

Global Corporate Governance: The Maelstrom of Increased Complexity

— Is It Possible to Learn to Ride the Dragon?

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Abstract: In the light of recent corporate scandals company failure is usually explained based on agency theory, leading to the conclusion that corporate boards and regulators must use agency theory to control management better. The authors use institutional theory to problematize this advice. We identify the role of accounting as to give predictability, hence preventing company failure. But this predictability can be questioned; it implies stability. Albeit partly with circumstantial evidence, we question this stability with factors making the conditions for management decision-making volatile, as explained by antecedents, and leading to unmanageable entities. The implications of this volatility have consequences for corporate governance and question the going-concern assumption, the basis of accounting. Hence, from the dominant explanations that corrupt management, or management with different interests than the principal, leads to company failure, we evolve another chain of cause and effect: volatility, with company failure as a result. It is argued that traditional accounting rituals are unsuitable for many companies. The paper indicates a need for de-institutionalization and reconsidering of accounting practices, and thus particularly the assumption of going concern.

Key words: accounting; complexity; corporate governance; going-concern; management control; information use; innovation; volatility; uncertainty

JEL codes: M00, M400, M420, O3

1. The Problem — Company Failure

With a background in scandals, such as Enron, WorldCom, Vivendi, Adelphia, Tyco, Global Crossing, this article reflects on how and why uncertainty and complexity in the management of firms may create problems of management control that spills over on the potential of corporate governance. Twelve of the 20 largest bankruptcy filings in the U.S. history took place in 2001 and 2002. All 12 companies received an unqualified opinion on their most recent financial statements filed prior to the bankruptcy filing (Carnegi & Connell, 2014; Uang, Citron, Sudarsanam & Taffler, 2006; Venuti, 2004). In response to the frustration with corrupt, or seemingly corrupt

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management, management cultures, or failing information systems, Palmer (2013, p. 5) suggests that “...new emerging theory and research on organizational wrongdoing present a fundamentally different perspective. It views *wrongdoing as a normal phenomenon*; behavior that is prevalent, not much different than rightdoing, perpetrated by people who are for the most part upstanding..., and is a function of a plethora of structures, processes, and mechanisms that are integral to the efficient and effective functioning of organizations.” [our emphasis] Another explanation is that management fails to see the information necessary because of taboos: “Fear can blind us: it is often impossible for an organization to acknowledge the biggest risks it faces, including extinction...” (Schoemaker & Tetlock, 2012, p. 7). Hence, we need to find methods to lift the fog of the taboos. A third approach recognizes that “Estimating a volatile future value is a fundamentally different task than making a forecast in stable market conditions.” (Haran & Moore, 2014, pp. 6-7), but proposes that this problem can be resolved by a method that gives better accuracy and greater flexibility for the decision maker.

This largely “internal” perspective on the causes of company failure identifies the principal antecedences to company failure in structural issues within the company, rather than in managers themselves, which is often the popular explanation. Hence, it is natural that voices have been raised for further control of management. Ever since management and ownership became separated, in the Italian city-states of the 12th to the 14th century, the primary objective of accounting and the development of new accounting principles has been the control of management. This paper discusses the limits of current management control systems. Focus is on the boundaries of information limiting the control of management and the possibility of improving corporate governance.

Critique against failures due to fraud are typically theoretically inspired by agency theory explanations, in terms of opportunistic behavior and strong incentives for moral hazard, while cultural aspects, such as institutional mechanisms are less common. Agency theory is based on pessimistic assumptions of management behavior and actions (Ghoshal, 2005; Hirschman, 1970).

In this paper we question the thoughts that are hegemonic in the fields of accounting. One such institutionalized assumption connected to the most central change that may take place in an organization that ceases to exist, i.e., the going concern assumption, is reflected on. The management control perspective of agency theory may contribute some knowledge for management control, with implications for corporate governance, but it is not sufficient. Management’s decision processes are exposed to problems of adverse selection; such problems are here reflected on from the perspective of institutional theory. We argue that the problem of adverse selection, due to high information asymmetries, may be a central part of the explanations of corporate failure. We base this view on arguments of institutionalized structures and information boundary-spanning causing problems for management control, and hence later also corporate governance. By adopting an institutional perspective, we challenge the rituals used in accounting, and the roles such rituals have in the institutionalization of behavior for maintaining social cohesiveness. We argue that companies are sustained by the rules governing them, and by institutional mechanisms supporting conservative behavior, rather than by real needs of management, whom they purport to serve in the interests of management control. This paper draws on the discussion of accounting relevance of the current accounting assumptions for use in management control that results in consequences for corporate governance and ethical considerations.

1.1 The Going Concern Principle, as Part of the Accounting Rituals

The going-concern concept considered as the accountant’s firm model is a central part of accounting rituals. Accounting started as the control of short-term (4-6 years) projects, such as ship-borne trading voyages to the Far East. The principle of the “going concern” was introduced in the Middle Ages, when trading trips became

recurrent. Liquidation of assets after each voyage seemed costly and ineffective in cases where the same investors were involved. The principle of the going concern enabled continuity in business transactions (Sapori, 1970). For the company to survive in a long-term perspective, this principle implies that the company's operational payments need to be lower than cash generated (Coyle, 2000, p. 125). The assumption of the going concern is fundamental to accrual accounting and has a direct connection to historical cost valuation (Venuti, 2004). This assumption justifies revenue recognition and matching principles, the allocation of costs over periods benefited, historical cost accounting and also the classifications within the balance sheet (Fremgen, 1968, p. 649). Yet, what if this assumption no longer holds?

The basic concept of the going concern and its attached accounting rituals has been relatively unchallenged in accounting. The axiom is a cornerstone in accounting, where the myth of the going concern realms of the past and the present holds for estimating the future, and where also the present becomes contiguous with the future (Cooper, Crowther & Carter, 2001; Koh & Low, 2004; Sterling, 1968). However, there are shortcomings with the concept of the going concern, which need further elaboration. Such shortcomings are connected to environmental circumstances, behavioral implications for management, as well as auditors, due to their ability and willingness to disclose going concern opinions, and finally conceptual un-clarity in the definition of the going concern.

One weakness of the going concern concept derives from contemporary changes from stable business environments, with long product and business life cycles, to rapidly changing cycles in dynamic business environments. The going concern principle is, as such, considered as a functional model of businesses in stable environments, and has also been central in the development of the industrial production. Edwards & Bell (1979, p. 15) wrote: “...*lacking evidence to the contrary the business entity has an indefinite life; continuance rather than imminent liquidation is the reasonable expectation.*” (Their italics). The business environment has changed, however, and over the last few decades new market conditions and technological advances have come to characterize a dynamic new environment. Product life cycles are no longer measured in 50 or 100 years, often not more than 3 to 5 years, and some not more than a couple of months (as with mobile phones). Even underlying business models, technological platforms, etc. have shorter and shorter economic lifespans (Schumpeter, 1947).

Weaknesses in going concern statements are connected to behavioral implications, due to company management. Venuti (2004) for instance, considers weaknesses in management and auditors' disclosure an issue of going concern opinions. The future is genuinely unpredictable for management, when assessing the company's potential of future survival, due for instance to changes in the environment. Decisions made are typically based on a limited number of variables that give logic and structure to our judgments and that simplify continuous recalculations of our guesses (Kahneman & Tversky, 1984; Simon, 1955). Disclosure of information on firm failure, where the going concern assumption is questioned, may also become self-fulfilling and receive severe behavioral implications, causing actual company failure (Frost, 1997; Venuti, 2004). Managers appear to be particularly reluctant in voluntarily disclosing going concern information in financially distressed situations, causing biases in disclosed information that also influence the quality of company information (Mutchler, 1985; Uang, Crowther & Carter, 2006). In line with this reasoning, managers have incentives to disclose trustworthy information to sustain company reputation (Healy & Palepu, 2001; Skinner, 1994; 1997), but also incentives not to disclose fully all information due to reputational concerns (Balachandran & Nagarajan, 1987; Kothari, Leone & Wasley, 2005) and to preserve competitive advantages (Johansson & Malmström, 2013). Nevertheless, dysfunctional management disclosure behavior has been suggested to be managed by robust corporate governance mechanisms, where the mechanisms aim to improve the quality of the going concern disclosure. Such

considerations touch upon management's willingness to disclose information on the going concern, while management's ability to disclose such information is another side of the coin that has not been thoroughly addressed. The lack of mandatory management disclosure of the company's ability to carry on as a going-concern has been criticized (Venuti, 2004).

Weaknesses in going concern statements are also connected to behavioral implications, due to auditors. Auditors' work with assessment and disclosure of going concern opinions is central in auditing, and as such among the trickiest parts of the auditors' work (Arnold, Bernardi & Neidermeyer, 2001; Louwers, Messina & Richard, 1999). The quality in auditors' going concern opinions, as well as their ability and willingness to disclose such opinions, has been questioned: for instance, their disclosure of opinions for companies that do not fail, and for not disclosing opinions on failing companies (Citron & Taffler, 1992; Geiger & Raghunandan, 2002; Tagesson & Öhman, 2015). Management reluctance to disclose reliable information causes information asymmetries that spill over onto auditors' ability to disclose reliable going concern opinions (Uang et al., 2006). Auditors' opinions are also ambiguous and appear to differ in clarity and distinctness. Auditors disclose subtle signals on the going concern that not may be anticipated by all stakeholders, where the ambiguous or implicit statements are used as strategies by auditors to deal with the sensitive situation of causing liquidation through the disclosure as such (Arnedo, Lizarraga & Sánchez, 2008; Carcello & Neil, 2003; Tagesson & Öhman, 2015). Going concern expectations appear to be disclosed too late, both by company management and by auditors.

Finally, weaknesses in going concern statements are also connected to conceptualization of the going concern concept. Un-clarity in definition of the going concern concept causes different interpretations and misunderstandings of the concept as such (Venuti, 2004). Words such as "significant" and "substantial", used in definitions, are ambiguous and may cause different interpretations. There are a number of key performance indicators that may be used for assessing potential going concern problems for companies and their business models; both company-specific and industry-specific indicators. Historical short-term and long-term information on financial and non-financial aspects are used for capturing historical trends, such as revenues, capital sources, and access to cash and funding. Information on the industry, competitors and the economy, and how such factors impacts on the company's future potential are also included in the assessment. Such information may be difficult to access, but also to analyze and draw conclusions on.

1.2 Management Control and Accounting as Myths of Predictability

A cornerstone of accounting is to reduce uncertainty, through a casual understanding of action outcomes in an uncertain business environment, when prognosticating an uncertain future (Cooper et al., 2001). Management accounting is aimed at assisting management in the control of the business and in decision-making, i.e., aimed to be used as part of the management control system (Cooper et al., 2001). The business becomes visible for management through the construction of selectively produced images, enabling measurement (Hines, 1988). The management control system and the underlying basis of accounting encapsulate myths of predictability that enable the creation of images of the organization, the decision-making within the organization, and the future of that organization (Cooper et al., 2001, p. 143). In line with this reality, accounting practices serve cultural purposes of justification, based on mythical rituals, where organizations and members become unified, reaching a common focus of the future (Latour, 1987).

Accounting serves as a filter for information to be included in the decisions, where the underlying logic of filtering is conservative in nature. Conversely, the rationality of accounting predictability may be challenged (Cooper et al., 2001), and we argue that this is in particular true in an era of turbulent change, where such

profound limitations may also cause severe risks of bankruptcy. Accounting involves dominant conceptions of reality that are shaped and reinforced by institutional mechanisms of management control, aimed to create shared logics and understanding of what are appropriate organizational structures and practices (Meyer & Rowan, 1977). An appropriate way of working and acting is established (Boxenbaum & Jonsson, 2008; DiMaggio & Powell, 1991; Greenwood & Hinings, 1996, p. 1027; Meyer & Rowan, 1977; O’Neill, McDonald & Deegan, 2015). Institutionalized thoughts and actions are embodied in rituals and routines, where the accounting rituals are used in decision-making — for instance in the assessment of measures as performance and for legitimation of decisions in front of stakeholders (Cooper et al., 2001, p. 143).

2. Complexity — Unmanageable and Unstable Entities

Capitalism has become more volatile as the compound result of several multi-collinear tendencies: Shorter Product Life Cycles, Wintelism, Changed Product Cost Structures, and Monopoly Rent. Some of these have only lately become manifest, and we can only give circumstantial evidence, as the validation of each of these comprise a research agenda in themselves.

2.1 Shorter Product Life Cycles

An element in the increasing complexity that faces management is found in the rapidly shortening life cycles of products. At the end of the 19th century the life cycles of products (services or experiences) were 50-100 years. Innovation was not a big issue. *Product life cycles have become much shorter. After the WWII, 20 years, and today only 3 years for many products.* However, in mature industries that have not yet suffered from substitution competition, the life cycles are still long. The “...shortening life cycles of new products. In the computer industry during the early 1980s, for example, hard disk drives would typically ship for four to six years, after which a new and better product became available. By the late 1980s, the expected shipping life had fallen to two to three years. By the 1990s, it was just six to nine months.” (Chesbrough, 2007, p. 24).

The consequence of shortening life cycles is that a hundred years ago only 1-2% of the turnover of the firm was at stake each year, while today it is one third! To **replace lost business**, to retain the same size of the company, the 1900 firm had to launch products that could replace 2% of its business each year. At the end of WWII, when an average life cycle was 20 years, products that could replace 5% of revenues had to be launched each year. By 1985 the average life cycle had decreased to 7-8 years. Hence, 12.5% new products had to be successfully launched each year. Today, with an average life cycle of 3 years, one third of the business is **up for auction every year**. With a failure rate of innovations of at least 100% (Evanschinsky, Eisend, Calantone & Jiang, 2012; Van der Panne, van Beers & Kleinknecht, 2003), and a needed 10% yearly growth, it is clear that managers of highly successful companies do not necessarily know if the firm will exist at the end of the year! *Since innovation is risky, the firm might need a product development portfolio that is as large as the current turnover, or even more!* (Van der Panne et al., 2003).

Table 1 Capitalism Is Becoming More Volatile, Own

	1890	1950	1980	2005
Average life cycle	50-100 years	20 years	7 years	3-5 years
% of turnover at stake	1-2%	5%	15%	30%
Necessary Innovation Portfolio	2-4%	10%	30%	60%
Portfolio with growth	2-4%	11%	33%	66%

2.2 Wintelism

To be able to develop new products in a short time, the shorter life cycles have made a new outsourcing model necessary. “Wintelism” was introduced as a concept to describe a new phenomenon that emerged after an antitrust decision against IBM in 1980. In the hope of creating competition, IBM was forced to outsource its component manufacturing. Instead of the traditional outsourcing model, IBM chose to specify only the input and output of components, leaving the supplier to decide the necessary transformation (Borrus & Zysman, 1997; Hart & Sangbae, 2002; Tan, 2002).

Less design work, faster design. As a consequence the buying firm does not need to “design” (innovate, product develop, construct) every detail of a product, only the “product architecture” at a “high” level of the product structure. This approach makes it is possible to *develop in shorter time*, which is *very important* with shorter and shorter life cycles.

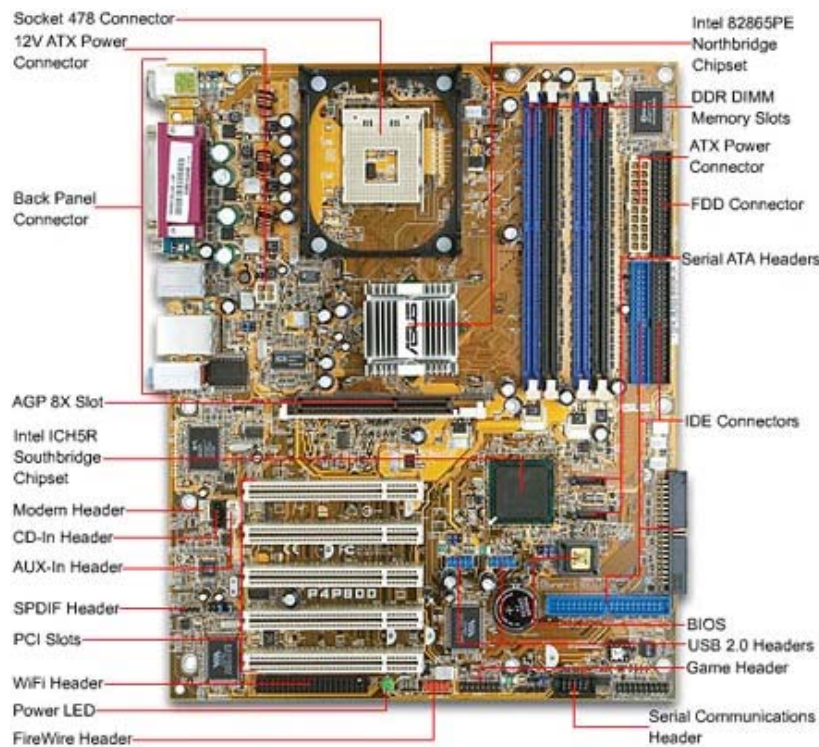


Figure 1 Traditional Outsourcing, Specifying in Every Detail, Philipson (2012)

Increased competition among suppliers. Since the firm only has to specify the function of the component (input-output), it is possible to *transfer* the necessary *information* simply and inexpensively, e.g., by a web page, to many more suppliers, increasing the competition among suppliers. Often thousands of suppliers, rather than as before maybe some ten, can be invited. It also becomes less expensive to *evaluate* the offerings of the suppliers. And the firm does not need to transfer detailed (and proprietary) knowledge to the supplier that has gained the bid—the supplier knows best how the component shall be produced.

The Unleashing of Creativity. The prospective suppliers can use their creativity to invent radically *new solutions* that either gives a much lower price, or higher performance, or new features — cf. Moore’s law and the development of the computer industry since 1980 (Mollick, 2006).

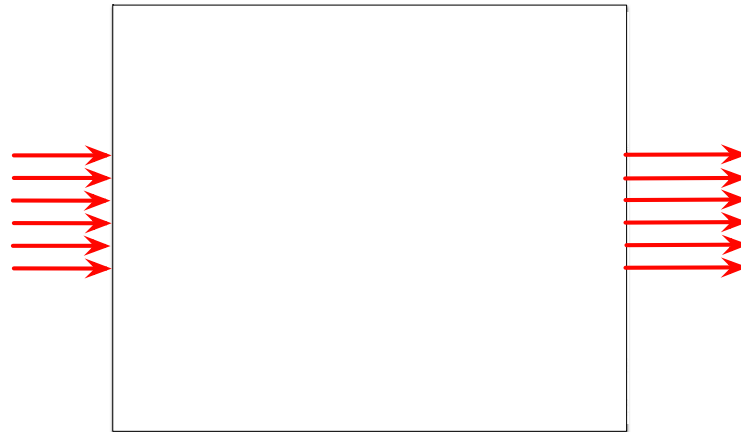


Figure 2 Wintelism. Philipson (2012).

The consequences of Wintelism are that it has opened up globalization (see below) of component production, radically increased productivity, and permitted firms to cope with the shortening time-frame left for the development of new products and services.

2.3 Changed Product Cost Structures

In addition, to maximize revenues in a shortened life span of products, firms are forced to address target groups on a global scale. The effects of this change are that the cost of marketing, as a share of the product's cost structure, has been increasing. Apart from marketing costs, the cost structure has changed as a consequence of the above-mentioned tendencies. Generally, during the short life span of products, it is hard to change production to make it more effective. Decisions need to a large extent be taken *before* the launch of the product. While a hundred years ago some 90% of costs were variable costs of production (direct labor, direct material, and various overhead costs in the manufacturing process), these are now typically 1-15% (2% for a music CD, 7% for a branded T-shirt; 10-15% for a mobile phone, or a personal computer). The large cost elements are now *fixed* production costs and *fixed* marketing costs: the costs for developing the product architecture of the computer, its operative system, some "basic" applications; the organization, and the evaluation of the value chain are now together the lion's share of the production costs. These costs are incurred before any revenues are assured. (Kurawarwala & Matsuo, 1996). Hence, a failure in the launch of a product has more profound effects; as the firm has to pay these costs upfront. Chesbrough (2007, p. 23) states that an important factor spurring the process of open innovation is "...*the rising cost of technology development...*" in many industries. [our emphasis]. He also gives examples from Intel and Proctor & Gamble, where these costs have increased 5 to 100 times over the last 20 years.

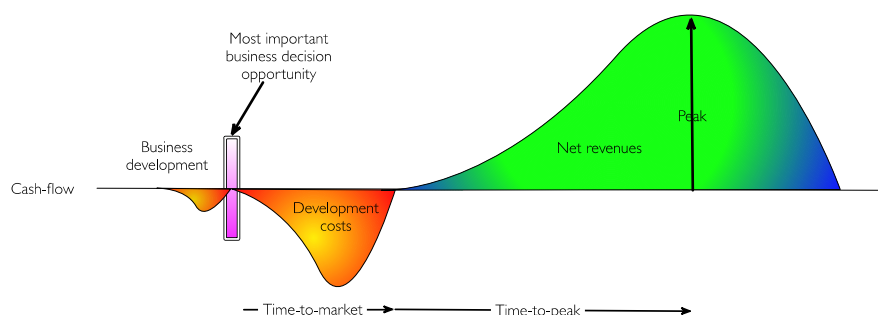


Figure 3 Main Phases of the Life Cycle Curve, Own

2.4 Monopoly Rent

Innovation makes it possible to reach Abnormal Earnings, AE, during the time that the innovation has not been imitated by competitors. Monopoly rent was used by Malthus (1798/1970), Ricardo (1817/1971), and Marx (1894/1981) to explain land rent. Marx (1894/1981) explained AE as the result of the re-distribution of profit in relation to the organic composition of capital. Schumpeter (1942, 1947) applied it to innovation, to explain how a temporary monopoly gives the innovating firm a competitive advantage. “Schumpeter argued that those who succeed at innovating are rewarded by having temporary monopoly control over what they have created. This control, in turn, is the lever that allows innovators to gain an enhanced position in the market and related temporary profits of ‘economic rents’ from their innovations.” (von Hippel, 1988, pp. 43, 58). In the accounting literature AE is normally measured by the neo-classic Ohlson model (AbuGhazaleh, Al-Hares & Haddad, 2012; Bernard, 1995; Feltham & Ohlson, 1995; Lo & Lys, 2000; Lundholm, 1995; Ohlson, 1995), which calculates the value of the firm as the net present value of future abnormal earnings. The Ohlson model updated the Gordon model (Gordon & Shapiro, 1956) with the Miller & Modigliani model (Miller & Modigliani, 1961). “Abnormal earnings bear on the difference between market and book values, that is, they bear on a firm’s goodwill.” Ohlson (1995, p. 662). However, the very fact that the model recognizes abnormal earnings is a fundamental conflict within neo-classical theory, as it abstracts from the fundamental assumption of perfect markets. The Ohlson model is one of the most cited and respected models in the accounting literature, but it has one major flaw: although the Ohlson model is an empirically well-validated prediction model, it fails to explain *why* these abnormal earnings can exist. Classical economics gives such a fundamental explanation. The result of these abnormal earnings is rapid, unforeseen changes. In mid-2007 Nokia retained 60% of the profits in the mobile phone vendor market. Then Apple introduced the iPhone. Four years later, Apple had 75% of the profits and Nokia zero! In 2013 Nokia ceased as an independent mobile phone manufacturer. In 2016, Microsoft that had bought Nokia, announced that it would close the mobile phone business. From being the leading and dominant player it was forced out of the market in 6 years. “...it can always be understood *ex post*; but it can practically never be understood *ex ante*...”, Schumpeter (1947, p. 150).

Organization researchers have long recognized “*pockets*” of *uncertainty* in organizations (Argyris, 1993; Argyris & Schön, 1978; Cohen, March & Olsen, 1972; March & Olsen, 1976; Pettigrew, 1990; Senge 1990; Weick, 1979; as summarized by Gabriel, 1998). We propose that *uncertainty has become generalized* and that we now only find *pockets of certainty*. In the accounting literature, such chaoticness has only been recognized lately, and only in texts that have had marginal impact on “mainstream” accounting (Cooper et al., 2001; Gabriel, 1998), or risk management (Power, 2009). Abu Ghazaleh et al. (2012) show that the goodwill of the companies listed at the London Stock-Exchange surpasses that of their equity. This means that if one questions them as going concerns, they are forced to liquidate!

“Critical” historians of accounting theory, such as Richard (2014) and Breyer (2014), although on a definitely different theoretical basis, agree that the going concern principle is the basis for modern accounting theory. Historical cost accounting, based on the going concern principle, is characterized as the capitalist accounting methodology par preference. Richard (2014, p. 22), on the other hand, characterizes modern accounting as “reckless”. While we agree with much of Breyer’s criticism of Richard for not studying the real economic basis of changes in accounting theory, Breyer (2014, p. 7) falls into the same trap, by identifying the problems as “...its pathology as a disease of social control, a growing problem of managerialism, that is, [the] increasingly unaccountable management”; making him a proponent of agency theory. In contrast, we hold that the problem is

that *the modern corporation has become unmanageable*. The going concern principle is not the very capitalist form of accounting, but the rational accounting method in a historical period of relative stability in capitalism.

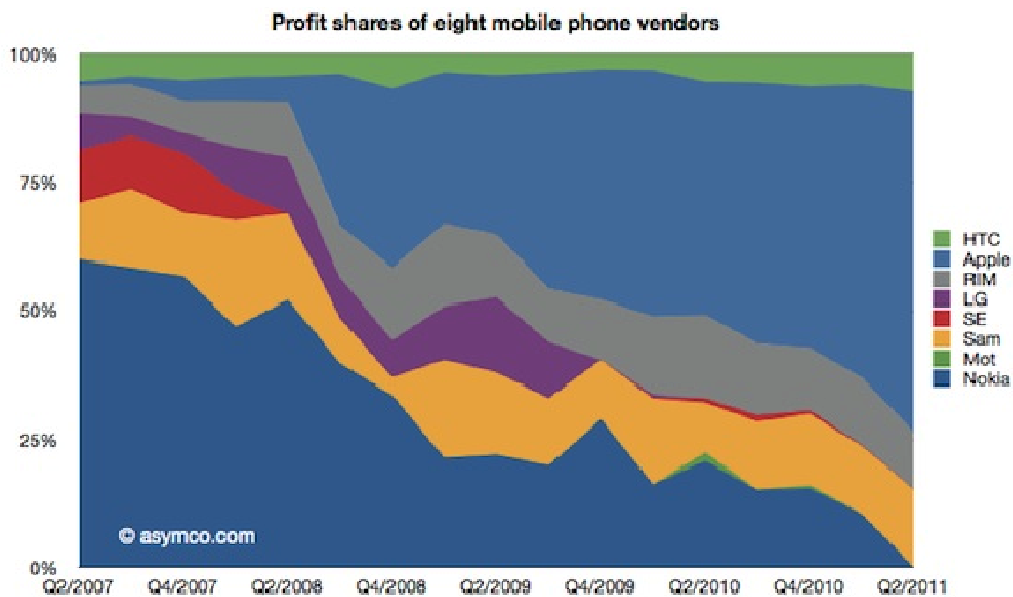


Figure 4 Profits in the Mobile Phone Vendor Market, Asymco (2013-06-28), with permission.

2.5 Consequences for Corporate Governance

In today's complex and uncertain global corporate operations, there is an increased need for management control, but that increased control is problematic, since it presumes that the main reason for corporate failure is dishonest CEOs and other senior executives, not that the reason for failure is their lack of control of the company! If the executives themselves cannot effectively control the company, the increased control of them might lead to the implosion of the whole system. In global corporations, with unrelated or loosely related businesses, this uncertainty gets multiplied, not weighted off. There is a clear risk that the priorities in corporate investment are wrong or shortsighted, when the corporation takes on diverse and unrelated activities (Philipson, 1980; Bettis & Prahalad, 1995; Grant, 1988; Lindqvist, 1979; Pehrsson, 2006; Prahalad & Bettis, 1986). With shortening life cycles we are *entering chaos theory, and leaving business administration*.

And here we come to the crux of the matter. *Corporate financial officers, relying on obsolete accounting practices, are unable to understand, in any kind of timely fashion, what is really going on at the dynamic fringes of their empires*. They are thus compelled by the antiquated systems, which they by tradition must employ, to manipulate the numbers to produce sensible quarterly reports, as demanded by law. Thus, the accustomed practice is manipulation, not simply to provide data, but to conform to the conventions of traditional accounting, so that manipulation becomes simply customary—merely a manner of doing business. Consequently, the ethical lines between normative practice and real ethical violations become obscured, if not blotted out entirely, in the minds of the practitioners. This reality leads to the kinds of financial scandals we have seen, and will continue to see, in our top organizations.

3. Discussion

The authors use institutional theory to problematize the dominant explanation that corrupt management, or

management with different interests than the principals, leads to company failure. We identify the role of accounting in providing predictability, hence preventing company failure. But this predictability can be questioned; it implies stability. Albeit partly with circumstantial evidence, we question this stability and propose another chain of cause and effect: volatility, as explained by the antecedents of (1) shorter product life cycles, (2) Wintelism, (3) changed product cost structures, and (4) monopoly rents, leads to unmanageable entities, with company failure as a result. The implications of this volatility has consequences for corporate governance, and the authors therefore question the going-concern assumption, the basis of traditional accounting practice and argue that traditional accounting rituals are unsuitable for many companies.

We can conclude that the concept of the going concern, as well as the disclosure and assessment of the concept, needs to be critically reflected on, in terms of weaknesses and potential improvements. Since company management and audit opinions appear to fail to indicate going concern problems clearly and early and warn stakeholders, such as investors, we believe that accounting practices have to change radically (Tagesson & Öhman, 2015). Previous studies show that the long-term effects of reflected action based on rituals, result in limits of acting and thinking in organizations (Gramsci, 1929-1935/1971; Hedberg & Jönsson, 1978; Levitt, 1960). In other words, the traditional accounting assumptions provide a kind of straitjacket that prevent managers from coping, practically and intellectually, with the chaotic world that is emerging. Management and auditors have information filters that need to be reflected on, to be prepared for critical changes before entering into crises. There is a need for de-institutionalization and reconsideration of accounting practices and thus particularly the assumption of the going concern. Management and auditor reporting standards need to be adjusted to the current situation and conceptualization needs to become more specific *and flexible* (Arnedo et al., 2008; Tagesson & Öhman, 2015) The predictive ability of accounting may be challenged for enabling further improvement of accounting adjusted to contemporary business needs in an age of global organizational chaos, not of global stability (Cooper et al., 2001).

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