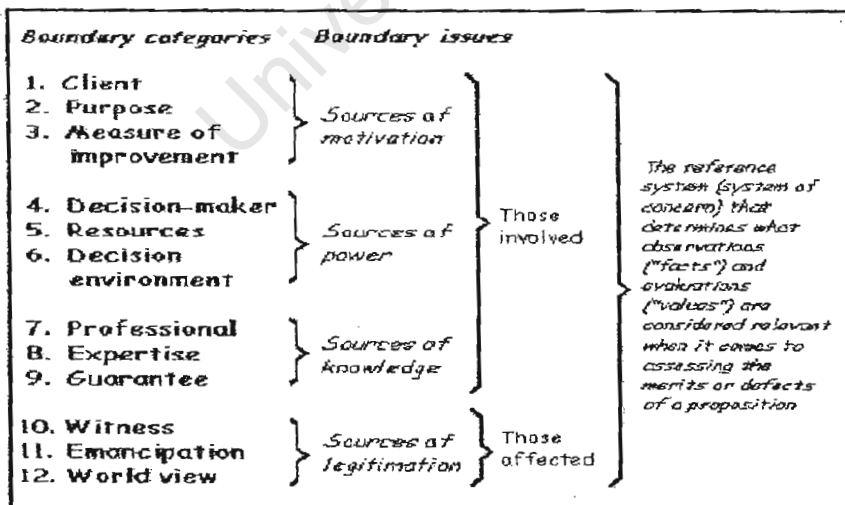
External audit ensures that the Metasystem is in place and is adequate and effective. In carrying out this role they need to ensure that the enterprise risk management process has identified all material risks and that they are adequately and effectively managed. They should, if appropriate, rely on the work of internal audit to help them develop their opinion on the financial position and the results of the corporation. If they cannot rely on internal audit work they should make this very clear to the board and insist on action being taken so that the costs of assurance to the board are optimised.

This work will help them to assess the accuracy and reliability of the management and statutory information processes. If strategic, financial, operational and compliance risks are soundly managed, external audit can confidently place reliance on these processes to ensure accurate statutory information is generated. It will position them to report confidently on the results of the operations and the financial position to the board and shareholders.

7.3 Power

In 6.2, the researcher introduced Critical Systems Thinking. Ulrich's Critical Heuristics of Social Planning (1983) described a systems approach that responded to societies and organisations that were dominated by the "dominance of dominant voices" (Jackson, 2000).

Critical Systems Heuristics developed certain questions to get through to the assumptions and values that are inherent in any social systems design. The boundary judgements inherent in the system were considered to be the way to make visible the designer's assumptions. Different value assumptions can make those interested in the system change boundary judgements, which has an impact on the facts. New facts can also make them change their boundary judgements.



(Source: W. Ulrich, 1983, p. 258; 1996, p. 43; and 2000, p. 256)

Figure 16 Boundary categories

The researcher applied these boundary categories with the specific 12 questions that are part of the methodology, to the current corporate governance practices that are influenced by the corporate governance guidelines. Ulrich developed the practical process to help us decide *what we ought to do* (Jackson, 2000: 316). The researcher has taken each of the boundary categories and looked at what the status quo of corporate governance is in South Africa. These has been placed in the left column and what ought to be, has been placed in the right column of the Tables [3]-[6]. These tables are presented below:

7.3.1 Sources of motivation

	STATUS QUO OF CORP. GOV. GUIDELINES IN S.A.	WHAT OUGHT TO BE
BOUNDARY CATEGORIES	CLIENT Inclusive approach	CLIENT Inclusive approach
	PURPOSE A Code of principles to guide governance of corporations. No integration and implementation guidance.	PURPOSE A complete Integrated Governance Model to guide directors and executives to ensure a balance of conformance and performance.
	MEASURE OF IMPROVEMENT Reference to balanced scorecard reporting.	MEASURE OF IMPROVEMENT Increasing stakeholder value

Table 3 Sources of motivation (Adapted from Ulrich's boundary technique)

Table 3 focuses on the boundaries that clarify the motivation behind the system. When we apply Ulrich's disciplined approach to the system representing the status quo, it closely represents what the system ought to be. The foundation of the inclusive approach and sound principles of governance, reveal a fair, balanced motivation to the governance of corporations. The guidelines would be more effective in motivating sound governance practices if they

were backed up with an integrated framework that helped directors and executives move from sound governance awareness to sound governance action.

The measure of improvement needs to emphasise the importance of increasing stakeholder value to ensure alignment with the overall motivation of the system of governance.

7.3.2 Sources of power

	STATUS QUO OF CORP. GOV. GUIDELINES IN S.A.	WHAT OUGHT TO BE
BOUNDARY CATEGORIES	DECISION MAKER Directors	DECISION MAKER Directors and stakeholder representatives
	RESOURCES All corporate resources	RESOURCES All corporate resources
	DECISION ENVIRONMENT Only dated company law limitations	DECISION ENVIRONMENT Regulations should encourage decision making to be in the interest of all stakeholders

Table 4 Sources of power (Adapted from Ulrich's boundary technique)

It is clear from table 4 that the current decision-makers are the directors who have significant power. This director power needs to be balanced. Appropriate stakeholders should be included on the board to ensure resources are used and decisions are made in the interests of all stakeholders. In addition, regulations need to encourage decision-making that is in the interests of all stakeholders.

7.3.3 Sources of knowledge

	STATUS QUO OF CORP. GOV. GUIDELINES IN S.A.	WHAT OUGHT TO BE
BOUNDARY CATEGORIES	PROFESSIONAL Various	PROFESSIONAL As is
	EXPERTISE Directors, executive management and consultants	EXPERTISE Relevant stakeholders where appropriate
	GUARANTOR Board	GUARANTOR Board and stakeholder representatives

Table 5 Sources of knowledge (Adapted from Ulrich's boundary technique)

Table 5 helps to reveal the current sources of knowledge that are taken into account for corporate decision making. In order to ensure sustainable decision-making, it is important to access the knowledge of the corporation's stakeholders. It gives the corporation a legitimacy that will drive value for all stakeholders on a sustainable basis.

Stakeholder representation on the board will help ensure the board has access to knowledge that will help ensure that their decision-making is in the interests of all stakeholders. Balanced decision-making will ensure sustainable value for all stakeholders over the long term.

7.3.4 Sources of legitimation

	STATUS QUO OF CORP. GOV. GUIDELINES IN S.A.	WHAT OUGHT TO BE
BOUNDARY CATEGORIES	WITNESS Executive and non-executive directors	WITNESS Directors together with stakeholder representatives
	EMANCIPATION Directors	EMANCIPATION Directors balanced with stakeholder representatives
	WORLD VIEW Embedding power of those who own the capital. "Inclusive approach" merely referred to.	WORLD VIEW "Inclusive approach" will only be truly implemented when powerful stakeholder representatives are included on boards.

Table 6 Sources of Legitimation (Adapted from Ulrich's boundary technique)

Representatives of those that own the capital, and are part of the system of governance, have developed the system. To a large degree it has been developed to maintain the significant power of directors. Law does not back the guidelines. Divergence from the guidelines require disclosure. There is no sanction except the possibility that capital markets will increase the cost of finance or withhold it from those that do not comply.

The table helps us to understand why many stakeholders, that are affected by the decisions and activities of corporations, feel that their interests are not appropriately protected or taken into account. Governance requires an approach that includes all stakeholders, but also ensures action is taken that is aligned to this philosophy. Stakeholder representation on boards will help to embed this balanced, inclusive approach and encourage value creation in a sustainable way.

7.3.5 Impact of Critical Systems Heuristics

The exercise undertaken by the researcher indicates that the motivation behind the system of corporate governance is sound but that more guidance is required to ensure that directors move from awareness to action that is in the interests of all stakeholders. There is a need to reconsider the powerful role of directors. It is suggested that better balance can be achieved in

a system of governance, if stakeholder knowledge and needs are taken into account when developing corporate purpose and strategy. In addition, it is important to ensure measures relating to strategy, include stakeholder value. Finally, if stakeholder value is to be taken seriously, it is important to include appropriate stakeholder representation on boards.

The Integrated Governance Framework incorporated director *awareness* and *action*. Testing of this framework indicated that while director awareness of their duties and the significance of their role was vital, action was required in alignment with the inclusive approach. The significant power of directors appeared to contribute to the lack of effective action. The challenge was therefore that directors were not only aware of their responsibilities but, more importantly, that their power was not abused, but used for the right action. Critical Systems Heuristics has helped to identify the importance of stakeholder representation on the board as a variable that can have a significant positive influence on the system of governance. The Integrated Governance Framework requires adaptation for this important influence on sound governance.

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7.4 Emergence of an Inclusive Integrated Governance Framework

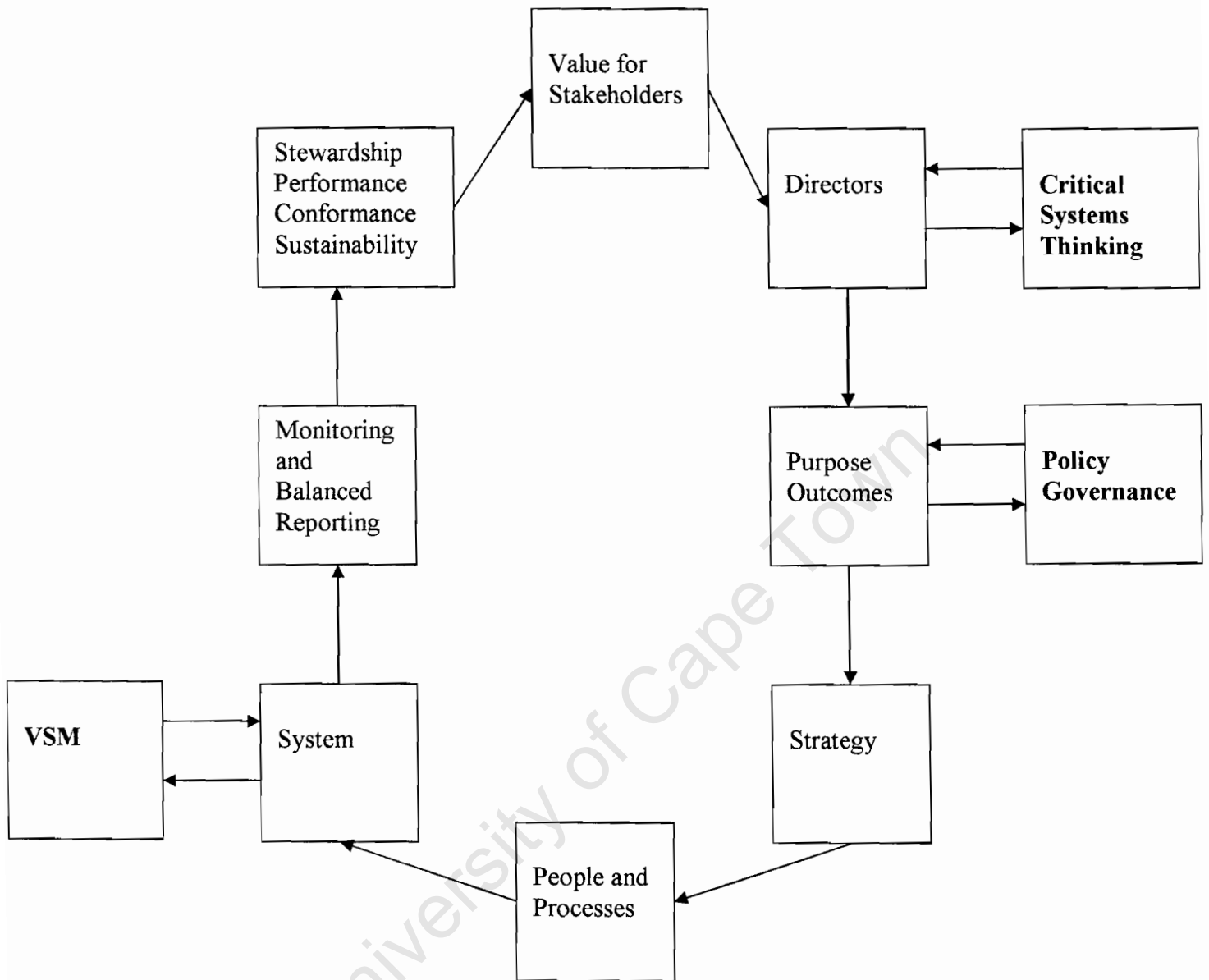


Figure 17 Developing the Inclusive Integrated Governance Framework

The Inclusive Integrated Governance Framework, which was guided by the above Figure 17, is built on the foundation of the Integrated Governance Framework and shown below as figure 18.

Improving governance is dependent upon directors and executive management being aware of their responsibilities, doing what they are accountable for, internal and external audit focusing on integrated, comprehensive assurance, and intelligent stakeholder activism. Reporting that compares results to policy, goals and strategy will help reinforce improving governance.

This approach to governance will ensure that directors can demonstrate stewardship, a balance of performance and conformance, and ensure that the corporation is sustainable.

The influence and the impact of the second cycle of action research, which was described in this chapter, is shown below and the Inclusive Integrated Governance Framework emerges.

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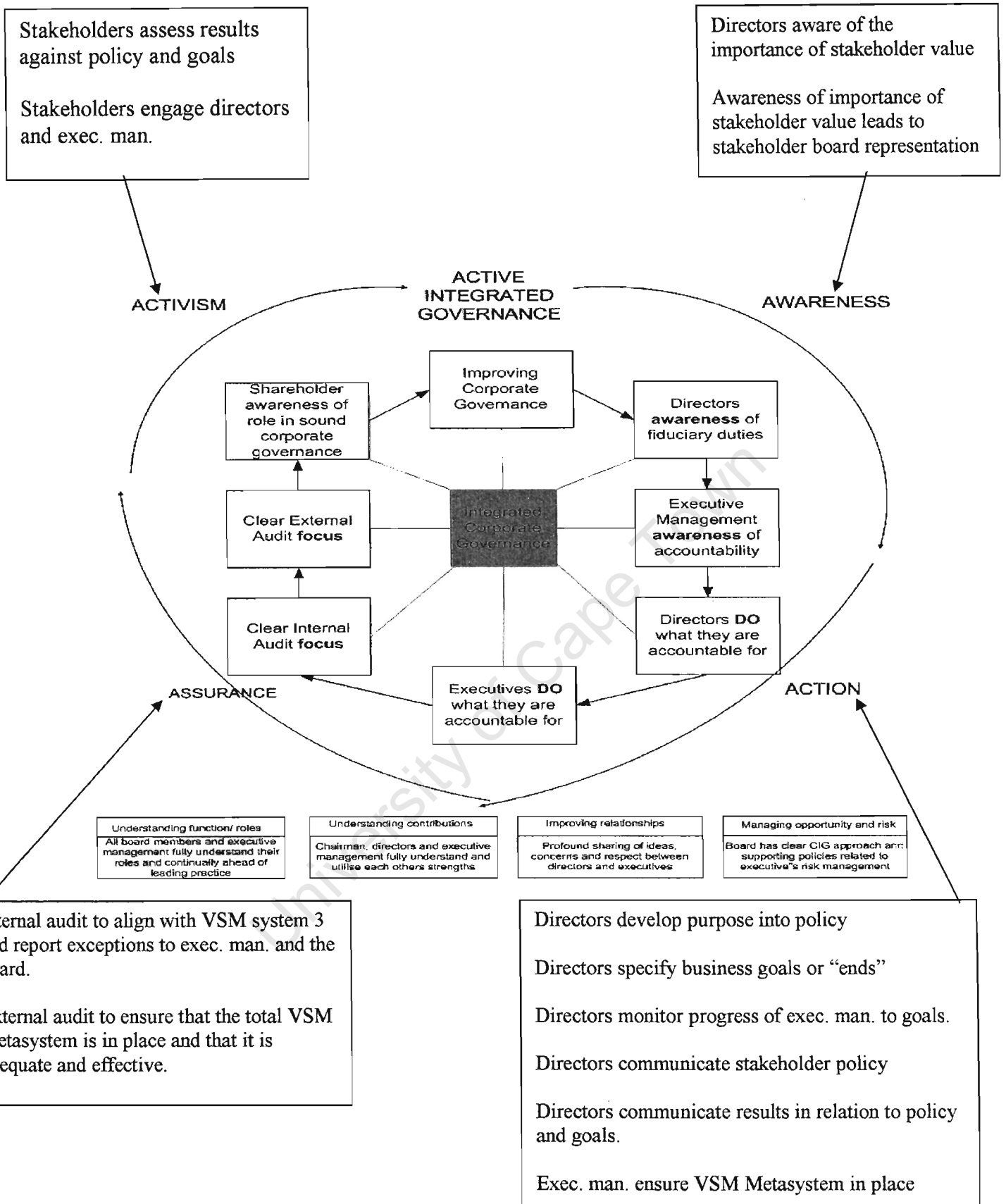


Figure 18 The Inclusive Integrated Governance Framework

7.5 Conclusion

Each of the three challenges identified in the first cycle have been carefully considered and dealt with. This work was incorporated into the Integrated Framework, and the Inclusive Integrated Framework emerged from the process. This Framework stands on the theory of governance introduced by the King Committee known as the inclusive approach.

The inclusive theory of governance is a sound foundation for the model and takes into account the need, in South Africa, to balance economic efficiency and society's broader objectives. The inclusive approach is fundamental to doing business in South Africa (King, 2002).

Agency theory drives corporate governance in many important parts of the western world. The "winds of change" are encouraging global society to ask the important question: Why only shareholder value? Surely stakeholder value is important and necessary for the long-term sustainability of the corporation?

The Carver Model helped the researcher introduce the important principle that the director's job is to identify the purpose of the corporation, in overall alignment with corporate governance, then to put policies in place that give guidance and require executive management to embed strategy so as to achieve business objectives or "ends." If policies incorporate all appropriate stakeholders, and effective communication takes place with these stakeholders, a powerful process is put in place that demands directors take action and focus on performance.

The researcher has not focused on encouraging performance through appropriate remuneration strategies. This is a provocative and necessary area of research. The researcher believes that the framework and the approach embedded in it, create a sound platform to pursue performance remuneration research that would further encourage director and executive management performance.

Stafford Beer's VSM Model has been tried and tested and is an appropriate model to guide the design of a system of corporate governance. It was shown to integrate effortlessly with the Framework developed by the researcher and has been used to guide a system of corporate governance in a large government organisation in Australia (Tepe & Haslett, 2002).

The researcher acknowledges that the challenge of power has not been dealt with comprehensively. The emergence of this issue is important. The Critical Systems Heuristics process applied by the researcher, also confirmed the significant influence of power on the system of corporate governance. This is a rich, very sensitive area for future research.

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CHAPTER 8

ASSESSING AND TESTING THE INCLUSIVE INTEGRATED FRAMEWORK

This chapter describes the qualitative process that was used to test the Inclusive Framework. The chapter describes how the feedback was obtained and assessed. Finally, the process used to identify and evaluate any changes that were required to the Framework is described.

8.1 Sharing and testing the Framework

Of four, very carefully selected experts, three were able to work through the process with the researcher, one was not available during the testing phase.

The three are described below:

1. The Managing Director of a very large Johannesburg based Corporate Governance Advisory practice, who in addition, serves on the board of governors of the International Corporate Governance Network.
2. The Head of Corporate Governance of one of the four largest commercial banks in South Africa. He was the Public Protector in South Africa before taking up his current role. This bank is also based in Johannesburg.
3. The Partner in charge of corporate governance at a very large law firm based in Cape Town.

Two interviews took place in Johannesburg and one in Cape Town. All participants gave a significant amount of uninterrupted time. One hour had been allocated for each interview. It turned out that the shortest interview was almost two hours. They were all extremely helpful and followed up with additional material and advice.

Please refer to Annexure A for the questions that were used to guide the interview discussion.

The researcher has consolidated the detailed responses in Annexure B using the following categorisation:

1. Purpose
2. Theory of governance

3. Corporate governance guidelines
4. Action to improve corporate governance
5. Integrated Corporate Governance Framework

8.2 Improving the Integrated Corporate Governance Framework

All action to improve governance has been set out in Annexure B. The action was carefully compared to the Inclusive Framework, and if incorporated in the Framework, the item was marked with **(I) for included**, if not incorporated, it was marked with **(E) for excluded**.

8.3 Impact on the Framework

8.3.1 Items that were excluded (extracted from Annexure B)

1. A bill of rights is required for all minority shareholders. **(E)**
2. Consider an ombudsman for minority shareholders. **(E)**
3. Perhaps it would help if the Financial Services Board did actual checks. **(E)**
4. Maybe a stakeholder/ consumer ombudsman is required. **(E)**
5. Perhaps a rating system for corporate governance would make a difference **(E)**
6. Board evaluation, monitoring and reporting is essential. **(E)**

8.3.2 Impact on the Framework of the items excluded

1 + 2. Minorities need protection. This is where the law needs to come through and provide real protection for minority shareholders. The new Companies Act that is being developed in South Africa creates the opportunity for this protection. Appropriate legislation, with an ombudsman to uphold the rights of minority shareholders, would go a long way to deal with the current imbalance of power.

3. If directors made full use of the Inclusive Integrated Governance Framework, it would not be necessary to introduce Financial Service Board audits. The system of Inclusive Integrated Governance is sufficient to ensure sound governance. The goal should be to move towards just enough regulation. It is accepted that until a comprehensive system of governance is in place, Financial Services Board checks could be beneficial to ensure directors focus on improving their governance practices.

4. A stakeholder/ consumer ombudsman could help to ensure that directors pay more attention to adding value to all stakeholders who are affected by the corporation.

5. Corporate governance rating systems exist, for instance the researcher has looked at a version of Standard & Poor's governance rating system that was presented at the International Conference on Corporate Governance (2003) by the UK Managing Director of Standard & Poor. There are also other rating systems. The researcher is of the opinion that governance-rating systems could influence improving governance practices, but they cannot, in current form, be described as systemic, integrated assessments of governance.

6. Board evaluation, monitoring and reporting is essential for improved governance awareness and action. Director evaluation is starting to take place. The boards undertake the evaluations on a self-assessment basis. Some boards have taken the step to bring in independent consultants to undertake the assessments. There are not many independent experts who have the range of skills and standing to undertake this work. The Inclusive Integrated Framework would be a useful tool to help those who have the human resource "soft skills" to identify the more technical aspects of sound, integrated governance, for overall assessment purposes.

8.4 Conclusion

After considering all feedback from the experts selected, the researcher is of the opinion that no major change is required to the Framework. The suggestions for improving governance have either been incorporated in the Framework or would be very useful to improve the environment that influences corporate governance. The environment would, in turn, influence specific corporations to improve their governance. It is suggested, that future research on corporate governance guidelines beyond King2, should include in the frame of reference, attention to the environment that influences the governance of corporations.

The reference to the assessment of directors is part of the monitoring and balanced reporting element of the Inclusive Integrated Framework. There is the need to specifically highlight this, as it is an important part of improving corporate governance and the action that the directors and stakeholders must ensure takes place.

The Framework has been subjected to two cycles of testing. The second and final cycle, in terms of the research undertaken, revealed that the Framework stood up well to the scrutiny of leading, recognised experts in corporate governance.

CHAPTER 9

CONCLUSION AND EVALUATION

This chapter reflects and traces the journey of the research, identifies important areas for future research and evaluates and concludes on the research undertaken.

9.1 An Integrated Framework to guide directors and executive management

The seeds for the development of this Framework were sown a number of years ago as the researcher observed the action and behaviour of directors and executive management “at the coal face.” Their power and influence on employees, customers, communities, suppliers, shareholders, the environment and economies was enormous. As the researcher observed and worked with them, he became aware of the significant influence corporations could have on the success of economies and the development of people. This concern, and the desire for improved governance and action, peaked as he became aware of the massive destruction in shareholder value of Enron, World Com, The Allied Irish Bank and Parmalat. The researcher was of the opinion that this destruction in shareholder value could have been avoided if an integrated governance system was in place.

So began the journey to build a framework for this important purpose. Systems thinking was seen as an approach that was suited for the development of an integrated framework. The journey started with the development of the Integrated Governance Framework, which was tested with partners from the “big 4” firms of accountants due to their wide knowledge of corporate governance practices and challenges.

The response at this first iteration was good, but the challenge remained to ensure that sound governance action actually took place. So began the second part of the journey to improve the framework. The challenge essentially was to encourage focused action by directors and executive management, who have the most leverage or influence on the overall system of governance.

This part of the journey made the researcher realise how much important work was available in the public domain that had not been incorporated into governance practices. This resulted in the assessment of Carver’s Policy Governance Model and Stafford Beer’s Viable Systems Model. (VSM)

The researcher introduced the simple principle of building policy for business ends, from the Carver model, and the VSM principles into the Inclusive Integrated Governance Model. At the same time the researcher considered all the theories of corporate governance and settled on the “Inclusive Approach” which is also the theoretical foundation for the King Report on Corporate Governance for South Africa (2002). The researcher broke away from the consistent application of an interpretive systems approach and, for a moment considered the influence and power of directors on the system of governance by working through Ulrich’s 12 questions that are part of his Critical Systems Heuristics methodology. This methodology falls into an emancipatory systems approach (Jackson, 2000), but was effective in demonstrating the imbalance of power in current governance systems. This power imbalance in the system requires attention and rebalancing. The researcher recommends appointing appropriate stakeholder representatives to boards, but acknowledges that this still requires important research that must include the views of all stakeholders.

9.2 Evaluation

The Inclusive Integrated Governance Framework that the researcher has set out in Chapter 8, aligns with the overall responsibilities of the Board as set out in the 2002 King Report on Corporate Governance for South Africa.

“The responsibilities of the Board under the inclusive approach in the 21st century will be to define the purpose of the company and the values by which the company will perform its daily existence and to identify its stakeholders relevant to the business of the company. The board must then develop a strategy combining all three factors and ensure that management implements this strategy. The board’s duty is then to monitor that implementation. The board must also deal with the well-- known financial aspects. The key risk areas and the key performance indicators must be identified, as well how those risks are to be managed” (King Committee, 2002:18).

This sets a sound foundation for the Framework. In addition, the model follows the theoretical underpinning of the King 2 corporate governance guidelines (King Committee, 2002). The King guidelines are built on the premise that the directors are accountable to the company in terms of company law and responsible to stakeholders that need to be identified by the company. The King (2002) guidelines encourage directors to develop stakeholder policies to clarify the relationships and goals that the company is working towards. The stakeholder value goal, that is inherent in the inclusive approach, does not imply that directors

incorporating the inclusive approach to corporate governance are following stakeholder theory.

This inclusive approach will help to ensure long-term sustainability, help to demonstrate stewardship and encourage performance and conformance. The inclusive approach naturally guided the development of the researcher's Framework. The Framework is aligned with the requirements for South Africa and guides directors and executives in the implementation of an integrated system of governance.

There are many countries that have built their own governance guidelines based on the agency theory where the board is considered to be responsible for directing and controlling the company, and accountable to the shareholders. This does not preclude the use of the Framework to guide directors and executive management towards sound governance, in these countries. Directors would instead focus their purpose on the shareholders, as argued by Carver (2001), and develop specific policy to create value for shareholders. In other words, the Framework can also help directors and executives implement a system of governance that is informed by a theory that corporations are accountable only for increasing shareholder value. Ignoring the legitimate needs of other stakeholders that the corporation effects, will, however, in the longer term, create performance and sustainability challenges for the corporation.

In addition to the Framework having a sound theoretical base, an integrated systems approach has been followed to ensure that the framework is comprehensive and systemic. It has been developed to respond appropriately to the significant risk and variety of the modern corporation. Stafford Beer's VSM model and the integrated nature of the Inclusive Framework make significant "strides" towards "closing the holes of the corporate governance net."

Part of the concern that started the researcher's journey, was the need to develop a comprehensive framework that incorporated performance as well as control. This balance is vital for all stakeholders. The incorporation into the framework of the simple principle of aligning all governance activity around the purpose of the corporation has contributed significantly to the development of a framework that encourages performance as well as conformance. Carver's Policy Governance Model has supported this important objective.

The researcher set out to develop a framework that could be used by all stakeholders to encourage sound governance practices. Two cycles of testing has ensured that the Framework

has made significant progress towards an integrated corporate governance framework for conformance and performance. Further progress will be achieved when the Framework is implemented and used by corporations and their stakeholders to guide their governance practices.

When we look at whose interests are served with the research, and the resulting Framework that emerged, the researcher acknowledges he has benefited a great deal. His personal goals of improving his corporate governance and research knowledge have been achieved. At the same time, the researcher has developed a framework that will ensure the interests of all stakeholders are served. It is important to note that this will require the inclusive approach as the theoretical foundation to the Framework.

9.3 Future Research

The researcher acknowledges that he has not provided detailed recommendations about who are the appropriate stakeholders to be included on the board of directors. This is a very sensitive area and will require extensive research and focus, to ensure an approach emerges, that can rebalance power appropriately and is accepted by all role-players. This is very fertile ground for interesting research.

The researcher has argued, strongly, for the King (2002) inclusive approach as a foundational theory for corporate governance. There is strong opposition to this approach, particularly in the United States of America where the agency theory is considered to be the appropriate option. The researcher believes the “winds of change” are starting to move governance theory towards one, that has a distinct stakeholder “flavour.” This is by no means a settled area in the subject of corporate governance. The researcher is not certain whether more research will move those currently favouring one of the theories. The issue will probably be driven politically with Company Law settling the issue for the country concerned.

The researcher has not focused on encouraging performance through appropriate remuneration strategies. This is a necessary area of research. The researcher believes that the framework and the approach embedded in it, create a sound platform to pursue performance remuneration research that would further encourage director and executive management performance.

Components of the Framework have been extensively tested. Stafford Beer’s VSM has been rigorously tested in a variety of practical environments. Carver’s Policy Governance has not

been subjected to the same testing process, but, four empirical studies have been published which examine the Policy Governance model.

A report has critically evaluated this research (Hough, 2004), and concludes on whether the model works:

“We would conclude that Policy Governance does appear to work, but on the current evidence it cannot be shown to be more effective than other approaches to board improvement”(Hough, 2004:216).

The conclusion continues and strips out the essential features of the model, which the researcher has done, and then makes the following suggestion:

“Perhaps what is required is combining these fundamental elements of Policy Governance and combining them with the best of other approaches to improved governance”(Hough, 2004:216).

The researcher has tried to do this. The Inclusive Framework presents a sound, integrated approach for improving corporate governance. Implementing and using this Framework to improve governance in corporations will begin new Action Research to improve the Framework.

9.4 Conclusion

The Framework is a generic one that can be used in any country, to guide sound governance practices, to balance conformance and performance. There is a desperate need for this balance. In many countries the swing to conformance is seen as “strangling” entrepreneurial activity. This was the major concern in the recent global KPMG & Economist survey (2005) dealing with current corporate governance trends.

The thesis contributes to corporate governance as it moves away from the corporate governance guidelines that have been developed by most countries on a linear basis, to a comprehensive, integrated model that guides all governance role players towards sound governance practices.

The Framework integrates the researcher’s work and experience, with important work that was done by Stafford Beer, John Carver, and the King Committee (2002). The Framework

which emerges, is in itself new, but it leans heavily on the very valuable work of those mentioned above.

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ANNEXURE A

Questions used in the direct interviews that had the purpose of testing the Inclusive Integrated Governance Framework. They were designed to initially build a shared foundation of understanding on the expert's view of corporate governance, and then to use this foundation to share and test the Framework. Open-ended responses were required so as to understand the world of governance as seen by the experts.

1. What do you believe is the purpose of corporate governance?
2. Do you feel that the corporate governance guidelines are built on a sound theory of governance?
3. How effective are the corporate governance guidelines?
4. What action needs to be taken to improve corporate governance?
5. Can the Inclusive Integrated Governance Framework help directors and executive management improve corporate governance?
6. What changes would you make to the framework?

ANNEXURE B

1. Purpose

For banking purposes the link to our customers is vital. We have to be seen to be doing the right thing.

Governance is about what you do when nobody is watching.

Corporate Governance is a system.

It is not there to plug gaps in the legal system.

It is an environment in which behaviour is informed

You cannot legislate corporate governance.

Business has a strong influence. To a large degree corporate governance is what business demands.

Corporate governance is not a legal discussion. It is practical stuff. Therefore it has to be flexible in its principle.

Corporate governance is very much about behaviour. E.g. Enron.

Corporate Governance is about managing conflicts of interest. E.g. with Enron the incentives were high to mislead shareholders.

Greed will always be with us. Governance is about trying to prevent the mischief.

2. Theory of Governance

Stakeholder “triple bottom line reporting” is vital to our business. We have to be seen to be doing the right thing by our customers.

3. Corporate governance guidelines

The flaw in King 2 is that it is voluntary and at the same time places heavy reliance on a broad sector of society. It assumes shareholders will intervene. King 2 cannot work in isolation. It requires appropriate shareholder activism as well.

4.Action to improve corporate governance

When I speak to bankers “their eyes glaze over.” They see governance as a soft issue. They need to see it as part of performance. **(I)**

There is a need to ensure strategy is checked and not just the other attributes of governance. **(I)**

There is a need to integrate governance activity and behaviour. **(I)**

The ethical behaviour perspective is so important. **(I)**

You need to put pieces of governance together and articulate them in a way that your people understand. **(I)**

Our people have to understand that behaviour of business people is part of corporate governance. **(I)**

The board is the heart. It’s like “peeling back an onion.” They need to ensure risk management is in place, values to guide behaviour and assurance that the risks are being managed. All this is required for a self-regulatory system. **(I)**

Pension fund trustees need to carry out their fiduciary duties **(N1)**

With “other peoples money” you need to ensure there is “sunlight” on all activities. **(N1)**

A bill of rights is required for all minority shareholders. **(E)**

Directors must not be allowed to appoint assessors for related party transactions. Independent assessors are required to ensure fair and reasonable assessment. **(N2)**

There is power in monitoring. **(I)**

Consider an ombudsman for minorities. **(E)**

Focus on the directors. They have the greatest lever to change poor governance. (I)

Power is the bottom line. A system to balance power is required. (I)

Perhaps it would help if the Financial Services Board did actual checks. (E)

Perhaps a rating system for corporate governance. (E)

Perhaps a government representative on board. (N3)

Look at the Alternative Exchange system where sponsors are required on the board. (N3)

Perhaps put some limits in place so that the directors do not all come from the majority shareholders. (N3)

Maybe a stakeholder/ consumer ombudsman. (E)

Board evaluation, monitoring and reporting. (E)

N1 Trustees must carry out their fiduciary duties with great care. This is specific to the pension and asset management industries and does not affect the appropriateness of the Inclusive Framework. The Framework could still be used to help trustees identify their specific purpose and ensure they put a sound system of governance in place to regulate their work.

N2 A specialist area. Does not impact the Framework.

N3 With stakeholder representation on boards, these are some of the specific suggestions that need to be considered.

5. Integrated Corporate Governance Framework

Yes, I believe the integrated framework can help improve corporate governance.

I feel your model is getting there but I am still concerned about independence.

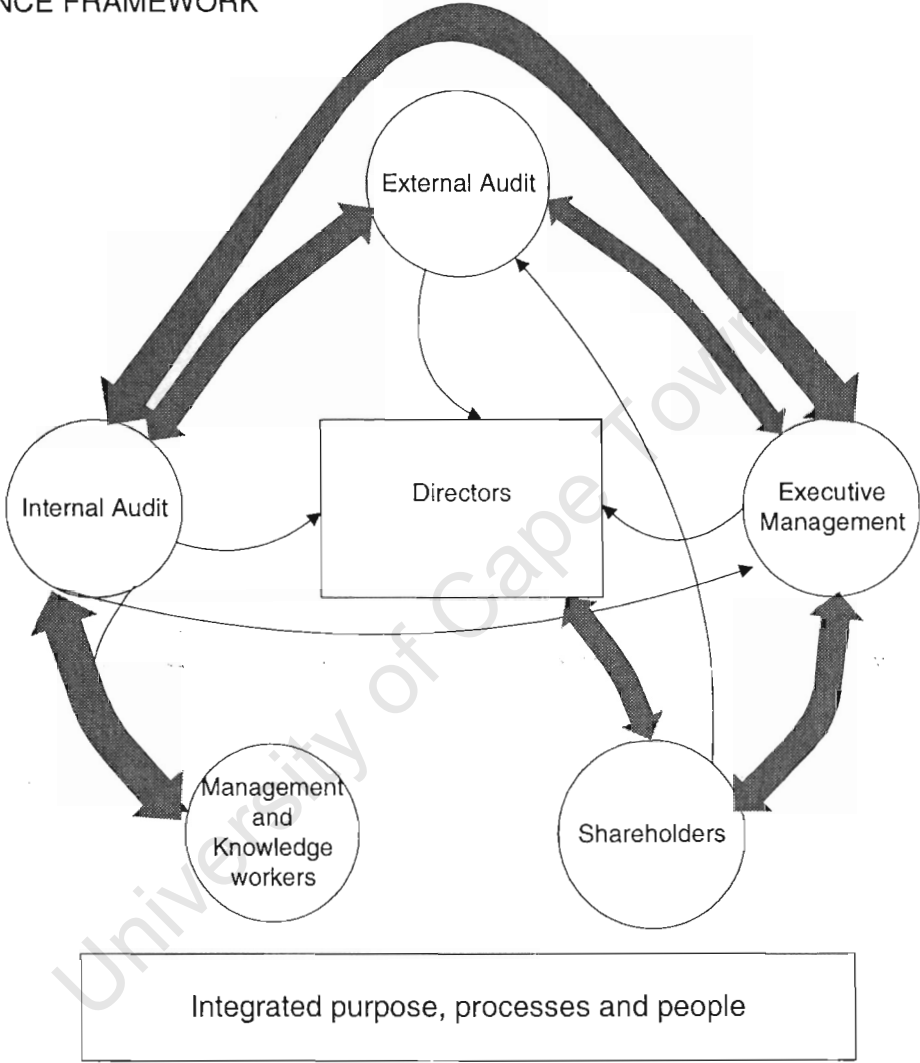
Yes your model will definitely help directors and executives but be very careful with the word stakeholder. It can be confused with stakeholder theory where there is a lot of controversy. In King 2 we made use of “the comprehensive approach” wording to clearly distinguish from the stakeholder approach.

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ANNEXURE C

ICGF Version 1

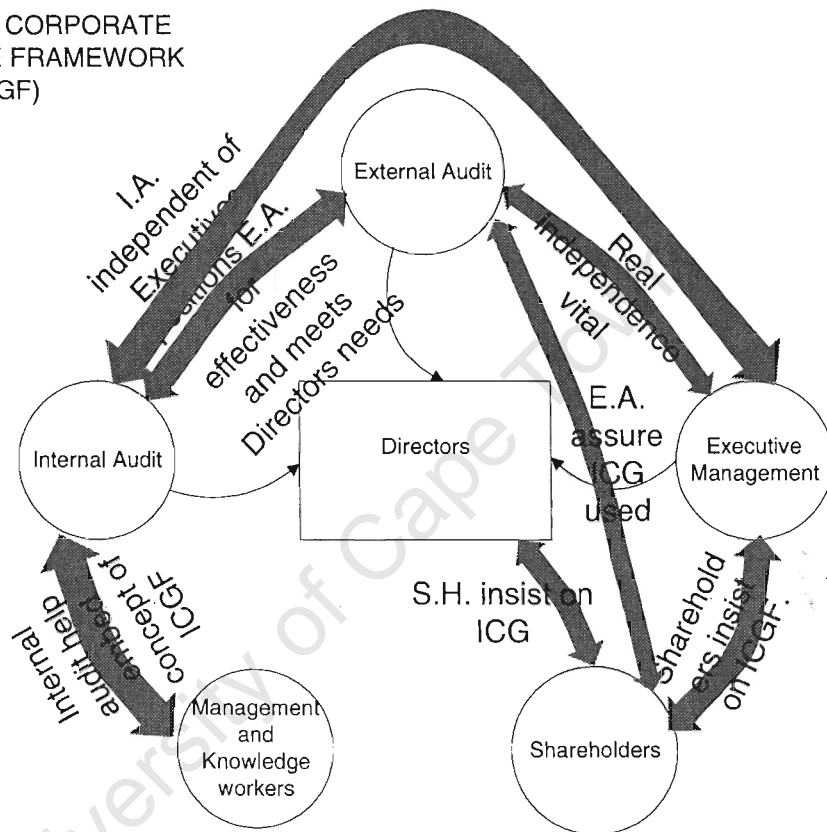
DEVELOPMENT OF INTEGRATED CORPORATE GOVERNANCE FRAMEWORK



ANNEXURE D

ICGF Version 2

INTEGRATED CORPORATE GOVERNANCE FRAMEWORK (ICGF)



Integrated purpose, processes and people to manage risk and achieve strategic objectives

REFER 1 to 19 on Annexure F

- Directors 1+2+3+8+9+10
- Executive Management 2+3+4+5+6+7+8+11+12+13+16+19
- External Audit 13+15
- Internal Audit 13+14+15
- Management and Knowledge workers 19
- Shareholders 18

ANNEXURE E

Towards an Integrated Corporate Governance framework

The voluntary code in South Africa and the UK is predominantly focused on form. (Boards, Directors Audit Committees, Nomination committees, Remuneration committees must be in place) In addition, requirements are set out for external auditors, internal audit, company secretary, accounting, risk management and in the case of the South African code, Sustainability reporting.

The form has been made clear but little has been done to clarify the integrated processes that need to support this form to give real substance to corporate governance. In addition not enough has been done to ensure all the major components or elements of corporate governance are integrated to ensure overall effective integrated governance.

Please refer to Annexure C & D for version 1 and 2 of the Integrated Corporate Governance Framework. It is accepted that the elements of corporate governance, included in the best corporate governance codes, are important and should be present in a sound system. The framework requires the integration of the elements and the required action set out in 1 to 19 below:

1. The Board develops a policy for the management of risk and risk tolerance criteria. **(ACTION)**
2. Executive management, together with the Board clarify the purpose of the company and develop an appropriate strategy taking into account the external environment and capabilities of the company. **(ACTION)**
3. This strategy has to be monitored constantly and if necessary changed. **(ACTION)**
4. Executive management documents the business model and value chain. **(ACTION)**
5. Executive management ensures effective processes are put in place to implement the strategy. **(ACTION)**
6. Executive management ensures correct people are in place to implement the strategy and embed the processes. **(ACTION)**
7. Executive management ensure all risks are identified that could prevent the objectives of the strategy being achieved. These risks should be linked to each process. The risks should be assessed and appropriate controls put in place to manage them. A monitoring process ensures the continuing effectiveness of the controls. **(ACTION)**

8. Directors review the risk assessment and ensure they are comfortable that all risks have been identified. Executive management needs to also demonstrate that the controls are cost effective in relation to the risk managed. **(ACTION)**

9. Risks identified must cover all operational, financial and regulatory risks. **(ACTION)**

10. Directors to ensure that a senior executive is linked to each process and are accountable for the performance of the process and the effective management of the risks. (Financial Services Authority in the UK requires senior executive accountability for each business process) **(ACTION)**

11. All processes to be flow- charted to ensure a “ picture” is available for all to understand the business and for business continuity. **(ACTION)**

12. The documented processes and all related risks to be retained in a risk data- base. **(ACTION)**

13. This data- base is to be used by all corporate governance role players. Management, external audit and internal audit. **(ACTION) and (ASSURANCE)**

14. Internal audit will use this database to develop a risk based audit plan. In terms of the assurance that internal audit provides the Board it is important that they check independently for completeness of risk in the processes. They will also assess the adequacy of the controls against leading practice and ensure the controls are cost effective. Any report will integrate all work done by internal audit relating to a specific process. This will require internal audit teams to be multi disciplinary to ensure financial, operational and regulatory risks are combined in one report (Internal Audit should be positioned to be as independent of executive management as possible. The head of internal audit is appointed by the Audit Committee and reports directly to the chairman of this committee. Funding for internal audit to be controlled by the Audit Committee) **(ASSURANCE)**

15. This positions external audit to assess the quality of internal audit work and to rely on it if the quality is appropriate. They will again look for completeness of risks and make use of the one data- base. If they are able to rely on the processes, due to the work of internal audit and executive management, they will be well positioned to report on the financial position and the results of the company for the financial year. All that will still be required is to verify the assets and liabilities. **(ASSURANCE)**

16. Many companies have a separate risk management department. This is unnecessary, as it tends to create additional risk databases that are not well integrated into the day-to-day activities of the company. Instead risk experts should be part of the businesses and ensure the risk identification, assessment, management and monitoring processes are effective. **(ASSURANCE)**

17. Companies have set up separate compliance departments. Often these departments are “toothless” as they normally report to the Chief Operating Officer. They normally have no functional responsibility and they are sometimes described as a middle office in asset management businesses. I.e. neither front office (portfolio managers and research) nor back office (processing, administration and accounting). The role should be integrated into the processes with specific responsibility to identify any changes in legislation that will have an impact on the business. They need to ensure processes and controls are in place to comply with any regulatory requirement impacting on the business and to train process people to understand the regulatory requirements. The regulatory monitoring they carry out should be automated into the process. Exception reports should be generated when controls are not complied with and these should go to both the process owner and the Compliance Officer. (In terms of regulation a Compliance Officer is required. To ensure appropriate independence, a qualified Compliance Officer should be part of the internal audit team.) **(ASSURANCE)**

18. Shareholders to insist the Board and executive management embed integrated corporate governance. Shareholders need to be empowered to discuss integrated governance with external auditors and directors. **(ACTIVISM)**

19. Executive management to change culture through changes in personal behaviour and “the tone at the top” to ensure all people understand the concept of integrated governance. The joint action and focus of the people become the greatest control in the management of enterprise wide risk. **(AWARENESS)**

ANNEXURE F

Testing the Integrated Governance Framework

Audit partner Response

The response of the partners was encouraging. The overall response was that they felt the Framework could help directors and executives implement sound, integrated governance. Taking into account the nature of the research and the qualitative approach, the following detailed responses are disclosed with the categories that emerged.

- “Risk management has been around for a while, why will this get through to the hearts and minds of directors and senior executives? What is going to make them take action?” (**ACTION and POWER**)
- “Risk management is a critical area – not “sexy,” but is critical to corporate governance. How can it be made to be done correctly as part of corporate governance?” (**SYSTEM of GOVERNANCE**)
- “Link the framework to the same UK requirement, where in terms of the combined code, the directors statement on the effectiveness of internal control must be audited by the external auditors.” (**ACTION and POWER** of directors)
- “Directors have the ability to leverage other corporate governance role players but the will and drive is just not there.”(**ACTION and POWER**)
- “The framework is sound but South African directors need a real wake up call to focus minds.” Here fines and imprisonment were suggested of up to 25years! (**ACTION**)
- “It will help to integrate roles and actions of executives and assurance providers but the real leverage is the Board of Directors.”(**POWER and SYSTEM of GOVERNANCE**)
- “How are you going to get boards to behave correctly and make the right decisions?”(**ACTION and POWER**)
- One partner felt that only strict legislation, similar to the USA, would focus minds.

ANNEXURE G

The International conference on Corporate Governance

Response was supportive and encouraging in one of the special interest groups. The attendees were academics, consultants, directors, chief executive officers etc. The conference attendees were from all over the world including: Canada, North America, United Kingdom, Europe, Japan, New Zealand and Australia.

Unfortunately you do not get a great deal of detailed feedback from these type of sessions and often you do not know what people really think. The researcher found it much more useful to share the ideas with specific individuals through informal interview and discussion.

- Toyohiro Kono – Professor, Gakushuin University Japan
- Dennis Garvis - Professor, Washington and Lee university USA
- Dr Keith Gay - Professor, Henley Management College UK
- Van Ramakrishnan - Managing Director, ODL Singapore
- Professor Thomas Clarke - Director, Centre for Corporate Governance, University of Technology, Sydney
- Nicholas M Bradley - Managing Director, Governance Services, Standard & Poor
- Professor Martin Devlin – Director, Massey University New Zealand
- Patricia Peter - Corporate Governance Executive, Institute of Directors, London.

In the case of two of the above, their eyes glazed over and it was clear that their interest did not go beyond the internal workings and behaviour of directors. Feedback from the others was largely encouraging. One person went so far as to say that this is exactly what is needed to embed corporate governance. An individual was however very sceptical and probed as to how the researcher expected to change the current behaviour of directors, which he correctly identified as vital to ensuring the success of the framework and performance in corporations. There were a number of references to action and performance. A theme that constantly came through was the power of directors and their ability to use it for themselves or for stakeholders including all shareholders. Not just controlling shareholders. The system of governance that was in place, driven by the codes of governance, was “toothless” with regard to director power and performance.

On the flight home I was fortunate to sit next to Keith Mokoape, Chairman of Cyber Sim and on the Boards of many South African companies. Keith was very encouraging and felt that the Framework would be very beneficial to South African directors. He pointed out that it would be necessary to be very creative to get their attention. He is involved with the local Institute of Directors and was very concerned that most of the courses they ran on corporate governance, at that time, had to be cancelled.

University of Cape Town

ANNEXURE H

SYSTEMS THINKING

Introduction to System Thinking

Different professions and disciplines do not share the same definition of the term “system.” This is problematic, however it is generally accepted that a system denotes a whole composed of parts which are organised and which influence each other.

A system is often thought of as an objective entity that exists in the real world. It is a perceptual construct, a product of what has been called “world – view.” (Checkland & Scholes, 1990) World – view is the “lens” or the “tinted” spectacles through which we view and interpret the world and our relationship with it. The concept “system” is not used to refer to things in the world, but to a specific way of organising our thoughts about the world.

Systems thinking is a discipline that helps us to make sense of our world. It is used to examine the “real” world to help us understand it better and to improve it where possible. It involves studying things in a holistic way, it is not a set of reductionist techniques. It aims to gain insight into the whole by understanding the elements, linkages, interactions and processes that comprise the whole system.

Prior to systems thinking, a group known as mechanists, believed everything that occurred was completely determined by what preceded it. (This became known as linear thinking). This mechanistic thinking adhered to analysis and reductionism. They believed everything could be understood in terms of the elements that made up the object or event.

The mechanist view of organisations was that they were made up of parts that could be made efficient in pursuit of a particular goal. When it was discovered that organisations or corporations failed to perform well as a whole when the parts were independently optimised, the need for a systems approach became apparent (Flood & Jackson, 1991).

Systems thinking developed as an alternative to mechanistic thinking. In mechanistic thinking a “system” is an aggregate of the parts in which the whole is equal to the sum of the parts. In systems thinking, a “system” is a complex and highly inter-linked network of parts exhibiting synergistic properties – the whole is greater than the sum of the parts (Flood & Jackson, 1991).

The central concepts of a system are shown in figure 19 below:

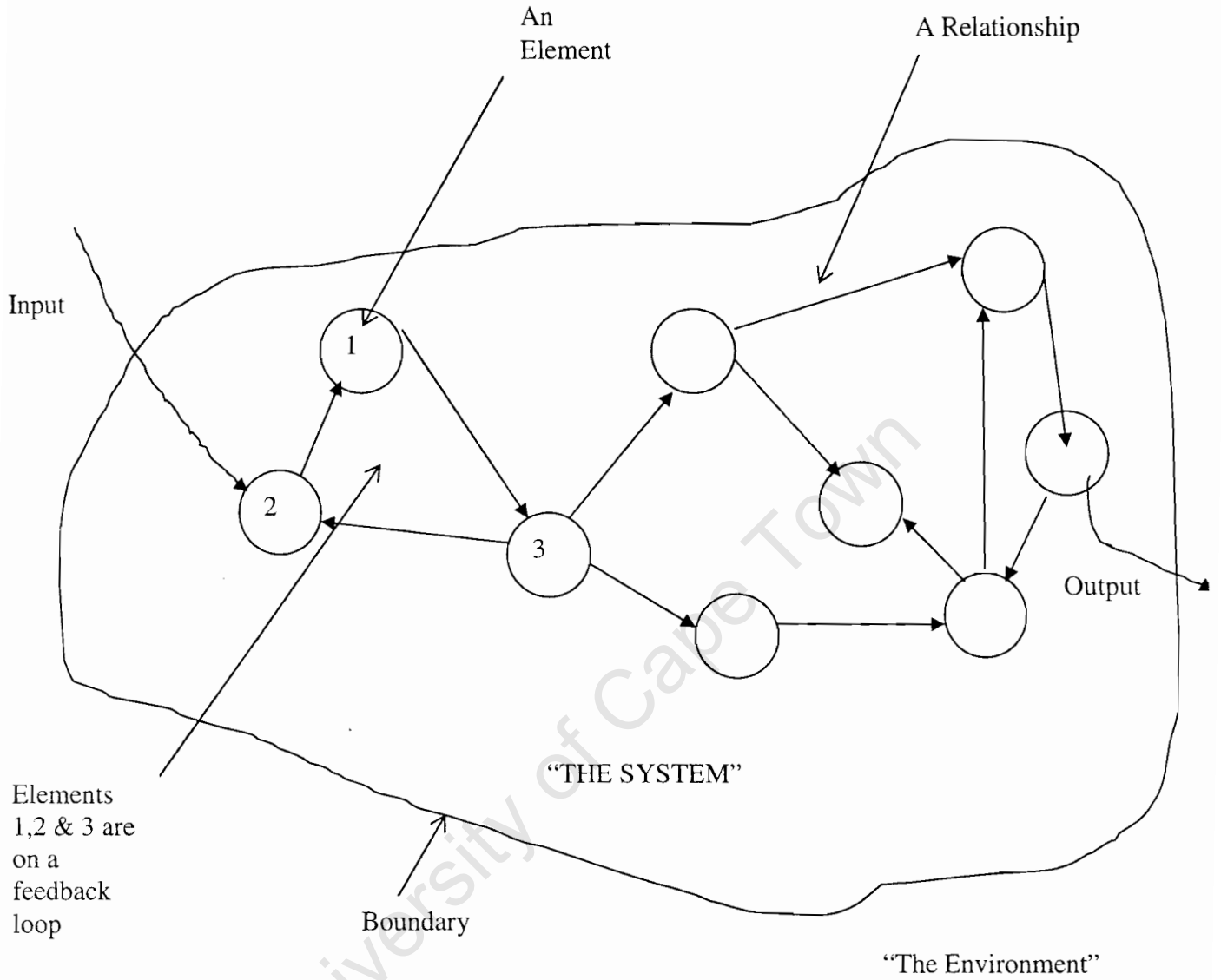


Figure 19 "A system" Adapted from Flood & Jackson (1991).

With reference to Figure 19 above, a system consists of a number of elements which are interrelated. A richly interactive group of elements can be distinguished from those in which few interactions occur. This is achieved by drawing a boundary around the richly interactive group. The system identified by the boundary will have inputs and outputs, which may be physical or abstract. The system does the work of transforming inputs into outputs. The behaviour of one element may feed back to another element because they are directly related. Feedback may be indirect via a series of connected elements. In either case the feedback influences the element that initiated the process.

A system so described is separated from its environment by its designated boundary. It is termed an open system if the boundary is permeable and allows inputs and outputs to and from the environment. A system that is able to sustain an identity by maintaining itself in a dynamic steady state, in a changeable environment, is said to be exhibiting some form of control. Essential to control is the communication of information between the elements. A system can be said to be purposive if it is carrying out a transformation, and is termed purposeful if its purpose is internally generated.

A system stabilised by its control mechanisms, and possessing an identity, can be further understood through its emergent properties. These are properties relating to the whole system but which are not necessarily present in the parts. The term “synergy” refers to the increased value of the parts working together as a whole. Emergent properties arise where a complex interconnected network exhibits synergy such that “the whole is greater than the sum of the parts.”

Systems are generally understood to occur in hierarchies, so that which may be viewed as a system, may also be viewed as a sub – system of a wider system (Flood & Jackson, 1991: 33).

Why use systems thinking?

Traditional decision-making tends to involve linear cause and effect relationships. By using Systems Thinking we begin to see complex interrelationships. Instead of analysing the problem in terms of input and output, we look at the whole system. This larger picture will normally provide more information, than traditional methods, and, therefore assist in ensuring better problem-solving decisions are made.

Systems Thinking helps to construct our mental maps of the situation. The observer identifies and selects the characteristics or behaviours of the system that are of interest. The observer

then identifies the elements of the system that co-produce these behaviours or characteristics. Since different observers may select different characteristics and behaviours, the elements identified by different observers will differ, and so the systems they construct will be different. In this sense a system is unique to the observer, yet the systems thinking disciplines position the observer so he or she is able to share their mental model of the situation with all the stakeholders in the system.

From a management point of view, this mental model, or system developed by the observer, allows the observer to describe the situation in its current state and to predict how a particular action will change its state or behaviour.

Having described systems thinking and how it can be used, the researcher now turns to describe the corporation as a system. His model of a system has been built upon his international work experience, familiarity with the literature and case studies, and discussions with directors, executive management, external auditors and internal auditors.

Developing the systems perspective of the situation

From systems thinking as outlined above it is clear that a system has some defining characteristics Checkland and Scholes (1990) have emphasised the following:

- Components or elements are interrelated
- Removing an element changes the system and its characteristics
- Control and communication to ensure systems survive can be identified
- The system has emergent properties (the product of the interaction between the parts or elements)
- The system has a boundary
- Outside the system boundary is an environment which affects the system
- A person has a specific interest in the system to understand and improve the real world

The researcher has a specific interest in corporations and the effectiveness of corporate governance. The defining characteristics of a system, as shown above, are considered useful to the researcher as they enable him to describe the corporation as a system. The researcher selects certain behaviours produced by corporate systems which relate to corporate governance. The purpose of using this approach is to communicate the mental representation, model or map the researcher holds of the situation.

Structure and Process

System elements or components can be viewed as structures or functions. (i.e. processes). These components are, of course, interrelated. The structure of a system is made up of stable components that carry out processes or are acted upon by processes. The board of directors is, therefore, a structural component while board reporting is a process that provides information to the directors.

The link between structure and processes is inextricable. In a corporation there will be no processes without structure and structure cannot exist without the processes. i.e. the board of directors cannot carry out their role, or indeed exist without information processes. In corporations, the system structure is influenced by the functional requirements of the corporation and complex human factors like culture and power. In addition, the human factors create and sustain the system structure (Waring & Glendon, 1998).

Conventional thinking and approaches to management systems, including corporate governance, tend to ignore the complexity of human behaviour and power. The simple, linear corporate governance models that have been developed, in line with conventional wisdom, ignore this complexity and increase risk to all corporate stakeholders.

Environment

This refers to the components or elements, or systems, which are outside the system in focus. These components affect the system. The system cannot control them and has little influence on them. For a corporation the components that form part of the environment would include the economy, taxation policy, regulatory legislation etc. The corporation will attempt to influence these components but will have limited success. They can have significant effect on corporations.

The external environment can have a significant effect on the risks of a corporation. When developing a framework for corporate governance, environmental factors must receive careful attention.

This environment can influence corporate governance. The Financial Services Board, pension fund trustees, asset managers, stakeholders including shareholders and government, could make a significant difference to corporate governance, if they worked together to improve the overall influence of the environment on corporations and corporate governance.

Prediction and Control

Systems can prevent undesirable consequences. This is done through prediction and control. In order for this to take place goals and objectives have to be clear and control and monitoring have to be appropriate.

With engineered or designed systems, goals are normally obvious and control and monitoring systems are designed and built as part of the system. Corporations present different challenges because of the predominance of human activity systems. Corporations often put processes in place with vague objectives and without clarifying the specific goals. Controls are often poor and badly thought through with monitoring systems not in place. The destruction of Barings Bank was largely the consequence of a failure to separate the responsibilities of front and back offices at the Singapore branch. Poor controls and management information through the Barings group, demonstrated poor prediction and control.

Waring & Glendon, (1998) state that conditions for control include:

- The process that has to be controlled must be understood.
- Inputs and outputs must be monitored accurately using appropriate means of measurement and at a suitable frequency.
- There must be appropriate communication links between monitor and controller.
- Goals, standards and performance criteria must be compatible with outputs that are monitored.
- Time delays between monitoring, control action and control effect must be within reasonable and appropriate limits.
- Control effect must be successful.

Although these conditions appear to be simple and straightforward, many corporations have not insisted that their processes are guided by these important, basic requirements. The hunt for greater market share, volume of sales and business globalisation appears to have influenced the inadequate internal control environments of many corporations.

“The more complex the perceived system and the factors that influence it, the less likely that the predictions will be accurate and control reliable” (Waring and Glendon 1998).

Corporations with human activity systems are complex (Toft, 1996). Process characteristics and control relating to human activity systems are totally different from other systems such as

engineered systems. These systems do not rely on human beings who are emotional and unpredictable.

It is important, therefore, that corporations, with their inherent human activity systems, have to take great care so as to understand the processes, to identify risks and to design appropriate controls and monitoring systems. The reliance on human beings with their unpredictable behaviour requires equivalent variety and responsiveness from intelligent control and monitoring systems.

Emergence and holism

Emergent behaviour from a system cannot be predicted from the disconnected components. In corporations, the outcomes of processes are not always predictable from the systems components, inputs, process and control characteristics. Once again this reinforces the need for appropriately complex, control and monitoring processes, to match the variety of the outcomes.

A holistic view requires that the widest possible set of components, influences and emergent properties are considered. This approach is in contrast with reductionism, where, in the search for simplicity, important features of a system may be lost because of the naïve simplification of complex management systems.

System Ownership

In systems terminology the “system owner” has an interest in a perceived system for the purpose of improvement etc. Ownership is sometimes referred to in corporations where employees have responsibility for a system or systems. In reality these individuals normally have no power or authority and the control expectations of senior executives and maybe directors would then be inappropriate.

This is a dangerous area and in terms of the researchers experience, prevalent in many corporations. Executive management requires reliable exception reporting systems to overcome this risk.

World – View

World - view is the way in which we make sense of the world, the perceptual window through which each person interprets the world. A shared world – view can be regarded as a component of culture (Waring, 1993). The world - view of the individual and the collective

world - view of a group to which an individual belongs, could be useful in understanding the impact of culture on the risk of a corporation. Shared world- views are, therefore, important for focus and integration in organisations. World – view can influence the attitude to risk in the corporation and what is required for sound corporate governance. Unfortunately the so – called risk and governance experts often ignore culture. Douglas (1992) has pointed out that the risk experts detest anything messy which impacts their clean scientific formulae.

Culture and power influence the risk environment and consequently the demands on corporate governance. The culture at Enron drove risk taking to inappropriate heights. The risk taking culture and the unchecked power of senior executives led to the destruction of shareholder value. Traditional risk management and corporate governance approaches do not adequately deal with this important influence.

Burrell and Morgan (1979) identified four principal world-view types. Functionalist, interpretive, radical structuralist and radical humanist.

Burrell and Morgan's world - view framework is a useful tool to help identify and understand the different world – view types and what therefore motivates individuals, groups, or the system of the corporation. This differentiation adds complexity to the challenge of developing a generic framework to guide risk management and sound corporate governance. Functionalist/ objective perspectives dominate financial institutions and most corporations. Current corporate governance guidelines appear to be driven by this perspective and, therefore, continue to ignore social scientists and their knowledge. (Interpretive perspective)

Conclusion

The researcher has attempted to give a brief insight into Systems Thinking.

Traditional approaches to management systems and the corporate governance challenge have been mechanistic and based on simple input – output or cause – effect models of how people think and act. Prediction and control are seen as straightforward outcomes of instructions, duties or roles laid down in company manuals.

Systems Thinking has helped the researcher share his mental model of some of the challenges and complexity inherent in the corporate governance situation.

ANNEXURE I

INTERVIEWEES FOR FRAMEWORK TESTING

Cycle 1

Select individual experts on corporate governance from Deloitte & Touche, Price Waterhouse Coopers, KPMG and Ernst & Young (Known globally as the “Big Four”).

Interviewee	Responsibilities	Experience	Training	Reason for Selection
Partner Ernst & Young.	Senior Audit Partner	25 years accounting, external audit and governance experience in South Africa	SA Chartered Accountant. Qualifying and ongoing professional training	Specific governance knowledge and experience with many industries and individual companies
Partner Deloitte & Touche	Partner Enterprise Risk Services (ERS)	20 years accounting, auditing and risk management global experience	UK Chartered Accountant. Qualifying and ongoing professional training	Global experience. ERS is responsible for governance consulting across all industries

Cycle 2

Select individual corporate governance experts in South Africa

Interviewee	Responsibilities	Experience	Training	Reason for Selection
Partner Edward Nathan Corporate Governance Advisory Practice	Managing Director	30 years corporate experience. Acknowledged international expert on corporate governance	Fellow of the Institute of Chartered Secretaries and Administrators	Principal convener and main editor of King Report 2002.

Interviewee	Responsibilities	Experience	Training	Reason for Selection
Nedcor Head of Corporate Governance	Senior Executive Enterprise Governance and Compliance	15 years legal and governance experience	Law (Senior Council)	Overall governance responsibility of a large corporation and to ensure diversity
Partner Sonnenberg Hoffmann Galombik	Corporate risk management, mergers, acquisitions and corporate restructuring	8 years legal, and governance experience	Wide range of commercial and corporate law experience	Partner with overall corporate governance responsibility

ANNEXURE J

The researcher has global experience in many of the corporate governance roles. This includes external audit, internal audit, risk management, compliance, financial management and senior management. In carrying out these roles the researcher had the opportunity to attend in excess of 20 Board and Audit Committee meetings. The observer/ participant experience has contributed significantly to the research undertaken for this thesis.

External Audit

Clients included:

- Nampak
- Investec
- Black & Decker
- Raine Investments
- Finewright Holdings
- Western Province Blood Transfusion
- TR Services
- National Mutual of Australasia

Internal Audit and Risk Management

Clients included:

- Old Mutual
- OMAM (South Africa)
- OMAM (UK)
- OMAM (USA)
- OMAM (Bermuda)
- Old Mutual Unit Trust Management company
- Old Mutual Investment Advisers (USA)
- Provident Investment Counsel (USA)
- Capel-Cure Myres (UK)
- Albert E Sharp (UK)
- Galaxy Investment Services
- Old Mutual Bank