IMD
Perspectives
for Managers
No. 101, September 2003

Beyond Preventing Crime: Where Does Corporate Governance Really Add Value?

Professor Ulrich Steger holds the Alcan Chair of Environmental Management at IMD and is Director of IMD's research project on Corporate Sustainability Management. He is also Director of the "Building High Performance Boards" program at IMD.

Whenever there is a whiff of company corruption in the air, the French detain their corporate elite for questioning, the Americans wonder when the sex angle is going to emerge and the British commission a new report on the role and effectiveness of non-executive directors.[1]

Since the recent spate of corporate white-collar misdeeds, many governments are taking a close look at corporate governance issues, but nations frequently have different approaches on how to deal with violations of standards.

But is the only purpose of boards and corporate governance to prevent "creative accounting," control executive perks and limit shareholder rip-offs? We doubt it. Enron had everything in place – all the necessary elements for corporate governance, even a reputed Stanford professor as chair of the audit committee, not to mention an elegantly formulated code of ethics. Economists believe with good reason that if huge and quick gains are to be had by being "creative," combined with a low risk of discovery (as long as the bubble lasts), then there is an incentive to behave in this way. Such sharp practice will stretch any control system to its limits; a board would not necessarily be needed to prevent it.

Signing off the books to ensure compliance with legislation in every aspect and every country is clearly *one* – but not the only – responsibility of boards as the key element of any corporate governance system. From our research more is required for corporate governance to add value to the corporations, the shareholders and stakeholders it serves, because the relationship between corporate governance within the legal framework and success is far from clear. Whether you take any of the current structures intended as remedies - number of independent directors, separating CEO and Chairman, committees - none of them have prevented corporate governance disasters or even bankruptcy. We have not predominantly looked at structures, but more at what really makes corporate governance "tick."

The Four Dilemmas of Corporate Governance Practice

The first step – according to our research – is to abolish the idea that there is *the* best corporate governance practice and to recognize that every corporate governance system is the "result" of four forces in varying degrees **(see Figure 1)**[2]:

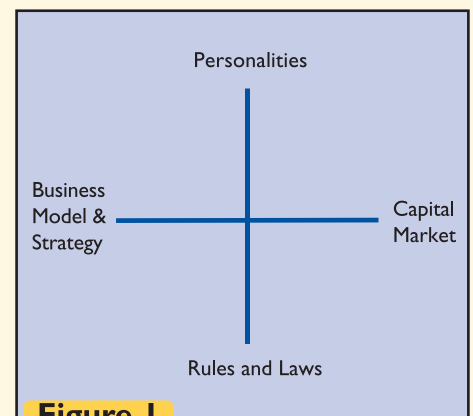


Figure 1

1 Skapinker, Michael. "A simple job becomes a thankless task." Financial Times (London Edition), March 2, 2002.

2 The four determinants of corporate governance practice.

IMD INTERNATIONAL
Real World. Real Learning®

"Direct corporate governance laws have surprisingly little influence on the functioning of boards."

When we asked in the interviews about the forces that really shape the corporate governance system, overwhelmingly these four influencing factors were proposed (and often in combination):

Probably most important is the **business model and strategy** a company pursues. Corporate governance for a bold strategy of growth in rapidly changing, volatile markets requires a different practice from more cautious development in a more mature market, due to different levels of risk taking, variances in speed and responsiveness required, etc. Indeed, we observed that with a fundamental shift in strategy, the corporate governance practice also changed.

Capital market expectations can shift rapidly (not only between boom and bust), thereby emphasizing different issues, such as unit-reporting, independent directors and pay disclosure – not always with an obvious logic.

The broader set of **rules and laws** in various countries (the often unwritten do's and don'ts) also has a bearing on corporate governance. Direct corporate governance laws have surprisingly little influence on the functioning of boards (law mostly came in when something went wrong). In addition to the two most common types of boards – unitary and two tier – our research revealed various other board structures. We saw unitary boards where an independent chairman and the majority of outside directors supervised the executive board members, much like the two-tier boards under German law. And in the German system we also found constellations, where the CEO was a bit more than just reporting to the chairman of the supervisory board. Issues such as the question of how to network – open and fluid vs. close-knit old boy networks – and the obligations towards society play a role here.

Last, but not least, are the **personalities.** Towering people with an excellent track record, powerful connections, etc. will always be at the center of decisions, regardless of how the process is defined. Since the 1998 merger between Daimler and Chrysler, DaimlerChrysler has had three distinctive formal governance systems. But irrespective of the form of the organization, nobody doubts that CEO Jürgen Schrempp was always firmly in control.

Typical Corporate Governance Models

From these four determinants one can derive and observe four clusters of typical corporate governance models, which tend to focus on how companies arrange their corporate governance practices and systems (taking the emphasis away from the ostensible legal system):

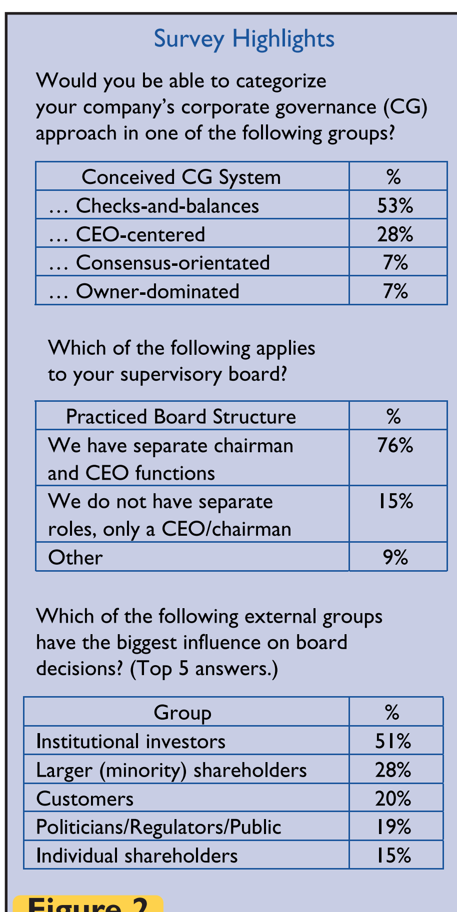
The CEO-centered model is very often found in the US – where the role is still frequently combined with that of the chairman of the board – and in France. Here the President/Directeur-Général plays a dominant role, regardless of whether the company opts for a unitary board structure (with a single administrative board "conseil d'administration") or a two-tier structure (with executive committee "directoire" and supervisory board "conseil de surveillance"). It allows for quick decisions, but tends to be a system with few checks and balances: not many CEOs allow a strong board that can challenge – or even stop – him or her and control the risk of often bold actions.

The checks-and-balances model is not only found in Germany in two-tier boards (i.e. executive and supervisory) but also in the UK, where the non-executive chairman and the majority of the independent directors define the boundaries within which the CEO and top management team can operate. For example, at BP in 2002 the unitary board had 11 non-executive and 4 executive members. The non-executive directors are also often in charge of evaluating the CEO (and the management board) systematically and periodically, as well as initiating the succession of the CEO.

In the **owner-centered** model, a big shareholder or – in privately owned companies – the family pulls the strings on important issues. The involvement in day-to-day business can vary. The US investor-guru Warren Buffett and the Quandt family at BMW are famous for having instilled in

managers the need to have uppermost in their minds the pertinent question: What does our owner think? The Ford family always steps in when things get tough. Others, such as the tycoon-turned-prime-minister Silvio Berlusconi, are known for occasionally becoming embroiled in business details.

The **consensus-orientated** model also looks at other stakeholders of a company, such as banks, suppliers and customers. Although closer relationships facilitate access to funding and the possibility of a longer-term view, this model is slow when it comes to decision making. In Japan, the relationship is often also built on a system of cross-shareholdings or in Germany on "old-boy-networks." Circumstances that international investors have long criticized for its lack of transparency. In general, it is typical in relation dominated segments of society, including the business environment – typically in emergent markets – where relations of trust are still more important than the newly evolving capitalist institutions, sometimes pushed by societal expectations (e.g. in Asia, inviting important stakeholders onto the board).



Survey Highlights

Would you be able to categorize your company's corporate governance (CG) approach in one of the following groups?

Conceived CG System	%
… Checks-and-balances	53%
… CEO-centered	28%
… Consensus-orientated	7%
… Owner-dominated	7%

Which of the following applies to your supervisory board?

Practiced Board Structure	%
We have separate chairman and CEO functions	76%
We do not have separate roles, only a CEO/chairman	15%
Other	9%

Which of the following external groups have the biggest influence on board decisions? (Top 5 answers.)

Group	%
Institutional investors	51%
Larger (minority) shareholders	28%
Customers	20%
Politicians/Regulators/Public	19%
Individual shareholders	15%

Figure 2

How do these Models Work?

Each model is a self-contained corporate governance system, with distinctive strengths but also weaknesses. For example, the checks-and-balances model is most effective in CEO selection and control, but often lacks strategic input. In the CEO-centered model it could be the other way around – here quick decision making and strategy implementation are promoted. The suitability of one of these four models to a particular company at a particular stage in the company life cycle and in a particular business environment may therefore change over time. A company may change the model if the business situation requires. In one instance, a company changed from a checks-and-balances model – with a separate chairman and CEO, and an executive and a supervisory board – to a CEO-centered model with a unitary structure when it started to pursue an ambitious M&A growth strategy in a consolidating industry. The need for quick decision making and swift implementation and monitoring of the chosen strategy was better met by the new system with a CEO at the helm, who was also an industry insider.

However, boards can only actively and successfully involve themselves in such decisions if they engage actively in the strategy setting of the company. As Bill George, former Medtronic chairman and CEO (now visiting professor at IMD), put it: "Rather than focusing on short-term stock prices, boards should be asking questions like: Are we being true to our mission and our values? Are we building shareholder value for the long term? How are we sustaining our growth? What risks are we taking to get there?" If such questions are thoroughly thought through and honestly answered, a board should be able to recognize the need and strategic value of a change to another corporate governance model to ensure the strategic fit between the corporate governance and the key processes of the company.

"Boards can only actively and successfully involve themselves in such decisions if they engage actively in the strategy setting of the company."

“Only if a board is committed to working on all three aspects – compliance, strategy and the right talent – will it add true value to a company.”

Some Highlights: How do Boards Work?

Beside the legal and the strategic aspects of the board's duties, board members should also be engaged in the selection and evaluation of the top executive team, and especially the CEO. Specialized board committees have become increasingly popular in recent years to promote these tasks. We asked company secretaries whether their companies had audit, nomination, personnel/reward, sustainability or other committees. According to our research, three-quarters of companies had an audit committee in place, which in 97% of cases was chaired by an independent director and not an executive, regardless of the corporate governance system in place. Strategy committees, by contrast, were rare. Only 25 companies had such a committee; the majority – 17 – were chaired by an inside executive. One can conclude that in the other cases, strategy was simply not considered a topic for a committee or that the board of directors did not systematically deal with strategy.

In addition, boards do not only have internal obligations. 51% of the responding companies reported that institutional investors as an external stakeholder group had the biggest influence on board decisions (see box). Increasingly, meetings with institutional shareholders are part of the chairman's duties, since he is believed to be slightly more detached than the executive management of the company and able to take an overview with a breadth of experience from elsewhere in the corporate world. On average, companies reported that non-executive chairmen spend 3.4% of their time with members of the financial community (in comparison: CEO 9.2%, CFO's 13.5%) and other members of the supervisory board were estimated to spend 4.3% of their total time. However, in some cases the estimate reached significantly higher maximums: 30% for the non-executive chairman, 25% for other board members, 45% CEO and 60% CFO. To which degree such meetings influence or convince existing or potential investors will depend largely on the commitment of chairmen and board members and how compelling their message is.

This issue of “Perspectives for Managers” is based on preliminary results of a global Corporate Governance research initiative. More than 200 questionnaires each on Boards of Directors and Investor Relations were analyzed between February and October 2002. In addition, 50 interviews were conducted with CEOs, chairmen and board members of European, American and Asian companies.

Only Committed Corporate Governance Adds Value

Regardless of the prevailing legal setting, companies formulate their own corporate system depending on their strategy and business model, the personalities in executive management and supervisory functions, the business environment and unwritten laws and rules. If one or more of these four parameters change, then companies have to change their specific corporate governance model in order to best adapt to the new situation. Value-adding boards play a critical role here, since their duties go far beyond the mere monitoring of legal compliance. Boards that also become closely involved with strategy development, top management selection and subsequent evaluation will be able to contribute significantly to such changes and will be alert to the need for them. Therefore, only if a board is committed to working on *all three* aspects – compliance, strategy and the right talent – will it add true value to a company.

As we have noted, it is difficult to put a monetary value on good corporate governance. But one thing is clear: corporate governance has a far-reaching trickle-down effect well beyond the boardroom. In a hierarchical organization the quality of the board's work is a benchmark for work down the line. How can you expect quality of work on the shop floor when it does not start at the helm of the company? As the old proverb goes, “The fish stinks from the head down.”

IMD
P. O. Box 915, CH-1001 Lausanne,
Switzerland
Tel.: +41 21 618 0342
Fax: +41 21 618 0715
info@imd.ch
http://www.imd.ch

Editor: Roger Whittle

© IMD, September 2003. No part of this publication may be reproduced without written authorization.z