

MARTIN HILB

New Corporate Governance

Successful
Board Management Tools

Third Edition

 Springer

ON THE CONTENT

Corporate governance is currently one of the few subjects that is topical for both research and practice, globally.

In this book, Martin Hilb introduces a new, integrated approach to corporate governance that attempts to overcome weakness in current research, teaching and practice.

“New Corporate Governance” is based on a reversed KISS principle:

Situational Targeted adaption of Corporate Governance practices to suit the (often-neglected) context of the company

Strategic Strategic direction of the company as a central board function, alongside the (often-dominant) monitoring function

Integrated Integrated selection, evaluation, remuneration and development of the board teams, instead of isolated Nomination- and Remuneration Committees

Kee it controlled Holistic board review from the perspectives of shareholders, customers, employees and the public, instead of purely financial controlling

This approach to directing and controlling companies integrates components of corporate governance that have historically been treated in isolation of each other in research, teaching and practice.

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Third Edition

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Foreword

Twelve years ago, I started to offer annual doctoral seminars in corporate governance and seminars for chairpersons and members of boards at the University of St. Gallen. In 1995, I published an “Integrated Board Management” concept and suggested that the board has to be developed as a team responsible for directing and controlling an organization (see level 4 in Fig. F-1).

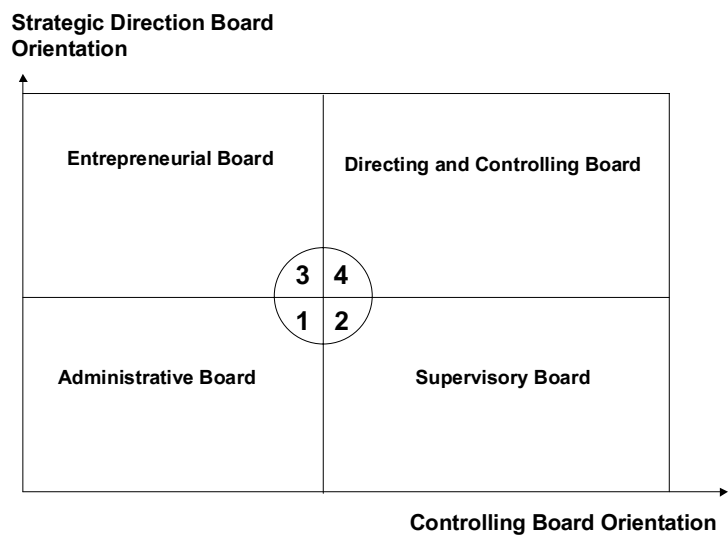


Fig. F-1. Development levels of boards

It is a great pleasure to publish the third English-language edition of this book within just less than three years. I thank the readers for their valuable feedback on the second version.

Since then, the subject of corporate governance has become highly topical worldwide because of the many corporate crises that have occurred – in

both countries that promote shareholder-value governance approaches¹ (such as the United States or Australia) and countries that strive for stakeholder-value governance approaches² (such as Germany or Japan).

Depending on the value system prevailing in a particular country or context, corporate governance has been seen to deal with “the protection of shareholders rights or... the rights of all, or at least a part of the stakeholders.”³

In research as well as in practice, the common assumption is that there are just “two basic models of corporate governance systems: the first model is the Anglo-American ‘market based’ model, which emphasizes the maximization of shareholder value, while the second model is the ‘relationship-based’ model, which emphasizes the interests of a broader group of stakeholders.”⁴

In this book however, I introduce a third way – “New Corporate Governance” that integrates the strengths of both approaches. I thereby avoid the traditional question of which approach should be used as a basis for corporate governance: the widely used, Anglo-American, shareholder-value approach or the stakeholder-value approach, which is found in a variety of forms.

I propose a both-and, glocal approach. In other words, I adopt both the global relevance of aspects of the Anglo-American board best practice (exemplified in Canada, New Zealand and Great Britain and adopted sometimes with little or no critical analysis in developing nations⁵), and the local governance best practices evident in the approaches adopted by many international firms operating in countries around the world. Companies only generate enduring success if they add value in all their activities for shareholders, customers, employees and society. Thus it is important for

¹ See Rappaport (1986) and Stewart (1991).

² See Freeman (1984:31), wherein stakeholders are defined as: “those groups without whose support the organization would cease to exist.”

³ Wentges (2002:74).

⁴ Tabalujan in Hasan (2002:488). See also the definition of corporate governance proposed by Shleifer and Vishny (1997:737) for an example of a pure shareholder model and Preston and Donaldson (1995) for a discussion of stakeholder orientations.

⁵ See Ahunwan (2003).

each board to determine the manner in which stakeholders share in firm success, according to that firm's requirements. For example,

- 50% shareholder value added (based on EVA)⁶
- 20% employee value added
- 20% customer value added
- and 10% public value added.

In each case, the requirements, the satisfaction and the voluntary loyalty of these stakeholder groups could be measured periodically, using an integrated feedback toolkit, for example.⁷

In response to the growing interest in corporate governance, I founded the IFPM Center for Corporate Governance, in order to focus my research, teaching and consulting activities in a targeted way using this integrated approach (see www.ccg.ifpm.unisg.ch).

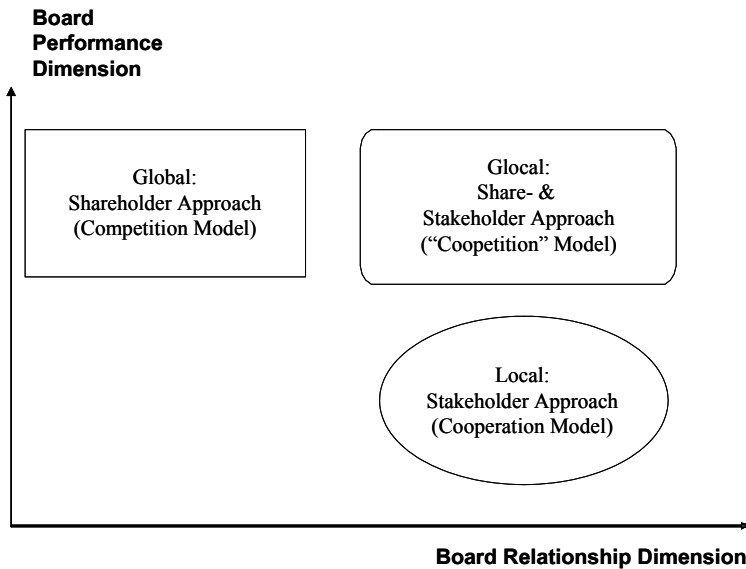


Fig. F-2. Models of corporate governance

⁶ See Stewart (1991).

⁷ Such as that developed by Hilb (2003).

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3rd edition
New York
2008



3rd edition
Berlin 2008



2nd edition
Saigon 2007



1st edition
Buenos Aires
2007



1st edition
Beijing 2008

This year the following new versions will be published:

- Portuguese: 1st edition, Sao Paolo 2008
- Russian: 1st edition, Moscow 2008

I would like to thank all the people who made contributions to the completion of these book versions. Firstly, I thank the chairpersons who have given me the mandate to implement new board concepts and carry out board evaluations on their behalf. Secondly, I thank the numerous participants on our board management seminars, board network workshops and annual doctoral seminars on corporate governance at the University of St. Gallen, for the many valuable contributions.

Special thanks go to the following academics and associates of our Institute: Professor Roman Lombriser for his valuable remarks; Ursula Knorr, for critically checking and professionally styling the original version of this book; Tudor Maxwell, for competently shaping the first English edition; and Julia Ramlogan for revising and editing the second and third English editions.

Special thanks also go to all those individuals who prepared other versions of this book into other languages:

- Ms Manli Fu (Chinese);
- Prof. Trung Dinh (Vietnamese);
- Ms Erica Maidana (Spanish).

Last but not least, I would like to thank Dr. Werner A. Müller of Springer Publishers for his valuable support with the simultaneous publication of both the English and German versions of this book.

St. Gallen, May 1, 2008

Martin Hilb

PART 0

Introduction

0.1 Background

In recent years, the topic of corporate governance has gained prominence as a result of the large number of attention-grabbing corporate scandals at the board level. What was formerly a topic of interest to academics has become a burning issue worldwide for researchers and practitioners alike.

- In **practice**, there seem to be four reasons that account for the public crisis of confidence – about the economy in general and about chairpersons and CEOs in particular.⁸

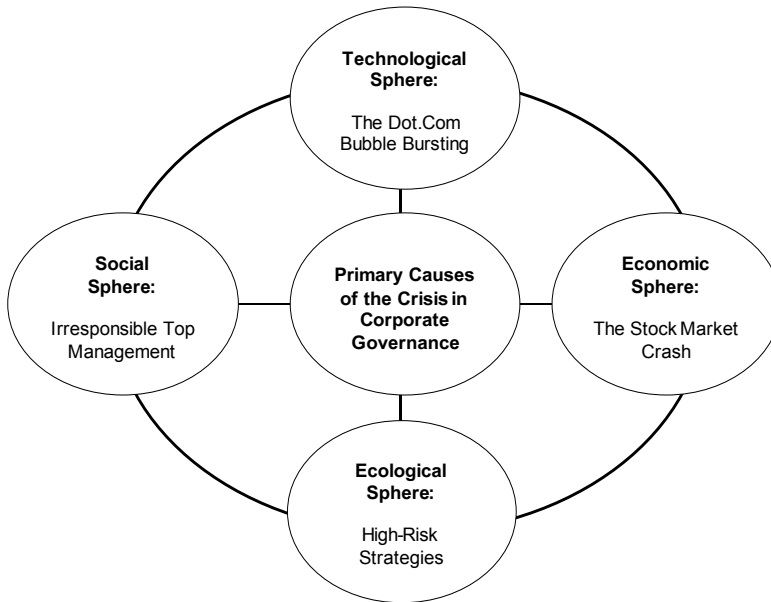


Fig. 0-1. Primary causes of the crisis in corporate governance

1. **In the technological sphere**, the main driver of the corporate governance crisis was the bursting of the dot.com bubble. The speculation on stock markets in high-tech companies throughout the world led, according to Alan Greenspan, to “irrational exuberance.” Although the internet undoubtedly resulted in a technological breakthrough, it was assumed that the internet invented a new business model, “which it didn’t. It is a tool that companies can use to build

⁸ Taylor (2003:1).

their business, if they can combine it with distinctive products (and or services), but nothing more than that.”⁹

2. **In the economic sphere**, the many corporate governance scandals in the United States, for example Enron, Worldcom, Global Crossing and Arthur Anderson, led to the greatest stock market collapse in US history. According to a Gallup survey, the public level of confidence in the US economy and its key officials, reached its lowest level since 1981.¹⁰ The positions of board members in the United States could be described as follows: “Highly important corporate positions with ultimate legal responsibility for the company, high liability and reputational risk, meager pay, too little time, support, or information to do the job,... and the job doesn’t even earn much respect nowadays.”¹¹
3. **In the risk management spheres**, numerous corporate collapses (such as Swissair) or strategic mistakes (such as Vivendi-Universal or AOL Time Warner) have shown that boards approved strategies that were too risky. There was a blatant lack of professional risk management at the board level, as demonstrated by audits of numerous boards of companies in different sectors. There also appears to have been an increasing separation of the economy and society, and an increasingly short-term financial-performance orientation.¹²
4. **In the social sphere**, there has been a striking lack of integrity exhibited by those responsible for directing and controlling corporations. In a doctoral seminar in the summer of 2003, we asked doctoral students from eighteen different countries to present cases of board mismanagement from their home countries. At the end of the presentations, we asked what all those case studies had in common. The answer was unanimous: lack of integrity, whether at the board, CEO, auditor or CFO level. The irresponsible and one-sided use of stock options was one particular feature of the board mismanagement cases presented. Indeed, Henry Mintzberg described this use of stock options as “legitimized corruption” in certain large, listed companies in North America and Europe.

⁹ Taylor (2003:3).

¹⁰ Business Week (September 23, 2002:14).

¹¹ Ward (2003:224).

¹² Gladwin et al. (1995).

According to Sir David Tweedie, Chairman of the International Accounting Standards Board, :

“Executive boards failed, non-executives were kept in the dark, audit committees failed, auditors fell asleep at the wheel, or let problems go, credit rating agents did none too well, analysts missed it, the SEC failed to regulate, and the investment banks and lawyers (and consultants) were part of the problem, helping companies with their questionable deals.... It wasn’t just one little piece gone wrong. The whole system was collapsing.”¹³

- **In research**, the above mentioned “mis-developments” made it increasingly clear that underlying theories were used in an undifferentiated and unidimensional way. For example, the much-applied *agency theory*¹⁴ has the following failings in corporate governance research:
 - “Much of agency theory ... unrealistically assumes that earnings and stock prices cannot be manipulated.”¹⁵
 - “Traditional agency theory builds primarily or exclusively, on extrinsic motivation.”¹⁶
 - Only the needs of top executives and shareholders (and in the worst case only the needs of top executives) were taken into account, but not the justifiable needs of employees, customers or the environment (the public realm, the natural environment or the heritage of future generations).
 - Finally, agency theory could not “... account for key differences across countries.”¹⁷

¹³ Newing (2003:6).

¹⁴ See Berle and Means (1932), Jensen and Meckling (1976), Eisenhardt (1989) and Aquilera and Jackson (2003:448ff).

¹⁵ Implying that some of the incentive systems in common use do not generate the alignment between principals and agents for which they were supposedly designed (Brecht et al, 2002:47).

¹⁶ Frey (2003:4).

¹⁷ Aquilera and Jackson (2003:448).

It has become evident that the role of the board should be handled in a more differentiated and holistic way. Corporate governance research should take into account the diverse roles that boards play.¹⁸ For example:

Resource dependency theory suggests that board members can play valuable roles in making resources available to, and in coaching the CEO. Thus the art of board leadership could be “to build and maintain trust in [directors’] relationships with executives, but also to maintain some distance so that effective monitoring can be achieved.”¹⁹

*Stewardship theory*²⁰ suggests that top managers can act in the best interests of the company even when financial incentives and monitoring systems are not in place to ensure that this is the case. Under such circumstances, the role of the board shifts from monitoring to support in strategy formulation and implementation at a high level.

And, *institutional theory*²¹ attempts to understand corporate governance in the context of social and cultural constraints imposed on organizations.

In the past, most research has addressed corporate governance from a single perspective. In the future it will be increasingly important to approach corporate governance from an integrated and “multi-theoretic” point of view. In this regard, Hung presents a valuable research-typology²² – one that can serve as a compass to orient users of the model presented in this book (see Fig. 0-3).

- **In theory and teaching**, a limitation of corporate governance can be described as follows²³: ‘One shortcoming has been the tendency of textbooks in the area to make prescriptions about the ‘best practice’ ... without providing a credible analytical framework for the students or the practitioners.”²⁴ There is a severe deficit of integrative corporate governance concepts. An analysis of the development stage of teaching shows that, as with HRM, “the future academic

¹⁸ See Hung (1998:105).

¹⁹ Daily and Canella (2003:376).

²⁰ See Davis et al.(1997).

²¹ See Aoki (2001).

²² Hung (1998:105).

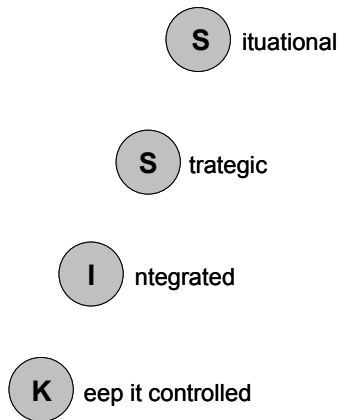
²³ These limitations apply equally to human resource management (HRM).

²⁴ Boxall (1992:60).

strength of corporate governance will depend on how effectively present scholars dedicate themselves to building credible analytical frameworks – focused at the level of the firm but with the capability of providing an adequate disciplinary basis for comparative corporate governance.”²⁵

0.2 Objectives

This book presents an integrated corporate governance framework: “New Corporate Governance”. This framework addresses the weaknesses of research, theory and practice. “New Corporate Governance” is based on a reversed “KISS” principle:



This holistic framework for the direction and control of enterprises integrates formerly isolated elements of corporate governance in research, teaching and practice.

Part 1 of this book analyzes the situational dimension of corporate governance based on constructs developed in institutional and situational theory.^{26,27}

Part 2 analyzes the strategic dimension of corporate governance based on stewardship²⁸ and role²⁹ theories.

²⁵ Boxall (1992:75).

²⁶ See Aoki (2001).

²⁷ See Fiedler (1967).

²⁸ See Davis et al.(1997).

²⁹ See Neuberger (1995).

Part 3 covers the integrated board management (and resource-oriented) dimension of corporate governance from the perspective of resource dependence theory.³⁰

Part 4 considers the monitoring dimension of corporate governance, drawing on agency³¹ and stakeholder³² theories.

0.3 Approach

This book is developed in three different phases:

- Phase I:** In the **problem definition** phase, the background, objectives, approach, definition of terms and basic framework are presented.
- Phase II:** In the **concept development** phase, the “New Corporate Governance” framework is presented in more detail (Chaps. 1, 2, 3 and 4).
- Phase III:** In the **evaluation** phase, the value and applicability of the “New Corporate Governance” concepts are presented and consequences for future theory and practice are derived (Chapt. 5).

The framework presented in this book has matured over the years as the author was active in the realm of corporate governance and explored different viewpoints on the topic in various roles:

- **as a student** in international corporate governance seminars at the Harvard Business School, Henley College in Oxford and the IMD in Lausanne
- **as a researcher** in annual corporate governance doctoral seminars at the University of St. Gallen; in workshops on corporate governance at the European Institute for Advanced Studies in Management in Brussels; and as a member of the European Council on Corporate Governance of the Conference Board

³⁰ See Hillman et al. (2000).

³¹ See Jensen and Meckling (1976), Fama and Jensen (1983), Eisenhardt (1989).

³² See Freeman (1984) and for example, Donaldson and Preston (1995).

- **as founder and director** of the IFPM Center for Corporate Governance
- **as a facilitator** of board seminars and network shops in North and Latin America, Europe, Asia and Africa
- **and as a consultant** developing integrated board management concepts, and implementing self- and peer-evaluation of boards in firms of different sizes, sectors and national cultures.

0.4 Definition of Terms

In this section, I define what I mean by “New Corporate Governance.” Then I delimit the concept and put it in context.

- (a) Cadbury defines corporate governance as a system, “by which companies are directed and controlled.”³³ Demb and Neubauer define corporate governance as “the process by which corporations are made responsive to the rights and wishes of stakeholders.”³⁴

By contrast, Shleifer and Vishny suggest that corporate governance deals with “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”³⁵

I support the view that the board of directors should both direct and control a firm. I therefore define “New Corporate Governance” as a system “by which companies are strategically directed, *integratively* managed and holistically controlled in an entrepreneurial and ethical way and in a manner appropriate to each particular context.”

- (b) I differentiate between “New Corporate Governance” and “traditional” corporate governance on the basis of four KISS dimensions, as follows:

³³ Cadbury (1992:1).

³⁴ Demb and Neubauer (1992:187).

³⁵ Shleifer and Vishny (1997:737).

Table 0-1. Differences between traditional and “New Corporate Governance”

Dimension	Traditional corporate governance	New corporate governance
Situational Implementation	No difference between national, industry and corporate culture	Implementation appropriate to the specific context of each firm (Keep it situational)
Strategic Direction	Strategic development is not a function of the supervisory board	Strategic development is a central function of the supervisory board (Keep it strategic)
Integrated Board Management	Only isolated nomination and remuneration committees in publicly listed companies	Integrated and targeted selection, appraisal, compensation and development of the supervisory and managing boards (Keep it integrated)
Holistic Monitoring	Controlling the financial dimension only	Holistic monitoring of results from the perspectives of shareholders, clients, employees and the public (Keep it controlled)

A further cornerstone of my definition of corporate governance is an entrepreneurial and ethical orientation.

- (c) The scope of “New Corporate Governance” could be illustrated as follows:

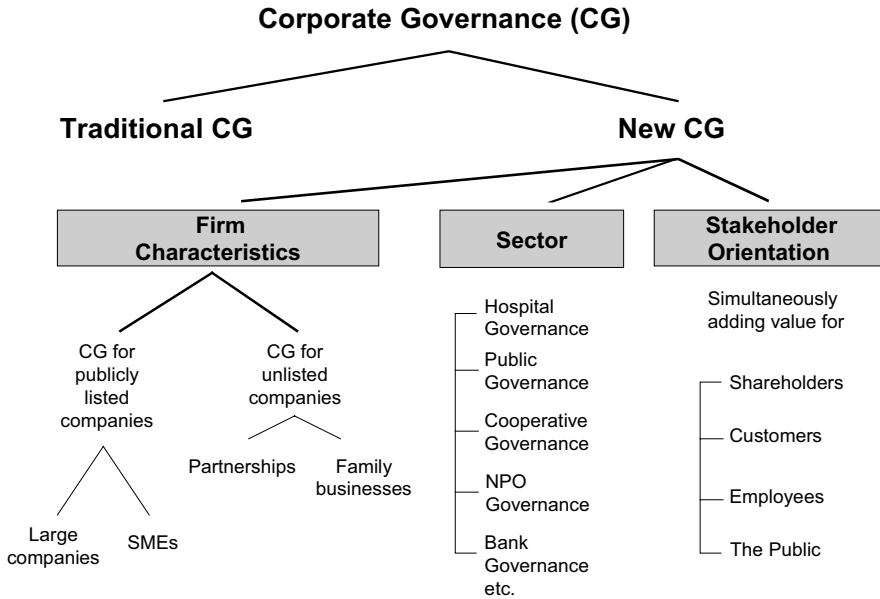


Fig. 0-2. New vs. Traditional corporate governance

0.5 The “New Corporate Governance” Framework

“Corporate governance researchers have a unique opportunity to directly influence corporate governance practices through the careful integration of theory and empirical study. It has not always been clear, however, whether practice follows theory, or vice versa.”³⁶

The “New Corporate Governance” framework presented here integrates the interests of the shareholders, customers, employees and public.

³⁶ Daily and Canella (2003:371).

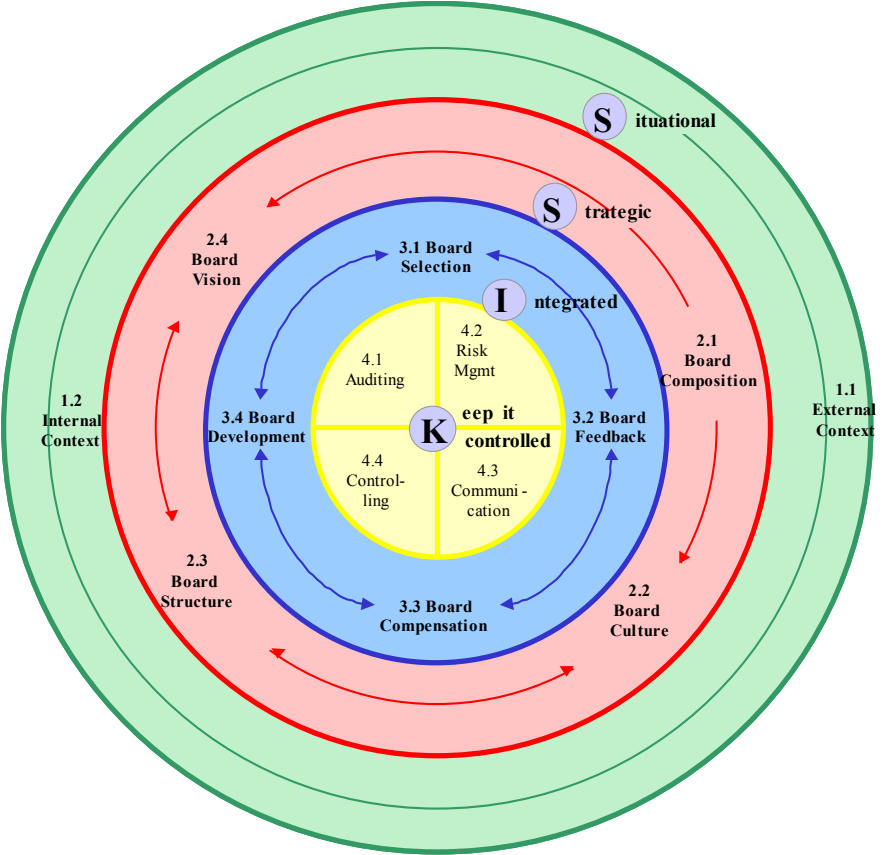


Fig. 0-3. Model of “New Corporate Governance”

The reversed KISS framework comprises four parts:

Part 1: The Situational Dimension (Keep it situational)

Here I differentiate between external and internal context. At the level of the external normative context, corporate governance practice differs with national, industrial and organizational culture.

At the internal context level, every firm has a different development level, ownership and power makeup: the size and complexity of the firm, the degree of internationalization and the ambitions of the board.

Part 2: The Strategic Dimension (Keep it strategic)

I identify four central success factors in corporate governance. The first prerequisite for a board culture characterized by constructive criticism and trust is the targeted selection of an exemplary board team, one that is comprised of people who act as role-models for both share- and stakeholders.

The culture of constructive criticism and trust is implemented through simple networked board structures and processes. These three success factors are prerequisites for the development, implementation and evaluation of stakeholder oriented board success measures.

Part 3: The Integrated Board Management Dimension (Keep it integrated)

This dimension integrates the targeted recruitment, evaluation, remuneration and development of members of the supervisory and managing boards.

For large, publicly listed companies, it is important to have a board management committee which handles not only nomination and remuneration, but also evaluation and development in an integrated way.

Part 4: The Controlling Dimension (Keep it controlled)

This dimension refers to auditing, risk management, internal and external communications and feedback functions of the board.

By “framework” I mean “an abstraction that preserves in economical form most of the points that have been developed.”³⁷ The proposed framework is articulated into four parts (based on the KISS principle):

Keep it situational	(Context)
Keep it strategic	(Strategic direction)
Keep it integrated	(Board management)
Keep it controlled	(Strategic control)

The danger of simplifying a complex system, as the “New Corporate Governance” framework is attempting to do, should not be underestimated: as soon as parts of a system are isolated, the understanding of the system is

³⁷ Weick (1979:95).

altered.³⁸ Only when we are aware of the limitations of any model and of the dangers of isolating sub-components in that model, can we call our approach scientific.³⁹

There are two main limitations of this framework:

- my visual representation lends itself to the usual critique of the social sciences, which is to “pay lip service to interdependence, and then to investigate the elements of the model in isolation from one another.”⁴⁰
- and, while the breakdown of corporate governance into single, central components has analytical relevance for our study, in practice these components are not always clearly delimited. There are a number of overlaps and interdependencies between the factors.

In spite of these caveats, “New Corporate Governance” meets the criteria proposed by Brown for the assessment of a [good] model: simplicity, clarity and logic of the formal structure, closeness to reality and, therefore, adequacy for relevant prediction.

In the next chapter, I present the situational dimension of corporate governance and my key assumption is that there is no such thing as a standard board approach.⁴¹

³⁸ Maleztke (1972:1515).

³⁹ Koenig (1967:7).

⁴⁰ McQuail (1973:83).

⁴¹ The graphical model of this idea is intended as more than a simple analogy. It should demonstrate “the key structure of the system under study” (Beer, 1981:75).

PART 1

Situational Dimension

Keep it situational

As a result of the many corporate scandals that have taken place around the world, best-practice corporate governance guidelines have been developed in most countries. Internationally, the biggest influence on these guidelines has come from the Institute of Directors (IoD) in London, through the advice they provide to other nations. Many countries that do not actually contract with the IoD for advice, nonetheless incorporate aspects of the IoD thinking in their best-practice guidelines.

This is a positive development, although the following issues should be noted:

1. the Anglo-American model of governance is being promoted as the global standard
2. soft law does not necessarily address the soft dimensions of a firm (in other words, laying down a new soft law does not replace the need for integrity in board relationships and processes) and
3. best-practice guidelines are typically designed for large, publicly listed firms.

In adopting corporate governance guidelines developed elsewhere, companies should be aware of the fact that best-practice guidelines for:

Listed companies	≠	Non-listed companies
Large companies	≠	Small companies
Public companies	≠	Family-owned companies
Bank governance	≠	Hospital governance
US companies	≠	British companies

Hence I base my approach on the principle “Keep it situational.”

Besides the board members themselves, the fit between the external and internal contexts is the most important determinant of a firm’s success (see Fig. 1-1).

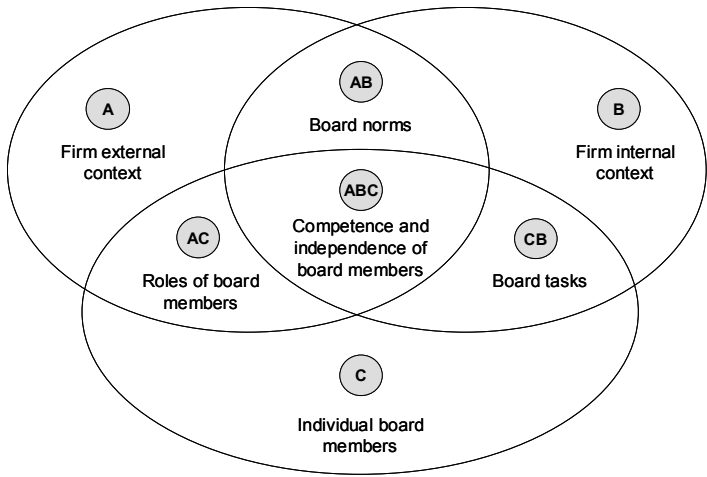


Fig. 1-1. Determinants of a firm’s success⁴²

In this chapter I review the external and internal context factors that have a lasting impact on firm success.

1.1 External Business Context

In the external business context I differentiate between institutional culture, national culture, and the normative context.

1.1.1 Institutional Context

To explain the institutional context, I use “actor-centered institutionalism.”⁴³ This new approach “bridges the gap between under-socialized agency theory approaches and over-socialized views of institutional theory”.⁴⁴ Thus it is possible to explain the differences between corporate governance rules, systems and practices in different countries on the basis of various institutional mechanisms. Those mechanisms define the impact on, and the roles of the different stakeholder groups.

⁴² See McGrath (1976:1320ff).
⁴³ See Scharpf (1997).
⁴⁴ Aguilera and Jackson (2003:448).

The agency theory paradigm that has been dominant in research and practice⁴⁵ ignores the perspective of corporate governance as “ultimately the outcome of interaction among multiple stakeholders.”⁴⁶

According to Aguilera and Jackson,⁴⁷ a comparison of corporate governance systems suggests that three stakeholder groups need to be taken into account:

- (A) providers of capital
 - (B) employees and
 - (C) management.
- (A) At the level of the providers of capital, the key question is: should the investment in a firm be primarily financially motivated or primarily strategically motivated? Where should the emphasis lie – should investors have a speculative or a long-term value approach? What should be the ratio of owners equity to debt in a firm? If the equity proportion is high, as is usually the case in the United States, then the shareholders interests are more central. If the debt proportion is high, as is usually the case in Japan, then the interests of other stakeholder groups are more central.

The different national contexts are differentiated from one another along the following institutional fault lines:

- property or ownership rights
- financial infrastructure or the type of financial system and
- the nature and extent of inter-firm networks.

In addition, the context of listed firms is influenced by the extent of shareholder activism.⁴⁸

Thus the following relationships can be represented:

⁴⁵ Since the seminal work of Berle and Means in 1932.

⁴⁶ Aguilera and Jackson (2003:449).

⁴⁷ Aguilera and Jackson (2003:450).

⁴⁸ See, for example, Marens (2002: 365).

Institutional conditions	Motivation of participants		Investment time horizon		Proportion of own capital	
	Strategic	Financial	Short-term	Long-term	High	Low
(1) Ownership rights						
a) Countries which privilege majority shareholders	×			×		
b) Countries which protect minority shareholders		×	×			
(2) Financial system						
a) Countries with primarily bank-based financial systems				×		×
b) Countries with primarily market-oriented financial systems			×		×	
(3) Nature and extent of inter-firm networks						
a) Countries with complex inter-firm networks	×			×		
b) Countries with few or simple inter-firm networks		×	×			

Fig. 1-2. Financial and economic relationships⁴⁹

- (B) The interests of the employees are neglected in corporate governance literature, with the exception of literature emanating from Germany.⁵⁰

Institutional contexts are differentiated from one another along the following lines:

1. representation of employees on the board and
2. the power of trade unions.

The equal voting rights granted to employee representatives on the supervisory boards of German firms and the significance of company unions in Japanese firms are examples.

⁴⁹ Aguilera and Jackson (2003:453f).

⁵⁰ See, for example, Menold and Dehlinger in Opitzer and Oser (2003:387).

- (C) The interests of top management as a stakeholder group have not yet been adequately studied in the corporate governance literature. There are grounds to believe that many of the recent corporate governance scandals can be related to the one-sided, help-yourself orientation of top managers, a phenomenon I refer to as a *top-executive value* orientation.

Institutional contexts are strongly differentiated from one another based on dominant management ideologies and dominant thinking about career paths. Whereas countries with presidential political systems (top-down approaches, such as those evident in France or the United States) generally grant CEOs considerable power and support, firms in countries with non-presidential political systems tend to be led in a more consensus oriented style. And corporate governance practices are strongly influenced by whether careers are advanced primarily within a firm, as in Japan, or by changing firms, as is the case in the United States.

Then the question arises, “how [does] the combination of institutional domains in a particular country shape corporate governance at the firm level?”⁵¹

Three types of conflict could surface:

1. *class conflicts* could arise when the interests of top management and shareholders are too much at odds with the interests of employees (for instance, in salary negotiations)
2. *conflicts between insiders and outsiders* can arise when the interests of top management and employees (insiders) oppose the interests of the shareholders (outsiders)
3. *and alignment conflicts* can arise when the interests of shareholders and top management are too divergent (e.g. the firing of a CEO).

1.1.2 National Context

A review of international corporate governance literature allows us to differentiate between the value orientations of three types of boards (see Fig. 1-3).

⁵¹ Aguilera and Jackson (2003:454).

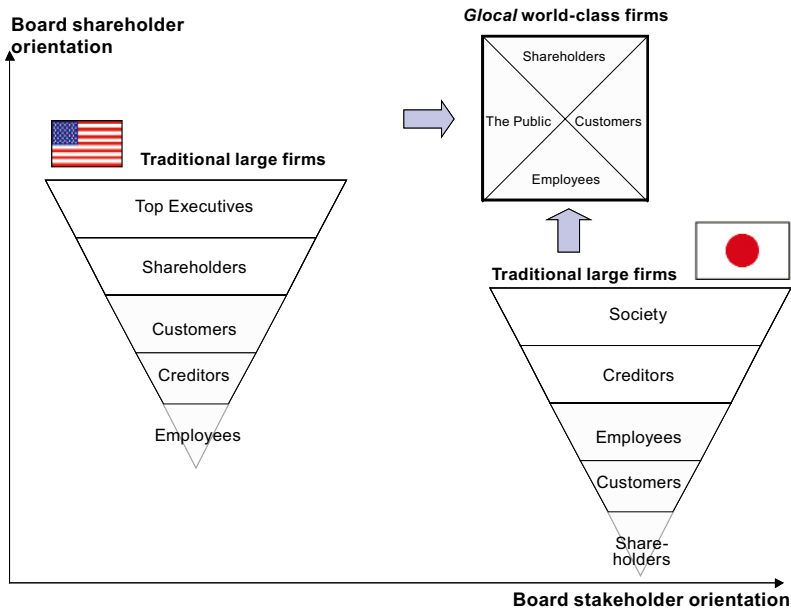


Fig. 1-3. Value orientation of boards

Those with:

- a primary orientation towards top executive and shareholder utility maximization (often evident in large, listed American firms)⁵²
- a primary orientation towards maximizing value for providers of debt and employees (often evident in large Japanese firms) and
- a simultaneous orientation towards shareholders, customers, employees and the public (often evident in world-class transnational – or what I call *glocal* – firms).

Usually, large US firms have relatively high equity stakes, whereas large Japanese firms usually have relatively low equity stakes. If 80% of the capital is provided by shareholders, then the shareholder approach and a short-term, “quarterly results” orientation takes precedence. Conversely, if only 20% of the capital comes from shareholders, then those shareholders

⁵² See for example, the shareholder orientation in Shleifer and Vishny (1997:737), the stakeholder orientation in Donaldson and Preston (1995:65), which is criticized by Stoney (2001), and the *glocal* approach proposed by Hilb (2003).

are less important, and the long-term orientation of large Japanese firms is better understood.⁵³

The ranking of the significance of the different stakeholder groups in many US firms differs considerably from the ranking of the different stakeholder groups in large Japanese firms. In the United States, one can talk about a *top executive value* mindset; shareholders also have a central role. Employees, with the exception of top management, have a less significant role. Society and the environment are almost totally irrelevant.

A Gallup survey conducted in 2002 in the United States reported that “90% of Americans felt that people running corporations could not be trusted to look after the interests of their employees, and only 18% thought that corporations looked after their shareholders a great deal. Forty-three percent, in fact, believed that senior executives were only in for themselves.”⁵⁴

Conversely, in large Japanese companies, society, external capital providers and employees (including top executives) have a central role, whereas until the recent economic crisis in Japan, shareholders had an insignificant role.

We have shown in a comparative study that, for a world-class company to be consistently more innovative and successful than its competition globally, the board has to systematically and sustainably pursue and regularly measure the satisfaction and the voluntary loyalty of shareholders, customers, employees (including management), and the public. Such *glocal* firms⁵⁵ exist in many countries, for instance, American company 3M, Japanese firm Sony or Swiss company Nestlé.⁵⁶ Similarly, there are many *glocal*, family-owned businesses, for example: Thompson in Canada, L’Oréal in France, Schindler in Switzerland, Hilti in Liechtenstein, Toyota in Japan, and Tata in India.

⁵³ See Gedajlovic and Shapiro (2002).

⁵⁴ Handy (2002:54).

⁵⁵ Firms we call *glocal* demonstrate both a shareholder- and a stakeholder orientation to corporate governance, giving “local partners, institutions and community groups adequate information on the activities of MNCs operating in their context, and the institutional means to have a voice in their decisions” (Child, 2002:147).

⁵⁶ According to Stern-Stewart, Nestlé ranks seventh in the world on the Wealth Added Index (WAI). It is the biggest food company in the world and, according to the *Financial Times*, the biggest transnational company in the world (i.e. one of the few companies governed by a truly multicultural board).

Such *glocal* firms are “among the most important (if not the most important) contributors to wealth and employment in virtually every country.”⁵⁷ A *Forbes* study confirms that these firms were “on average 15% more profitable and 14% faster growing than the industry average and one third more profitable when controlling for size variations.”⁵⁸

In order to achieve such a *glocal* orientation, the following critical question has to be asked within a firm: “Whom and what is a business for? The answer once seemed clear, but no longer. Ownership has been replaced by investment, and a company’s assets are increasingly found in its people.... Both sides of the Atlantic would agree that there is, first, a clear and important need to meet the expectations of the company’s theoretical owners: the shareholders. It would, however, be more accurate to call most of them investors, perhaps even gamblers.... But to turn shareholders’ needs into a purpose is to be guilty of a logical confusion. We need to eat to live; food is a necessary condition of life. But if we lived mainly to eat, making food a sufficient or sole purpose of life, we would become too large. The purpose of a business... is to make profit so that the business can do something more or better.”⁵⁹

The South African “King II” best-practice guidelines are among the few guidelines in the world to explicitly endorse an orientation that concerns itself with the interests of stakeholders beyond the shareholders.⁶⁰ Such an orientation, however, requires that firms have the capacity to identify and manage the conflict that often arises within and between different stakeholder groups⁶¹ (see Fig. 1-4).

⁵⁷ Neubauer and Lank (1998:11).

⁵⁸ *Forbes* (22 May 1995) in Neubauer and Lank (1998:11).

⁵⁹ Handy (2002:51). Carter and Lorsch (2004:56) support this idea: “If we look into the future, the idea that boards are responsible solely to shareholders becomes increasingly suspect.”

⁶⁰ Kapp, in Noetzli (2004:44).

⁶¹ See Mann (2003:53).

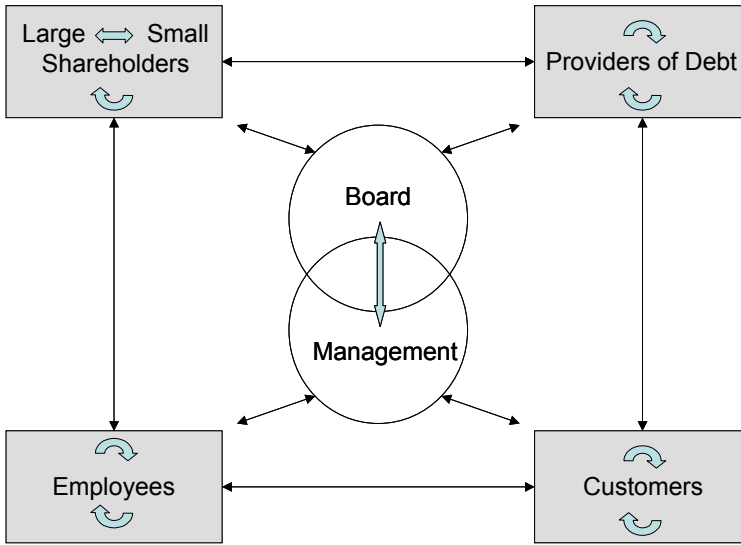


Fig. 1-4. Stakeholder conflict: inter- and intra-group

Corporate governance practice is strongly influenced by national culture. Countries can be divided into five groups according to the level of their orientation towards competition and cooperation (see Fig. 1-4).

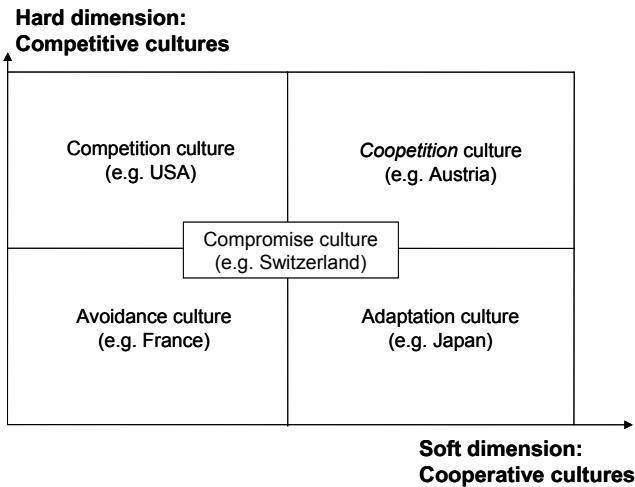


Fig. 1-5. National culture differences (based on the MODE model)

Hard and soft national cultures can be differentiated from one another along the following dimensions.

	Dimension	Type of Culture	
		Hard	Soft
1	Time horizon	Short-term	Long-term
2	Emphasis	Task orientation	Relationship orientation
3	Driving force	Goals	People
4	Reinforced qualities	Performance and mobility	Commitment and loyalty
5	Motto	"Nobody is indispensable"	"Foster cooperation and networking"
6	Decision making	Fast (top-down)	Slow (bottom-up)
7	Goal	Transparency	Innovation
8	Strategy	Clarity	Flexibility
9	Distinctive feature	Predictability	Adaptability
10	Feedback	Controllability	Reaction speed

Fig. 1-6. Hard and soft national cultures (Laurent, 1997)

Every positive attribute can also be a liability when it is over emphasized. Laurent (1997) identified the following limitations of both cultural dimensions, i.e. those which have an enduring impact on corporate governance practices in any country.

The attributes of national cultures also determine the normative regulations in a given country.

	Hard Culture	Soft Culture
1	Over-structuring	Confusion
2	Excessive short-term orientation	Insufficient short-term orientation
3	Demotivation of the individual	Constraints on the individual
4	Obsession with numbers	Obsession with the group
5	Lack of social grace	Resistance to change
6	Obsession with planning	Obsession with vision
7	Micro management	Ambiguity
8	Exaggerated belief in the system	Exaggerated power games
9	Rigidity	Chaos
10	Overemphasis on the market	Overemphasis on hierarchy

Fig. 1-7. Comparison of the shadow sides of hard and soft national cultures

1.1.3 Normative Context

In the normative context, there are two dimensions – legality and legitimacy – as shown in Fig. 1-8.

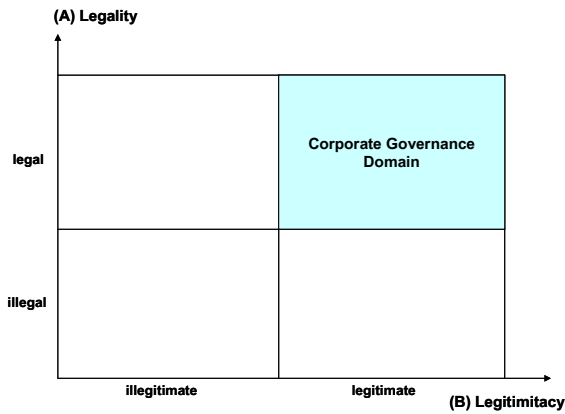


Fig. 1-8. Corporate governance domain

Normative rules of corporate governance should encourage the behavior of all members of the supervisory and managing boards to be both legal and legitimate.⁶²

Legality of Board Management

In the domain of corporate governance, we differentiate between hard and soft norms. What is legally prescribed and socially recommended differs greatly from country to country. The following graphic depicts an overview of the development of international codes and laws on corporate governance:

⁶² Indeed, institutional theory describes how firms develop within the constraints imposed by society and law (see Meyer and Rowan, 1997; and Selznick, 1957, for discussions of institutional theory).

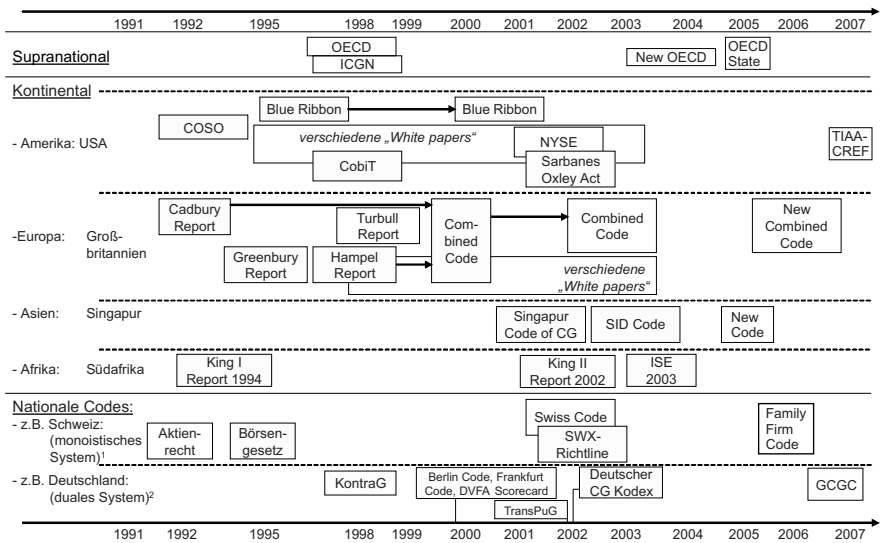


Fig. 1-9. A time line of the development of selected international and national codes and laws on corporate governance⁶³ (c.f. www.ecgi.org/codes)

1. In Switzerland⁶⁴ the “Economie Suisse” recommendations⁶⁵ are geared towards large, publicly listed companies. They do not apply equally to medium-sized publicly listed companies, and are not at all suited to unlisted SMEs.⁶⁶

The challenge in Switzerland is to adjust the best-practice code to new international trends and research findings, to incorporate modifications that make them relevant also to medium-sized listed companies and to develop voluntary, easy-to-use recommendations for SMEs.

⁶³ See Graf, Waldersee and Laufermann in Pfitzer and Oser (2003:460ff) for a comment on the European Commission’s action plan for improvement of corporate governance by 2008.

⁶⁴ See recommendations from Erny (2000), Ackermann in Noetzli (2004:15), and Volkart and Cocca in Noetzli (2004:12).

⁶⁵ See Hofstetter (2002).

⁶⁶ See Behr in Noetzli (2004:23).

2. **In Germany,**⁶⁷ known for its relatively high level of regulation and relatively low number of listed firms,⁶⁸ the co-determination practice that includes representatives of employees on the supervisory board⁶⁹ (the most extensive involvement of employees in corporate governance worldwide), leads to a board that is too big and complex to act effectively and to hold critical discussions on central and delicate subjects.⁷⁰ It is therefore important to look for alternative approaches.

In Switzerland, since the shareholder reform of 1991, boards enjoy relatively wide ranging powers. According to paragraph OR 716a of Swiss commercial law, the board actually has powers for both direction and control, with the following inalienable rights and tasks:

1. “the strategic leadership of the organization
2. the direction of the organization
3. the determination of the accounting, financial control and financial planning systems
4. the appointment and termination of the CEO
5. the monitoring of implementation of strategy by management
6. the production of the annual report, the preparation of the AGM and the overseeing of the implementation of its decisions [and]
7. informing the courts in the case of financial crisis.”

In many countries, the mission of the board is limited to a supervisory function.

Important legal developments in corporate governance internationally are, for example:

- in the United States, the “Sarbanes-Oxley Act”(2002)
- in Canada, the “S-11 Bill” (2001)
- in the UK, the “Combined Code” (2003) and (2006)
- in Japan, the “New Commercial Code” (2003) and
- in France, “*La Loi de Sécurité Financière*” (2003).

⁶⁷ See Pfitzer and Oser (2003).

⁶⁸ See Mann (2003:132f).

⁶⁹ See Pfitzer and Oser (2003).

⁷⁰ See Hax in Noetzli (2004:53).

As a result of the numerous corporate crises, many countries have developed corporate governance guidelines (as soft law). After the financial crisis of 1997, the OECD principles of corporate governance were published as a global point of reference for international policy dialogue in 1999 and further refined in 2004.

There is considerable variance between the levels of development of corporate governance (best-practice) recommendations. Surprisingly, the highest standard of corporate governance best-practice recommendations worldwide is reflected in the South African “King II” report,⁷¹ which incorporates, *inter alia*, recommendations regarding risk management and “Integrated Sustainability Reporting.”

On each continent, the following countries play a leading role as far as corporate governance recommendations are concerned: in Europe, the UK (*New Combined Report*, 2006), in Asia, Singapore (2005), in the Americas, Canada (2002) and in Africa, South Africa (2002).

Concerning effective board management practice, the rankings are different. The latest *IMD World Competitiveness Report*⁷² ranks countries according to their corporate governance practice as follows:

Ranking by Board Management Practice	Europe	America	Asian	Africa
1.	Luxembourg			
2.			Australia	
3.	Denmark			
4.			Singapore	
5.			Hong Kong	
6.		Chile		
7.			Malaysia	
8.			New Zealand	
9.	Norway			
10.	Switzerland			

Fig. 1-10. Ranking of board management practice effectiveness

Two facts are remarkable:

1. With the exception of the UK, the most important industrial countries, such as the United States, Germany, Japan and France, are not

⁷¹ See King (2002) and Kapp in Noetzli (2004:44).

⁷² Garelli (2007:397).

the most exemplary from the points of view of either best practice guidelines or effectiveness of corporate governance practice. The best examples are to be found in the smaller countries: for guidelines, South Africa, Singapore and Canada, and for practice, Finland, Chile and New Zealand.

2. Even well polished codes and recommendations are not enough if integrity does not receive sufficient attention in addition to hard and soft law. Daniel Johnston, General Secretary of the OECD, noted that “do we want a world based on values? Rules will always have loopholes, and there will always be those who spend their time trying to wriggle through them. This thinking appears to have invaded much of the corporate world. Are our students today learning values or learning rules? I hope both, but with a good dose of the former. Because any set of rules alone, if disconnected from the values that those rules are ultimately meant to reflect, is like a body without a soul.”⁷³

This leads us to the second central dimension of the normative context.

Legitimacy of Board Management

All corporate governance reforms at the level of hard and soft law and firm’s value statements are useless if the board members lack integrity. The following example of an international company’s mission statement graphically illustrates this point.

⁷³ See Johnston (2003:3). Also, Carter and Lorsch (2004:15) record the following statement by a board member: “Our board satisfies all the requirements of Cadbury, Greenbury and Hampel, but our board meetings are a complete waste of time.”

Communication

We have an obligation to communicate. Here we take the time to talk with one another. And to listen. We believe that information is meant to move and that information moves people.

Respect

We treat others as we would like to be treated ourselves. We do not tolerate abusive and disrespectful treatment.

Integrity

We work with customers... openly, honestly and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.

Excellence

We are satisfied with nothing less than the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.

Fig. 1-11. Example of the mission statement of an international firm

This mission statement sounds truly enticing. But words are cheap. This mission statement belonged to ENRON. One year before its collapse, ENRON was elected one of the best US firms as far as corporate governance was concerned. It failed because of a lack of integrity in areas critical to good governance. And it demonstrates how quickly companies found lacking in such areas can move from “first to worst”!

Integrity, a cornerstone of economic activity, is not present in the same measure in all countries.

Firm-ethics ranking	Europe	North America	Asia	Africa
1	Denmark			
2			New Zealand	
3			Australia	
4	Sweden			
5		Canada		
6	Switzerland			
7	Netherlands			
8	Austria			
9	Luxembourg			
10		USA		
11			Singapore	
12	Norway			
13	Iceland			
14	Finland			
15	Germany			

Fig. 1-12. Ranking of executive boards corporate ethics behavior⁷⁴

It appears that in this ranking is missing most Asian, Latin American, Eastern European, Middle Eastern and African countries.

Transnational firms would benefit from the development of *glocal* rules of integrity. The thoughts on world-ethics from Kueng⁷⁵ and the “King II” report,⁷⁶ which are in “Chapter 3: Ethical Practices and Organizational Integrity” for corporate governance practice, constitute a starting point.

Boards have the central task of ensuring the continued existence of a firm in the interests of all relevant stakeholders, with integrity. The board members act as representatives of different and partially overlapping interest groups. In publicly traded corporations, the main stakeholder groups are as follows:

⁷⁴ Garelli (2007:396).

⁷⁵ Kueng (2001).

⁷⁶ King (2002:108ff).

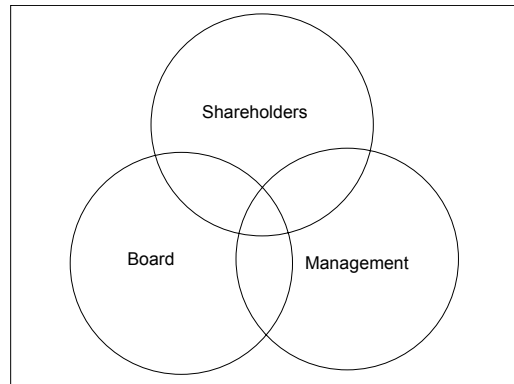


Fig. 1-13. The board in a publicly traded firm⁷⁷

In family-controlled businesses, family members are also important stakeholders:

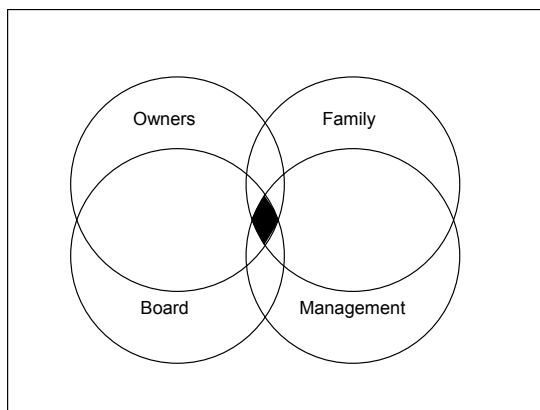


Fig. 1-14. The board in a family-controlled business

In this case, emerging conflicts of interest must be recognized and avoided by careful attention to board composition.⁷⁸

⁷⁷ Neubauer and Lank (1998:14).

⁷⁸ According to the new regulations of the New York Stock Exchange (1 Aug. 2002), listed firms are required to create a “Code of business conduct and ethics”, including clauses addressing, for example, “**Conflicts of interest:** should be prohibited and a method should be provided for communicating potential conflicts so they can be avoided... **Encouraging the reporting of any legal or unethical behavior:** the company should proactively promote ethical behavior and ensure there will be no retaliation” Verschoor (2002:22).

I have adapted an important maxim from an old Jamaican proverb:

“Never take a board seat you can’t afford to lose.”

To ensure that firms survive and thrive, boards need “both-and” goals (as illustrated in Fig. 1-15).

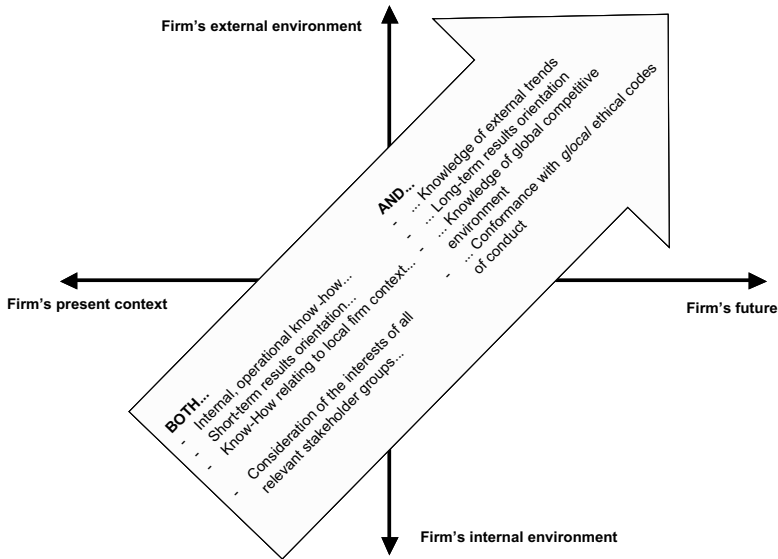


Fig. 1-15. “Both-and” goals of boards

This brings us to the internal board context.

1.2 Internal Business Context

The following internal context dimensions influence corporate governance:

- ownership
- board configuration
- organizational complexity
- board role players
- degree of internationalization
- mix of board functions.

1.2.1 Ownership

The ownership conditions in a firm determine different governance systems. For example:

1. family-owned firms (family-firm governance)
2. cooperatives (cooperative governance)
3. non-profit organizations (NPO governance)
4. government agencies (public governance) and
5. public listed companies (corporate governance in the narrow sense).

1. Family-owned Firms (Family-business Governance)

Family-owned firms, which constitute 85% of all firms in the OECD countries, can be characterized by the intersection of the interest groups included in Fig. 1-14. The typical entrepreneur often fulfils the function that represents all four interest groups: as primary owner, head of the family, chairperson of the board and CEO (the area shaded in black).⁷⁹

But there are obviously a multitude of different forms that family businesses can take⁸⁰: “Approximately one-third of the 1,000 largest companies in the world are controlled by the families. Of those, half are traded publicly and half are privately held.”⁸¹

Davies suggests that governance advice to family-owned businesses must take into consideration the level of development of the business:

- “A first generation business may only require a small, informal advisory board rather than a board of directors
- when a family is small enough for all adult members to meet regularly... all the family needs is a family council (in the second generation)
- a third generation family may even need a family assembly to bring together the members of the family annually to learn about and discuss the family business, plus a family council to help develop policy for the family.”⁸²

⁷⁹ See Zafft (2002:18).

⁸⁰ Neubauer and Lank (1998:15).

⁸¹ Ward (2005:10).

⁸² Davies (2003:11).

In Switzerland, firms that are not publicly traded are under no legal obligation to include non-family members on their board. In those cases, the board functions exclusively as a representative (or administrative) board,⁸³ which fulfils its legal and statutory functions:

- selection of top management
- appointment of auditors
- holding an annual board meeting and
- holding an annual general assembly for approval of dividend distribution.

“Familyness”⁸⁴ can be a competitive advantage compared to public companies dependent upon good family business governance: “It is their commitment to family unity that motivates them to be effective owners and support their business for the long term.”⁸⁵

Schneider,⁸⁶ a successful entrepreneur, pointed out the following possible weaknesses of such firms:

- “The boss knows everything and can do everything better; he has an opinion about everything and tolerates no contradiction.
- Yes-men are in such cases over-represented in the management team.
- Earlier successes results in self-satisfaction.
- Earlier accumulation of reserves result in a false sense of security.
- Old recipes for success are used repeatedly in spite of changing circumstances.
- Blood ties or friendship sometimes substitute for professional competence.
- The interests of the owners, family and firm are not clearly distinguishable.
- As the money comes from his own pocket, the humble entrepreneur demands too little from his management and collaborators; or the self-assured entrepreneur, oriented towards appearances, removes from the company the liquidity which could be needed to revitalize or modernize the firm.

⁸³ Schmid (2002:7).

⁸⁴ Muehlebach (2004).

⁸⁵ Ward (2005:10).

⁸⁶ Schneider (in Schmid 2002:12ff).

- No one knows exactly where money can be made or lost. The question ‘why’ is never asked.
- The delineation between strategic and operational activity is even more blurred than usual.
- Pragmatism rules, and planning is put-down as ‘scientific claptrap.’
- [And] disputes over power and influence among the owners can paralyze the firm and poison the atmosphere.”

Many successful humane entrepreneurs (with “cool heads, warm hearts, and working hands”) attempt to distribute roles in a timely manner to reflect the interest groups depicted Fig. 1-14.⁸⁷ According to Schneider,⁸⁸ a family-owned business should recognize the value of the following roles on the board:

Compensator role	(to provide otherwise lacking know-how)
Evaluator role	(to identify and overcome firm blind spots)
Provocator role	(as a thorn in the flesh of self-satisfaction)
Promoter role	(for the constant promotion of professionalism)
Monitor role	(for realistic self-evaluation)
Initiator role	(as champion of constant change)
Conservator role	(as protector of justified continuity)
Prospector role	(to ensure prudent, ongoing strategy, financial and investment planning)
Defender role	(to protect the long-term interests of the firm against abusive actions by owners)
Moderator role	(for solving conflicts between family owners, board members and management)
Controller role	(for monitoring and implementing the board’s decisions)

⁸⁷ Kwak (2003) finds that firms in which families own 30% or less tend to outperform other firms, whereas higher levels of ownership can lead to conflicts of interest and “expropriation” of wealth. She endorses the benefits that family businesses can reap from including independent directors on their boards, and from diversifying their investments so that family members do not necessarily go into management in any one particular firm.

⁸⁸ Schneider (in Schmid 2002:12ff).

In the following paragraphs, we depict for illustration a real-life example from our experience.

Illustrative Case Study for Part 1: Keep it Situational

(All names and dates have been changed in this “living” case)

Max Meier (61), a “humane” entrepreneur (with a cool head, a warm heart and working hands), succeeded his father as Baker in 1967 in Appenzell, Switzerland, and has over the last 35 years developed the family business into an internationally successful group of companies renowned for its chocolate specialties.

In 2002, the consolidated annual turnover reached *€250 million*. The group of 7 firms, employing 670 people, were acquired by Max Meier over a twenty year period.

Max Meier does not have any designated successor. He is owner, Chairperson, President, CEO and head of the family. His personality is characterized by a rare combination of entrepreneurial flare, creativity, sales talent and high moral standards. His wife, the only other member of the board, is the financial manager. Together with Max, the couple constitute an ideal private and professional partnership.

Max and his wife have four children:

- Max junior (36) completed an apprenticeship in pastry-making and then finished a law degree at the University of Geneva. Now he is responsible for exports in the firm and is based in Geneva.
- Monika (34), a Professor of Sociology at the University of Constance, resides in Kreuzlingen (in the north-west corner of Switzerland).
- Freddy (32) has a master’s in finance from the Wharton School and is CEO of the Schocko chocolate manufacturing company (acquired two years ago), one of the most successful sweets manufacturers in Entlebuch, Switzerland.
- Nicole (28) is an artist based in Paris. After her fine arts degree, she sojourned in Florence and Paris and furthered her studies in Vancouver and Rome.

Six months ago, Max Meier suffered a heart attack. He now asks you, as a competent, trustworthy and old friend, how he should confront the issues of board composition and management appointment.

How would you advise him?

“Families need corporate governance both to operate the business and to promote family harmony. This means putting in place decision making and monitoring procedures that are open and fair, as well as possibly hiring non-family members as advisors, managers and directors.”⁸⁹

A best-practice example is offered by HILTI in Schaan, a family-owned business and world leader in fastening systems, lead by Michael Hilti (son of the founder). Michael Hilti soon became aware of the fact that “the board of a family-owned business should not be [only] a body mandated by law, but a committee that really supports the business.”⁹⁰

Michael Hilti is the only family member, the chairman of the family trust and the business owner. In those capacities, he is a member of a small, professionally structured, goal-oriented board. This board, in turn, leads and controls a professional management team made up of competent non-family members.

If “familyness” is a competitive advantage (as in the case of HILTI) or a competitive disadvantage, can be determined by filling out the following questionnaire which has been developed by Mühlebach.⁹¹

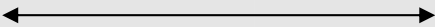
If the profile is located on the right hand side (as in the case of HILTI), “familyness” is a competitive advantage. If the profile is located on the left hand side, “familyness” is a competitive disadvantage.

⁸⁹ Zafft (2002:19).

⁹⁰ Hilti (cited in Schmid 2002:7f).

⁹¹ See C. Mühlebach (2004).

How does the family's influence, tradition, structure and philosophy impact the resources of the business?



Physical Capital

Location and real estate

Location	disadvantageous (i.e. holding on to an unfavorable location out of tradition)						advantageous (i.e. prime business location, unique physical distribution network, pioneer advantages)
Real estate	unattractive (i.e. capital tied up in real estate not essential for company operations)						unique (i.e. non-imitable, historical, highly symbolic buildings)
Access to raw materials	disadvantageous (i.e. restricted access, cost disadvantages)						advantageous (i.e. possession of mineral resources, transaction cost advantages due to long-established relationships)

Technologies and equipment

Machinery	outdated (i.e. neglect of the necessary investment)						state of the art (i.e. higher flexibility due to own fabrication)
Plants and equipment	outdated (i.e. neglect of the necessary investment)						state of the art (i.e. unique factory layout)
Technology	outdated (i.e. lack of investment, lack of know-how)						state of the art (i.e. special production process)

Financial Capital							
Financing							
Capital structure	inadequate (i.e. insufficient leverage)						advantageous (i.e. flexible, high creditworthiness)
Cost of equity	high (i.e. high interest and dividend claims)						low (i.e. "patient capital")
Capacity for self-financing	low (i.e. excessive dividend payments hinder growth and development)						high (i.e. financial independence with regards to investment decisions)
Investing							
Dividend policy	immoderate (i.e. excessive dividend payments surmount the necessary investments)						moderate (i.e. consequent reinvestment policy)
Investment horizon	short-term (i.e. orientation towards short-term results draws on the company's resources)						long-term (i.e. transgenerational thinking)
Propensity to taking risks	riskaverse (i.e. lack of entrepreneurial thinking)						ready to take risks (i.e. family as venture capitalist)

Human Capital							
Active contribution of family members							
Role model	negative (i.e. distrust, family conflict and intrigues, personal enrichment at the expense of the business)						positive (i.e. mutual attachment, openness and trust, willingness to perform)
Qualification	insufficient (i.e. nepotism, incompetent family members in leadership positions)						excellent (i.e. specific process knowledge and industry-specific experience)
Transfer of knowledge and contacts	neglected (i.e. lump risk, sole concentration of knowledge and contacts onto the entrepreneur)						excellent (i.e. mentoring, passing on of implicit knowledge and relevant contacts)
Behavior towards employees							
Leadership	self-righteous (i.e. authoritarian, autocratic, arbitrary, intransparent)						participatory (i.e. team-oriented, involving)
Working climate	demotivating (i.e. characterized by distrust and control)						motivating (i.e. familiar atmosphere, mutual support)
Continuity	low (i.e. lack of development and promotion prospects)						high (i.e. shared identity, loyalty, constant contact partners towards customers)

Organizational Capital							
Structures and processes							
Organizational structure	bureaucratic (i.e. centralistic, inflexible, hierarchical)						flexible (i.e. federalistic, adaptable, flat hierarchies)
Communication	uncommunicative (i.e. deliberate hold back of information, intransparency, distrust)						open (i.e. permanent, informal communication, open dialogue with all stakeholders)
Dealing with conflicts	destructive (i.e. escalating conflict, conflicts are put under taboo)						constructive (i.e. constructive criticism, search for solutions)
Corporate culture							
Corporate culture	agency-culture (i.e. control-culture, motivation mainly through monetary incentives)						stewardship-culture (i.e. trust, intrinsic motivation, culture of human entrepreneurship)
Norms and values	diffuse (i.e. unclear values, lack of vision)						clear (i.e. deeply-rooted values, values and norms are lived up to)
Readiness for change	low (i.e. perceptive filter, strategic rigidity, backward-looking)						high (i.e. forward-looking, entrepreneurial orientation)

2. Cooperatives (Cooperative Governance)

Until recently, cooperatives have been treated with little interest or even contempt in research, teaching and practice. Only recently, researchers (Voiakina⁹² and Eckart⁹³) have shown that cooperatives possess attributes which are extremely promising for many organizations.⁹⁴

A cooperative is “an autonomous association of persons: united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.”⁹⁵

The International Cooperative Alliance, who propose the above definition of cooperatives, also propose the following principles for cooperatives:

1. “voluntary and open membership
2. democratic member control
3. member economic participation
4. autonomy and independence
5. education, training, information
6. co-operation among co-operatives and
7. concern for community.”⁹⁶

A central challenge facing boards of cooperatives – in addition to offering general strategic direction and control – is “to ensure that cooperatives are not simply overrun by market forces, but take a proactive stance in the design of their future governance model.”⁹⁷

Cooperatives differ from listed companies essentially because the members of the cooperative are simultaneously customers, owners, members of the general public and employees. This facilitates the stakeholder orientation required in a highly diverse organization.

⁹² Voiakina (2003).

⁹³ Eckart (2003).

⁹⁴ See also Merrett and Walzer (2004).

⁹⁵ www.ica.coop/ica/info/enprinciples.html, cited in Eckart (2004:1).

⁹⁶ www.ica.coop/ica/info/enprinciples.html, cited in Eckart (2004:1).

⁹⁷ Eckart (2004:3).

Another feature of cooperatives, is that the owners' shares are usually non-transferable, and this results in a high degree of loyalty among the owners, the customers, the general public and the employees.

3. Non-Profit Organizations

Only recently has "non-profit governance" become the standard term for the directing and controlling functions of organizations acting for worthy causes.

"In contrast to conventional firms, in which economic goals are the main priority, the non-profit organization considers its economic function only as a basis for its activities. Organizations built around worthy causes subject themselves to a much more complex set of expectations, as is the case with cooperatives."⁹⁸ It follows that non-profit organizations usually take the legal form of a foundation or an association, and pursue primarily ethical and charitable goals.

However, there are many regrettable occurrences, for instance "the unprofessional use of donations, overburdened management, irregularities in association leadership."⁹⁹ It is not unusual to witness a precarious "dependency between voluntary supervisory boards and professional management."¹⁰⁰

We should therefore be grateful that in some countries standards for corporate governance for non-profit organizations have already been developed so that charitable organizations "can be transparent in their dealings with the public, and generate trust."¹⁰¹

4. Public Organizations (Public Governance)

In most cases, recommendations to public companies are derived from best practices in private firms.

It is to Frey's credit that he noted that "corporate governance can [also] learn from public governance."¹⁰² Agency theory, often discussed in connection with corporate governance, is exclusively focused on the activation of extrinsic motivation and negates intrinsic motivation factors. By contrast,

⁹⁸ NZZ-Kommentar Number 239 (2003:10).

⁹⁹ Voggensperger and Thaler (2003:10).

¹⁰⁰ Rhinow (2003:15).

¹⁰¹ Voggensperger and Thaler (2003:10).

¹⁰² Frey (2003:3).

in the public governance discussion, intrinsic motivation plays a central role. For instance, involvement and voting rights of employees at the board level, management responsiveness to different constituencies, the granting of titles as recognition and the clear distinction between executive and normative board functions are often features of public governance. An obvious challenge in public governance, though, is maintaining the delicate balance between political influence and management effectiveness.¹⁰³

5. Publicly Listed Companies (Corporate Governance)

Corporate governance research and teaching concentrates almost exclusively on publicly listed companies. The same is true for OECD guidelines and most national best-practice recommendations.

Before I address this group of companies in more detail in the following sections, we should clarify what such companies can learn as far as direction and control are concerned:

- from family-owned businesses (family-based governance), the meaning of the entrepreneurial designing function of boards
- from cooperatives (cooperative governance), the commitment to simultaneously address the needs of customers, owners, employees and the public
- from non-profit organizations (non-profit governance), the meaningfulness and the ethics of doing and
- from public organizations (public governance), the emphasis on intrinsic motivation as primary action motivator (following the motto: immaterial factors pre-eminent, material factors appropriate).

1.2.2 Board Configuration

Different board configurations or orientations can be identified, according to the distribution of power.

¹⁰³ Schedler in Noetzli (2004: 26)

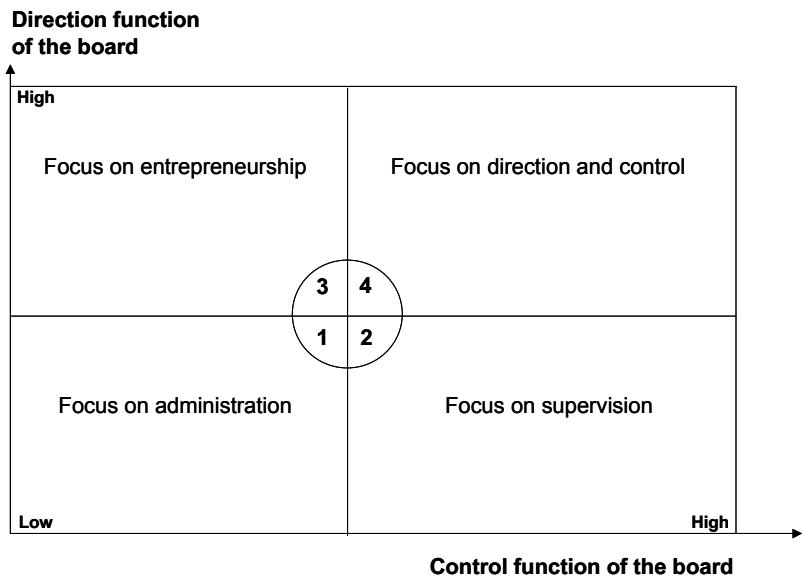


Fig. 1-16. An illustration of different development levels in boards that are based on the different board systems mentioned below

The “Trial” Board System

In some socialist and islamic countries, there exist (according to the author) the so called “trial” board system:

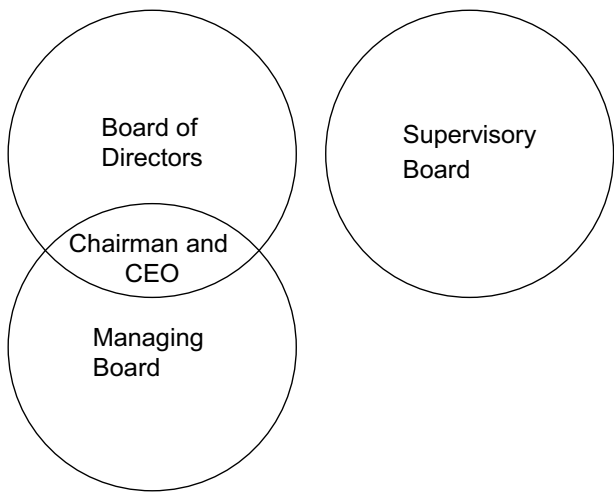


Fig. 1-17. The “trial” board system (e.g. in China, Vietnam and Islamic Banks)

The role of the Board of Directors e.g. in China and Vietnam focuses on direction and the role of the Supervisory Board (determined by the ruling Party and the State) focuses on controlling. In Islamic Banks, the role of the Supervisory Board (which is composed of Imams) focuses on Ethical Guidance.

The “Dual” Board System

In some countries (Germany, the Netherlands, Poland, Slovenia and Indonesia, for example), the “dual” board system is used. Its main characteristic is that the members of the managing board (in Germany, known as the *Vorstand*) are not allowed to sit on the supervisory board (the *Aufsichtsrat*).

The advantage is that there is a balance of power. The disadvantage is that political power struggles can result, and such power struggles can be detrimental to the long term competitiveness of the firm.

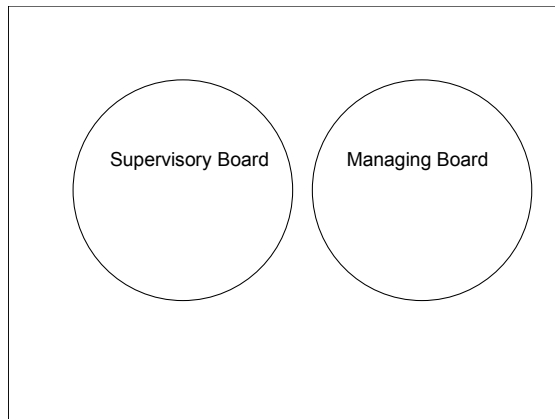


Fig. 1-18. The “dual” board system (e.g. in Germany): a focus on supervision

The “Monistic” Board System

In most countries a “monistic” board system is used. This means that the supervisory board includes members of the management team.

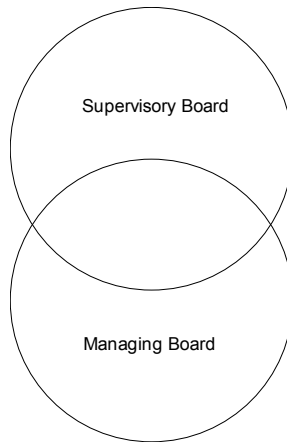


Fig. 1-19. The monistic system (e.g. in Switzerland, though in Switzerland the dual system is possible, even compulsory for banks)

Two types of “monistic” boards can be identified:

- **The executive board model** (used in many family-owned businesses, where most family members are simultaneously members of both the supervisory and managing boards.)

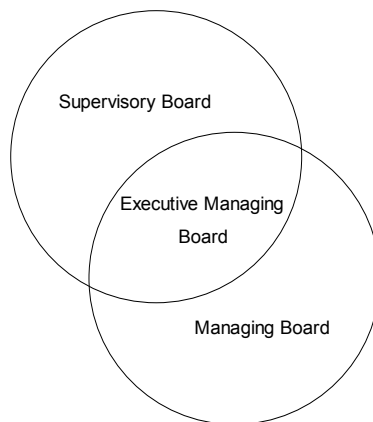


Fig. 1-20. The executive board model: a focus on entrepreneurship

- **The non-executive board model** (predominant in the United States, where the majority of board members are external and independent.)

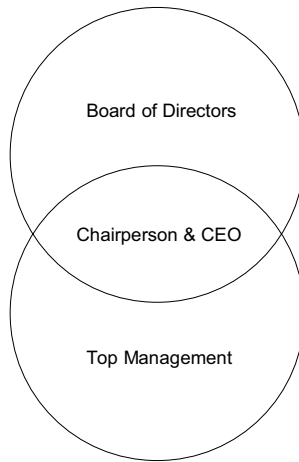


Fig. 1-21. The non-executive board model: Focus on administration

These two traditional models present a risk of power concentration with the CEO and a lack of critical feedback from stakeholder groups.

Supervisory boards are often purely “administrative,” meeting because the law requires it. To overcome the limits of these models, the additional function of lead director was introduced. The lead director is an independent personality who chairs the board’s meetings when the chairperson and CEO are the same person, and when the issues at stake constitute a conflict of interest for that person.

The Third Way: The Board as a Mechanism for Direction and Control

This model addresses the requirements of the latest international (e.g. *OECD Principles*, 2004) and national efforts (e.g. “King II” report, 2003; *Combined Report*, 2003; *Economiesuisse Recommendations*, 2002).

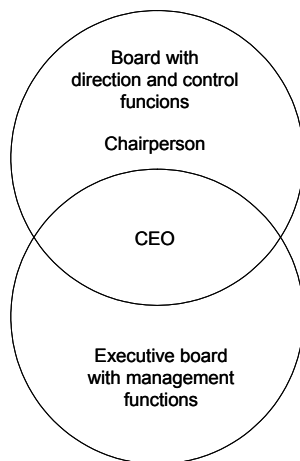


Fig. 1-22. Direction and control board model

The majority of board members should belong to a “...class of totally independent directors who have no vested interests.”¹⁰⁴

In practice, the board should not comprise¹⁰⁵:

- more than two members of senior management (ideally only the CEO should represent management)
- persons who have an active business relationship with the firm (such as suppliers, customers, vendors, consultants and auditors)
- representatives of the main source of debt funding
- people responsible for too many board mandates
- people who do not have enough time or
- people who do not have any firm-relevant know-how.

The recent “King II” report suggests: “Where the roles of chairperson and CEO are combined, there should be either an independent non-executive director serving as deputy chairperson or a strong, independent, non-executive director element on the board. Any such decision to combine roles should be justified each year in the company’s annual report.”¹⁰⁶

¹⁰⁴ Vermeulen (2002:20).

¹⁰⁵ Malik (1998:171).

¹⁰⁶ King II report, in Business Report (2002:8).

The limits of such recommendations should not be underestimated, however. They can improve governance conditions, but such conditions are not in themselves sufficient to attain success or avoid crisis. Even when the functions of chairperson and CEO are separate, much hinges on the relative power of the players (for example, at UBS, Ospel vs. Arnold; and at SAir Group, Burgisser vs. Goetz). In spite of the separation of positions, necessary checks and balances are often missing.

The chairperson plays a central role. She or he “works with and through a chief executive and evidences a ‘hands-off’ managerial style, coupled with open and warm personal relationships that extend to board members. Objectivity, experience, vision, sensitivity and purposeful style are the hallmarks of this profile and capture the elements of being both an outsider and an insider. This chairperson regards his/her role as one of facilitation, unity and commitment and avoids competition with his/her executive.”¹⁰⁷

The chairperson has the task of ensuring the right mix of people on the board (see Fig. 1-23). Ideally, he/she will lead a directing and controlling board.

The lowest board development level would be a ceremonial board (chaired by an all-powerful chairperson and CEO).

The current dominant board development level in many countries is the compliant board (which is only based on legal compliance).

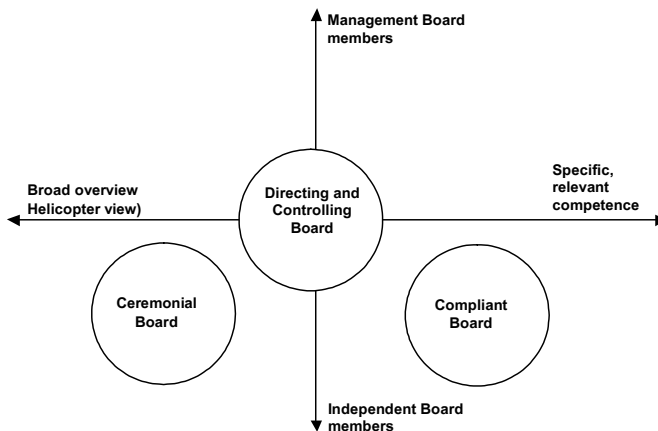


Fig. 1-23. A board composed for direction and control

¹⁰⁷ Bendixen and Thomas (2000:69).

According to one American chairperson, in the future, the art of being a good chairperson will involve “having your nose in and your hands out” of company business.

A recent investigation by McKinsey & Co. reported that “institutional investors would pay heavy premiums (in some cases, nearly a third more) for well-governed emerging market companies compared with less transparent, more dishonest entities, even if financial performance was similar.”¹⁰⁸

The multiplicity of national and international standards notwithstanding, Böckli suggests that the core issues can be defined as.¹⁰⁹

1. the confusion of the roles and responsibilities of the board and the firm management
2. unclear definition of what the controlling function of the board really means (“after one has tried for so many years to separate the controlling function – namely internal auditing – as a special management task distinct from every other function.”)
3. the danger of creating the board, and particularly the audit committee, as a purely administrative function
4. the danger of requiring too much from board members
5. the danger of requiring too much from audit committee members
6. and the danger of risk avoidance and a lack of entrepreneurial spirit in boards.

Besides the power balance between and within the supervisory and managing boards, the complexity of the organization is a further defining characteristic of corporate governance practice.

1.2.3 Organizational Complexity

In organizational complexity, we distinguish between:

- (A) organization size
- (B) stage of development

¹⁰⁸ Vermeulen (2002:20).

¹⁰⁹ Böckli (2001:9ff).

(A) Organization Size

Ideally, boards in small firms should have three members; boards in medium-sized firms, five; and large firms, seven. In most cases, committees with more than eight members are hard to manage. For instance, when a lunch for nine guests takes place, sub-groups will automatically emerge and interact with one another; it is not possible for each guest to interact with all the others.

The absolute number of members of a board is dependent upon only one factor, however. Of more importance is the complexity of the know-how, roles and social characteristics of the board.

(B) Stage of Development

The board and management of a firm should be comprised and structured differently, depending on the stage of development of the firm.

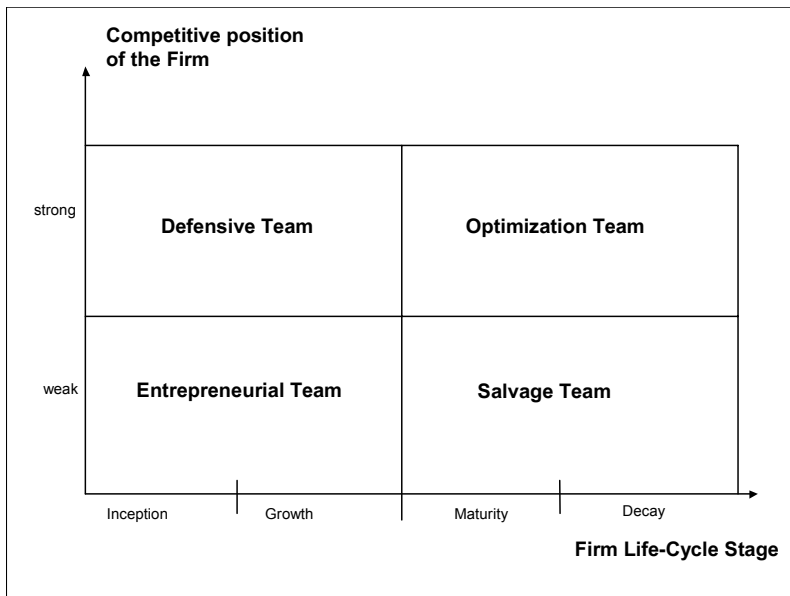


Fig. 1-24. Leadership requirements based on stage in firm life-cycle¹¹⁰

¹¹⁰ Laukmann and Walsh (1986:95).

We need to take into consideration the fact that:

- a clear delineation of the individual phases is not always possible
- the sequence of the stages of the firm life cycle is not always followed
- and firm development can be influenced by board and management interventions.¹¹¹

This stage will be discussed further in Sect. 2.1.

1.2.4 Board Role Players

At board level, the following role players can be distinguished:

1. Chairperson of the board
2. external/independent board members and
3. board secretary.

1. Role of the Chairperson of the Board

Malik suggests that it is the chairperson who leads the board and the firm to success, increased value and accountability.¹¹² The most important role of the chairperson is to guarantee that “boards provide the leadership (and control) which is expected of them.”¹¹³ Thus, professional leadership of board meetings is one of his or her most important tasks. “The resource which chairmen have to handle is the time and the talent of their board members.”¹¹⁴

Malik also suggests that competent chairpersons seek consensus on issues facing the board, but that they do so by using unconventional approaches: systematically teasing out dissension in the conviction that truly robust consensus emerges from an exploration of different opinions.¹¹⁵

The meeting location is also of importance: “for chairpersons to be in control, they have to be in a position to see all participants, which is why I

¹¹¹ Elsik (1992:139).

¹¹² Malik in Noetzli (2004:50).

¹¹³ Cadbury (2003:34).

¹¹⁴ Cadbury (2003:80).

¹¹⁵ Malik in Noetzli (2004:50).

prefer round tables.”¹¹⁶ In international companies, the professional use of video-conferences and web-cameras is of growing importance.

Cadbury recommends that the agenda be arranged in three subject areas:

1. information on the company progress (according to top management): “periodic reports on sales, profits, shares of market and cash come under this heading,”¹¹⁷ as would surveys of employees or other stakeholders
2. matters requiring board decisions and
3. other important discussions on “matters which need resolution, or on which the executives are looking to the board for guidance.”

It is important that “chairpersons normally refrain from expressing their views on an issue, until other board members have had the opportunity to express theirs.”¹¹⁸ The position of chairperson requires “a talent for listening, for leading and for inspiring, and the time to do so.”¹¹⁹

It is also important “that the chairperson and the chief executive see their jobs as complementary not as competing... and that the two individuals have to establish trust in each other.”¹²⁰ Furthermore, the tasks, roles, competencies and responsibilities of the chairperson of the board should be described briefly and agreed upon, and then it should be assumed that “anything not included in that [agreement] was the responsibility of the [CEO].”¹²¹

In conclusion, it can be said that “chairpersons are there to orchestrate the discussion, so that it comes to a fruitful conclusion. The test is straightforward: how much of a board’s discussion time is taken up by its chairperson?”¹²²

¹¹⁶ Cadbury (2003:80).

¹¹⁷ Cadbury (2003:84).

¹¹⁸ Cadbury (2003:90).

¹¹⁹ Cadbury (2003:103).

¹²⁰ Cadbury (2003:117).

¹²¹ Cadbury (2003:118).

¹²² Cadbury (2003:241).

2. Role of the Independent/External Board Members

Ideally,¹²³ all members of the board (excluding the CEO and possibly one other member of top management) should be independent, in order to properly fulfill their functions.¹²⁴ Cadbury assumes that independent board members are “independent of management and free from any business and other relationship which could materially interfere with the exercise of their independent judgment.”¹²⁵

The extensive British PIRC report suggests the following criteria for independent board members. “A board member:

- should not be a former executive
- should not be a professional advisor
- should not be a significant customer or supplier
- should not be appointed as a result of a personal relationship
- [should be] selected by a formal process
- should not stay on the board too long
- should not be a close relative to an executive/director
- should not be an employee
- should not participate in share option schemes
- should not be considered to have pensionable service
- should not represent a major shareholder

¹²³ “There appears to be overwhelming support among financial researchers for outside directors providing beneficial monitoring and advisory functions to firm shareholders ... indicating that firm performance suffers if the proportion of independent outsiders is too low or too high” (Fields and Keys, 2003:5). See also the best-practice guidelines of the *Canadian Coalition for Good Governance*: “Define and report to shareholders, the responsibility of the chair; establish and report to shareholders, the annual review process for the chair; have the independent chair set board agendas with the CEO and be responsible for the quality of the information sent to directors; require the chair to hold... sessions of independent directors without management present, at every board meeting and every committee meeting” (Beatty, 2003:12).

¹²⁴ Here, it is important to differentiate between board membership and participation of top managers in board meetings. Often, it is valuable to invite participation of top managers to address agenda items in board meetings.

¹²⁵ Cadbury (2003:21).

- should not have directorships in common with other directors
- [and] should not hold a position with a body that received donations.”¹²⁶

The British NAPF (National Association of Pension Funds) has the following standards for independent board members, focusing on what board members should be, have or do, rather than what they should not¹²⁷:

1. “A willingness to contribute to strategy and to challenge executives on strategy and other matters, as necessary
2. a readiness to challenge the company’s mergers and acquisition policy
3. an ability to contribute to financial and capitalization issues
4. relevant experience for all the needs of the company’s business
5. independence of mind
6. individuals with sufficient time to devote to the needs of the business
7. integrity and preparedness to resign over matters of principle, should that be necessary
8. and a willingness to learn and continue to learn, not only about the business and its market sectors, but also about the role of the independent director.”

An additional mechanism by which board members’ independence can be strengthened is ensuring that they have a budgeted allowance for advice and development.¹²⁸

There is an important distinction between non-executive board members and independent board members. “All independent directors are non-executive, but not all non-executives are independent.”¹²⁹ Important shareholders can be non-executive, but not independent board members. “Their role is primarily to safeguard the interests of the venture capitalist, which often clash with those of the company.”¹³⁰

¹²⁶ Clarke (1998:122).

¹²⁷ Hasan (2002:341).

¹²⁸ See Dalton (2003:43).

¹²⁹ Merson (2003:13).

¹³⁰ See Dalton (2003:43).

The difference between executive and non-executive members can be defined as follows:

Executive member

- dependent
- full-time employment
- salaried employee
- internal know-how
- hands-on

Non-executive member

- independent
- part-time employment
- contract or fee based pay
- external know-how
- hands-off¹³¹

Sometimes exceptions to these rules can be important. For example, important shareholders can be board members if this is explicitly agreed upon by the other board members, and if they “disclose [any] potential conflict [of interest] and excuse themselves from the discussion in situations where there could be a conflict.”¹³² The same goes for the selection of an executive board member other than the CEO. It may be valuable to elect as a board member a successful former CEO, someone who has served as chairperson of the board of another company more than four years earlier.

3. Role of the Board Secretary

The importance of the company secretary has been largely underestimated in research and practice.¹³³ Therefore we recommend to call him/her “Corporate Governance Officer”. As compliance officer, the company secretary is not a board member, but is a partner in board and committee meetings.

“He or she must supervise due process under company law to ensure that... the correct annual returns are made to the relevant authorities at the right times; the board follows proper procedure under its Memorandum and Articles of Association; board agendas are drawn up for board meetings; full minutes are kept; and minutes of board papers are circulated in a timely manner so that directors have time to read and absorb them; and ensure both their accuracy; and that appropriate actions are being taken by the executives.”¹³⁴

¹³¹ Merson (2003:10).

¹³² Carter and Lorsch (2004:97).

¹³³ Cadbury (2003:23 and 129).

¹³⁴ Garratt (2003a:94).

“The other main project on which the chairman and the company secretary are likely to work together is the company’s annual report and accounts”¹³⁵ and making “the arrangements for the AGM.”¹³⁶

1.2.5 Degree of Internationalization

The stages of internationalization can be grouped into four categories¹³⁷:

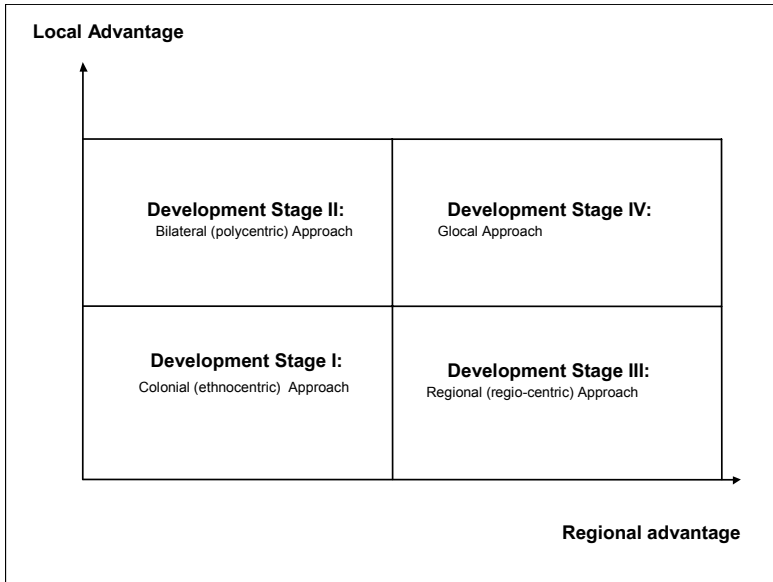


Fig. 1-25. Stages in multicultural board and management development

Development Stage I:

Ethnocentric composition of the board and management teams: a colonial approach.

This approach is often used at the beginning of the process of internationalization (as well as during times of crisis). The human resource policy of the head office will be applied in all domestic and foreign operations as a package. Both chairpersons and managing directors of the subsidiaries are home country expatriates. Even today, Japanese firms use this approach

¹³⁵ Cadbury (2003:128).

¹³⁶ Cadbury (2003:129).

¹³⁷ Perlmutter and Heenan (1974:121ff).

with very few exceptions (i.e. Sony). The advantages are visible primarily in the first phase of the firm's internationalization. In this first phase, in order to implement the head office strategy and HR policy congruently, responsibility for the creation of a new foreign subsidiary is delegated to an experienced member of the head office.

This approach should, however, be constrained in its use (at the beginning or in times of crisis), as the drawbacks accumulate in the long term. Aside from the fact that sending expatriates abroad results in very high transfer and remuneration costs, the danger of insufficient consideration being given to local markets and conditions is real. In that respect, there are numerous examples of Japanese multinational companies that used to use the ethnocentric approach. The best upper-middle managers were lost because their nationality precluded their being given full responsibility for local subsidiaries. These disadvantages are often the reason why, after a certain time on the international scene, many firms move on to the polycentric approach.

Development Stage II:

Polycentric composition of the board and management team: a bilateral approach.

This federalist concept emphasizes the local autonomy of the subsidiaries when developing, producing and evaluating policy. All subsidiary board members and employees are recruited locally. Many US and European firms or groups of firms apply this approach. It will mostly be used in sectors where the contact of management with government and local administration is very important and can be better ensured by local managers.

The clear advantage of this approach is that it is the least expensive. The national needs of customers and employees are better taken into account, and at an international level, the advantage of a federalist umbrella organization can be better realized.

However, there are drawbacks: many firms using this approach have witnessed the secession of foreign subsidiaries from the global strategy of the head-office. Furthermore, this approach precludes one of the most important advantages of multinational companies over national ones: in such multinational firms, the development possibilities for board members and employees are as limited as those in national companies.

Development Stage III:

Regio-centric composition of the board and management team: a regional approach.

This approach derives from the emergence of a common European human resource management model. The idea is that in a Europe without borders, there should be a unified regional model of recruitment, evaluation, compensation and development of boards and human resources. This approach is applied by some multinational US firms that often have regional headquarters, for instance in North America, Europe, Africa, the Middle East and Asia.

Firms that make use of a regional personnel policy gain access to borderless labor markets of large trading blocks (such as the EU and NAFTA) and can therefore establish a competitive advantage over solely national firms.

The drawbacks become manifest when global board and human resource potential cannot be optimally developed. A common false assumption is that unified economic spaces imply unified national cultures. My own consulting experience in 60 countries and the comprehensive studies of Hofstede¹³⁸ have shown, however, that there is no such thing as a unified continental culture. There is no such thing as *a* European culture nor is there *one* Asian culture nor *a single* North American culture. Cultural differences between the UK and Greece are larger than those between the UK and New Zealand, for example.

The concepts I have presented this far can be classified as ethnocentric approaches:

- development level I embodies a pure ethnocentric approach
- development level II is a subsidiary based ethnocentric approach
- and development level III is a regional based ethnocentric approach.

Those three have in common a perspective which does not connect the comparative advantages of single approaches. Thus either the multicultural national differences (level II) or the regional commonalities (level III) will be overplayed or a “neither-nor” strategy (level I) will be followed. These three perspectives render impossible the advantages of the “both-and”

¹³⁸ Hofstede (1984 and 1991); Scholz and Schroter (1991:35).

approach of true multicultural board and personnel development (level IV in Fig. 1-25).

Development Stage IV:

Geocentric composition of board and management team as a *glocal* approach.

Only the geocentric approach attempts to integrate the firm and country cultural specificities and the national differences on the board and personnel management levels appropriately. This approach allows the development, introduction and evaluation of worldwide normative guidelines and systemic simplifications, with due consideration for strategic regional conditions and operative national peculiarities. This approach will be applied independently, regardless of the culture of the home office or of the industry, by some of the most successful transnational firms, e.g. British pharmaceutical concern, GlaxoSmithKline or Swiss food manufacturer, Nestlé. The drawbacks of this approach are the inordinately high transfer and compensation costs (e.g. attaining in some cases three times the level of a polycentric approach) and the potential personal risks associated with frequent relocations.

However, in the future, as the proportion of international business carried out by companies grows, the advantages of the *glocal* approach will increase in importance. These advantages are:

- optimal use of international board and HR potential
- better alignment of board and management teams of foreign subsidiaries with the global vision and strategies of the home office, simultaneously taking into consideration local conditions and strengths
- development of a cosmopolitan learning-oriented corporate culture, in which a strong competitive synthesis of the comparative and transferable strengths of the different national cultures can be achieved
- and creation of attractive personal development possibilities for the board members and executives of the different national companies.

As the advantages are limited to a relatively small portion of cosmopolitan, transfer-ready board members and managers, it will be advisable in future to apply a combined approach based on the priority and target group of the board and personnel management (see Fig. 1-26).

Priority	Target group	Approach
Normative	Board and management team at home and abroad	Geocentric
Strategic	Transfer-ready project teams and managers	Regio-centric
Operational	Employees (non-managerial)	Polycentric

Fig. 1-26. Combined approach of multicultural board and HR management

Board committees and corporate HR executives limit themselves to the participative development, introduction and evaluation of integrated board and HRM concepts. As usual, those concepts have to do with recruitment, appraisal, compensation and development of board and management teams at home and abroad. Regional personnel managers have to effect the development, introduction and evaluation of the strategies passed down from the center, for managers and members of regional project teams. Local personnel managers concentrate on operational personnel concepts derived from the regional strategies to address the need of all local employees who do not want to be transferred abroad. Organizations exhibiting the following characteristics can be described as *glocal*: “global competitiveness, multinational responsiveness, and worldwide learning.”¹³⁹

How can firms become more *glocal*?

Globalization means that firms must confront themselves with increasingly complex competitiveness requirements regardless of their size. This applies also to virtual firms. Firms must learn to act with entrepreneurial flair in and between a large number of different cultures. The global agenda for such firms is to learn from each culture the best it has to offer, and to adopt and implement those best practices that are transferable.

Firms need what I call “*glocalpreneurs*,” managers capable of integrating global and local with integrity, leadership, management and entrepreneurial competence.

In other words:

- not everyone who has an **appropriate personality** also has multicultural competence
- not everyone who has **multicultural competence** also has management competence

¹³⁹ Bartlett and Goshal (1989:21).

- not everyone who has **management competence** also has leadership competence
- not everyone who has **leadership competence** also has entrepreneurial competence
- and not everyone who is **entrepreneurial** behaves ethically.

But: someone who has all these qualities is a real *glocalpreneur*.

The board and top management leadership team of a transnational firm, comprising *glocalpreneurs* with a spectrum of core competencies, could thus be described as a team of “transformation managers.”¹⁴⁰ According to Tichy and Devanna, “They describe themselves as change agents:

- they are courageous
- they believe in people
- they are value oriented
- they have a life-long learning orientation
- they can deal with complexity, ambiguity and uncertainty
- and they are visionaries.”¹⁴¹

Such a team of *glocal* and transformation-oriented board members and managers is an important prerequisite for the development of a corporate culture based on trust, the capability to (un)learn and personal and societal values.¹⁴²

¹⁴⁰ Tichy and Devanna (1986:271).

¹⁴¹ Tichy and Devanna (1986:271).

¹⁴² Konzes and Posner (1988).

Subsidiary Governance

The recent US subprime crisis has created huge problems for most global banks.

What is the important lesson learned for Corporate Governance of Global Banks?

It is impossible for Audit Committees of complex global banks to direct and control operations and risks in all worldwide operations for example, by conducting 12 meetings per year.

We suggest therefore to introduce for such complex global organizations (mainly in financial services) an overlapping subsidiary governance system as follows:

Instead of having so called puppet boards in most subsidiaries (who only search for local compliance), we recommend to compose in all main subsidiaries, a board team comprising of members with the same well diversified local know-how as the local management team possesses to direct and control the subsidiary operations and risks. The subsidiary board team is to be chaired by a member of the corporate board.

1.2.6 Mix of Board Functions

Boards undertake the following tasks in many countries¹⁴³:

1. selection, review, remuneration, development and sometimes the removal of the CEO (or other important members) of the management team
2. co-development and evaluation of corporate strategy structure, and culture
3. budget development and financial planning and control
4. reporting to the shareholders and
5. board self-review.

¹⁴³ Hung (1998:101ff).

Depending on the country, industry and firm culture, boards perform the functions illustrated in Fig. 1-27 in different proportions:

1. coaching
2. directing
3. knowing
4. controlling
5. networking and
6. balancing.

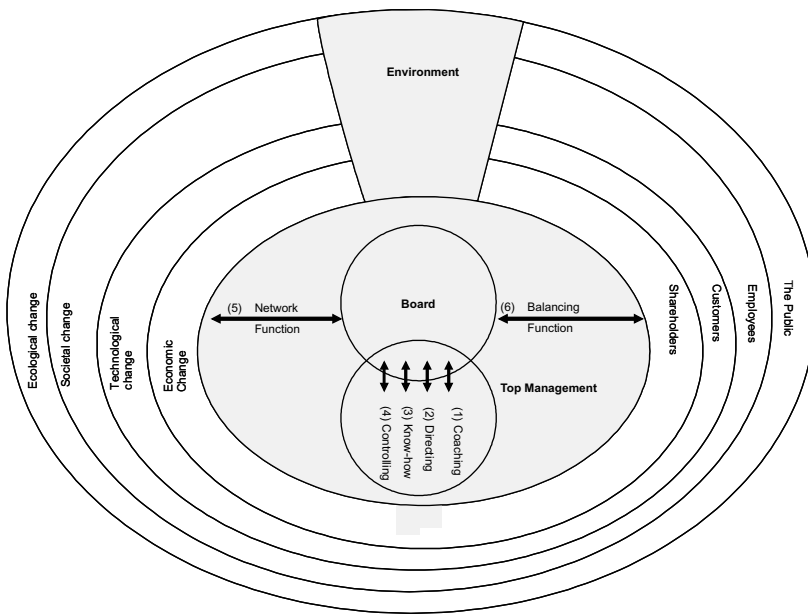


Fig. 1-27. Board functions

Based on an analysis of most board roles, the directing and controlling functions of boards are central in the corporate governance discussion. Thus, depending on the context, a different mix of functions is chosen, as depicted in Fig. F-1 in the foreword. In that illustration, quadrant 1 (the board as an administrative function) is usually chosen by firms that do not want to have external direction or control; quadrant 2 (the board as a supervisory function) corresponds to the German model of governance; quadrant 3 (the board as an entrepreneurial function) is chosen most often

by pioneer firms; and quadrant 4 (the board as a directing and controlling function) is aimed at by Swiss hard and soft laws.

Based on the contextual factors described above, a highly differentiated representation of board practices emerges around the world.

Country	Shareholder vs. Stakeholder Perspective of Boards	Monistic vs. Dual Board-System	Geo vs. Ethnocentric Board Composition (at least 1 foreigner on the Board)	Proportion of firms separating roles of Chairperson and CEO	Proportion of external Directors on the Board	Employee representation on the Board	Board Size	Board Function	
								Direction	Control
USA	SH	M	E (24%)	15%	77%	None	13		X
Canada	SH	M	E (25%)	66%	80%	None	12	x	X
Brasil	SH	M	E (10%)	20%	60%	None	6		X
Australia	SH	M	E (1%)	70%	75%	None	8		X
Japan	ST (excludes SH)	M	E (0%)	100%	5%	None			X
France	SH / ST	M / D	E (62%)	0%	82%	Yes, (minority)	13		X
Germany	SH / ST	D	E (34%)	100%	100%	Yes (parity)	15		X
Italy	SH	M	E (40%)	100%	73%	None	11		X
Great Britain	SH	M	E (40%)	90%	50%	None	9	x	X
Netherlands	SH / ST	D	E (38%)	100%	100%	None	7		X
Switzerland	SH / ST	M	E (59%)	63%	89%	None	9	X	x

Fig. 1-28. International comparison of board characteristics¹⁴⁴

There is certainly no single corporate governance template for international companies.¹⁴⁵ However, the globalization of capital markets, dominated by the UK and United States, is forcing a sort of convergence.

In this book, we have referred to *glocal* corporate governance. In other words, for the parent company and the boards of subsidiaries, there is convergence towards a corporate governance model:

- both a small directing and controlling board (ideally comprising seven members), and a larger non-accountable network/advisory board (including members of the different constituencies)
- taking into consideration both the interests of the shareholders as well as those of customers, employees, and society

¹⁴⁴ Pic (1997:18).

¹⁴⁵ Pic (1997:34).

- both a monistic system and, if necessary, a dual system (in banks for example)
- both a geocentric and a polycentric approach to appointing the supervisory and managing boards
- both insiders and external independent members sitting on the supervisory board
- both a directing and a controlling function and
- both generalist competences (entrepreneurial and leadership competences developed in other firms) and specialist competences (in auditing, risk management and HRM, for example).

It is important to observe not only the global OECD guidelines (www.oecd.org), but also the best practice soft law established in many countries:

- in North America, e.g. the “DEY” report in Canada (www.ecgi.org/codes/menu_americas.htm)
- in Asia, e.g. the “Bosch” report in Australia (www.ecgi.org/codes/menu_asia_pacific.htm)
- in Africa, e.g. the “King II” report in South Africa (www.ecgi.org/codes/country_pages/codes_south_africa.htm)
- in Europe, e.g. the “Combined” report in Great Britain (www.ecgi.org/codes/menu_europa.htm)

In addition, it may be advantageous to prepare a board charter (or a “Board Magna Carta”¹⁴⁶) setting out the specific requirements of board members of a particular firm:

- “To request that a vote be taken in a particular manner (roll call, show of hands, voice or secret ballot)
- to request added information on any subject brought before the board and to personally question anyone who presents to the board before a vote is called
- to request changes to the minutes before their approval and have changes made that accurately reflect what actually happened

¹⁴⁶ Ward (2003:22) cites a practical example developed by Young.

- to have personal opposition to an item passed by majority vote be reflected in the minutes¹⁴⁷
- to move to defer action on any item of business to a later date (this, of course, must still be approved by a majority vote) and
- to request a summary of internal policies and procedures that the board has developed through its history.”¹⁴⁸

Having dealt with the firm external and internal contexts in this chapter, we turn to the strategic dimension of the firm in Part 2.

¹⁴⁷ This being of considerable importance in any subsequent legal proceedings.

¹⁴⁸ Young’s practical example, cited in Ward (2003:22).

PART 2

Strategic Dimension

Keep it strategic

For integrated board management, we propose four main preconditions for success in developing, implementing and controlling corporate strategy (see Fig. 2-1):

1. diversity: strategically targeted composition of the board team
2. trust: constructive and open-minded board culture
3. network: efficient board structure and
4. vision: stakeholder oriented board measures of success.

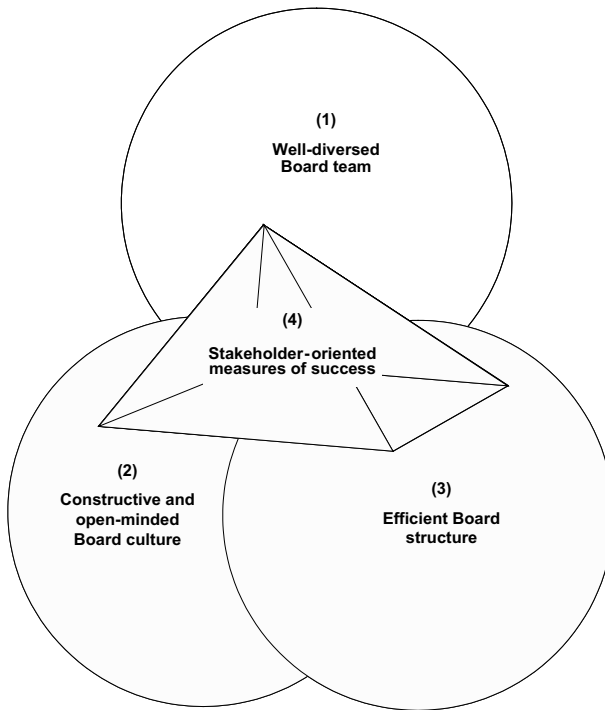


Fig. 2-1. Preconditions for successful integrated board management

These four components have to be integrated in a process as shown in Fig. 2-2. At each of the different levels, success measures are established relating to the important stakeholder groups, and then the responses of members of those stakeholder groups are measured periodically to assess the performance of the company leadership.

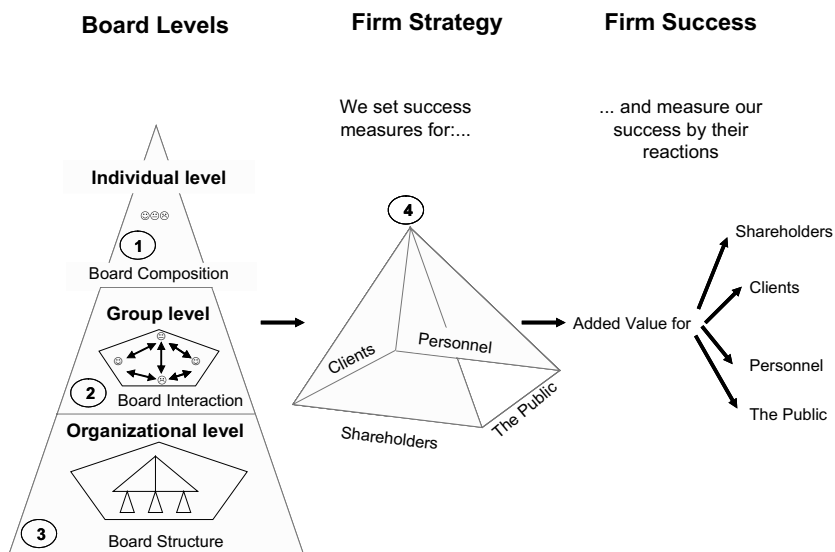


Fig. 2-2. Relationship between board, strategy and success¹⁴⁹

Anglo-Saxon researchers have been studying the relationship between corporate governance and firm success. A new study conducted at the University of Basle in Switzerland confirms that higher share price and lower cost of capital are directly linked to good corporate governance.¹⁵⁰

2.1 Targeted and Diverse Board Team Composition

"Governance starts and ends with the board of directors."¹⁵¹ Before the recent collapse of many high profile international firms, many boards in large firms looked similar to the one shown in Fig. 2-3.

¹⁴⁹ See Macus (2002).

¹⁵⁰ Beiner, Schmid and Zimmerman, in Noetzli (2004:24).

¹⁵¹ George (2002:22f) "...it is hard to imagine that the failures at Enron, Swissair, K-Mart, and other companies would have happened if they'd had robust governance systems in place."

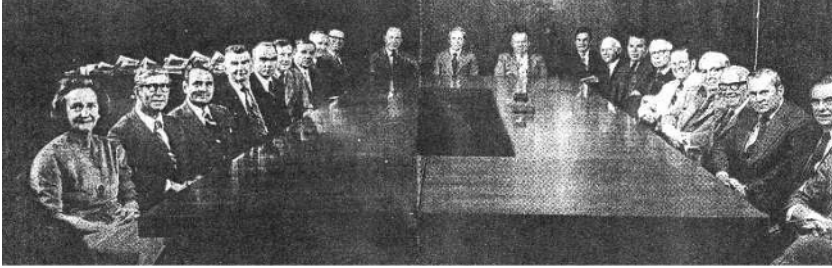


Fig. 2-3. Example of the board of a traditional large firm

What do you find striking about this board?

In addition to the large number of board members, all the members exhibit the same characteristics as the chairperson and CEO of the board of this US firm (with the exception of the female board secretary). They are all:

- male
- American
- white
- at least 58 years old and
- current or former chairpersons/CEOs of other large firms.¹⁵²

Given such homogeneous board composition and the recent crises in the governance of large firms, one must ask the question Peter Senge asked of board teams:

“How can a team of committed board members with individual IQs above 120 have a collective IQ of 60?”

¹⁵² “The most common statement I heard from directors and executives about the Fortune 500 companies was ‘Oh, the board of directors – that’s ten friends of the chief executive, a woman and a black!’” Garatt (2003:xxi). Further, according to Macus, in Noetzli (2004:51), studies show that board members who are similar in demographic characteristics to those of the CEO tend to perform their monitoring tasks less diligently.

The counter question posed by N. Negroponte – “Where do good new ideas come from?” – is simple to answer:

“From differences... [and] the best way to maximize differences is to mix

- ages
- cultures
- disciplines.”

and I would add gender, core competencies and board roles.¹⁵³

It should be noted though, that diversity can only become a competitive advantage when it is well managed¹⁵⁴ and led.¹⁵⁵

A targeted and diverse team of five to seven members should be created on the basis of criteria relevant to strategy. There is no such thing as an ideal board composition. A recent study by Macus¹⁵⁶ confirms that optimal board composition depends on the nature of the firm and its context. In my consulting, I try to find the best possible board composition by asking the following questions (using both self- and external evaluation):

Where are the current board strengths and weaknesses situated, with regard to criteria such as:

- know-how
- team roles
- and demographic data? (See Fig. 2-4.)

Nils Jent and myself have developed and implemented the following Diversity Disk for board practice.

¹⁵³ Westphal and Frederickson (1999) and Peteraf (1993) found positive relationships between good selection and strategic success. According to Fields and Keys (2003:13) “a key factor in diversity’s successful impact on firm performance is the value found in the heterogeneity of ideas, experiences and innovations that diverse individuals bring to the firm.”

¹⁵⁴ Cox (1993).

¹⁵⁵ Maier (2002).

¹⁵⁶ Macus (2002:11).

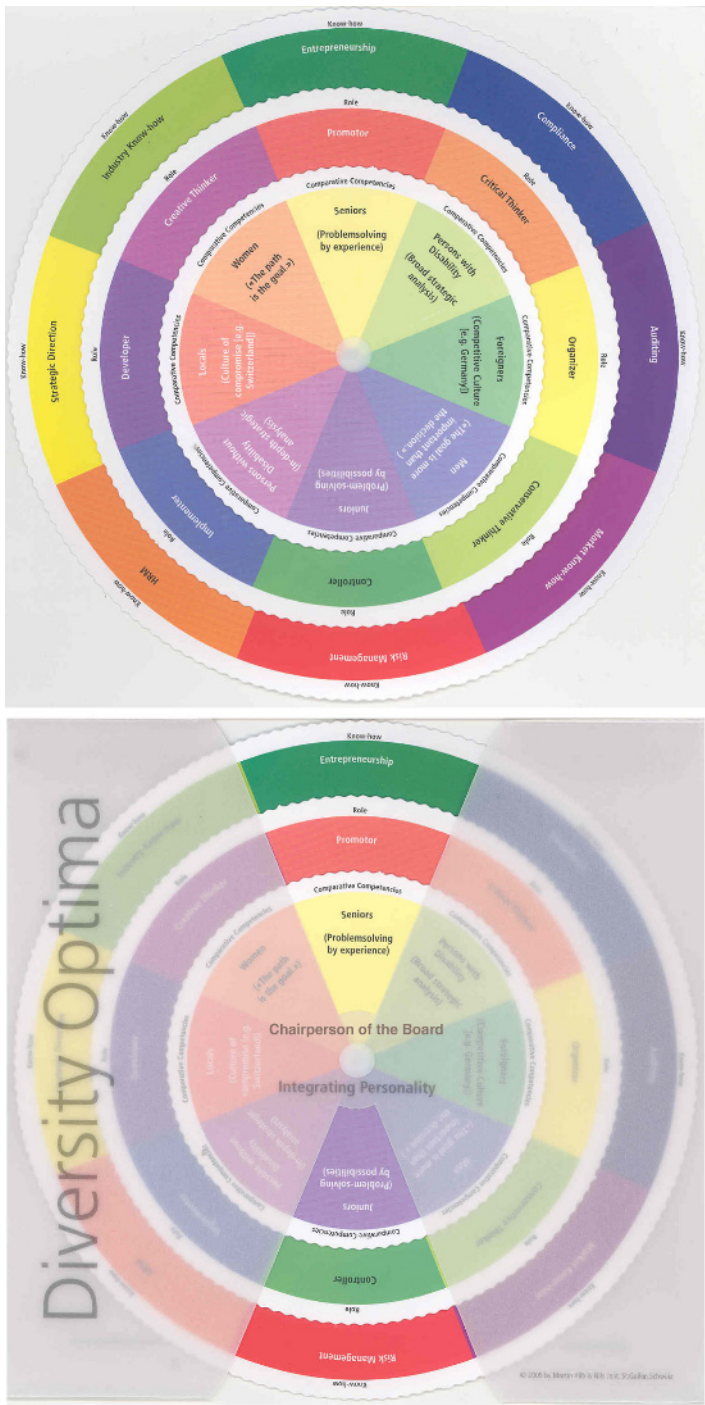


Fig. 2-4. Targeted board diversity based on different criteria

Board diversity can be a competitive advantage or a competitive disadvantage. This depends on the following two statements:

- (1) The diversity of a board team should never be more complex than the reality. If your company is operating only in Switzerland for instance, you do not need an American on your Board.
- (2) Diversity on the board level only adds value if each board member knows his/her own identity and the identities of all the other team members (with the strengths and corresponding weaknesses).

Our board diversity disk can be used in board practice as follows:

The Outer Disk: Necessary Board Know-How

Determine first which know-how areas you need on the board level. The rule should be that the Board of Directors should possess the same know-how areas as the Top Management Team to be able to direct and control effectively.

Then you determine, which necessary know-how areas are already represented on the board level and which know-how areas are lacking on your board.

If for example, 'entrepreneurship' know-how is necessary for your board, and you have a competent, committed and integer entrepreneur on your board, you need also a member with the complementary know-how on the opposite side of the disk, for example, risk management know-how. If you have no expert with risk management know-how on your board, you should look for such a board member at you next Annual General Meeting.

Even if you have all the necessary know-how within your board, this does not guarantee success. To make a board team effective, you need board members with different complementary board roles.

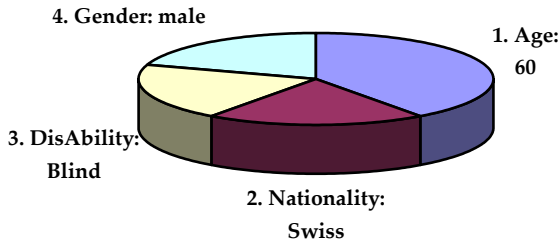
The Middle Disk: Necessary Board Team Roles

Determine which board roles are represented on your board by asking your board members to name their most appropriate board team role. The complementary roles are also included on the opposite side of the disk.

If for example, one board member's board role (and strength) is the "promoter role", then his weakness is the "controller role" which is on the opposite side of the disk. Only if the board members know their own strengths and weaknesses, can they appreciate the appointment of a board member with the complementary skills and roles.

The Inner Disk: Comparative Strengths of Social Data

We all possess a unique kaleidoscope of social data, which can be shown in a pie chart:



Each board member determines his/her dominant social data: in the above example, it is the age which dominates the behaviour of this person most.

The comparative strength of this VEP (Very Experienced Person) is his/her rich tacit knowledge. His/her weakness is his/her adaptability to the latest Information Technology.

To limit the size of a board team to maximum of seven members, the characteristics of the three disks have to be combined, for example, one board member has the following profile: HRM experience with success record/Promter role/Age 60 (VEP).

In the following paragraphs I present an example of the application of the instrument to the board composition of an international company.

In one-on-one conversations with the chairperson, the board members, the CEO and three representatives of the major shareholders, I discussed the actual and most desirable composition of the board using the following board-diversity tools.

(A) Targeted Composition Based on Board Know-How

First, there are the subject-specific areas of competence that must be represented on the board in order to be able to successfully fulfill the strategic direction and controlling functions of the board.



Fig. 2-5. Essential areas of board know-how in an international bio-technology firm

I begin by establishing the importance of the various areas of competence and the levels of satisfaction with the existing board, according to the board members, the top management team and major shareholders; thus, I identify the areas of competence missing in the actual board.

(B) Targeted Composition Based on Board Roles

A board's success is facilitated not only by a variety of subject-specific competencies, but also by a variety of complementary roles.

A conceptual framework specific to board-team roles, based on Margerison and McCann's¹⁵⁷ and Henley's¹⁵⁸ theories of team roles (see Fig. 2-6) can be used.

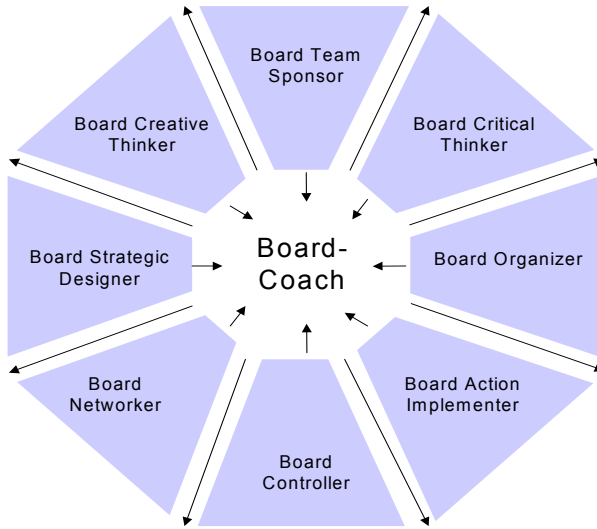


Fig. 2-6. Board team-roles concept

It is important that board members know their strong and weak points (which are exact opposites as represented in Fig. 2-6.) with respect to the board roles and that they are aware of their board colleagues' strengths and weaknesses.

It would be ideal to have all main roles in the board team, with the board secretary playing the organizing role and with various members of the board playing the networking role simultaneously.

¹⁵⁷ Margerison and McCann (1985).

¹⁵⁸ Henley (2000).

I call this “targeted diversity” on the board team.¹⁵⁹ In cases when board heterogeneity is established without an awareness of the strengths and weaknesses of the different members with respect to board roles, board diversity can become a problem and can give rise to board team conflict.¹⁶⁰

By using the approach illustrated in Fig. 2-6, it is possible to identify missing board roles, quite frequently simply by using on a visual representation of the roles evident in the existing board team. If, for example, the controller role is missing in a board, a new member should be appointed; one who demonstrates controlling skills in addition to the appropriate firm-specific know-how.

This role-based approach allows the interactions between board members and members of the top management team to be shaped into a partnership. In many board-level crises in the recent past, this role-based approach was not used, resulting in serious consequences:

“Although Swissair had a wide scope of knowledge, experience and individual competencies on its board, the board as a group failed to put them to use. The interactions that took place among the directors and between directors and the top management team were arguably not enough to provide the board with the necessary insight into not only what was going wrong, but also what was going badly. Even if single directors did recognize the problems, they were not able to communicate their perspective to the entire board.”¹⁶¹

(C) Targeted Board Demographic Composition

According to Jent,¹⁶² the Equal Opportunity Movement resulted (even in Europe) in demographic “equality” of members of boards or top management being treated as “uniformity.”

“As a result, many talented people with, ‘no unusual’ demographic characteristics are not optimally used by boards and top management in many companies. For example, females are employed at board and top management levels where males are dominant based on their comparative strengths. The consequences: the females often fail (unless they become

¹⁵⁹ Maier (2002).

¹⁶⁰ See also Staffelbach in Noetzli (2004: 47).

¹⁶¹ Macus (2002:12ff).

¹⁶² Jent (2003).

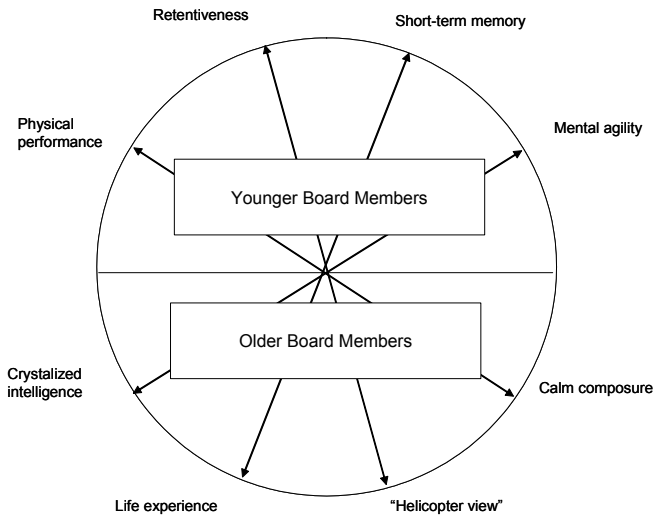


Fig. 2-7. Comparative strengths of older and younger members of boards and top management

more masculine than the men).”¹⁶³ The same applies to other social data such as age (see Fig. 2-7) or solidarity with national culture (see Fig. 2-8).

In Europe, only 7.3% of all board members are women.¹⁶⁴ Norway is the first country in the world to implement a quota for the proportion of board members that are required to be women: a minimum of 40% of board seats on the 600 listed companies have to be occupied by women. Firms that fail to comply with this requirement stand to lose their listing.¹⁶⁵ The Norwegian minister of the economy, Ansgar Gabrielson, supported the decision as a means of better using the well-developed human potential existing in the nation’s women, and using the diversity argument that organizations that consciously develop their diversity have advantages with respect to innovation (see Fig. 2-8).

In order to support the proposed legislation, it could be very valuable to develop databases of the women available, qualified and willing to serve on boards in the country. Such initiatives have already been undertaken in Canada, Norway, and Switzerland.

¹⁶³ Jent (2003).

¹⁶⁴ See Heyrick and Struggles (2005 study:14).

¹⁶⁵ Martin (2004:1). Sweden is likely to implement a law in 2004 requiring a minimum of 25% of board seats to be held by women, and in Switzerland a parliamentary initiative is working to establish a law requiring a minimum of 30% of board seats to be held by women.

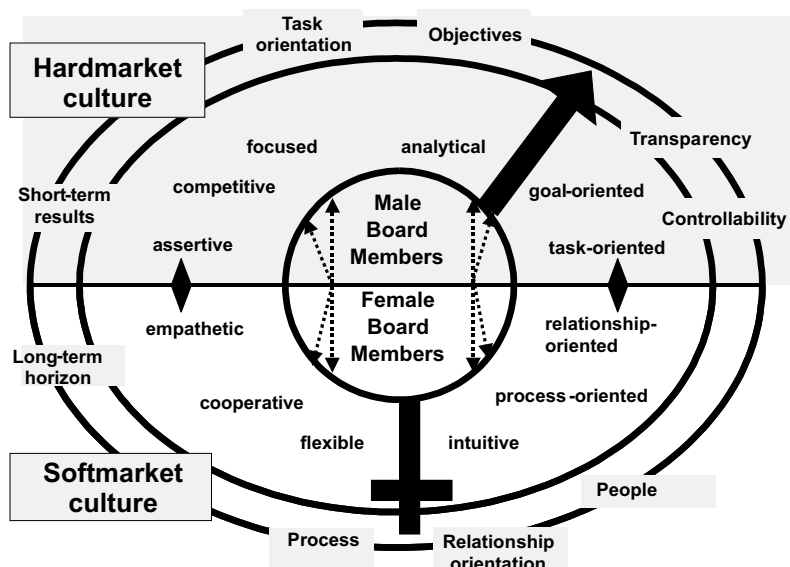


Fig. 2-8. Comparative strengths of board members of different gender and national culture

The composition of boards of large transnational firms should also reflect diversity in terms of national culture; ideally mirroring the extent of their operations in different parts of the world.¹⁶⁶ For example, if operations are distributed across North America, Europe and Asia, then it would be ideal for the board to comprise members with profound cultural know-how and market experience relevant to those regions (and with track records in those countries proving their experience).

I have developed the following kaleidoscope of social data for board practice.¹⁶⁷

¹⁶⁶ See Ackerman in Noetzli (2004:14).

¹⁶⁷ *The Report of the NACD Blue Ribbon Commission on Director Professionalism* (NACD, 1998) recommends that “a substantial majority of the board should be independent and that serious consideration be given to board candidates with diverse backgrounds because of their unique experiences and perspectives that they offer. Candidates provide diverse contributions as a result of gender, ethnic background, geographic origin, or professional experience gained in the public, private or for profit sectors” (Fields and Keys, 2003:2).

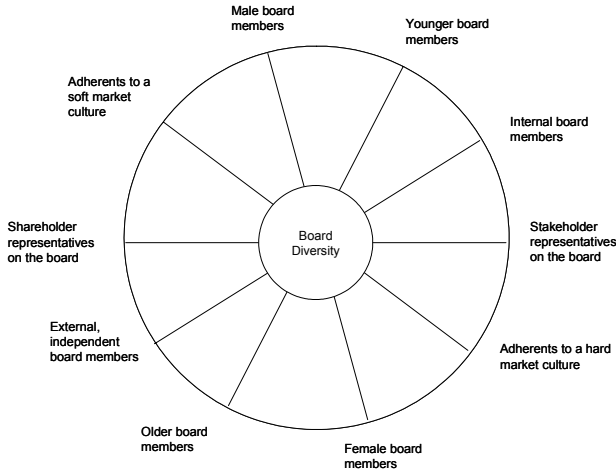


Fig. 2-9. Kaleidoscope of social roles of board teams

Based on the strategic potential of board composition that includes know-how, diversity, and team roles, a board may be structured in the following way:

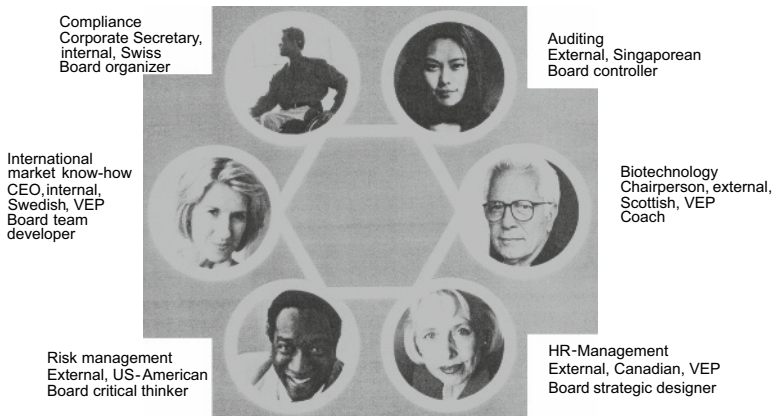


Fig. 2-10. Example of a board selected deliberately for a biotechnology firm (VEP=Very Experienced Person)¹⁶⁸

¹⁶⁸ The chairperson must therefore have the competence necessary to identify and manage conflicts arising on the basis of the multicultural nature of the board. See for example recommendations made by Appelbaum and Elbaz (1998).

Based on the strengths and weaknesses of the existing board, the job profile for a new board member can be drawn up (see Fig. 3-8).

(D) The Coaching Role of the Chairperson

The chairperson maintains the central responsibility for targeted board selection and leadership of the board, and has to be able to work constructively with the CEO in carrying out the associated duties.¹⁶⁹

Another central task of the chairperson is effectively leading meetings. The agenda items are important; the effectiveness of a board can be strongly influenced by the design of its meeting agenda.

The following rules apply:

- “Both set and stick to the board agenda. The chair must be the one who actually sets the board’s agenda for the meeting, but after soliciting (input from) other directors on what they want to see covered,” says Stephanie Joseph of the Director’s Network in New York.
- According to Louise Corver, President of Corporate Learning and Development, the excellent chair should have “an ability to stay above detail, to think at the big-picture, strategic level.... [Excellent chairpersons] keep strategic vision, but can also get their hands dirty if need be, knowing both the vision and how to fulfill it.”
- “Good boards... periodically take some time after a board meeting to discuss how the meeting went and what they might do differently”¹⁷⁰ (or alternatively, anonymous questionnaires could be collected after each board meeting with a review of the meeting).
- “Build unique relationship, with each board member and use them to shape consensus.”¹⁷¹

According to Müller,¹⁷² a meeting agenda should contain the following:

- the nature of the meeting
- the place, date, time of the meeting
- the participants in the meeting

¹⁶⁹ Westphal (1999).

¹⁷⁰ Carter and Lorsch (2004:127).

¹⁷¹ Ward (2003:21).

¹⁷² Müller (2003).

- a first item referring to the minutes of the last meeting
- a standard strategy check
- the date of the next meeting
- a general survey at the end and
- supplementary issues.

The central portion of the meeting (the strategy check) should be divided between two issues:

- “major issues affecting the company’s future and
- discussions... with key executives about the issues facing the companies major businesses.”

The few “key issues that are likely to be at the heart of the company’s success over the next five years” should be discussed in detail at strategy workshops set up during the year.¹⁷³

Müller recommends the following methods for directing meetings¹⁷⁴:

- assume preparation
- introduce each agenda item
- integrate or synthesize the contributions
- formulate motions clearly
- deal with important issues first
- clearly state proportions of votes or breakdown of opinions
- keep to the schedule (limit contributions)
- explain the context and highlight the implications of each item
- propose a schedule of communication (who informs whom how when on what) and
- assess and define confidentiality.

¹⁷³ Carter and Lorsch (2004:146).

¹⁷⁴ Müller (2003); see “Meeting Schedule Checklist”: Charon (2005:161-163).

It is important to know that “80 to 90 percent of the chairperson’s role happens outside of board meetings. It’s a poor chairperson who tries to make everything happen inside the meeting room.”¹⁷⁵

An exemplary chairperson and a strategically composed board are essential prerequisites for building a constructively critical board culture based on trust, and that is essential for a firm’s innovative and competitive strength.

2.2 Critical but Constructive Culture of Trust

In Fig. 2-11 we differentiate between international boards that are characterized by:

- (+) future- and outward-oriented direction and control cultures (outer circle)
- and (–) historic and inward-looking traditional board cultures (inner circle).

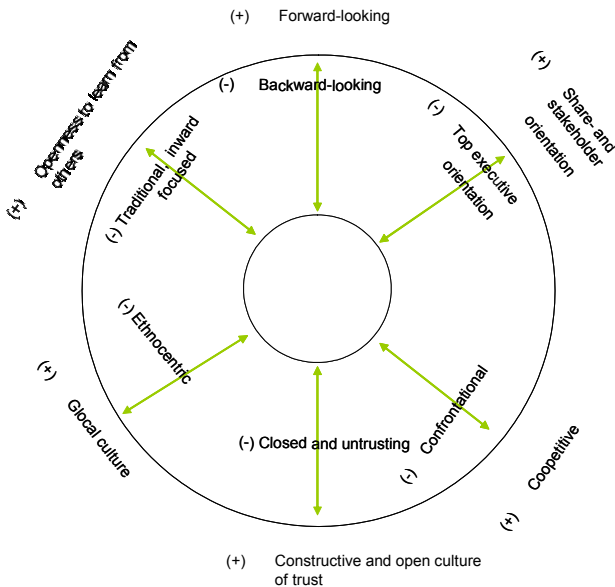


Fig. 2-11. Board cultures

¹⁷⁵ Ward (2003:24).

The aim is a constructive, critical board culture of trust.¹⁷⁶ An underlying assumption is that:

“Trust is like air,
always necessary,
but the necessity only becomes apparent
when it’s gone.”

(Michael Pirson)

In order to create a constructive-critical culture of trust, well-tested board processes need to be put in place. Finkelstein and Mooney¹⁷⁷ developed the following guidelines based on an empirical study:

- goal 1: engage in constructive conflict
- goal 2: avoid destructive conflict
- goal 3: work together as a team
- goal 4: know the appropriate level of strategic involvement
- goal 5: address decisions comprehensively.

The question is how board members and senior managers communicate both within their peer groups and with each other. Socio-grams¹⁷⁸ or 360°, cooperative rules (see Fig. 2-12) can be very useful in ascertaining the nature of the interactions between board members and senior managers.

I have developed and implemented the following practical exercise: all board members are asked to record what they like best about cooperation with each other within the board team on a yellow “Post-It” note and what they like least about their cooperation with each other on a red “Post It” note.

¹⁷⁶ “Following the collapse of such great companies as Enron, Tyco and Worldcom, much attention turned to the companies’ boards. Yet a close examination of these boards has revealed no broad pattern of incompetence or corruption. In fact, the boards followed most of the accepted standards of board operations... However, what distinguishes exemplary boards isn’t just following key structural tactics, but rather creating robust effective social systems. The key to generating such a team includes creating a climate of trust and candor, fostering a culture of open dissent, utilizing a fluid portfolio of roles...” Sonnenfeld (2002:16).

¹⁷⁷ See Finkelstein and Mooney (2003) on p. 101 or the checklist for effective board processes.

¹⁷⁸ See Macus (2002).

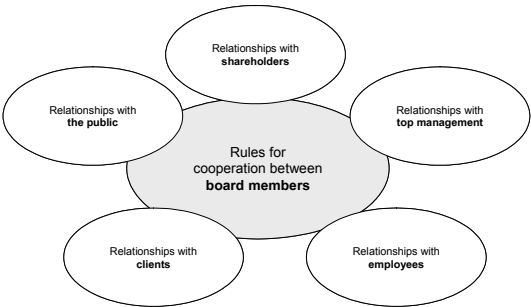


Fig. 2-12. 360°, cooperative rules of boards

Then a yin-yang rule is developed for each problematic issue (see Fig. 2-13). These cooperative rules, which may also be developed for the intended relationship towards other stakeholder groups (see Fig. 2-12), form the basis of every day board communication.

If a member of the board violates any of the cooperative rules during the meeting, anybody attending the meeting may draw attention to the fact, for example by holding up a red “Post It” note with the number of the rule that has been violated.

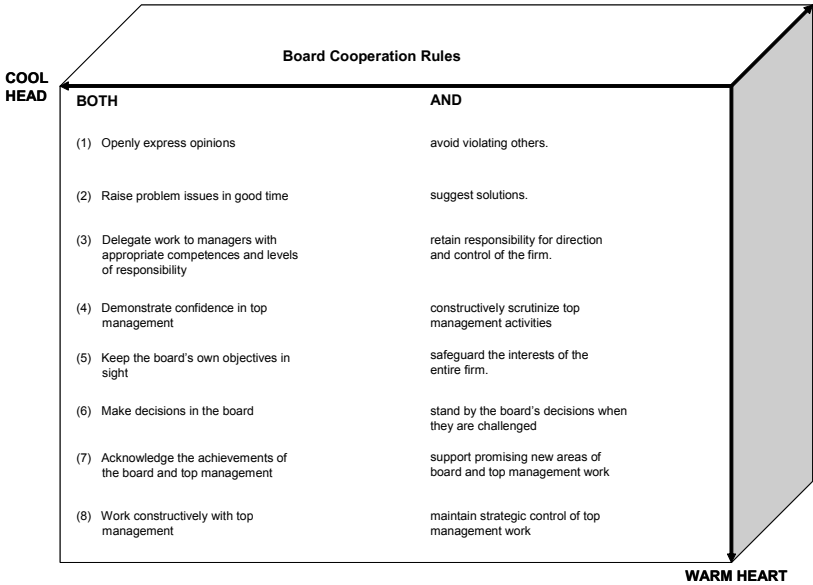


Fig. 2-13. Example of yin-yang rules for board cooperation

To illustrate this approach, the next section depicts a real-life situation from my own experience.

Illustrative Case Study for Part 2: Keep it Strategic

(All identifying data and names have been changed in this living case.)

Jacques Ferrier, Chairman of the Board of M-Tec International, is concerned that the aftermath of a recent M-Tec acquisition is threatening to tear his board apart and cause considerable damage to the company.

M-Tec International

M-Tec is a high-tech computer company based in Geneva, Switzerland, with a post-acquisition turnover of CHF 320 million, 650 employees and a 2002 listing on the Swiss stock exchange. The appointment of a new Chairman (Ferrier) and CEO (Suter) in quick succession in 1998 proved highly beneficial to the company, and despite the tough market conditions prevailing in 2002, M-Tec shares have traded at values consistently higher than the listing price. The recent acquisition of a rival business of equal size with highly complementary products and markets resulted in an additional, positive movement in the share price.

The Conflict

Despite the positive performance, however, a major challenge has arisen at the board level. The recent acquisition caused a division of the board into two camps. The Chairman, the CEO and the CFO supported the acquisition. They acted on the advice of a lawyer specialized in economics who studied the acquisition in some detail and who indicated that the acquisition could bring positive value for M-Tec.

Three directors opposed the acquisition based on their conviction that the costs of integrating two companies are frequently underestimated and that the purchase price was therefore too high. All three directors opposing the acquisition were important shareholders in the company.

In order to make the acquisition decision under intense time pressure, the seventh director – himself a pioneering entrepreneur – received a call while on a trip in the United States. He supported the acquisition based on the threat of losing the opportunity to another rival company.

After the split vote, a serious tension became apparent between the two groups of directors. In every meeting, the CEO and board members supporting the acquisition were challenged with questions about the decision, and they felt the attacks to be unjustified.

One board member opposed to the acquisition was particularly critical, and his comments appeared to provoke emotional reactions that threatened the board's ability to function in the best interests of the company.

The Leadership

Jacques Ferrier (65) has an impressive track record as a pioneering entrepreneur. He began his career as an apprentice in a bank, obtained his A-levels and then a degree in economics from the University of Neuenburg, Switzerland. He held various sales, marketing and management positions in an international commercial enterprise with its head office in Lausanne and branches in Rio and New York and then, at the age of 35, he decided to open his own logistics company. Within 20 years, he succeeded in building up a concern with an annual turnover of CHF 250 million and 480 employees in eight companies in eight different countries.

As his two daughters took no interest in the company, he sold his concern to a big German group on good terms in 1998. That same year he took up the position of Chairman of the Board of Directors at Banque Régionale Vaudoise (BRV) in Lausanne and became a member of the Board of Directors at M-Tec International.

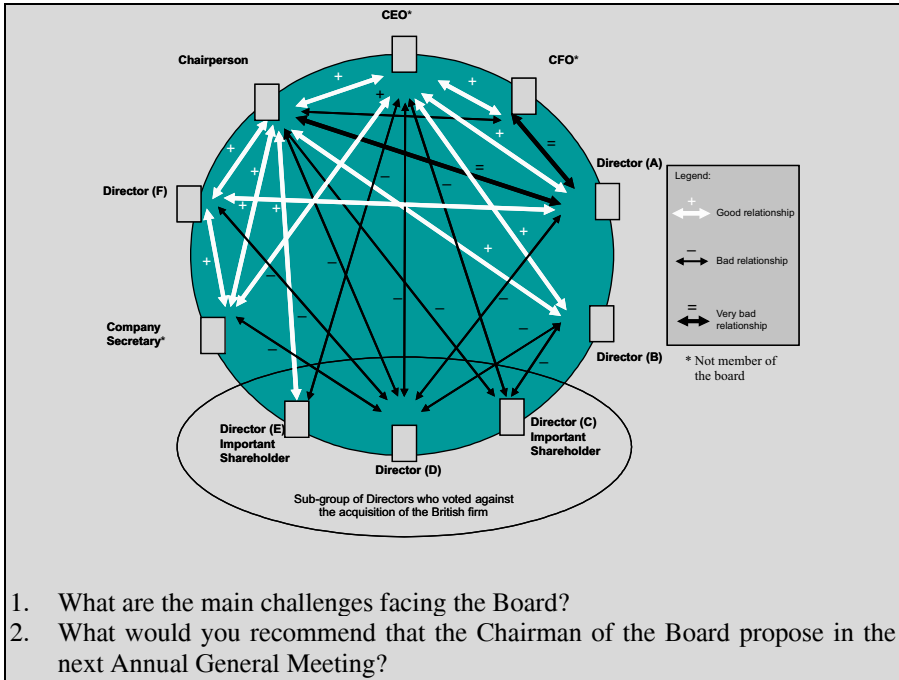
During the first board meetings at M-Tec International, Ferrier was exposed to the unprofessional leadership by Chairperson and CEO, Jean Marmier. When Marmier was dismissed by the three families owning the greater part of M-Tec International, Ferrier was asked to take over his position.

Ferrier undertook two major tasks in his first months as Chairman and CEO. He appointed an American consulting firm to do a comprehensive analysis of the company. The results of the consulting analysis were sobering. He also asked an executive search firm from Geneva to find a new CEO. His search led him to Dr. Marc Suter within just three months. The company was now back on track again.

Suter graduated with a doctorate in informatics from the ETH in Lausanne, and an MBA from the IMD in Lausanne. After his graduation, he established a successful career with an American producer of computer hardware with offices in Zurich, New York and Tokyo and finally became director for Central Europe. As part of the executive search process, Suter was given the opportunity to study the consulting report into the state of M-Tec. He was fascinated by the results and convinced the search consultants that he would be able to effect fundamental changes in M-Tec. In fact, over a period of three years, and in cooperation with Ferrier, Suter turned the company into a successful high-tech business.

Problem Analysis

Ferrier's concern about the viability of the Board has led him to contact you for advice on how the conflict should be managed. He has assured you access to all the Board members. Through preliminary discussions with both board members and top managers, the following illustration of relationships among the company leaders has been generated.



This case study demonstrates that, aside from board processes, board structure and composition are also of critical importance.

2.3 Networked Board Structure

When board teams are too large “inside-the-boardroom free-rider”¹⁷⁹ risks exist. When board teams are too small, however, there is the danger of too great an intimacy.¹⁸⁰

My experience has shown that, ideally, a small company should have three board members, a medium-sized one five, and a large concern seven.

¹⁷⁹ See Healy (2003:154): “The board’s large size... increased the inside-the-boardroom free-rider problem. (Why prepare if I’m a small player inside the boardroom?)” See also Fields and Keys (2003:16), who find that investors place higher value on earnings for companies with a small board. Australian and New Zealander firms are exemplary in that they have an average board size of seven (Healy, 2003:154).

¹⁸⁰ Malik (2002).

In each case, each member should be selected to fulfill criteria relevant to the firm.

I recommend neither a large, representative board (as proposed by Senn) nor a small, professional board (as proposed by Ebner). Instead, I recommend a deliberately selected, strategic, diverse, accountable *directing and controlling* board of three, five or seven members depending on the size of company (Fig. 2-14).

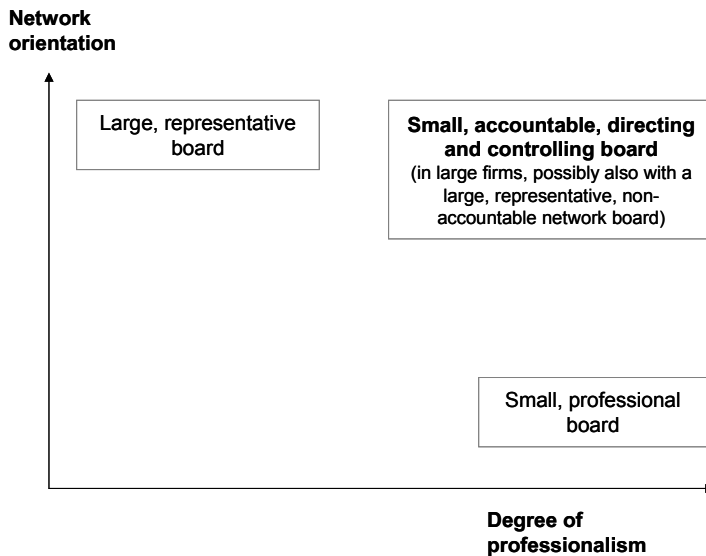


Fig. 2-14. The directing and controlling board

For large companies it may be helpful to also establish a large, representative, but not legally accountable networking board. Such a board could be made up of highly acclaimed portfolio partners from various relevant stakeholder groups with relevant know-how who cooperate on projects under the supervision of board members.

Although three committees are the recommended norm, I usually recommend only two sub-committees, which may be modified to fit a company's context and sign:

- an integrated audit and risk management committee and
- an integrated board management committee responsible for targeted nomination, feedback, remuneration and development of the board and top management.

In contrast to many national best-practice guidelines (which recommend separate nomination and remuneration committees), I propose an integrated committee which nominates, evaluates, remunerates, develops and (if necessary) votes out chairpersons, members of the board, members of committees and top managers.

If a company wants to keep separate remuneration and nomination committees, I recommend that the same members be nominated to each committee.

The chairpersons of the sub-committees should be independent (free of conflicts of interest) have well-founded professional know-how and experience as well as a proven track record in the relevant field (i.e. audit and risk management or recruitment and remuneration respectively).

In international firms, an important issue is how boards of the parent company work with subsidiaries. In this regard, four different approaches can be identified (see Fig. 2-15):

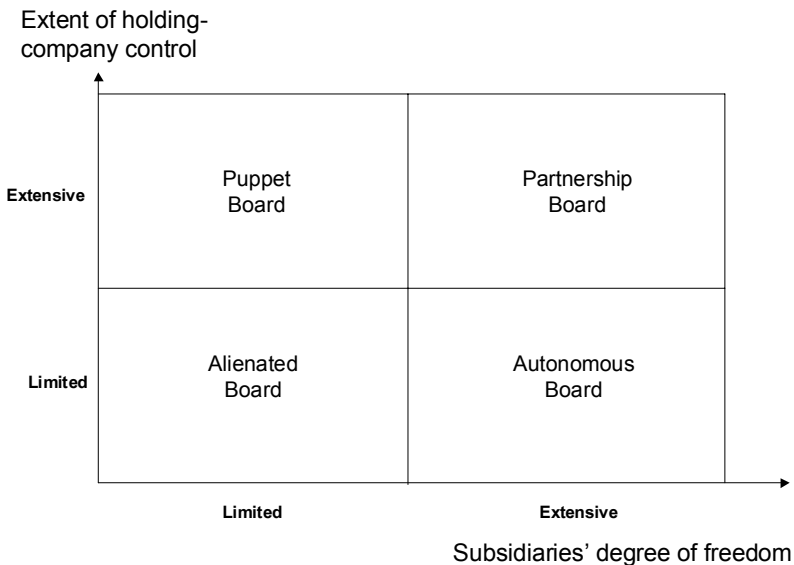


Fig. 2-15. Tension between control by the central board and degree of freedom offered to subsidiary boards¹⁸¹

¹⁸¹ See the "PA" approach (2000).

Subsidiary boards are frequently not more than “Puppet boards.” Their directors merely fulfill the requirements of local law. What distinguishes more advanced board approaches is that balance of control and freedom – based on partnership – that is necessary to achieve synergies in the functioning of both boards. The composition of the board and the board culture, structure and success measures have to be in alignment. (See “Subsidiary Governance” Box in Chapt. 1.2.5).

In the next sub-section, I present this idea using the “matrioshka” approach. It involves:

- normative, top-down, forward-looking direction from the board and top management of the holding company
- strategic, horizontal integration of the board and management of the subsidiaries
- and operational, bottom-up performance improvement from management and boards of the subsidiaries.

2.4 Stakeholder-Oriented Board Success Measures

Besides the HOW question (how do we cooperate with each other in the board?) and the WHICH question (which board structures are appropriate?), the WHAT question (what is the enduring, differentiating factor that distinguishes our company from our most important competitors?) has to be asked.

Strategic corporate (entrepreneurial) success measures established between board and management are traditionally drawn up and considered as in Fig. 2-17.

I share Rindova’s view that “Corporate governance researchers who argue that directors’ contribution to strategy are limited by their lack of information, time and firm-specific knowledge ignore the importance of director’s general expertise in enabling them to make important contributions to strategy.”¹⁸²

¹⁸² Rindova (1999).

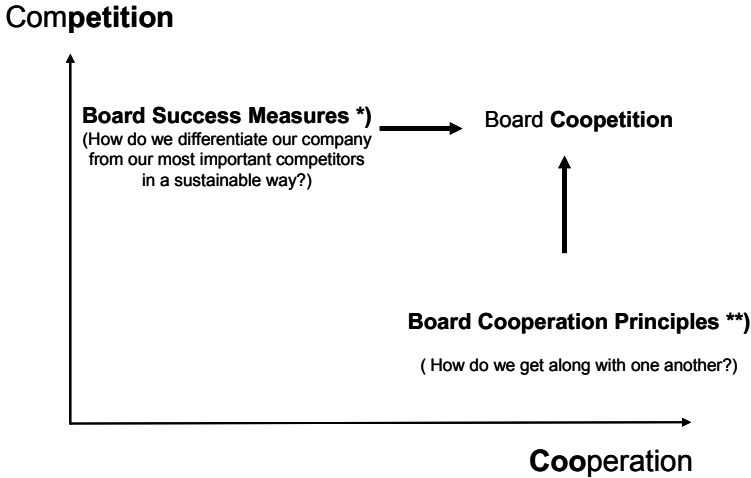


Fig. 2-16. “Coopetition” is the successful balance of cooperation and competition in the board

*) See example on page 105/**) See example on page 92.

	Phase 1 Initiation	Phase 2 Ratification	Phase 3 Implementation	Phase 4 Monitoring
Board		X		X
Management	X		X	

Fig. 2-17. Traditional strategic roles of board and top management¹⁸³

“The contribution of the (deliberately targeted) board members in strategy development should not be underestimated. Their extensive experience (demonstrated by their track record) and their less detailed perspective (relative to management) allow them to play an important strategic role.”¹⁸⁴

I hold that strategy initiation (or the development of success measures) requires the involvement of both the board and top management (see Fig. 2-18).

¹⁸³ Fama and Jensen (1983).

¹⁸⁴ Keller (2002).

In Switzerland, some of the most important and non-transferable functions of the board of directors are determining and monitoring strategy (according to article 716a paragraph 1 OR). This contrasts with the responsibilities of, for example, German boards of directors.

Though this does not mean that the board is required to develop firm strategy itself, corporate crises such as Swissair indicate a need to rethink the roles of boards and top managers, chairpersons and CEOs. The chairperson can play a key role in initiating such thinking and giving impetus to change initiatives.

Phase Level		Phase 1	Phase 2	Phase 3	Phase 4	Phase 5
		Value Creation	Strategy Development	Strategy Ratification	Strategy Implementation	Strategy Monitoring
Board	Normative	X		X		X
	Strategic		X			
Management			X			
	Operational				X	

Fig. 2-18. Cooperative strategy initiation

In developing strategies, according to Wunderer,¹⁸⁶ the chairperson has to do the following:

- observing and influencing strategic issues
- encouraging strategic adaptations
- stimulating a visionary and strategic perspective instead of a planning perspective
- contributing at both content and methodological levels

¹⁸⁵ Adapted from Fama and Jensen (1983).

¹⁸⁶ Wunderer (1995) and Westphal and Frederickson (2001).

- promoting the strategy process in a powerful way
- encouraging board members to make contributions
- ensuring timely distribution of information to board members
- moderating controversial strategic discussions and
- watching over the development and implementation processes, checking the validity of premises and reaching strategic landmarks and final objectives.

A clear delineation of the roles of top management and the board is essential. “The directors are responsible for setting the overall vision and long-term direction of the company, including risk and return expectations and long-term financial goals. Management’s primary job is to develop and implement an appropriate growth strategy that responds to the board’s direction.”¹⁸⁷

A common breakdown of roles is as follows:

Phase 1: Strategy Development

1. Based on the board’s approved vision of business (WHAT?), the management develops the basis of strategy (HOW?) and offers various appropriate alternatives with positive and negative scenarios.
2. The board critically analyzes the current state of the firm, and the proposed strategies using an extensive trend, competitor and SWOT analysis in close cooperation with management.

Phase 2: Ratification of Strategy

3. The board approves the strategy that promises most enduring value for the relevant share- and stakeholder groups and that is achievable given its resource requirements.
4. All board decisions are recorded concisely, important milestones in implementation are identified, and key data requirements are specified for all relevant stakeholder groups.

¹⁸⁷ Beatty (2003:18).

Phase 3: Implementation of Strategy

5. The management converts the strategy into action in a focused and contextually appropriate manner, using the matrioshka approach.

Phase 4: Monitoring Strategy Implementation

6. In every board meeting, the board monitors key indicators and progress with respect to important milestones so as to introduce appropriate interventions if there is significant divergence from the approved strategy.
7. The board concisely records the details of proposed interventions and initiates them.

The following questions may serve as a checklist for developing and monitoring strategy¹⁸⁸:

- “Has a regular strategy check been institutionalized?”
- Are the strategy proposals based on a well-grounded company analysis?
- Have the environmental conditions been taken into consideration, and are they correct and relevant?
- Are possible changes in the business environment being monitored, and have they been incorporated in the strategy process?
- Are strategy proposals comprehensive?
- Have fundamental requirements of the vision been addressed?
- Do the strategies meet the objectives set for the mid- and long-term?
- Are the strategies free of internal inconsistencies?
- Do the new strategies improve the long-term value creation potential and competitiveness of the firm?
- Do the strategies seem realistic?
- Are the strategies ethically appropriate and legally sound?
- Are the financial implications of strategies included in the plans?
- Are the negative consequences of the worst case scenario bearable for the company and not ruinous?”

¹⁸⁸ Chini (1986) and Guy (1999).

For these strategic questions to be addressed, though, it is essential that the board members have been selected in a deliberate, targeted way, that the board operates in a culture of trust and through an effective structure, and that there is a clear differentiation between the normative function of the board and the operational responsibilities of top management.

Concerning the time-horizons of strategic interest, a board should agree on an appropriate breakdown of time spent on each relevant horizon (following the IMD approach¹⁸⁹), for example:

- 20 % on questions relating to the past
- 20% on questions relating to the present
- 40 % on questions relating to the immediate and near future (up to three years)
- and 20% on questions relating to the long-term future of the firm (five years or more).

All of these questions – looking back, considering the present, looking forward – include issues such as market position, innovation, labor productivity, capital requirements, time and knowledge, attractiveness in the labor market, liquidity, cash flow and profit compared with relevant competitors.¹⁹⁰

I introduce the matrioshka approach in practical settings as follows:



¹⁸⁹ See Abdel (2001).

¹⁹⁰ See Malik (1998); Beatty (2003:18) also suggests that in addition to annual board strategy workshops, boards review recent developments that could impact on the strategy at each board meeting.

Both the board and management of the corporate head office have developed measurable objectives concerning the company (the outer doll); these success standards set the “crash barriers” or boundaries for subsidiary or branch activities.

If these boundaries are not appropriate for the contexts of branches or subsidiaries (represented by the inside dolls), the company’s objectives and success measures will appear “hollow” to the local board members and management and will fail their central goal of creating meaning.

Feedback mechanisms must be included in this system of overlapping board and management teams in order to ensure that suggestions for improvement are fed into the appropriate contexts. To make the vision play a central role in the development of the firm, another two factors are critical: first, an impartial analysis of the company’s external and internal worlds; and second, the development of action plans, success measures and guiding principles derived from the vision that are relevant to every sub-unit of the company.

The following statement¹⁹¹ is an example of a normative guiding principle:

“The primary role of the board of this company is to help create long term value for its shareholders, customers, employees and society. The board believes that the company should rank in the top quartile of peer companies in total shareholder return (including the cost of capital), as well as in voluntary loyalty levels of customers, employees and society as measured over three and five year periods.”

¹⁹¹ This opinion contrasts with the usual shareholder-value maximization statements made, for example by Pitman in Garratt (2003:xxv).

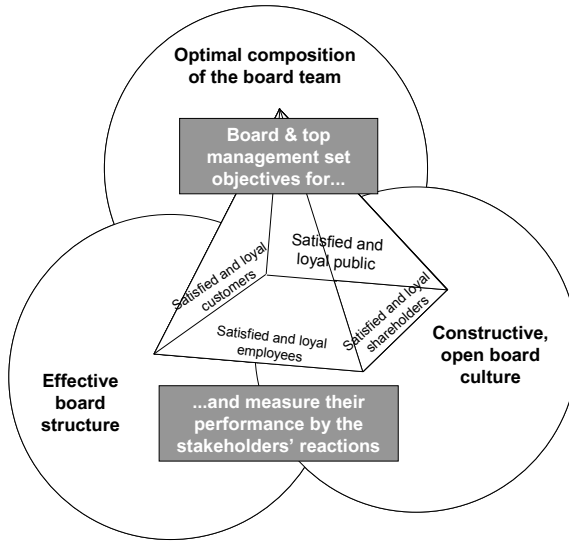


Fig. 2-19. Requirements and dimensions of company objectives

This strategic direction function is the basis for the targeted selection, evaluation, remuneration and development of board members and top management which will be described in more detail in Part 3 of this book.

PART 3

Integrated Board Management Dimension

Keep it integrated

Based on analyzes of board practices carried out by the doctoral students, the following weaknesses have been found in the majority of the companies assessed:

1. insufficient board attention given to strategic direction
2. a lack of professionalism in selection, feedback, remuneration and development of board members and top management and
3. limited or irregular review of the performance of the board, coupled with insufficient strategic control and risk management by the board.

In order to address these weaknesses, I propose an integrated board management concept (illustrated in Fig. 3-1).

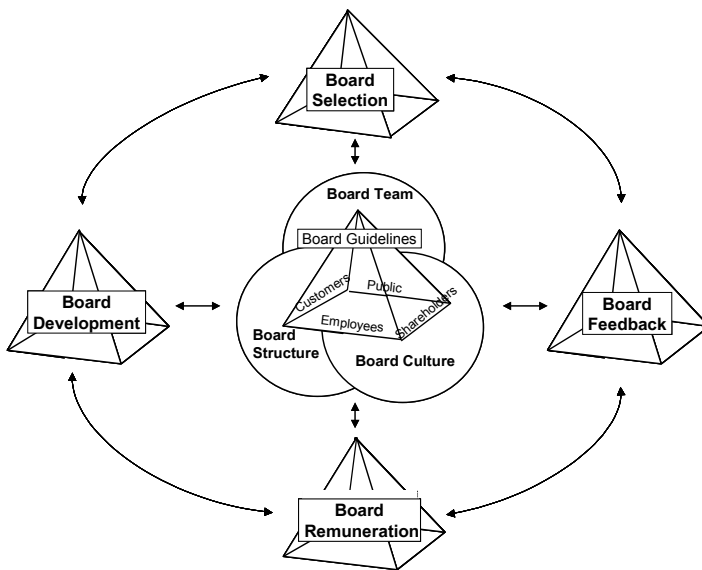


Fig. 3-1. Integrated board management (HR Governance)

This concept comprises three dimensions:

1. The strategic elements that are the focus of attention (as discussed in Part 2), remain:
 - exemplary board team
 - constructive, open board culture
 - effective board structure and

- stakeholder-oriented board success standards.
- 2. The main processes of the integrated cycle concept presented in this chapter are:
 - selection and composition
 - review and feedback
 - remuneration and
 - development.
- 3. Using an evaluation methodology (described in Sect. 4.4) the success of board work is checked regularly.

This concept fits in with the modified “KISS” principle,¹⁹² which forms the basis of Parts 2, 3 and 4 of this book:

K eep it
I ntegrated
S trategic, and
S timulating

The most important board management instruments need to be aligned with the firm’s objectives in a holistic way, and they need to involve all relevant share- and stakeholder groups in development, implementation and evaluation.

This concept ensures that the processes of selection, performance management, reward and development of board members and top managers offer added value for all stakeholder groups.

The following four elements apply to integrated board management in small and medium-sized enterprises (SMEs) without committees, as well as to larger public companies (with an integrated board management committee, as discussed in Sect. 3.5).

¹⁹² I differentiate between three versions of the KISS principle:

- the codex from the United States, “Keep it simple and stupid”.
- my reinterpretation of that codex, presented in a 1995 book on Integrated HR Management and here as the basis for Part 2, 3 and 4.
- the reversed KISS principle presented in this book: “Keep it situational, strategic, integrated and controlled.”

3.1 Targeted Selection of Board Members

First in the cycle of integrated board management, is the deliberate selection of board members based on know-how, commitment and team role.

Quite frequently, the question arises as to whether there are enough recruits for the board who satisfy these criteria. Böckli, a renowned Swiss expert on corporate governance, addressed the difficult challenge of selection by suggesting that an ideal board member:

BOTH...	...AND
Has no conflicts of interest	has broad, practical experience in different firms
Is an independent, outside member	has an intimate knowledge of the firm
Has a track record of long-standing international business success	is not a CEO of another institution
Has time to be a committed board member	has other independent board seats
Is not paid too highly	commits enough time to preparation and attendance of board meetings & workshops, and to passing on implicit know-how
Is already as well-off as possible	is not dependent on the board position
Takes on personal risk as a board member	has unlimited solidarity with firm performance

Fig. 3-2. Contrasting requirements of board members

In fact it is often difficult to find the right board members. I have developed and implemented the following ten-step approach to professional selection of board members.

My approach is illustrated by an example of a professional search for a new chairperson of the board at an international company whose founder-chairperson wants to resign on grounds of his age in the next year's General Meeting.

Phase 1: Determination of the Main Tasks of the Board of Directors

First, the tasks of the chairperson, the board committees and the full board of directors must be determined (see Fig. 3-3).

Responsible Person/s Main Tasks	Chair	Committees		Board	Time commitment to the main tasks of the board
		Audit & Risk Management Committee	Nomination, Review, Remuneration & Development Committee		
1) Direct leadership of the board and CEO (<i>Coaching</i>)	X				20%
2) Indirect leadership of members of the board and top management (<i>Board management</i>)			X (Proposal)	X (Approval)	20%
3) Strategic direction and forward planning (<i>Strategic direction</i>)	X			X	30%
4) Strategic review of past performance & Risk Management (<i>Strategic control</i>)		X (Proposal)		X (Approval)	20%
5) Managing relationships with shareholders, employees, partners, analysts, customers, the media, and the public. (<i>Relationship management</i>)	X			X	10%
For example, an average of 2 days per week for the chairperson	X				100%

Fig. 3-3. Breakdown of the main tasks of the board

Phase 2: Determination of Main Tasks of the New Chairperson of the Board

Based on the breakdown of the main tasks of the board, the main tasks of the incoming chairperson are determined by the outgoing chairperson and the nomination committee (see Fig. 3-5). In determining the tasks of the chairperson, the time commitment required must be considered. Such commitments are dependent on the extent, diversity and complexity of the tasks assigned to the chairperson. Fig. 3-4 depicts the time that could be anticipated for different degrees of involvement.

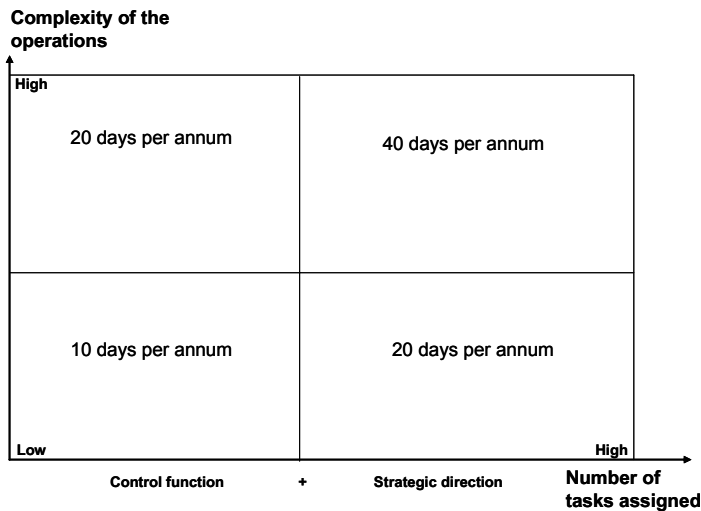


Fig. 3-4. Days per annum required from the chairperson for different levels of involvement¹⁹³

¹⁹³ Adapted from a model developed for minimum time commitments required of US chairpersons by Carter and Lorsch (2004:78).

(A) Coaching • Holding efficient board meetings • Overseeing the process of establishing meeting agendas and the schedule of meetings of the board • The right to cast the deciding vote on a board decision • Right to attend management meetings • Role of chairperson in branches
(B) Indirect Leadership • Guarantee professional election and voting out of office of board members, board committee members and top management positions • Carry out constructive and impartial valuations of board members, board committees and top management • Ensure as much as possible fair remuneration of board members, members of board committees and top managers • Ensure targeted development of board members and top management • Conduct periodic internal and external evaluation of board performance
(C) Strategic Direction • Ensure that the firm's normative and strategic aims are supported and upheld by board members, top management and personnel • Monitor decision-making processes at important milestones

Fig. 3-5. Main tasks of the new chairperson

(D) Strategic Control

- Address deviations from targets in important decisions concerning the company
- Ensure that all relevant materials and documents are available to board members in a timely manner
- Ensure that all necessary professional audit and risk management activities are carried out at the board level

(E) Relationship Management

- Building and maintaining a culture of open, constructive criticism and trust within the board, the board committees and between the board and top management
- Cultivating professional relationships with shareholders, employees, customers, partners, investors, media representatives and the public.

Fig. 3-6. Main tasks of the new chairperson (cont'd.)**Phase 3: Know-How and Distribution of Roles in the New Board**

The optimal distribution of know-how and team roles in the new board is also based on the distribution of the main tasks and responsibilities of the board (see Fig. 3-6):

Board team roles	Creative (CEO)	Coach (Chair)	Con- structive critic	Con- troller	De- veloper	Organizer (Co. Secr.)
Board know-how						
International Market (Europe/Asia/Americas)	X					
Alliance Management		X				
Biotechnology			X			
Audit & Risk Management				X		
Selection/Feedback/ Reward/ Development					X	
Compliance						X

Fig. 3-7. Optimal selection of a board of five members and a board secretary, based on company relevant criteria

It is important to choose the roles, know-how and personalities of the chairperson and the CEO such that they complement one another.

Phase 4: Determining the Chairperson's Job Profile

The new chairperson's job profile (see Fig. 3-8) is defined on the basis of main tasks (Fig. 3-6) and role definitions (Fig. 3-7).¹⁹⁴

I use a simple method that differentiates along four dimensions of competence:

- personality
- know-how
- social and
- leadership.

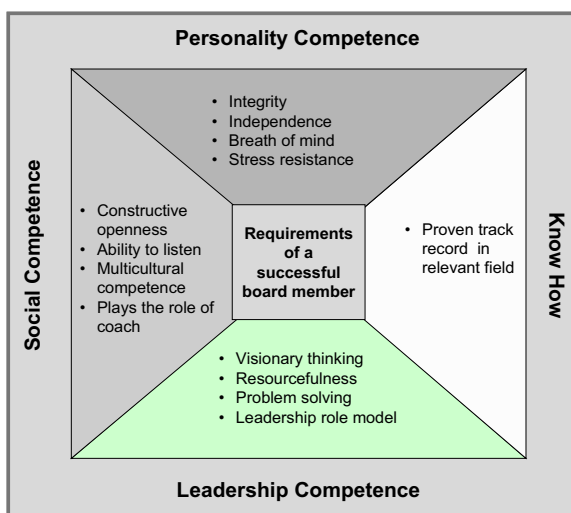


Fig. 3-8. Job profile of a new chairperson

¹⁹⁴ See Beatty (2003:7), who recommends that a chairperson “devote time to serve effectively by not committing to too many other corporate and non-profit boards.”

Phase 5: Development of a Recruiting Process

Define the process by which the nomination committee will identify possible candidates for the role of chairperson, both within and outside the organization.

Depending on the situation, it is possible that an inside candidate is nominated, that outside candidates are nominated by committee and board members or that an independent outside board search consultant is asked to prepare a list of possible candidates.

Phase 6: Systematic Structuring of the Selection Process

A simple matrix (see Fig. 3-9 as an example) could be used to record the connection between board specific job criteria and interviewers.

Interviewer Time	Chairperson	Board member	Board member	Score
	9:00	10:00	11:00	
Evaluation criteria				
<u>Personality competence</u>				
- Integrity	X	X		
- Independence	X	X		
- Breadth of mind	X		X	
- Entrepreneurial nature	X	X		
<u>Know-how</u>				
- International market experience		X	X	
- Track record of board experience		X	X	
- Profound marketing experience	X	X		
- Mastery of relevant languages		X	X	
<u>Leadership competence</u>				
- Role model lifestyle	X		X	
- Visionary thinker		X	X	
- Problem solver		X	X	
- Resourcefulness	X		X	
<u>Social competence</u>				
- Constructive openness	X	X		
- Ability to listen		X	X	
- Multi-cultural competence	X		X	
- Team-role: coach		X	X	

Fig. 3-9. Example of an interview matrix for potential new chairpersons

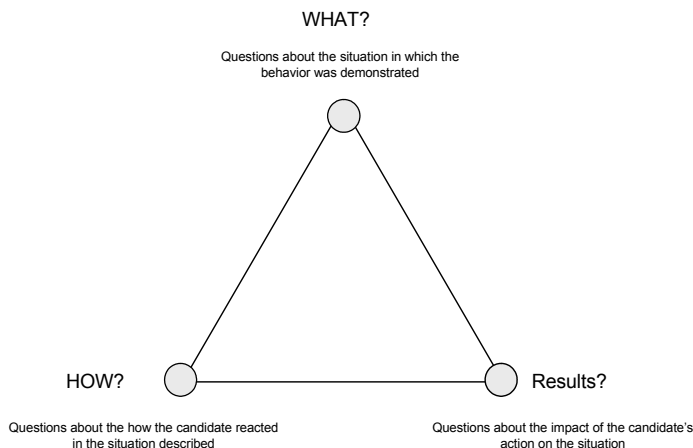


Fig. 3-10. Triangle of questions on board selection

At least three interviewers (in our case the present chairperson and two committee members) should separately interview candidates for the new chairperson.

In order to get objective results of interviews, each job criteria should be controlled by two separate interviewers at least.

“Behavior triangle”¹⁹⁵ questions can be asked for each evaluation criterion (see Fig. 3-10).

In practice, provocative, theoretical and yes/no questions still prevail. So, a skillful board candidate will give a theoretical answer to the theoretical question, “What is your strongest point?”

A questioning technique that explores actual past behavior is likely to be more productive. For example, in order to explore integrity, the questions could be:

- What was the most intense conflict of interests you had to cope with in your company in the last two years?
- How did you solve the conflict?
- What were the consequences of your action?

¹⁹⁵ In this regard, see Byham’s (1977) “targeted selection” interview method.

Phase 7: Selection Committee Processes Candidates' Information

In order to reach a consensus decision, the following process could be followed:

- Each committee member rates the aptitude of the candidate according to criteria agreed upon beforehand on a scale of 1 to 5, where
 - 5 = far above average
 - 4 = above average
 - 3 = average
 - 2 = below average
 - 1 = far below average
- In a short meeting, the interviewers discuss the scores, and, in cases where results differ, they back up their opinions using the “behavior triangle” framework.
- Then the interviewers try to agree on a combined score for each of the evaluation criteria. Where there is uncertainty regarding aspects of candidates' profiles, further inquiries should be made.

Phase 8: Study Applicants' References

By mutual agreement with the applicant, and in countries where this is possible, it is recommended that references be obtained for the applicants. Then the technique illustrated in Fig. 3-10 should be applied again, with particular focus on the criteria in which the interviewers scores were different.

Phase 9: Presenting the Candidate to the Board and Top Management

The best candidate is now introduced to the board and questions may be asked by the directors and by the candidate. If a consensus is reached with the board, and with input from the top management, the candidate is proposed as the new chairperson of the board.

Phase 10: Induction of the New Chairman

A professional board selection is finalized with the induction of the new chairperson into the company, the board and the management. For illustration purposes, the program for such an induction process followed by a Canadian company is presented in Fig. 3-11.

8:45	Welcome and agenda review
8:45–10:15	Corporate overview (company history, legal framework and business structure)
10:15–10:30	Break
10:30–11:00	Corporate plan overview
11:00–11:30	Review of mission, vision and values; strategic direction; structure; distribution; products and services
11:30–12:00	Corporate finance overview
12:00– 1:30	Lunch with board and senior management
1:30– 2:30	Role of the director (governance model, liabilities, board policy manual and info sources)
2:30– 3:00	Corporate affairs overview
3:00– 3:30	Board functions (work plan und meeting schedule, evaluations, individual evaluations, board training and development, chair and CEO evaluation, corporate secretary evaluation)
3:30– 3:45	Board and shareholder communication and services
3:45– 4:00	Wrap-up and follow-up questions

Fig. 3-11. Example of induction of a new board member¹⁹⁶

Illustrative Case Study for Part 3: Keep it Integrated

Michael Miller is the founder of a successful international high tech company in the medical field. His company operates worldwide, and has annual sales of 420 million Euros. The Headquarters is located in Zurich and total staff includes 6,500, 90% of which are outside of Switzerland.

In 2002, Michael Miller's company was successful in acquiring Phamtex International, another family owned company, headquartered in Forth Worth, Texas.

Phamtex was the biggest competitor with similar sales and headcount figures. The owner had no successor and therefore wanted to sell the company.

Miller offered the CEO position for the new merged company to Michael Kennedy who was the former successful CEO of Phamtex.

¹⁹⁶ Ward (2003:63). See also Cray (1999).

Kennedy accepted the offer under the condition that he remained in Forth Worth and suggested to manage the organization one week from Forth Worth and one week from Zurich.

Miller agreed with this and the merged company continued to be very successful.

Suddenly, Michael Miller realized that he had no successor for Michael Kennedy in case of his leave. This was a great risk, because it takes at least one year for an outsider to get familiarized with the sophisticated high tech products of the company.

Michael Miller asks for your advice. What would you recommend to him?

3.2 Targeted Feedback for Board Members

Board feedback aims to meet two objectives:

1. Supporting and developing the motivation of board members to act in the interest of the firm, and
2. Enhancing the professional and role competence of board members.

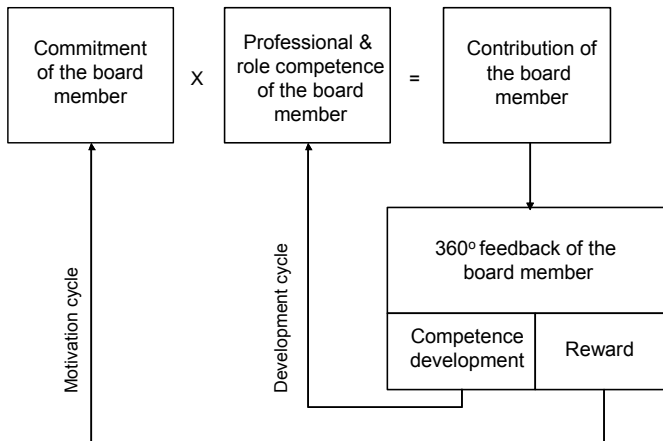


Fig. 3-12. Cyclic board feedback

Formal performance assessments of personnel are conducted in many companies. Sometimes they are conducted with CEOs and members of top management, but they are not usually conducted with board members.

I prefer self-assessment and informal feedback talks between the chairperson and board members to external or more formal assessments. Assessment talks usually only take place (in unprofessional board management situations) when a member is about to resign or when a severance package is to be negotiated.

If board members are selected in a targeted and professional manner, simple feedback mechanisms should be agreed upon and instituted by the board team. Ideal feedback mechanisms are nothing like assessment talks. Rather, they involve a dialogue among board members that relates directly to justifiable reward packages and development processes.

As an example, every year the board could formulate a central aim for all board members. In addition, each board member agrees on individual goals together with the chairperson. At the end of the year a feedback dialogue could be held between the chairperson and each board member. The chairperson would then present feedback based on input from top management and other board members or perhaps based on contact with relevant customers, shareholders, personnel and members of the public.

Based on the comparison of the self and external evaluations and on the extent to which board members have reached their personal and collective objectives, implications for reward and development are drawn for the following year in office.

This system places high demands on chairpersons and board members and should only be introduced when the board team

- is not too big and is ideally composed
- maintains a constructive, open culture of trust
- has agreed on stakeholder-oriented board success measures and
- a well established reward and development system.

Another possibility for review is as follows:

- each board member can elect to have a 360° feedback¹⁹⁷ assessment by an unbiased consulting firm on a voluntary basis and
- each board member can decide to whom a brief feedback questionnaire should be sent for analysis (see for example Fig. 3-13).

Self- and external evaluation of board members (Confidential)					
3= exemplary 2= acceptable 1= should be improved					
Criteria	Board members				
	A	B	C	D	E
1. Meeting preparation – thorough study of support documents					
2. Constructive, open contributions					
3. Attention to contributions from other members					
4. Critical scrutiny of the CEO's decisions & action					
5. Strategic thinking					
6. Freedom from conflicts of interest					
7. Deep knowledge of finance and auditing					
8. Integrity					

Fig. 3-13. Brief board feedback questionnaire

There are three domains of feedback, as illustrated in Fig. 3-14.

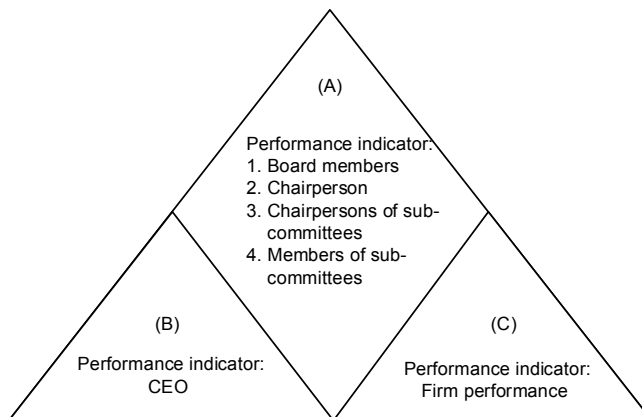


Fig. 3-14. Feedback on various performance indicators

¹⁹⁷ See Beatty (2003:33).

The **company performance indicators (C)** will be discussed in Sect. 4.4.

The **collective board performance (A)** is illustrated in the following real-life example, which is based on the board evaluation concept by Medronic.¹⁹⁸

Evaluation of Collective Board Performance					
Each question should be evaluated by each board member with the following point system:					
Needs improvement		Satisfactory		Excellent	
1	2	3	4	5	6
(1) All board members review long-range strategy in sufficient detail and either make suggestions for improving it or approve the strategy.					
Comments:					Score
(2) The board takes an active role in the formulation of long term financial goals and monitors progress effectiveness during each year.					
Comments:					Score
(3) The board has established an effective board committee structure that ensures time for focusing clearly on key.					
Comments:					Score
(4) The assignments given to board committees allow members to focus on important details while enabling the entire board to focus on core strategic matters.					
Comments:					Score
(5) The board evaluates the process of search for- and selection of new board members in an effective way.					
Comments:					Score

Fig. 3-15. Example of a board review questionnaire

¹⁹⁸ See Lorsch and Spaulding (1999:11ff), and George (2002:22f).

(6)	The board is properly structured and prepared to act in case of an unforeseen company crisis.	
	Comments:	_____
		Score
(7)	The board has sufficient resources and information to be able to approve major compensation plans (compensation of chairperson, board members, CEO and top executives).	
	Comments:	_____
		Score
(8)	The management evaluation process by the board is enhanced by the regular visibility of various senior management people in sufficient form and manner to have reasonable judgment in management succession, promotion and organization.	
	Comments:	_____
		Score
(9)	The board has adequate information and exposure to ensure ethical, legal and socially responsible company policies and action.	
	Comments:	_____
		Score
(10)	The chairperson manages meetings effectively.	
	Comments:	_____
		Score
(11)	The board assures that systems are in place for quality and reliability of company products and services and for corporate compliance with all applicable laws and regulations.	
	Comments:	_____
		Score
(12)	The board assures that key global corporate policies are in place worldwide and that the company complies with them.	
	Comments:	_____
		Score
(13)	In summary, how do you rate the overall performance of the board?	
	Comments:	_____
		Score

Fig. 3-15. *Continued*

Each board member assesses the team performance of the board and sub-committees based on criteria selected in a previous board workshop, and passes the assessment anonymously on to a consulting firm. Overall results are coded and aggregated and returned to the chairman, who presents them (with comparisons to the previous year's results) to all the members of the board in a meeting. The results are discussed and an action plan agreed upon for making targeted improvements, with details of who is responsible for specific actions in set timeframes.

In order to evaluate the individual performance of the board chairperson (A.2), the committee chairpersons (A.3), the members of the committees (A.4), and the board members (A.1), an anonymous internal and external evaluation may be carried out. The slightly modified Bank of Montreal¹⁹⁹ board feedback process may serve as an example.

Peer Feedback for Directors

How to complete the peer feedback for the directors survey: The method for completing the survey which has proven most convenient is to complete it by row, not by column. That is, rate all directors on the first dimension A), then rate them all on B) and so on. When reading each dimension, first ask, "Who stands out as exemplary in that regard?" Rate them as 3's. Then ask, "Who needs improvement?" Rate these as 1's. The remaining directors (those not rated a 3 or a 1) are presumed to be fully satisfactory. You do need to write in a 2 for these – blank boxes will be presumed to be 2's. If you do not feel that you have sufficient experience with an individual director to give an opinion, write "n/a."		Please use the following scale to rate your colleagues: 3 Outstanding, exceptional contribution in this regard 2 Fully satisfactory, no improvement required 1 Improvement required				
DIMENSION	CANDIDATE					
		A	B	C	D	E
A)	Demonstrates high ethical standards in his/her personal and professional dealings.					
B)	Willing to act on – and be accountable for – boardroom decisions.					
C)	Evidences diligent preparation for meetings (knows the material; has well-formulated questions).					
D)	Contributes meaningfully and knowledgeably to board discussions; provides valuable input.					
E)	Willing to express a view, even if it runs contrary to prevailing wisdom or the direction of the conversation.					

Fig. 3-16. Example of an individual director feedback questionnaire

¹⁹⁹ Beatty (2002)

F)	Shows an understanding of strategy and vision – provides strategic insight and direction; conceptualizes key trends, evaluates strategic decisions.				
G)	Demonstrates an ability to identify the costs, benefits and implication of board decisions.				
H)	Financial literacy – demonstrates a strong understanding of financial statements, ratios and other indices of performance; has grasped not only the fundamentals, but can see the issues behind the numbers.				
I)	Appropriately questions data and information presented to the board for its deliberations.				
J)	Team player – works effectively with fellow directors; tries to build consensus; manages conflict constructively.				
K)	Communicates persuasively and logically; voices concerns; raises tough questions in a manner that encourages open discussion.				
L)	Listens effectively to others' ideas and viewpoints; encourages contributions from other directors.				
M)	Has a personal track record of achievements, which lends credibility to his/her business judgment as a board member.				
N)	Effectively applies his/her knowledge, experience and expertise to issues confronting the bank				
O)	Available when needed; accessible and approachable.				
P)	Demonstrates a solid understanding of the role, responsibilities and legal duties of a director.				
Q)	Demonstrates an understanding of the distinction between governance and management and acts appropriately in his/her governance role.				
R)	Overall, makes a valuable contribution to the functioning of the board.				
If you have any specific comments – positive or negative – that you think would be helpful to pass on to one or more of your fellow directors, please write these opposite the name of the director for whom the comment is intended. A summary of these comments will be passed on to the director in his/her individual report, but the source will be anonymous. Comments, if any:					
A:					
B:					
C:					
D:					
E:					

Fig. 3-16. *Continued*

Each board member evaluates all board members (the chairperson, the chairpersons of committees, and all remaining board members including him-/herself) based on criteria selected in a board workshop and from open commentaries on the performance of each member. The questionnaires are sent to an independent consulting firm which presents the aggregated results relating to each member in a feedback talk. Board members also receive a summarized version of their own results.

The **CEO's feedback (B)** may be carried out based on a questionnaire previously agreed on by the chairperson and board members. It could also be both internal and external.

A number of possibilities exist for the review of the CEO's performance²⁰⁰:

- self-evaluation by the CEO (together with feedback from the board members based on both input and output measures of performance)
- review of the CEO's performance in a meeting with independent directors (along with the self-assessment performed by the CEO)
- combinations of the above together with anonymous reviews by outsiders
- a discussion of the anonymous outside reviews with the independent board members or
- a discussion between the Chairperson or Lead Director and the CEO, to determine which steps of action should be taken.

The following feedback questionnaire (Fig. 3-14) is also based on the CEO evaluation process at Medtronic.²⁰¹

²⁰⁰ See Carter and Lorsch (2004:160f).

²⁰¹ Lorsch et al. (1999:11f).

Chief Executive Officer Evaluation				
General function: Responsible for the success or failure of the company. Leads by providing the vision and philosophy for the company. Develops and implements strategic and operational plans to achieve the vision and oversees the operation of the company; develops management, allocates resources and ensures control. Acts as the company's chief spokesperson. Works with the board to develop policy and maintain oversight.				
Each question should be evaluated by each board member with the following point system:				
Well below expectations 1	Below expectations 2	Meets expectations 3	Above expectations 4	Well above expectations 5
(1) Leadership: The CEO leads the company with a vision which is well understood, widely supported, consistently applied and effectively implemented. The CEO is respected as a role model for principles, values and behavior.				
Comments:				Score
(2) Strategic planning: The CEO assures the development of a long-term company strategy, which establishes objectives and plans that meet the needs of customers, shareholders, employees and society. Ensures consistent and timely progress toward strategic objectives. Obtains and allocates resources consistent with strategic objectives.				
Comments:				Score
(3) Financial results: The CEO establishes appropriate annual and longer term financial objectives and manages the company to consistently achieve these goals. Ensures that appropriate systems are maintained to protect assets and maintain effective control of operations.				
Comments:				Score

Fig. 3-17. CEO evaluation scoring sheet

(4)	<u>Top management team:</u> The CEO attracts, retains, motivates and develops an effective top management team capable of achieving the company's objectives. Provides for management succession. Comments: _____ Score _____
(5)	<u>Human resources management:</u> The CEO ensures the development of effective HR recruitment, appraisal, reward, development and communications programs to provide and motivate the necessary human resources to achieve objectives. Comments: _____ Score _____
(6)	<u>Communications:</u> The CEO serves as the company's chief spokesperson, communicating effectively with all of its stakeholders. The CEO ensures that the company, and its operating units, contribute appropriately to the well-being of their communities and industries. Comments: _____ Score _____
(7)	<u>Board:</u> The CEO works closely with the board of directors to keep them fully informed on all important aspects of the status and development of the company. Facilitates the board's governance, composition and committee structure. Implements board policies and recommends policies for board consideration. Comments: _____ Score _____
Key challenges in the year ahead: _____ _____	
Thoughts and concerns: _____ _____	

Fig. 3-17. Continued

Based on the board feedback, actions have to be taken in the following two areas:

- targeted remuneration of board members (presented in Sect. 3.3)
- and targeted development of board members (presented in Sect. 3.4).

3.3 Targeted Remuneration of Board Members

In the American society, it is common for the highest paid CEOs/Chairpersons to be celebrated on the cover of business magazines.

Before the stock market and dot.com crashes occurred, for example, the winners were: Wang (gold medal), Eisner (silver medal) and Kamazin (bronze medal).



Fig. 3-18. The highest paid American CEOs and chairpersons in the year before the stock market and dot.com crashes.²⁰²

Stanford Business School professor Edward P. Lazar answers the question about whether such high remuneration really relates to a commensurate increase in firm value or personal motivation as follows: “... the CEO’s pay isn’t motivating the CEO so much – he’s already there. Rather, it’s serving to motivate the vice presidents who are competing against one another to become CEO.”

²⁰² “75% of share options issued by major companies in America went to the top five executives [in each of those companies]” Newing (2003:6).

This may be valid for a society in which many people dream about becoming the president of an organization. And as long as the American approach to remuneration – with its wide margin between highest and lowest wages – was limited to the United States, outside countries could just remain critical observers.²⁰³ However, since the merger of American, European and Asian firms built large, transatlantic enterprises, an Americanization of the European CEO and board compensation systems has become evident.

A few years ago I was invited to a large, transatlantic enterprise's hearing. The question posed to the experts was: How should we compensate our firms' top employees, now that we have discovered that European managing directors earn 2.4 times less than their American colleagues at the same level of competence?

My proposal that the European directors be transferred to the United States and that they be compensated and taxed according to US standards, was rejected! Instead, the European top executives were kept in Europe and compensated according to American standards.

Many firms with transatlantic merger or acquisition partners chose the same approach to remunerating their directors and therefore increased the average of the director's fees in Europe significantly.

The question remains: how should the remuneration of executives, chairpersons and members of boards and committees be managed in order to be fair from the points of view of the individuals remunerated, the shareholders, the employees, the clients and the public?

I have developed and implemented a "magic triangle" of remuneration-fairness for board members (see Fig. 3-19).

²⁰³ See Osterloh in Noetzli (2004:63).

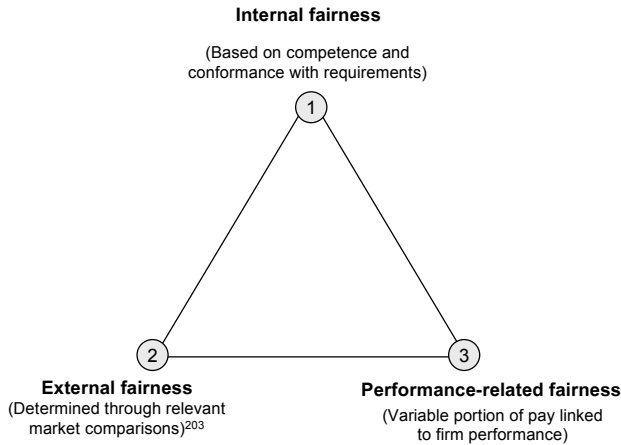


Fig. 3-19. The magic triangle of remuneration fairness for board members²⁰⁴

For most boards, I recommend a fixed remuneration policy. In this regard, the recommendations from the Higgs report are helpful: “the level of remuneration of a non-executive director should be benchmarked against the daily remuneration of a senior representative of the companies’ professional advisors.”²⁰⁵ In some cases it may be useful to apply the top management performance-based pay to board members. In such cases, the remuneration could have fixed and variable portions as described below.

The fixed portion of remuneration takes into account:

1. The regular requirements of board members (internal fairness), but with consideration of the following issues²⁰⁶:
 - position within the board team (chairperson, delegate to a committee, member)
 - position within the board committee (chairperson or member)

²⁰⁴ To assess external fairness, companies could use remuneration comparisons, or they could use the DuPont approach, in the words of the CEO: “We no longer base the compensation of the CEO on what other CEOs are getting. Instead, we use the pay of the senior vice presidents – the people who actually run the business – as a benchmark, and then decide how much more the CEO ought to get. The CEO isn’t going to overpay the SVPs, because he has to make a return on them. So that avoids the upward spiral” (Elson, 2003:72).

²⁰⁵ Higgs Report, par. 12.24, in Carter and Lorsch (2004:135).

²⁰⁶ Böckli (1992:412).

- extent of liability
 - opportunity costs, including both the fulfillment of duties and the renunciation of other (competing) work and
 - extent of influence of the board member on firm success.
2. The fees that competing firms pay for comparable board positions (external fairness).

The variable share considers the firms performance and connects:

1. the individual performance of each board member (in terms of the extent to which they met their individually-set goals)
2. the merit of the board team (in terms of the extent to which it met board-team goals) and
3. the firm's performance, ideally measured with reference to performance indicators relating to shareholders (such as EVA), employees, clients and the public.

The relation of the fixed and the variable share of the board members' remuneration has to be adapted to the particular situation of the firm. The variable share could be accentuated, constituting, say, 60%–70%, when the board members have direct influence on firm performance and when that influence can be measured.

The variable share can be determined by using a simple “apportionment cube” (see Fig. 3-20). According to the cube, the following dimensions should be taken into account for the variable component of board remuneration:

- long-term orientation (3 years)²⁰⁷
- performance of the firm and
- benefit to the shareholders (50%, say) and other stakeholders (50%).

²⁰⁷ See, for example, Porter (1992:81): “Compensation systems need to move in the direction of linking pay more closely to long-term company prosperity and to actions that improve the company's competitive position.”

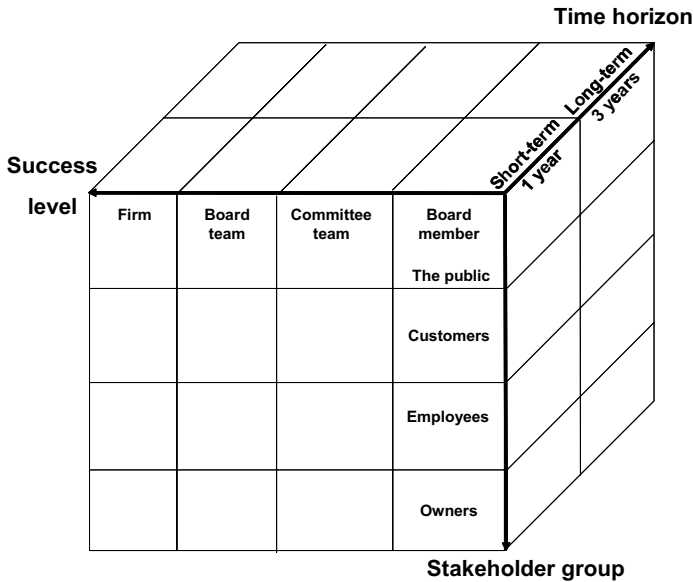


Fig. 3-20. Basis for determining the variable component of remuneration

I suggest the use of an integrated board, management and personnel remuneration system. Depending on the extent of responsibility, different variable proportions and long term orientations may be chosen. For example:

- Board members: 70% variable, with a three-year horizon
- CEO: 50% variable, of which 50% is based on a three-year horizon, and 50% is based on a one-year horizon
- Executives: 40% variable, of which 40% is based on a three-year horizon, and 60% is based on a one-year horizon and
- employees without executive responsibilities: 10% variable, based on a one-year horizon.

I therefore developed the incentive checklist shown on Fig. 3-21:

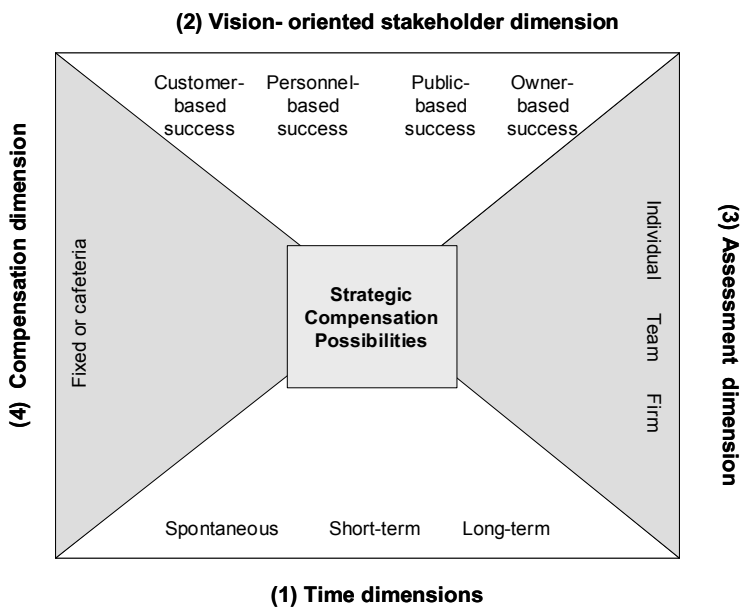


Fig. 3-21. Combination of material incentives for board, top management, executives and other personnel

1. Time dimension
 - spontaneous
 - short term (1 year)
 - long term (3 years).
2. Vision-based benefit dimension
 - added value for clients
 - added value for employees
 - added value for the public
 - added value for shareholders.
3. Assessment dimension
 - individual
 - team
 - branch
 - firm.

4. Dimension of payment

- fixed
- “cafeteria”-based.

1. Depending on the chosen time dimension the following goals could be set:

- spontaneous reward of extraordinary performance or behavior of individuals or teams using a spontaneous reward system
- targeted remuneration linked to short-term operating profits using a bonus system
- targeted remuneration linked to long-term performance using an incentive system.

2. The benefit created by individuals or teams should be measured and rewarded in accordance with the firms vision relative to important stakeholder groups:

- clients
- personnel
- shareholders
- the public

(e.g. 50 % based on EVA,²⁰⁸ 20% indexed customer loyalty, 20% indexed voluntary employee loyalty, 10% indexed reputation of the company).

3. The individual should be assessed according to her/his position, and based on the contribution the performance of:

- the team
- the unit (e. g. a division)
- the entire firm.

4. The reward can be paid as a fixed amount or according to the cafeteria-concept.

²⁰⁸ See Healy (2003:168ff).

An example is presented in Fig. 3-22. Introducing a new bonus or incentive program, a firm has to consider its vision, its culture, taxes and the state of development of the country in which it is located.

Target group	Objective	Basis of calculation (as %-share of total bonus)	Sum in %		
			Short (1 yr)	Long (3 yrs)	Total
Board	Recognition of board contribution to group success	Firm success: 60% Board-team performance: 40%		70%	70%
Top executive team	Recognition of contribution of top execs. to the success of divisions and the entire group	Firm success: 30% Division success: 40% Individual performance: 30%	10%	50%	60%
Branch exec. team	Recognition of the contribution of the branch exec. team to branch, division and group success	Firm success: 10% Division success: 20% Branch success: 40% Individual performance: 30%	25%	25%	50%
Branch managers	Recognition of the contribution of branch managers to work unit, branch, and division success	Division success: 10% Branch success: 25% Work-unit success: 35% Individual performance: 30%	20%	5%	25%
Personnel	Recognition of the contribution of every employee to work unit and therefore branch success	Branch success: 20% Work-unit success: 40% Individual performance: 40%	10%		10%

Fig. 3-22. Example of a combined bonus/incentive program for boards, top executives (at group and branch levels), managers and personnel

In many European countries, stock options are being used as a tool for long-term remuneration. This type of incentive system has been used in the US for quite some time, but has received increasing criticism from researchers and practitioners. One of the reasons why many European groups introduced stock-option plans can be explained as follows: “This is a way of connecting the advantages of options to the economic performance of

the firm, which – at the same time – gives a benefit to the shareholders by raising the share price.”²⁰⁹

A simple imitation of the American stock-option program in Europe (e.g. in Germany and Switzerland) would be unwise for the following reasons:

- owners of stock-options are privileged relative to owners of shares, since they are positively affected by an increase in share price, but they are protected from the negative implications of a decrease in share price
- owners of stock options usually have no direct influence over the price of the underlying shares, but if they have rights to a substantial portion of company stock, they could theoretically provide information to assist traders or speculators (and be guilty of insider trading)
- stock-option programs pre-suppose “that a rise in the value of the firm is associated with a rise in the value of shares.” This mechanism will only work (and then in a limited way) if the capital markets are efficient and
- stock-option programs are designed for the American society, in which “in 1995, on average, the total income of a CEO exceeded the income of an average worker by 212 times.”

The conclusion drawn from this statistic was taken out of an article of the *Fortune* magazine: “Incentive stock options don’t work. If CEOs want shares, let ’em buy some.”

The same applies for non-executive members of the board. Higgs recommends “that they should not hold options, arguing that options are more likely to encourage holders to pay undue attention to share prices rather than to underlying performance.”²¹⁰ According to Crawford, “owning stock is perhaps the best way to get directors to focus on the job.”²¹¹ The best-

²⁰⁹ See the guidelines for designing stock options developed by Brandes, et al.(2003).

²¹⁰ Higgs in Merson (2003:51).

²¹¹ Gray (2002:43). Elson (2003:73) adds three reasons why stock options should be replaced by stock: “First we’ve got to link pay to performance. But stock option plans are adopted for accounting reasons and are not geared to performance. Second, we want executives to hold onto equity portions longer. Executives paid in options can get out of their stock right away after they have

practice guidelines of the Canadian Coalition for Good Governance suggest that companies “require directors to own the equivalent of five years of annual fees in the form of shares or deferred share units after five years on the board; stop stock option grants; continue to invest a significant proportion of annual compensation in shares once the required multiple is met (as appropriate to individual circumstances).”²¹²

When using my strategically targeted incentive-system promoted in this Part, publicly listed enterprises have the possibility of using indexed shares for the variable share of remuneration. Non-listed (family) firms (that have to use competitive remuneration systems as well) may use virtual shares instead.

Such an approach is “more reliable and more related to performance and success than the exclusive use of (incentive) stock options that are dependent on short-term movements in the stock market price. The main

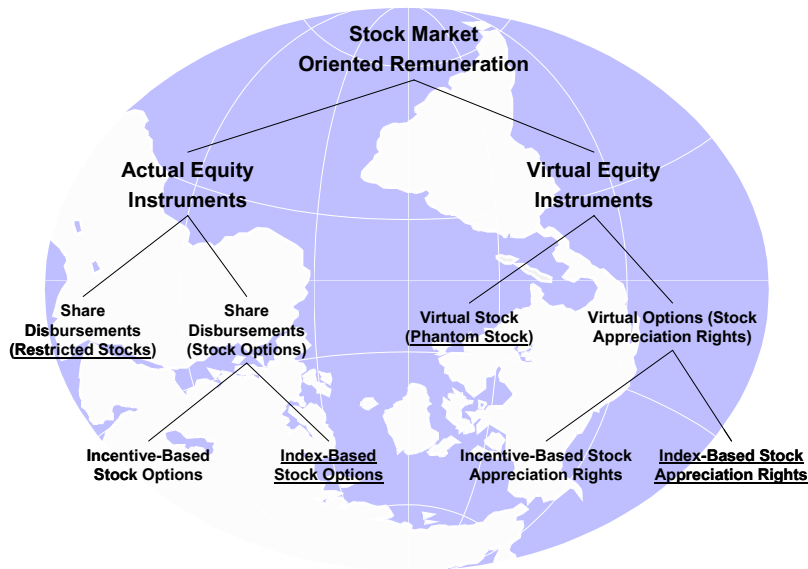


Fig. 3-23. Forms of share-based remuneration
problem in many firms is not – as is often assumed – the shareholder-value

exercised their options. Third, we want executives to bear some downside risk, and stock options, in the main, do not do that.”
²¹² Beatty (2003:10).

orientation, but rather it is a one-sided, executive-value orientation (at the expense of the shareholders, the clients, the personnel and the public).”²¹³

This fact has led to excessive transparency rules concerning the remuneration of board members and top management in most countries. Switzerland is a good example. The following “SWX guidelines” have been compulsory since July 1st, 2002.²¹⁴

“5. The following information about the compensation for and shareholding of the members of the issuer’s board of directors and senior management as well as loans to the aforementioned must be disclosed:

- 5.1 Content and method of determining the compensation and shareholding programs. Basic principles and elements of compensation and shareholding programs of acting and former members of the issuer’s board of directors and senior management as well as the authority and procedure for determining such.
- 5.2 Compensations for acting members of governing bodies.
 - 5.2.1. The total of all compensations such as fees, salaries, credits, bonuses and benefits in kind (benefits in kind are to be valued according to the market value at the time they were conferred) that were consented by the issuer or one of the issuer’s subsidiaries during the year under review and directly or indirectly benefited members of the board of directors and/or the senior management; this also applies to all the members of governing bodies who gave up their functions during the year under review (i.e. who were no longer members of the governing bodies on the disclosure deadline).
 - 5.2.2. The amounts are to be disclosed for: a) the executive members of the board of directors and the senior management en toto; b) the non-executive members of the board of directors en toto.
 - 5.2.3. Additional severance payments to the persons mentioned above who gave up their functions in the governing body during the year under review, are to be disclosed separately.”²¹⁵

²¹³ Bernhardt and Witt (1997: 85)

²¹⁴ For most SWX guidelines, the principle applies: “comply or explain.”

²¹⁵ SWX (2002:5).

The SWX guidelines further require disclosure of

- share capital assignment during the year under review
- total number of shares owned by directors and top executives
- all details pertaining to share options
- additional fees and remuneration and
- any independent loans that were made during the year under review.

Natural and legal entities close to board members and top managers are to be integrated into the disclosure from the points of view of share-ownership, share capital assignment, share options and independent loans.

In addition, “For the member of the board of directors that received the highest total sum of compensation... the compensation as well as the share and option allotments... that were conferred in the year under review must (without providing a name) be disclosed separately.”²¹⁶

Concerning public companies, the Swiss Executive Federal Council proposes even more (comprehensive) regulation than the Swiss stock market. According to the suggestion of the Swiss Executive Federal Council all earnings made by board members from a company are to be disclosed in future. This would include the sum total of the fees and the individual earnings of the board members and details of the highest package, without revealing the name of the executive to whom it was paid. Further, members of the board and top management would have to quote any share participation in the company.

In summary, the variable component of remuneration of board members in many large public companies must be strengthened at the expense of the fixed component, in order to better link payment to the performance of the individual board member, the board team and the company’s success, and in such a way as to make it possible to influence firm leaders’ behavior (for which purpose I prefer shares to share options).

Such an approach assumes that remuneration is seen as an integrated part of a board management approach. The features of board management described in Part 2 of this book (concerning board team, culture, structure and success standards) are necessary prerequisites for success in this regard

²¹⁶ SWX (2002:7).

and must be integrated with the thoughts presented on board feedback (Sect. 3.2) and board development (Sect. 3.4).

3.4 Targeted Development of Board Members

The targeted development of a board can happen on three levels:

1. individual members of the board
2. board teams and
3. the entire organization.

Each director has to take responsibility for his or her own development, but the chairperson acts as the coach.

1. **At the individual board level**, it is assumed that each board member possesses “integrated-success” intelligence (according to Fig. 3-25), implying that each member possesses board relevant competence, motivation and integrity to direct and control the company.

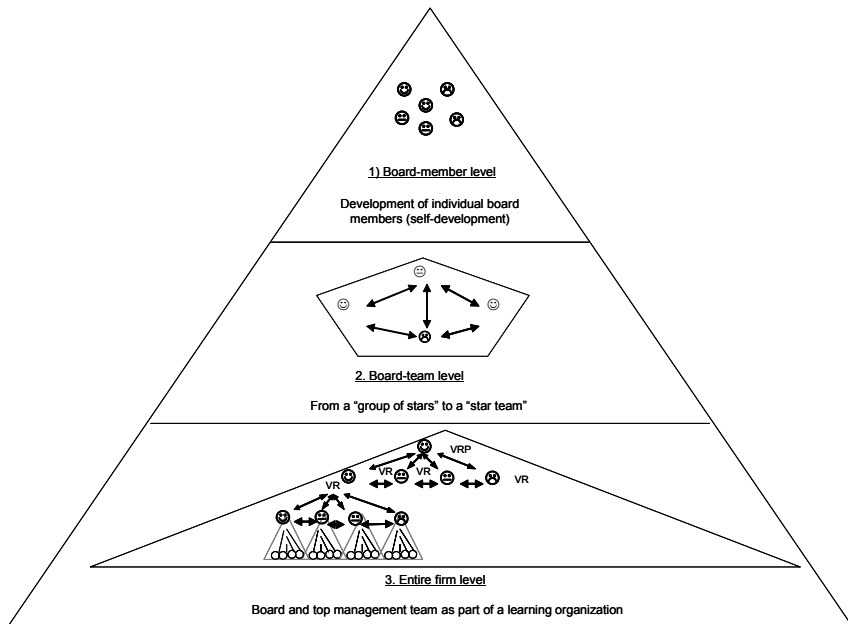


Fig. 3-24. Three levels of board development

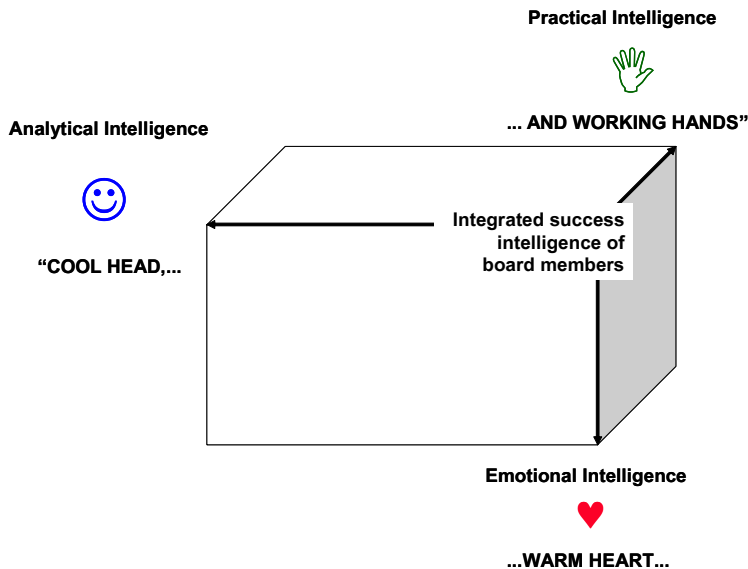


Fig. 3-25. Integrated success intelligence

Integrated success intelligence can be developed (in some countries) using Garrett’s²¹⁷ start-stop-continue method:

“This can be as simple as hanging flipchart paper on the boardroom wall with the name of each director beneath the words ‘start, stop, continue.’ The directors are encouraged to write in each of the three categories which would help that director to be more effective on the board: what they should stop doing, what they should start doing, and what they should continue to do.”

I suggest changing the sequence, though. Ask first what is positive and what the board member should continue doing. Then ask what the board member should consider to do in the future and, finally, what the board member should avoid doing.

I suggest the use of a “Post-It” note approach, as follows:

- | | | |
|------------------|---|----------|
| yellow “Post-It” | = | Continue |
| blue “Post-It” | = | Start |
| red “Post-It” | = | Stop |

²¹⁷ Garrett (2003:234).

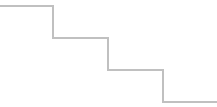
 Actions Board members	Continue	Start	Stop
A Miller			
B Meier			
C Bitt			
D Clark			
E Peters			

Fig. 3-26. Garret’s “start, stop, continue” assessment tool

Ask the board members, without indicating their names, to complete the post-its for their colleagues (e.g. on a yellow “Post-It,” a director could write, “Asks concise critical questions”).

Besides board specific know-how, a successful board team requires a targeted variety of team roles (described in Fig. 2-6).

2. In order to ensure that a **board functions as a team**, I have found it useful to combine the “team design method”²¹⁸ and the Henley role model. The example in Fig. 3-27 compares the role strengths board members of an international professional service enterprise ascribe to themselves (black field), and the role strengths their colleagues ascribed to them (light gray field). It is important that in a functional team members get to know and respect their own role strengths, as well as those of their team partners. Without this knowledge and respect, successful team work is not possible.

²¹⁸ Margerison and Mc Call (1985): in which, paradoxically, “creative” and “practical” are defined as opposites. Indeed, this fact is often criticized (see Henley, 2000).

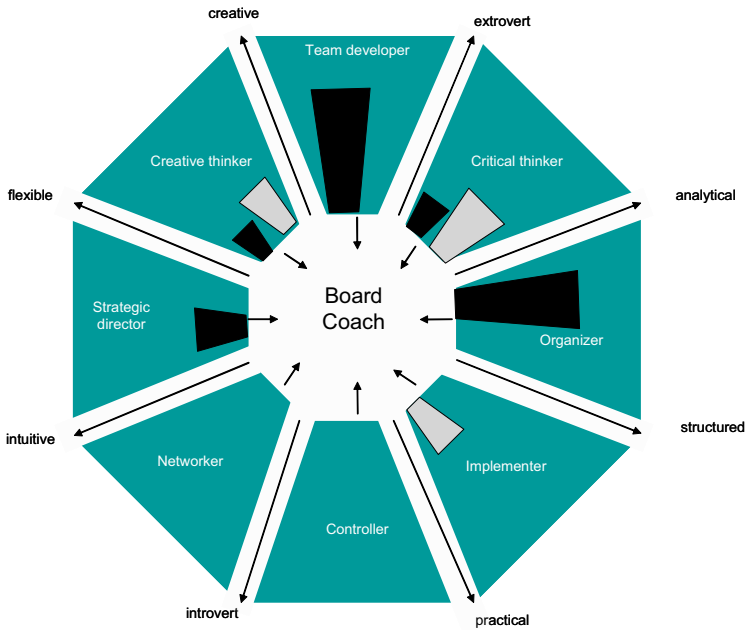


Fig. 3-27. Self- and team-evaluation of board roles²¹⁹

The results highlight two things:

1. Self- and team evaluations do not create a perfect image of a board member. There are always three aspects:
 - the way board members see themselves (black field)
 - the way board members are seen by others (gray field)
 - and the way board members really are.
2. At the end of the board workshop, the participants make an analytical assessment. With the board depicted in Fig. 3-27 for example, it was agreed that the board role strengths were imbalanced and that a new board member with strengths as a controller (and ideally also with additional strengths as a networker and implementer) was to be found.

To assist with self- and team evaluations, we developed an e-tool²²⁰ (see Fig. 3-28).

²¹⁹ In this practical example, the self-evaluation is indicated as black columns, and the team or external evaluation in light colored columns. The graphic highlights the strengths and weaknesses of the board.



Fig. 3-28. E-tool for the development of board teams

Using this e-tool all board members can fill in their own role-strengths; and with a mouse click, they can see the weak points of the board team.

When board and top management teams are diverse, selected in a targeted way, and know their own and their colleagues' weaknesses and strengths, then they can act as part of a learning organization.

3. **At the level of the entire organization**, board members and top managers can be part of a learning organization as illustrated in Fig. 3-29.

Dubs explains his model as follows: "The board has to address a strategic problem. Instead of presenting one answer or a variety of answers, the top managers present the problem together with supporting documentation. This allows the board members to apply their own knowledge and skills so that new knowledge and skills are created and brought to bear on firm decisions and actions.

²²⁰ Hilb, Müller and Wehrli (2003).

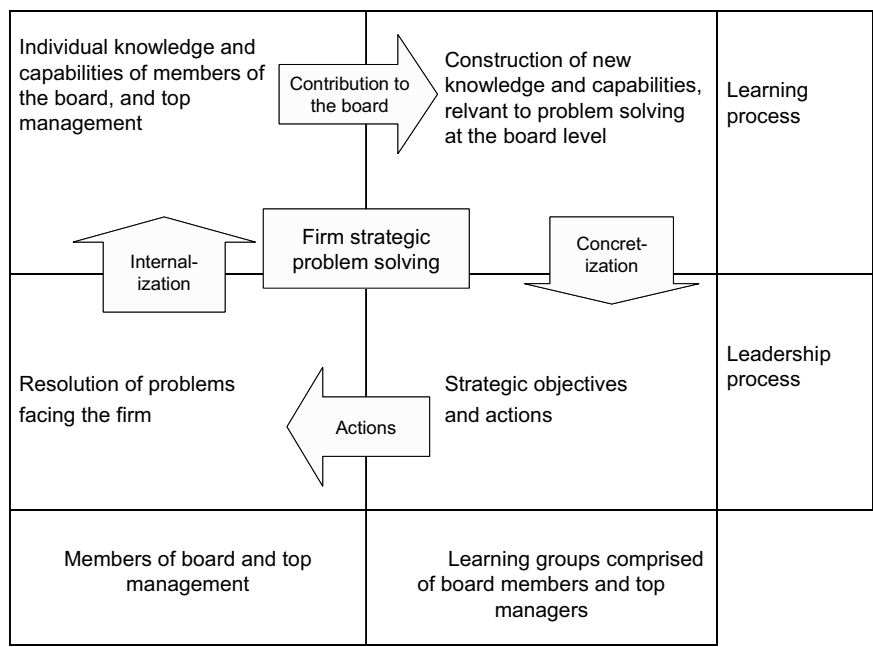


Fig. 3-29. The board and management team as part of a learning organization²²¹

“Thus the board is no longer only responsible for choosing between strategic alternatives. Rather, its primary role is in directing. This objective can only be reached, however, when the work of the board is redesigned:

- The management must inform the board of real challenges as early as possible, and/or the board must highlight challenges facing the company itself. Board meetings can no longer be conducted as poor quality military inspections, in which all issues are glossed over in order to avoid critical questions.
- The board must be prepared to work on individual agenda items in the spirit of the learning process.
- Dominating and know-it-all board members have to be prepared to learn by listening to unconventional thinkers and outsiders.
- The board orientation changes from backward-looking reporting, to active supervision and direction.”²²²

²²¹ Dubs (2003:7f).

²²² Dubs (2003:7f).

I recommend that larger companies introduce an extensive “board development program”. Such a program could ensure that successful managing directors of foreign subsidiaries be made directors of multicultural boards of other foreign subsidiaries during their tenure as managing director. The duration of the responsibility may be limited (to a maximum of three years, for example), to offer new developmental challenges to both the companies and the board members.

Development programs presuppose that the boards of larger companies already have integrated board management committees responsible for nomination, remuneration, feedback, reward and development. An integrated board management committee should receive annual reports identifying talented managers (see Fig. 3-30); then the board should ensure that development programs are in place to enable the company to offer 80% (for example) of all key positions in the company to internal candidates.²²³

Thus it is important to regularly “create opportunities for high-potential executives to make frequent presentations to the board and meet socially with the board.”²²⁴ It is also valuable for board members to seek regular contact with important customers, suppliers and shareholders,²²⁵ and to visit best-practice firms.²²⁶

Past board evaluations (which I present in Sect. 4.4) have shown that in quite a number of leading companies, management and board-level succession planning is inadequate.

In this regard, having CEOs and top managers present their succession plans (following a structure such as that illustrated in Fig. 3-30) to the board has proved a successful approach.

Using the board and HR questionnaire (illustrated in Fig. 3-30), candidates can be short-listed as potential successors. These candidates can then be tested using the approach presented in Fig. 3-9 for external board candidates.

²²³ “Every one of the top ten on the list of the world’s most admired companies... has a boss who was appointed from inside” (*The Economist*, 6 March 2004:61).

²²⁴ Beatty (2003:17), and Ward (2003:27).

²²⁵ Carter and Lorsch (2004:149).

²²⁶ Carter and Lorsch (2004:131).

Organization unit	Proposed by: on:	Approved by: on:
	Leader of the organizational unit:	Direct senior of the leader of the organizational unit:
	Date:	Date:
	Personnel officer responsible:	Firm director:
	Date:	Date:

Name of the manager	Position	Age	Years of service	Years in current position	Salary grade	Appraisal of past performance	Appraisal of potential	Potential successor and successors age	Development actions		
									On the job	Near the job	Off the job

Possible evaluation scores

L = Performance scores:

A = Excellent overall performance (top 10%)

B = Very good overall performance

C = Good overall performance

D = Satisfactory overall performance

E = Unsatisfactory overall performance

P = Potential assessment:

I = Promotable immediately (work out action plan)

II = Promotable within the next two years (work out an individual career plan)

III = Capable of development within a function

VI = Potential satisfied in the current position

Fig. 3-30. HR questionnaire for the board²²⁷

For the development of the board, the on-the-job and near-the-job measures of development are applied (according to Fig. 3-30).

Most importantly, succession plans should be in place for the chairperson, the board members and members of the top management. Then development measures and succession plans have to be determined for individual board members.

²²⁷ Every year, the heads of the department could carry out an evaluation of performance and potential and a succession plan for their employees using a personnel planning questionnaire (see Fig. 3-29). This evaluation would be discussed with the divisional director, who would conduct the same sort of evaluation for the heads of department. This process can cascade upwards. The personnel director would then coordinate these meetings and present the complete coordinated personnel resources program to the CEO for ratification. Human resources planning programs are effective only when they are linked to the appropriate incentives (development objectives). It is important that a development path is be defined for every employee and that development objectives and incentives be planned and implemented step by step.

Assessors	HR Executive	CEO	Chair-person	Score
<u>Appointment criteria</u>				
<u>Personality competences</u>				
– Ability to learn	X	X		
– Motivation to perform	X	X		
– Integrity	X		X	
– Stress resistance	X	X		
<u>Professional competence</u>				
– Subject specific professional skills		X	X	
– Sales talent (market orientation)		X	X	
– Entrepreneurial spirit	X	X		
– Helicopter view of the business		X	X	
<u>Leadership competence</u>				
– Goal orientation	X		X	
– Problem solving orientation		X	X	
– Exemplary lifestyle	X		X	
– Ability to manage resources	X		X	
<u>Social competences</u>				
– Primary role: coach	X	X		
– Secondary role: developer		X	X	
– Communication and social skills	X		X	
– Optimistic realism		X	X	

Fig. 3-31. Matrix for the selection of a top sales executive

The following international institutions of executive training have specialized in board seminars: Henley; IMD; HBS; University of St. Gallen.

3.5 Integrated Board Management Committees for Large Firms

Board members in large firms seldom have enough time and know-how to fulfill all board functions in board meetings in an ideal way. This is why most best-practice standards around the world recommend committees for special areas.

In addition to the audit committee, separate nomination and remuneration²²⁸ committees are recommended. Practice has shown that the recommendation to have separate nomination and remuneration committees has been adopted from other national guidelines without critical analysis of the benefits and disadvantages of this approach. (In Europe, for example, the British Combined Code is followed in the guidelines produced by many other countries.)

I suggest the formation of an integrated board-management committee with four central functions:

- selection and composition
- evaluation of performance (feedback)
- remuneration and
- development.

The integrated board management committee develops proposals in each of the four areas described above considering both board members and top management and then presents these proposals to the entire board, which retains full responsibility for the functions transferred to the board management committee.

These tasks are based on my integrated board management approach (see Fig. 3-1).

Only integrated selection, evaluation, compensation and development of board members and top management brings about the intended professionalization of this field of competence.

This committee, however, does not have any competence for deciding personnel matters. As I suggest that the number of board members in small companies be limited to three, in middle-sized companies to five and in large companies to seven, I suggest the formation of two committees only for large companies:

- an integrated board management committee (presented in this chapter) and
- an integrated audit and risk management committee (ARMC) presented in Sect. 4.0 in the following chapter.

²²⁸ Conyon and Peck (1998) found that “top management pay and corporate performance were more aligned in companies with outside dominated boards and remuneration committees.”

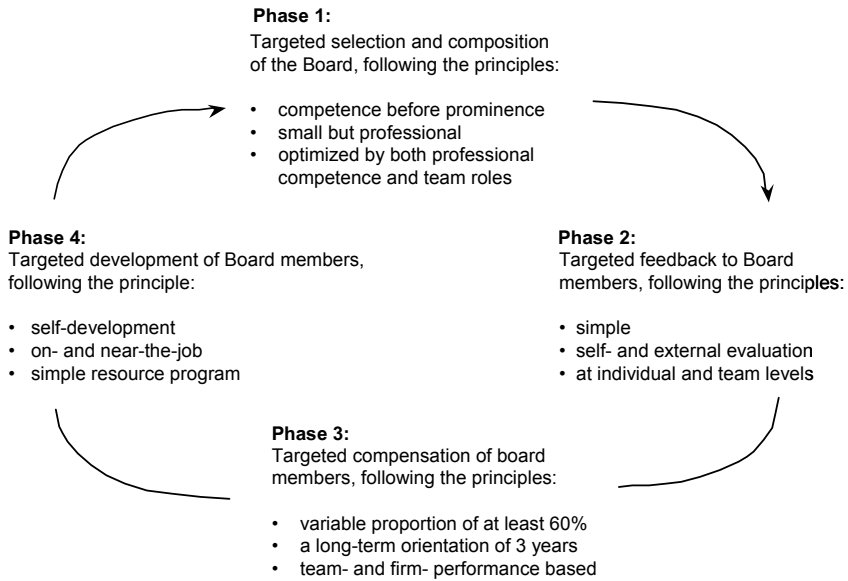


Fig. 3-32. Cycle integrating the four board functions

They should comprise three independent members each.²²⁹ “To be considered as independent, non-executive members of the board should not have been managers within the company in the most recent three years, and should have no business relations with the company.”²³⁰

Interlocking directorates have a negative effect on independence and should be avoided. Publishing the details of such directorates in annual reports (as in best practice guidelines frequently recommended in various countries), in my opinion, does not suffice. Publication only reinforces the fact that transparency has to complement sound design and practice at the board level.

The following dependencies should be avoided:

- family relations with a member of the board or management
- a dominant equity stake
- business, financial or family relations with a dominant shareholder and
- close connections with internal or external auditors.

²²⁹ See Michaels (2003:9).

²³⁰ KPMG (2002:77).

It is recommended that “the chairperson and CEO... as a rule, are invited to the meetings, unless their own compensation is at stake.”²³¹

In order to fulfill this integrated board management function professionally, I recommend the appointment of a chairperson known to have tried and tested HRM experience (above all in the fields of selection, evaluation, compensation and development).²³²

In countries such as the United States,²³³ where companies are required to have two separate board committees, I recommend the selection of the same members to the remuneration and nomination committees in order to ensure the integration of the selection, review, remuneration and development processes.

²³¹ KPMG (2002:88).

²³² See Carter and Lorsch (2004:107).

²³³ See Carter and Lorsch (2004:89).

PART 4

Controlling Dimension

Keep it controlled

In part one of this book, we dealt with the normative, legal and ethical contexts influencing corporate governance, following the motto “keep it situational.” In part two, we dealt with the strategic direction responsibilities of boards, based on the motto “keep it strategic,” and addressed issues such as board teams, culture, structure and strategic success measures. Then in the third part, we dealt with the integrated board management function through its responsibilities regarding selection, feedback, remuneration and development of board and management teams, based on the motto “keep it integrated.” Now in this fourth part of the book, we address the monitoring function of the board following the motto “keep it controlled.”

In this integrated approach, the monitoring board dimension encompasses the following:²³⁴

- the integrated audit and risk management committee for publicly listed companies (Sect. 4.0)
- the auditing function of the board (Sect. 4.1)
- the risk management function of the board (Sect. 4.2)
- the communication function of the board (Sect. 4.3)
- and the evaluation function of the board (Sect. 4.4).

4.0 Integrated Audit & Risk Management Committee

Within the last few years I have carried out self- and external evaluations for boards. Here, I introduce the instruments that I developed for this purpose in Sect. 4.4.

Three quarters of all the boards that I have evaluated (in sectors such as banking, insurance, computer and bio-technology, pharmaceutical and professional services companies) reveal a common characteristic: the risk management at board level was either non-existent or could be radically improved.

In all those cases (with the exception of a bank, where a separate risk management committee was advisable), I recommended the inclusion of a

²³⁴ The compliance function is the responsibility of the company secretary in my framework.

risk management function in the audit committee, thus creating an integrated audit and risk management committee.

Risk management review is a task that belongs to the full board, just as the ultimate responsibility for strategic direction does. However, as with auditing, in most cases, the know-how of the board members is insufficient to fulfill this task in a professional way. In addition, the integration between audit and risk management review systems is often lacking at both strategic and operational levels.

An integrated audit and risk management committee (ARMC) has the following objectives:

1. to supervise of the internal controlling system, especially the internal audit reports and professionalism, integrity and independence of the internal audit team members (Sect. 4.1.2)
2. to supervise of the professionalism, integrity and independence of the external audit (Sect. 4.1.1)
3. to analyze and critically examine of the annual report and the interim reports (semi-annual reports and quarterly reports)
4. to ensure a comprehensive, professional risk management system exists within the company (Sect. 4.2) and
5. to ensure effective communication between committees, external auditors, management (CEO and CFO), internal auditors and risk management professionals.

The ARMC finds itself “in a constant tension between over- and under-reaction, between over-enthusiasm and carelessness.”²³⁵ While the legislators and many chairmen of audit committees in the post-Enron phase in the USA²³⁶ have been confronted with the accusation of over-enthusiasm, the biggest mistake of many continental European companies is “an inadequate identification of the impact of diagnosed mistakes and insufficient examination of those issues.”²³⁷

“Audit committees should take care not to duplicate the role of the auditors.”²³⁸ The center of attention is a professional analysis and scrutiny of

²³⁵ Böckli (2003:562).

²³⁶ See Richardson and Baril (2003:37).

²³⁷ Böckli (2003:562).

²³⁸ Buffel (2003:19).

internal and external auditing reports, (interim) annual reports and risk management scenarios. This responsibility is frequently underestimated in the manuals of the leading audit companies. The ARMC has the right to carry out any examination necessary in order to fulfill its tasks. It has direct access to external and internal auditors as well as to all employees of the firm. The audit committee can call in legal, financial, accounting and risk management experts in order to fulfill its tasks at the firm's expense.

The ARMC should consist of three board members who are independent and who have had no executive functions in recent years. "The key to building a successful audit [and risk management] committee is attracting members courageous enough to ask tough questions and stand up to management, members whose interests are clearly independent from management."²³⁹ At least two members of the ARMC have to be equipped with sufficient knowledge and demonstrated experience with proven track record in the field of finance and accounting. At least one member has to have proven expert knowledge in auditing and risk management.²⁴⁰

Members of the ARMC are proposed by the integrated board management committee to the full board, which has the responsibility of ratifying or modifying such a proposal.

The ARMC should meet four times a year, or more frequently if necessary. The head of the ARMC draws up an agenda prior to each meeting. The ARMC should invite members of top management (the CFO, the head of internal auditing and the head of risk management) and the head of the independent external auditing team to meetings on a regular basis.²⁴¹

In addition, discussions have to be held with certain individuals:

1. "together with the CFO (alone), about the quality of the committee on the one hand, and the quality – from her/his point of view – of the internal auditors and the external auditors on the other hand
2. with the internal auditors (alone), about their most important findings and about their cooperation with the CFO and external auditors
3. with the top team of the external auditors (alone), to conduct an open discourse about the quality of the accounting reports produced by the

²³⁹ Richardson and Baril (2003:38).

²⁴⁰ See Herrmann (2003:42).

²⁴¹ See KPMG (2003, part 5:1f).

CFO and her/his team, about weaknesses in the accounting system, and about the internal controlling system and its effectiveness”²⁴² and

4. with the risk management officer about the risk report and other targeted questions raised by board members.

In practice it has proven successful to cluster the documents presented to the ARMC in different categories²⁴³:

- category 1: data for the annual report
- category 2: “notes” (attachments)
- category 3: “all that should be written in notes, but is not.”²⁴⁴

Böckli, who lead an Audit Committee for Nestlé – the first in a Swiss public listed company – and who lead the UBS Audit Committee from 1998–2002, summarizes the limitations of such committees as follows:

1. *“The leaning-back syndrome”*: (this implies that board members who do not belong to the committee,... do not explore the annual report and its notes further...)
2. *The Audit Committee as agenda setter*: (... expresses its opinion on all possible number-relevant leadership problems,... and within the joint board it takes some sort of leading position...)
3. *Audit Committee interference in financial management*
4. *The Audit Committee as internal auditor and compliance officer*
5. *The blessing of company decisions via the Audit Committee*
6. *The Audit Committee as “super auditor”*
7. *The Audit Committee as internal investigating commission*
8. *Empty formalisms and brainless ticking-off*: (instead of struggling over real issues,... the investigating commission wastes its time on extensive cross-checks and superficial issues...)
9. *The Audit Committee as expert committee*: (... you cannot get around ...electing a pensioned auditor or pensioned professor in the special field of auditing, or a former CFO onto the board.)

²⁴² Böckli (2003:565).

²⁴³ Böckli (2003:566).

²⁴⁴ Böckli (2003:566).

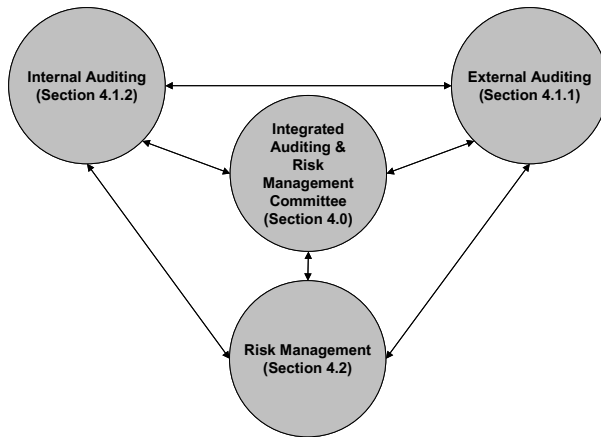


Fig. 4-1. Auditing and risk management at the board level

10. *Tendency to demand too much of the members:* (a new expectation gap is formed; expectations are set that cannot be met. The Audit Committee is understood as ‘general agent’ for the entire finance, accounting and risk management of the group.”²⁴⁵

I share all these concerns, except for number 9. Based on my board consulting experience, I’m convinced that members of an ARMC can only effectively carry out complex tasks of auditing and risk management at the board level if they have well-founded know-how, independence, time, integrity, social competence and long-standing experience with a proven track record in auditing and risk management. This is the only way an ARMC can have an effective controlling function.

4.1 Auditing Function of the Board

During the last few years, more and more “creative auditing” cases have become known (the ENRON, TYCO and Worldcom crises have good examples). These cases brought the auditing function into disrepute.

Such “creative auditing” includes the following unethical practices²⁴⁶:

- manipulating the stock price
- overstating revenues

²⁴⁵ Böckli (2003:567-570).

²⁴⁶ See Meyer (2003:2).

- exploiting gaps and the lack of transparency in sections of the US GAAP
- showing excessive operational profits
- camouflaging debt
- failing to identify the capital in the balance sheet dedicated to stock-option remuneration
- failing to register extra purchases (with values reaching into the billions) and
- the creative assessment of non-quoted options.

Considering all this, a professional cooperation between the board or the ARMC and the external and internal auditing functions is becoming increasingly important.

The controlling function of the board has to be clearly differentiated from specific monitoring functions (as illustrated in Fig. 4.2).

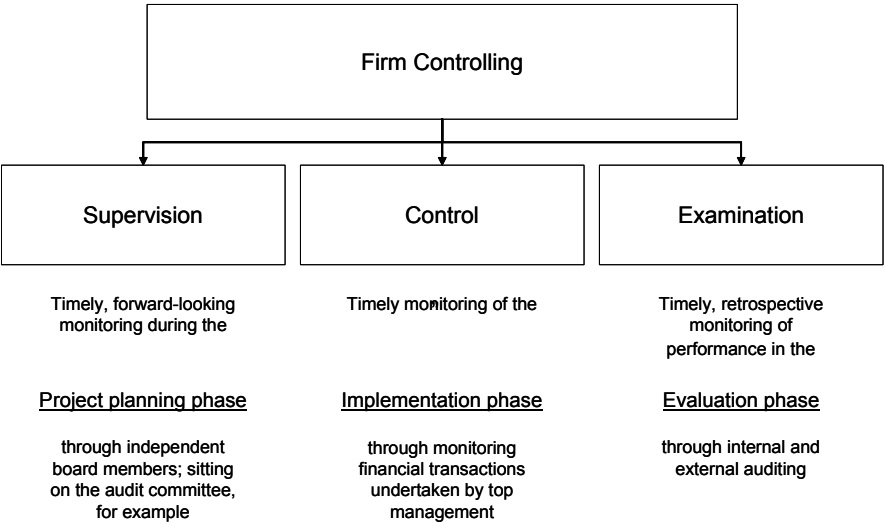


Fig. 4-2. Firm monitoring function²⁴⁷

²⁴⁷ Schneider (2000).

4.1.1 Cooperation with the External Auditors

The central qualities of an auditor are the competence, independence, objectivity, transparency and integrity that are applied to the production of an audit report.²⁴⁸ The external auditor is the only external institution that can give an objective view of the financial condition of the company.²⁴⁹ However, it can only contribute to the transparency of the financial accounting and to the improvement of the quality of the internal control if a focused cooperation is achieved between the external auditor, the board the ARMC (to which it reports) and the internal auditor (which also reports to the ARMC).

In order to ensure the independence of the external auditors, both the auditors and the auditing firm should be changed periodically – and according to at least one auditing expert, this change should be made every three years.²⁵⁰ This recommendation does not need to be legislated for firms to adopt it and make it an official part of their operations.

4.1.2 Cooperation with the Internal Auditors

The task of the internal auditors is to establish as independent and objective as possible a financial supervision function for the ARMC and the board.

The following three tasks constitute the main focus of attention:

1. Financial reporting: Observation of the financial targets (assurance) and consulting regarding the realization of targets (advisory), while the quality and integrity of the financial information and the protection of material and immaterial values is a central focus of attention.²⁵¹
2. Operations: Observation of operational targets and assessment in respect of realization of the targets.
3. Compliance: Surveillance of compliance with laws, regulations, guidelines on a national, industrial or firm level.

²⁴⁸ Vogt and Alresch (2003:814).

²⁴⁹ Vogt (2003:817).

²⁵⁰ Imhoff (2003:124).

²⁵¹ See Bumbacher (2003).

As such, the demands placed on the internal revision have grown. They used to be restricted to the second task (operational compliance).²⁵²

The effectiveness of the internal control system and compliance are currently a central focus in corporate governance. The function (which formerly reported to the CFO), reports to the audit and risk management committee.

It is important “that the auditors have access at all times to all areas of the company – basically nobody may be excluded – and that it extends to all proceedings. The subject of the audit is not only the numbers produced by the financial and accounting system. Everything has to be open to audit revision. The firm’s systems and functions also require auditing. The audit has to incorporate business and management on a comprehensive basis.”²⁵³

4.2 Risk Management Function of the Board

Many risk management approaches in practice have the following weaknesses:

1. “They are restricted to operational risk management and are only practiced at the management level
2. Even at the management level, they are
 - often very fragmented, and hardly coherent with other functions (treasury, insurance, IT, legal, internal audit, etc.)
 - they treat risk as inherently incompatible, where each case has to be treated independently
 - in addition to the fragmentation of risk management functions, there is a lack of integration between risk management processes and results in general, and existing management processes
3. [They] are often misunderstood as prevention management. Even if the focus on loss minimization is not necessarily a bad thing, such a focus sometimes obstructs the search for entrepreneurial opportunities and the fact that risk management is in fact a tool for generating value and

²⁵² Bookal (2002:47): “When we call for public reporting on internal controls (i.e. internal auditors), we have to be ready to furnish boards with the information they need to make informed decisions and disclosures.”

²⁵³ Malik (2002:226f).

4. [They] frequently have their roots in the ‘command and control’ age – an indicator that many companies have not achieved the balance between comprehensive checks and the necessity of sufficient entrepreneurial freedom of movement and optimized risk costs.”²⁵⁴

Therefore, it is the task of the board and top management to define an integrated, future-oriented risk management concept; one which is integrated with the existing planning and leadership processes, which is equally directed to the realization of opportunities and which does not constrain entrepreneurial freedom. Such a risk management concept should guarantee that management must cope with daily risk²⁵⁵ and it should keep the responsibility for directing and controlling within the board.

As in the case of corporate strategy, the board is responsible for the determination of the strategic risk objectives and for guaranteeing focused, operational risk management practices at managerial levels. “The Turnbull Report of 2000 (in the UK) made the first breakthrough... by suggesting that boards must report annually to their owners their risk assessment and decision making processes (not content).”²⁵⁶

At the board level, risk management deals with the “process of early detection, prevention and management of dangers as well as identification and effective realization of entrepreneurial opportunities ... (this means the conscious) exploration of risks where opportunities can be realized, and in the prevention or reduction of risk, where the anticipated risk outweighs the expected gains. Risk management deals primarily with higher assurance in planning, and a higher probability that company objectives are achieved, and thus the realization of a higher company value.”²⁵⁷

“What is missing... is a framework and process for simultaneously dealing with both... governance and risk in one model.”²⁵⁸

I take the following spiral approach as a starting point for the risk management at board level.

²⁵⁴ Ernst & Young (2002:7).

²⁵⁵ Ernst & Young (2002:7).

²⁵⁶ Garrett (2003:XXII).

²⁵⁷ Ernst & Young (2002:7).

²⁵⁸ Shaw (2003:25).

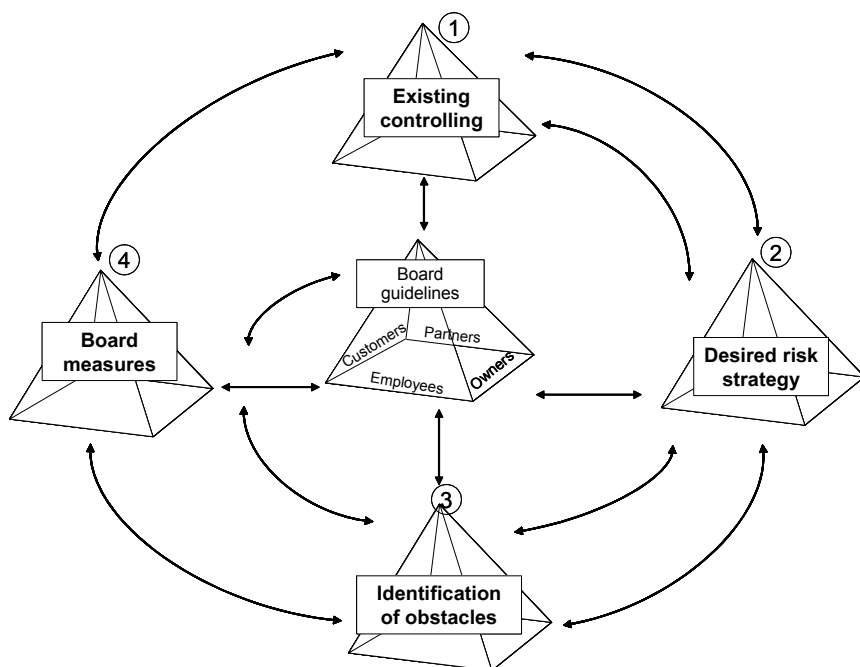


Fig. 4-3. Cyclic approach to risk management at board level

Phase 1: Existing Risk Controlling

1. “This involves listing all contextual-, process- and information-related risks that have to be considered to realize all objectives that are strategically relevant to the board and operationally relevant to the management.
2. Then prioritizing these risks on a risk map, in order to focus the attention of the board and the management on the most important risks. All risks can be classified according to a risk management cube (see Fig. 4.4).
3. Then the focus shifts to an investigation of the risk drivers that can be influenced by the board and top management. The identification of positive and negative risk drivers is often carried out by means of mind-mapping techniques.
4. Finally, an attempt is made to measure the risk. Depending on the situation, it may be reasonable to quantify the risk (e.g. effects on the cash flow) or to apply scoring models or to prioritize the risks – at least relative to one another.”²⁵⁹

²⁵⁹ Ernst & Young (2002:11).

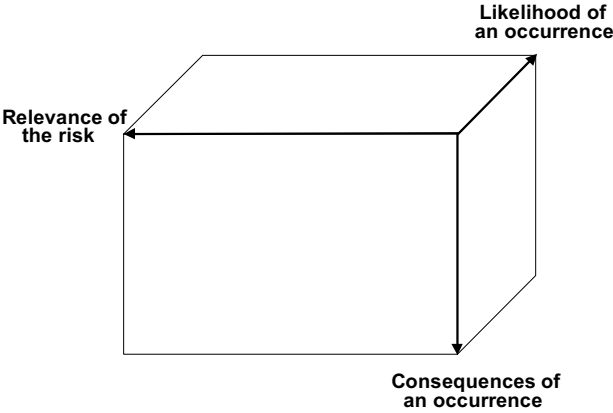


Fig. 4-4. Risk management cube²⁶⁰

The business risk matrix (Fig. 4-5) and the world map of the e-vulnerability in a company’s global operations (Fig. 4-6) are examples of techniques used in practice.

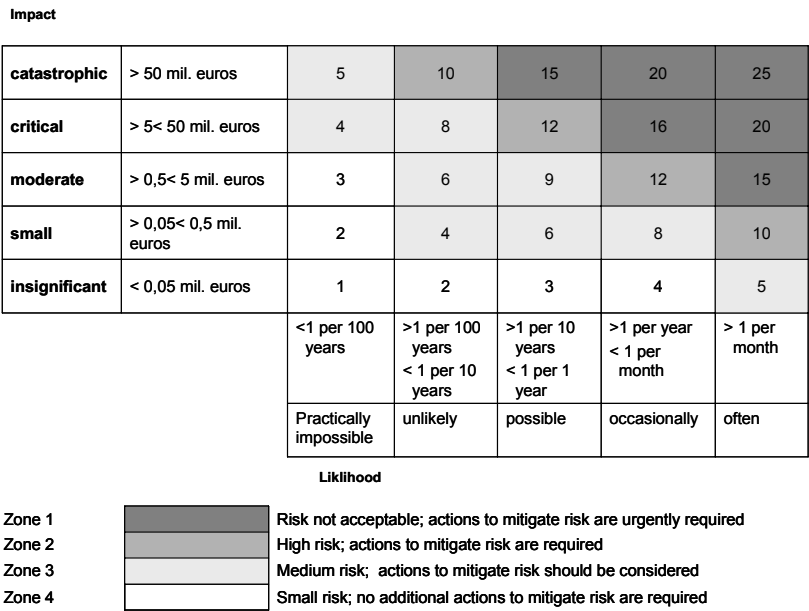


Fig. 4-5. Example of a company risk matrix²⁶¹

²⁶⁰ See Kalia (2003).



Fig. 4-6. The world map of the e-vulnerability in a company's global operations²⁶²

Müller's²⁶³ company risk matrix serves as an illustration of how risks can be classified into zones based on their significance and probability.

Phase 2: Desired Risk Strategy

Based on the company's strategy and the risk policy, the following possibilities exist²⁶⁴:

- avoidance of risk (give up all associated strategies)
- acceptance of risk (no introduction of risk mitigation measures)
- reduction of risk (introduction of risk mitigation innovations)
- transfer of risk (insurance or hedging) and
- extension of risk (reinforced use of opportunities with a positive opportunity-risk relationship).

²⁶¹ Müller (2003)

²⁶² Gygi (2003:B11).

²⁶³ Müller's (2003) presentation at a board conference.

²⁶⁴ See Ernst & Young (2002:11).

Phase 3: Identification of Risk Barriers

Before measures can be introduced, the most important obstacles that exist between the existing situation (phase 1) and the desired situation (phase 2), have to be identified.

In this regard, the following questions are relevant:

- is the risk concept realistic?
- have the risk processes been identified completely? and
- are there enough financial, time and human resources available for management of this risk at board and management level?

Dubs differentiates between the following risk traps²⁶⁵:

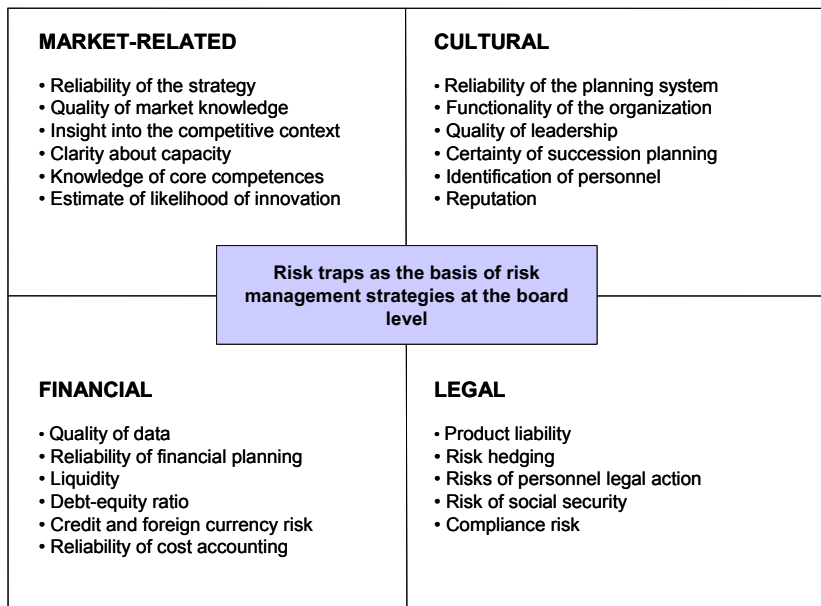


Fig. 4-7. Risk traps²⁶⁶

²⁶⁵ Dubs (2003), and Protiviti Guidelines (2002:11f).

²⁶⁶ Dubs (2003). Also, Overell (2003:4) suggests that “The biggest risk in any company comes from staff... The majority of FTSE 300 companies now have whistle blowing procedures in place.”

Phase 4: Risk Management Measures

In this phase, the focus is on the determination of operational measures that allow a board to have a strategic influence on risk management while taking the obstacles identified in phase 3 into account. Specifically, the planned intervention, the dates by which milestones should be achieved, the personal and financial resources required to implement the intervention and the people responsible for each intervention are determined and communicated.

Applying this approach in a cyclic fashion, the board returns to phase one, in which the current situation is analyzed again.

For a quick check of the risk management fitness, the board can use the simple one-page questionnaire included as in Fig. 4-8. This questionnaire allows board members and top management to identify critical areas for risk management. The questionnaire is filled out anonymously, and all questions that are not marked with a “yes” should be discussed by the board, and where necessary, interventions should be designed to address weak areas.

Risk management “fitness” check	
A) For the board	YES
1 Has the board fixed risk targets (limits), and are those targets validated regularly?	☐
2 Does the board have a comprehensive risk policy (for all risk categories, and all areas of company business)?	☐
3 Do you, as a board member, know the greatest risks facing your company (in the sense of opportunities and threats)?	☐
4 Are you up to date about the essential changes in the risk profile of your company?	☐
5 Do you, as a board member, get involved with the identification and assessment of relevant risk, and do you participate in the determination of risk mitigation or management strategies?	☐

Fig. 4-8. Risk management “fitness check” at board and top management levels (KPMG)²⁶⁷

²⁶⁷ KPMG (2003).

-
- 6 Have you considered non-financial risks adequately (e.g. reputation, trade mark risk, customer risk, personnel risk)? ☐
- 7 Are you informed about the risk assessments and interventions through regular board reporting? ☐
- 8 Have you analyzed your personal, board-related risk profile, and taken any necessary risk mitigation or management actions? ☐

B) For top management

- 9 Has the company defined a systematic, standardized and ongoing process to identify and assess risk, to derive risk management strategies and action plans and to monitor their implementation? Has this been communicated and implemented? ☐
- 10 Has the company created an inventory of significant risks and defined and analyzed interventions commonly used to manage them? ☐
- 11 Does your company continually collect, record and analyze information on risk in order to be able to draw from a broad basis of historical information in risk management interventions? ☐
- 12 Has your company clearly defined the line managers responsible for risk management, and has it assigned the necessary financial and temporal resources to this task? ☐
- 13 Is the assessment of systematic risk (in the sense of opportunities and threats) a fixed part of regular business processes (e.g. strategic planning, annual budgeting)? ☐
- 14 Is a systematic risk analysis carried out for important decisions (e.g. decisions on investments)? ☐
- 15 Do you have an IT-based tool to efficiently and effectively support the risk management process of the company? ☐
-

Fig. 4-8. *Continued*

This KPMG “fitness check” demonstrates the importance of the communication function at board level.

4.3 Communication Function of the Board

In this section, the communication between board and management and the external information policy of the board are introduced.

4.3.1 Internal Communication Between Board and Management

I have developed and introduced the following simple model of the communication between board and management:

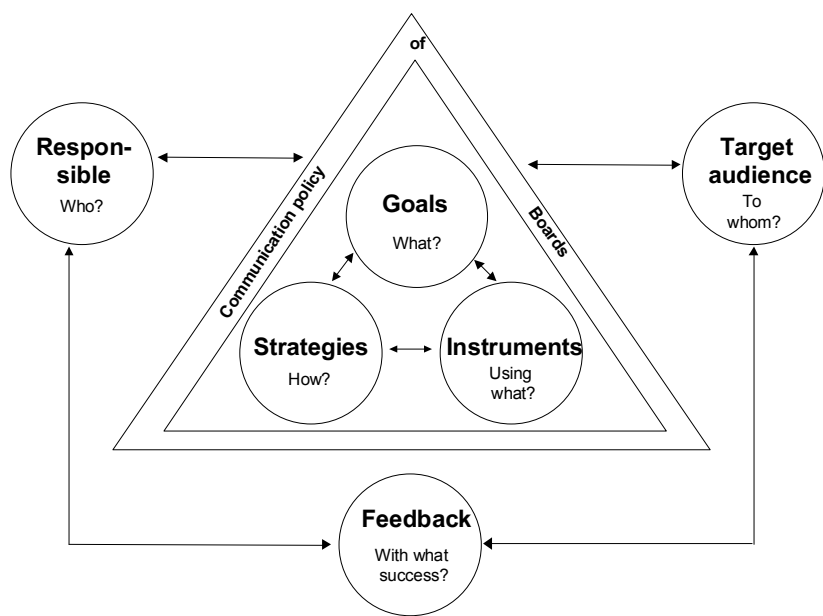


Fig. 4-9. Board communication policies

In the context of board communication policies, the old Laswell question is relevant: “Who informs whom, about what, how, using what means and with what success?”

The board and top management are interchangeably responsible for the roles of responsible and target audience. And the exchange of information is of critical importance in this regard. The extent and quality of the information delivered by the CEO to the board sets the boundaries of the contribution that the board can make to good governance.²⁶⁸ The objectives, strategies and tools of board communication policy are outlined below:

4.3.1.1 Objectives of Board Communication Policy

The following two objectives are most relevant:

1. Content

To promote transparency of information at board level, through the exchange of information that is comprehensive, true, understandable and relevant to both board members and top managers, and that relates to financial and market performance, personnel and environmental objectives, and challenges facing divisions within the firm and the firm as a whole.²⁶⁹

Based on our “KISS” framework, the following topics should be addressed and discussed regularly by the board:

- Keep it situational: compliance
- Keep it strategic: strategy
- Keep it integrated: people
- Keep it controlled: operative effectiveness²⁷⁰

2. Relationship

To create a real culture of trust and learning through the constant improvement of the relationships between board members, board committee members, top managers and managers in functional areas and to deal with conflict in a constructive way, to dismantle prejudices and to avoid unnecessary confrontations.

²⁶⁸ Macus in Noetzli (2004:51).

²⁶⁹ The greatest frustration of board members “is not that they get too little information, but that they get too much information that is neither well organized nor well summarized” (Carter and Lorsch, 2004:27).

²⁷⁰ See Charan (2005:69).

The quality of this constant board dialogue is enhanced mainly through active listening and the constructive openness of the chairperson and CEO (see Fig. 4-10).

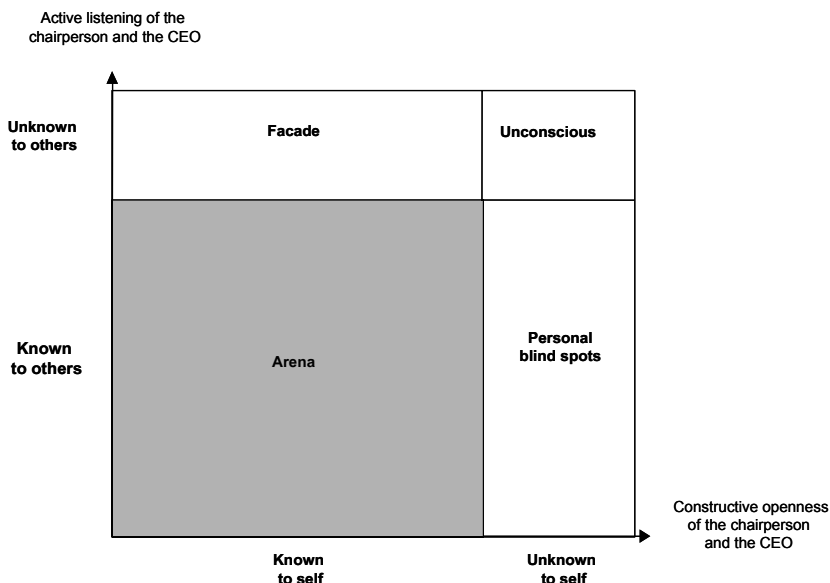


Fig. 4-10. Communication arena that the chairperson and CEO should target (following the Johari concept)

4.3.1.2 Board Communication Strategy

The board and management information policy should be designed according to the following four principles:

1. completeness
 2. objectivity
 3. comprehensibility and
 4. timeliness.
1. It is possible at any time for board members and top managers to leave each other in a state of confusion, without consciously communicating untruthfully. This can happen simply when communication remains superficial and when the underlying causes of relevant phenomena are not examined. The principle of completeness states

that board members and top management are obliged to reconstruct for each message the adequate context.

2. Complete objectivity in communication does not exist. The principle of objectivity is therefore about striving for a communication that is as true as possible in the eyes of the board members and top managers.
3. The principle of comprehensibility states that all information should be transmitted in such a way that it meets the communication requirements of the target audience and that it corresponds with contexts known to that audience. For comprehensibility, the following basic rules apply:
 - simplicity and brevity (conciseness)
 - clear structure (clarity of arrangement) and
 - logical consistency (logical order).

Comprehensible means that the relevant aspects of the communication are accurately and clearly presented in executive (or better still, board) summaries.²⁷¹ In board communication, the “one-page” principle can be very valuable.

“Whenever it is not feasible to communicate face-to-face and it is therefore necessary to communicate in writing, the one-page principle should be followed to reduce bureaucracy and increase information effectiveness. This means all e-mails and memos should be put on one page only and all reports should be summarized on one page. The original report can be attached as a PDF File.”

4. The principle of timeliness strives to balance the fact that most information is valuable primarily because of the time at which it is received, with the fact that it is impossible to communicate everything in an instant.

The sequence of the information delivery can be determined as follows:

1. hierarchy (board members and management should be informed about relevant events before other target groups are contacted)
2. and target audiences (in general, an announcement should never be released to the general public before board members and management have oriented themselves and their employees – maintaining the primacy of the internal public).

²⁷¹ Böckli in Noetzli (2004:36).

4.3.1.3 Board Communication Tools

We differentiate between two main groups of information tools:

- primary (basic) communication mediums that can enable direct verbal contact between the board and management and
- secondary (additional) communication mediums, where special information instruments are used for transmitting information.

In general, direct verbal communication is superior in its effectiveness to other communication mediums. For this reason, a primary medium should be chosen for communication between the board and management whenever financially and physically possible.

The system of overlapping communication groups is, in my opinion, helpful in realizing the two most important communication objectives described above: the creation of information transparency and the creation of a culture of trust. This system is divided into three levels and is illustrated below using the example of a medium-sized organization, also operating on three levels:

Level 1: Monthly Management Communication Meetings

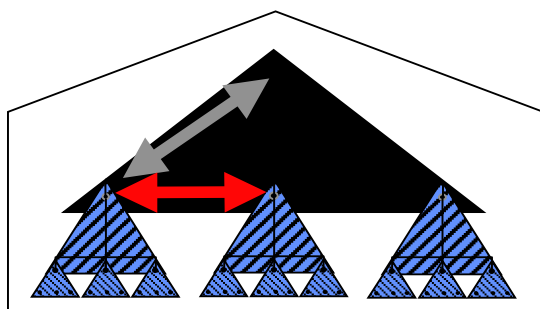


Fig. 4-11. The top management communication meeting

This monthly meeting takes place on a fixed day and is followed by a lunch. All managers participate. It is carried out as follows:

- Two days prior to the meeting, each manager has to report via e-mail the most important events of the last month and the most important objectives for the next month in her/his unit. This report goes to the chairperson and the management team, and is a maximum of one page long.

- The managers attending the meeting (or their representatives if they are absent) ask questions that came to mind after reading the e-mails of their colleagues.
- At the end of the meeting, the minute-taker presents an information checklist on one page (see Fig. 4-12) that serves as a base for the communication meeting of the unit that takes place the following day.

Department	Most important activities within the last month	Main targets for the next month	Notes for the board
Marketing			
Production			
R & D			
Finance			
Informatics			
HR Management			
Management			

Fig. 4-12. Example of a monthly information checklist

Level 2: The Monthly Section (Unit) Communication Meeting

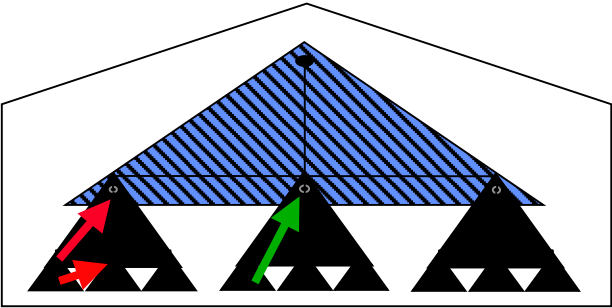


Fig. 4-13. The section (unit) communication meeting

The section communication meeting is carried out the following day in all sections of the company:

- Following the information checklist, the section head informs employees about the most important issues raised at the management team meeting.
- Afterwards, all department heads report within their departments the most important issues facing the department and the most important objectives for the coming month.
- Following that, and if desired by the employees who take part, topical issues are discussed and information is exchanged (using a more informal approach).
- Each member of management reports directly to the chairperson any additional, relevant information surfaced at the meeting. The chairperson adds the information to the information checklist as a remark.

Each communication meeting has an associated cost: first, the remuneration and social benefit contributions of all the meeting participants; but secondly, frustrations that can be the result of badly organized information sessions. Therefore, economic principles should be applied to the organization of meetings; achieving the two most important communication targets (improvement of transparency and relationships) with a minimum input of money and time.

In order to be able to improve the impact of the system of overlapping communication groups, a standardized evaluation card is useful. Using such a card, participants are asked to give a brief evaluation of the meeting when it has finished. The meeting facilitator can carry out an effective control of the success of the session and thus realize improvements for the next session.

Level 3: Board – Management Communication

As part of each board meeting, the CEO reports along the extended information checklist (Fig. 4-12) about the most important events of the past period and about the most important objectives of the sub-units of the organization. At the end of the board session, the chairperson and the CEO discuss all information arising out of the meeting that should be forwarded to the management.

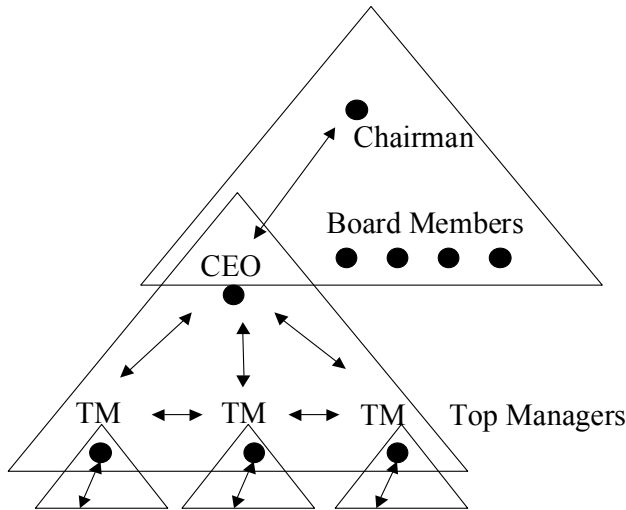


Fig. 4-14. Board – top management communication meetings

Besides the formal internal communication processes, the board also has to obtain information from independent sources.

“This implies one of the most critical issues, which is the fine line between justifiable access to suitable information on the one hand, and information obtained under circumstances that involve undermining management on the other hand. A good measure of the need to improve access to information as a foundation for judgment and also to improve board member comprehension about the functioning of the company, is their involvement in projects that are of central and overall importance.”²⁷²

In a board meeting, it may also be sensible to formulate some essential questions about which board members should be continually informed. For example:

- “Where is shareholder value being created and destroyed in the company?”
- What are the major risks to which the company is exposed?
- What is the level of employee morale (and voluntary loyalty compared to competitors)?

²⁷² Malik (1998:193f).

- What are the threats to customer satisfaction (and customer loyalty compared to competitors)?
- What is happening to... our corporate image?
- How does our strategy differ from that of our competitors?
- How is our stock viewed by the analysts who cover us?²⁷³

4.3.2 External Communication Between Board and Stakeholders

It is the task of the chairperson to oversee the communication between company and all relevant stakeholders. The latest “King II” report describes the function of the board in the context of communication as follows:

1. “It is the board’s duty to present a balanced and understandable assessment of the company’s position in reporting to stakeholders. The quality of the information must be based on the principles of openness and substance over form. Reporting should address material matters of significant interest and concern to all stakeholders.
2. Reports and communications must be made in the context that society now demands greater transparency and accountability from companies regarding their non-financial matters.
3. Reports should present a comprehensive and objective assessment of the activities of the company so that shareowners and relevant stakeholders with a legitimate interest in the company’s affairs can obtain a full, fair and honest account of its performance. In communicating with its stakeholders, the board should take into account the circumstances of the communities in which the company operates.
4. The directors should report on the following matters in their annual report:
 - that it is the director’s responsibility to prepare financial statements that fairly present the state of affairs of the company as at the end of the financial year and the profit or loss and cash flows for that period
 - that the auditor is responsible for reporting that an effective system of internal controls and risk management have been maintained

²⁷³ Carter and Lorsch (2004:151).

- that appropriate accounting policies supported by reasonable and prudent judgments and estimates have been used consistently
- that applicable accounting standards have been adhered to or, if there has been any departure in the interest of fair presentation, this must not only be disclosed and explained but also quantified (and)
- that there is no reason to believe the business will not be a going concern in the year ahead or an explanation of any reasons otherwise.”

Switzerland has also possessed a state-of-the-art “Corporate Governance Directive” since 1 July 2002. Information publication requirements of the SWX can be accessed at www.swx.com.

As the examination of the annual reports of 2001 and 2002 of Swiss companies through the Institute of Accountancy and Controlling of the University of Zurich²⁷⁴ has revealed, the information on corporate governance in Switzerland has improved considerably as a result of the introduction of the SWX transparency rules of 2002.

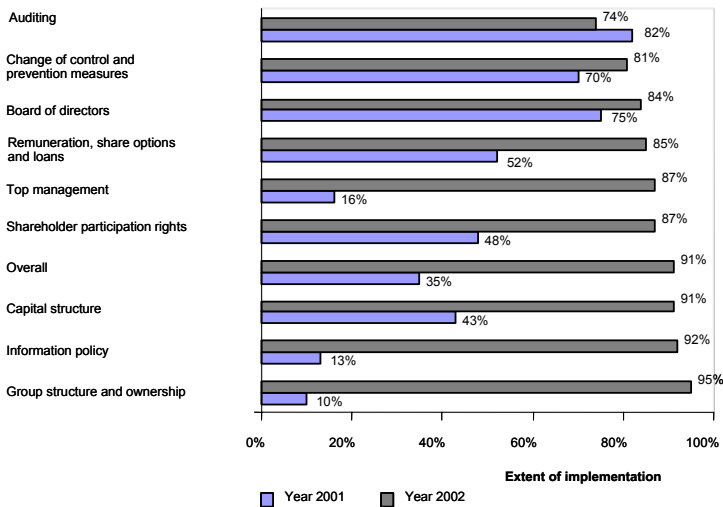


Fig. 4-15. Degree of implementation of the SWX corporate governance transparency rules in reports of Swiss companies in 2001 (prior to introduction) and in 2002 (after introduction)

²⁷⁴ Meyer (2003:13).

Since many shareholders do not behave as part-owners of the company, there is an “absentee-owner syndrome, and likely misunderstanding between board and shareholder of what is expected.”²⁷⁵ One of the central responsibilities of the board is therefore “to make every effort to help shareholders better understand their policies with respect to governance, and their management oversight and control responsibilities. Communicating with shareholders should be undertaken using every possible media channel, including print, the company website and web-casts, to Annual General Meetings where questions are encouraged. The goal of the company should be to attain continuous and conspicuous disclosure of all significant facts, policies and procedures to all shareholders simultaneously.”²⁷⁶

“Over the past decade, online and digital communications technology has become a standard tool of business at every level of the corporation, except the boardroom.”²⁷⁷ Thus, Ward recommends: “Tech is wonderful, but limit what you give the directors to real board needs.... Make sure it’s user driven, not tech driven. Make the software interface... graphic, with lots of hyperlinks to referenced material. If the agenda mentions the February minutes, the director can click on the link and review those minutes.”²⁷⁸

In the future we are likely to see an increased role of the corporate web site²⁷⁹ for on-line participation of shareholders in general meetings in good corporate governance practice.²⁸⁰

This concerns a holistic evaluation of the relationship between management and all relevant stakeholders by the board (Fig. 4-16).

In order to measure the success of the company periodically, the board can use approaches such as the balanced scorecard or my simple concept of integrated firm performance evaluation,²⁸¹ which integrates the evaluation of the demands, satisfaction, and voluntary loyalty of customers, shareholders, employees and the public.

²⁷⁵ See Healy (2003:193).

²⁷⁶ Beatty (2003:21).

²⁷⁷ Ward (2003:6).

²⁷⁸ Ward (2003:7).

²⁷⁹ See, for example, BP’s website, at

www.bp.com/company_overview/corp_gov/index.asp.

²⁸⁰ See Newell and Wilson (2002:21), and Ward (2003:136).

²⁸¹ See Hilb (2002).

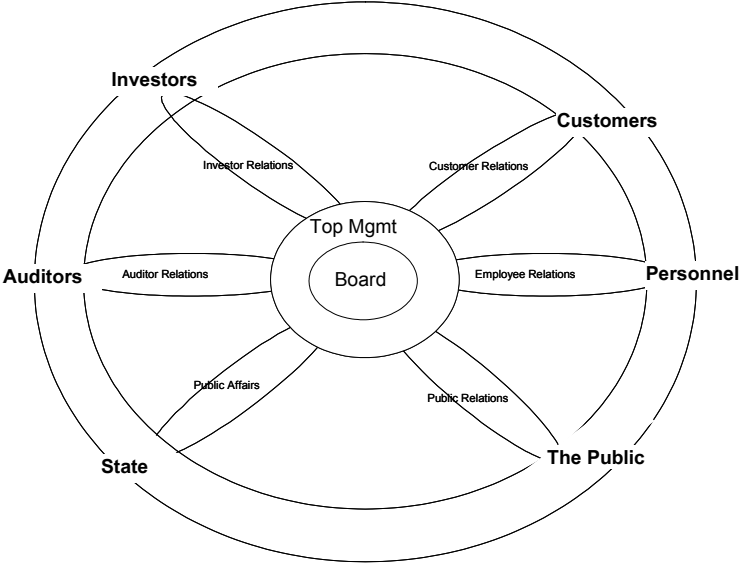


Fig. 4-16. Evaluation of relationship management with key stakeholders through the board

Even if a company meets all communication demands in an optimal way, it has to know that communication is still just an aiding tool. Even the best communication cannot make bad situations disappear.

In addition, the old communication rule has to be noted:

Believed	≠	Said
Said	≠	Heard
Heard	≠	Understood
Understood	≠	Agreed
Agreed	≠	Done
Done	≠	Retained

4.4 Review of Board Success

With regard to reviewing board success, there are two relevant functions:

- the controlling function of the board (Sect. 4.4.1) and
- the self- and external evaluation of the board (Sect. 4.4.2).

4.4.1 Controlling Function of the Board

The following questions have to be tackled first:

1. Does the board get regular (e.g. quarterly) information on the financial situation of the company?
2. Does the financial reporting contain statements on all financial indicators (company value, cash flow, profitability, liquidity)?
3. Is the extent of the reporting fine-tuned (not too much, not too little)?
4. Does the board get regular information on non-financial indicators (e.g. market shares, employee satisfaction, competitor behavior)?
5. Is strategic control enabled though reports on significant deviations of the strategy implementation?
6. Has the board communicated its requirements and expectations to the management concerning frequency and form of the (delivered) information? and
7. Is there a possibility that the board can check the accuracy of the information that is delivered (e.g. via the internal audit)?²⁸²

Under Swiss law (OR Art. 716 a) the board is responsible for financial planning, the accounting system and financial controlling. According to Bernet,²⁸³ the following tasks can be related to the provision of strategic direction:

²⁸² KPMG (2003:7). See also Newing (2003:6), and for Europe, the critical recommendations made by Pastré (2003).

²⁸³ Bernet (2003).

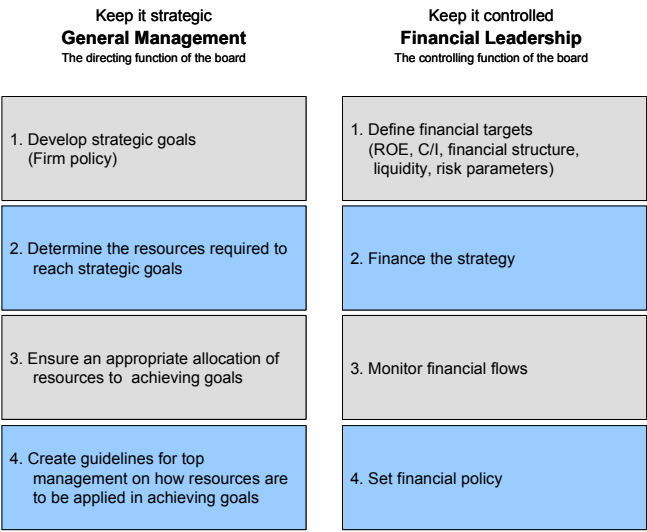


Fig. 4-17. The directing and controlling function of the board

The board has to follow the ancient rule that only a bandit spends more than he has! In other words, “You should not want more than you can pay for.” Also, the board could well use a “board-cockpit” approach to key indicators, for only “what gets measured, gets managed.”²⁸⁴ The board is dependent on critical information for formulating or assessing opinions, events relevant to the company and monitoring processes and requires both internal and external comparative data. Private rating systems (such as Standard & Poor’s²⁸⁵) and neutral research institutes can be used for external comparative information.

Canada is playing a pioneering role in this regard. The Institute for Board Effectiveness at the University of Toronto, under the leadership of Professor David Beatty and Timothy Rowley, has implemented a comprehensive rating system for listed companies in Canada.²⁸⁶ This system has been used to evaluate 225 Canadian firms on the basis of the following criteria:

- 1. independence of board members
- 2. subject-specific competence of board members

²⁸⁴ Reichenberger (2003:B7).
²⁸⁵ See, for example Pfitzer and Oser (2003:379); results of their ratings can be viewed on their website.
²⁸⁶ Rowley and Beatty (2002)

3. commitment of board members
4. efficiency of board structure
5. effectiveness of board processes and
6. board output (based on the success of key decisions in the last three years).

The evaluation produces both disaggregated and aggregated scores, and the companies are then classified according to the following rating system:

Board rating	Board effectiveness	Distribution of boards
AAA+	Perfect score	0%
AAA	Outstanding	7.1%
AA	Above average	2.2%
A	Meets expectations	7.5%
BBB	Average	6.7%
BB	Improvement required in some areas	8.0%
B	Improvement required in multiple areas	8.0%
C	Substantial concern about board's effectiveness	12.9%
D	Board requires major reform	47.6%

Fig. 4-18. Example of a leading Canadian rating system²⁸⁷

This rating system was applied to some companies during 2002. When the scores were recalculated a year later, there was evidence of considerable improvement in board practices in Canadian companies.²⁸⁸

In my approach to corporate governance, I assume that successful companies use both shareholder and stakeholder approaches, so I recommend the shareholder-oriented economic value added approach (developed by Stern and Stewart) along with a simplified version of the balanced scorecard approach (developed by Kaplan and Norton).

The balanced scorecard approach attempts to balance all the elements that have impact on success: external and internal success perspectives, short and long term objectives, monetary and non-monetary indicators, and input and output factors. More recently the balanced scorecard approach has been implemented as a “strategic monitoring system” at the board level, through which two or three key indicators are monitored in each of four areas: finances, sales and marketing, operational performance, and

²⁸⁷ See Rowley and Beatty (2002).

²⁸⁸ Clarkson Center for Board Effectiveness (2003:12).

human resource management. “Such models are needed to help directors cope with complexity and to ensure that they focus on the things that really matter.”²⁸⁹

In this context, I have developed a very simple, integrated, diagnostic tool for boards and top management. This enables a relatively objective, systematic, goal-oriented diagnosis of firm success to be carried out periodically, taking into consideration the views of shareholders, customers, employees and the public. Key indicators for expectations, satisfaction and voluntary loyalty are monitored for each of the important stakeholder groups (see Fig. 4-19).

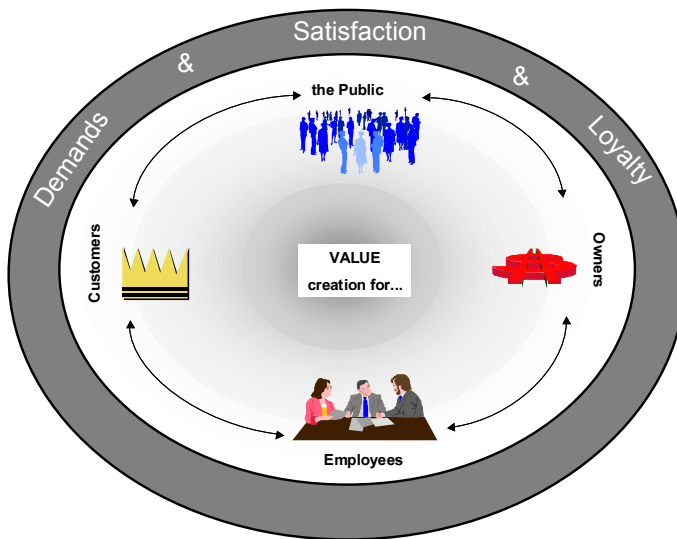


Fig. 4-19. Four dimensions for diagnosing the success of the company

In the following section, I present board review instruments which I have developed and introduced in practice.

4.4.2 Self- and External Evaluation of the Board

In the following sub-sections, I present the objectives, phases of implementation, and tested instruments for board review.

²⁸⁹ Carter and Lorsch (2004:153).

4.4.2.1 Goals of Board Review

With a self- and external evaluation of boards, two goals (that belong together) are pursued:

- 1. the periodic, objective, systematic and functional diagnosis of strengths and areas for development and of the corporate governance policies and practices in a company in general and
- 2. the joint development, implementation and re-evaluation of interventions for the improvement of the corporate governance policies and practices, and the board and management teams, based on the results of the diagnosis.

To enhance the efficiency of board teams, I use the approach illustrated in Fig. 4-20.

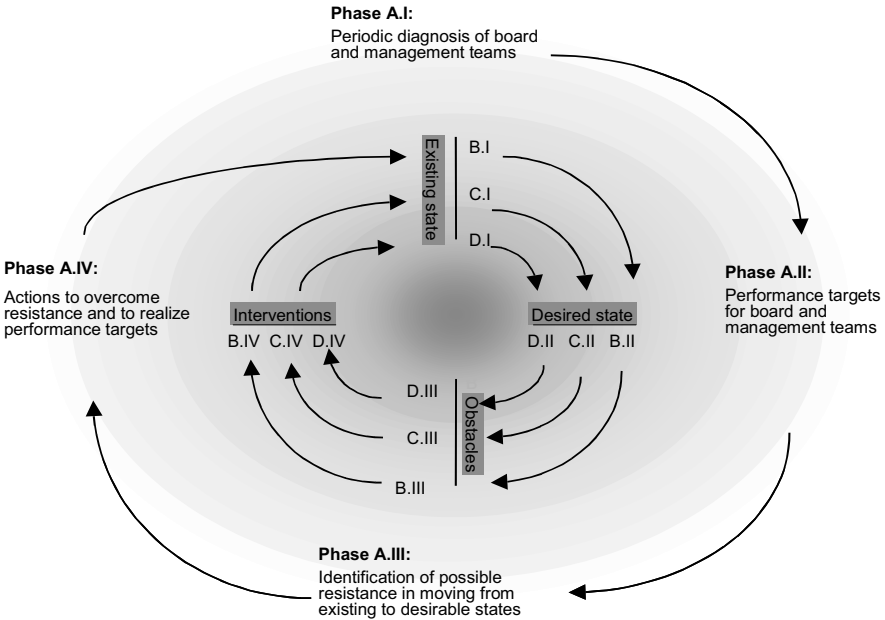


Fig. 4-20. Spiral concept of corporate governance and board development

This spiral diagram should illustrate that the neglect of a phase can seriously impede corporate governance and board development. In an extreme case, omitting a phase would cause development to stop altogether.

4.4.2.2 Instruments for Self- and External Review of Boards

I have developed two instruments for self- and external review of boards and have implemented them successfully in boards in practice:

1. the standardized board interview and
2. the one-page survey with board, management and shareholder representatives.

1. The Standardized Board Interview

My copyright protected method has two features:

- a standardized interview situation with a set of cards as a standardized support tool and
- the deduction of an action plan.

The Standardized Interview Situation

After agreeing on the standard board success variables for the company with the chairperson and the board team, I carry out interview dialogues lasting roughly two hours each. As an external board consultant, I talk with each board member and, if desired, with each management team member and with representatives of the main shareholders. The results of these dialogues are strictly confidential.

The conversations take place in a hotel meeting room or at the board member's place of work. Each board member is presented with two sets of cards – one red and one green – upon which dimensions of board practice have been printed. The board members are then asked to sort the red cards in order of importance and to facilitate the task, they are asked to sort the cards into four sub-categories (see Fig. 4-21). The same procedure is followed with the green cards, indicating level of satisfaction with each of the issues on the satisfaction template (see Fig. 4-22).

While the board members are sorting the green cards, I record the importance factors on an interview form (that has been modified to relate specifically to the company under investigation – see Fig. 4-23) in red as an importance profile.

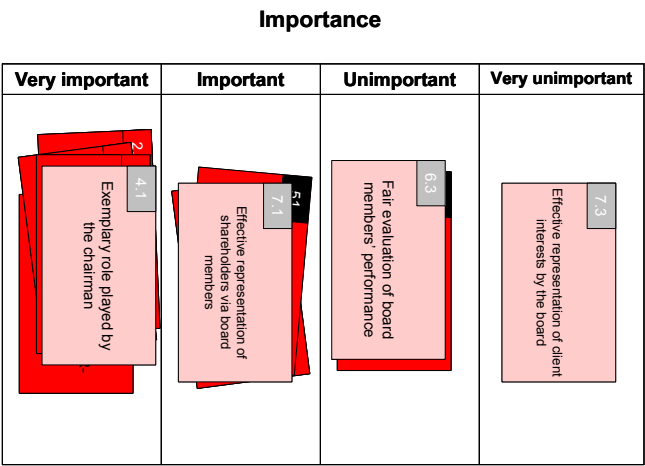


Fig. 4-21. Set of red cards and importance template for the corporate governance factors from the point of view of a board member

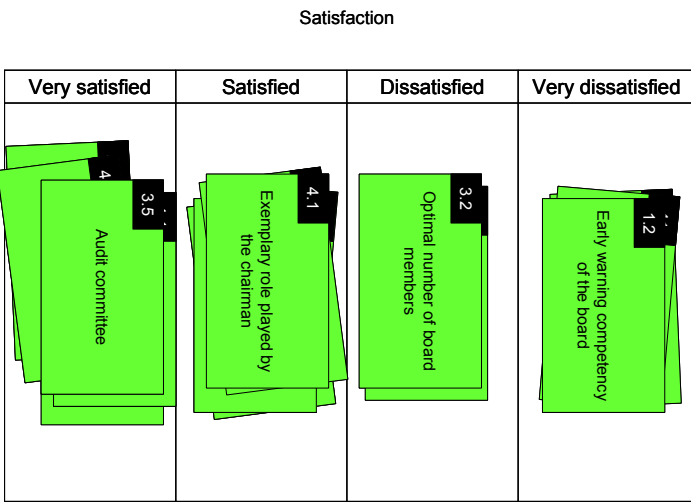


Fig. 4-22. Green set of cards for board members to rank their satisfaction with corporate governance practices

Board review



Fig. 4-23. Example of an evaluation profile drawn up during a dialogue

After the cards have been sorted, the importance and satisfaction profiles are represented graphically on the interview form presented in Fig. 4-23. This clearly illustrates the differences between importance and satisfaction for each corporate governance success factor. I then discuss the factors indicating the highest difference between perceived importance and perceived satisfaction. The conversation that follows with the board members is guided by the rank order and extent of the deficit values. For each factor, the main reason for the deficit is explored and a suggestion for improvement is generated. At the end of the conversation, three general questions are posed:

1. What do you like best in the board?
2. What do you like least in the board?
3. In your opinion, what should be done to address the issue raised in question 2?

After having conducted all conversations, the computer-aided evaluation starts for board, management and shareholder member profiles. For each of the three groups, a final profile is calculated indicating the group average score for importance, satisfaction and the gap between the two.

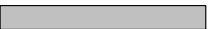
1.	Board team culture of trust	(-1,5)	
2.	Board entrepreneurial thinking	(-1,5)	
3.	Comprehensive risk management at board level	(-1,4)	
4.	Professional selection of board members	(-1,4)	
5.	Board ability to work as a team	(-1,3)	

Fig. 4-24. Differences between importance and satisfaction (deficits) for a board, based on averaged inputs from the board, the management and the main shareholders

The Action Plan

After the evaluation, the final results of the deficit-profile method are presented to the chairperson, and then to the board. Together the next steps are defined. A brief summary of the most important answers to the open-ended questions is presented in a constructive way, without revealing answers of single board members.

The chairperson now has to develop an action plan (see Fig. 4-25) with the board, that determines who will do what, by when, to overcome the greatest deficit values (as a rule of thumb, I focus on all deficits greater than one).

Who?	What?	By when?	How?	With what resources?	To what end?

Fig. 4-25. Action plan template

To assess the success of the proposed interventions, I have found it useful to conduct the standardized board interview periodically (every two years, for example).

2. The Periodic Short Survey

The Initial Situation

Wherever the standardized board interview is not suitable for financial or geographic reasons, a short survey can be conducted using the following guidelines:

- *Completeness:* whenever possible, all members of the board, and if so desired, all top managers and key representatives of the shareholders are interviewed
- *Inquiry tool:* the easiest approach is for the chairperson to distribute the questionnaire during a board meeting to all members, requesting them to send the completed questionnaire in a pre-paid envelope to a neutral organization responsible for the analysis and interpretation of the results
- *Degree of compulsion:* in this approach it is possible to guarantee that participation is voluntary
- *Analysis of the survey:* the board evaluation should be managed by an external, neutral organization
- *Data evaluation and interpretation:* the neutral, external organization has the task of evaluating and presenting the results firstly to the chairperson and afterwards to the board
- *Length of the questionnaire:* the questionnaire should not require more than two pages: as such, it is short enough to encourage board members to complete it and long enough to obtain a good overview of the issues in need of attention

- *Degree of standardization*: the questionnaire is standardized to facilitate evaluation and comparison with results generated at other times. It contains three short open-ended questions to allow for responses on issues not covered in the questionnaire
- *Survey variables*: to take the situational circumstances into account, the issues addressed in the questionnaire can be adjusted to the needs of the company by the chairperson and board members
- *Periodic review*: to ensure that interventions aimed at improving governance are effective, the survey should be carried out at regular intervals – every two years, say, and
- *Competitive context*: the short survey can also be used to compare results with comparable companies, providing such analyses are managed by a trustworthy, neutral, external organization.

The Semi-Standardized Survey

The basic questionnaire again contains issues relevant to corporate governance, and board members are asked to indicate the importance they ascribe to each issue, and the extent to which they are satisfied with performance relative to those issues. In order to capture individual opinions and needs, three open questions are included in the questionnaire. For specific categories such as important shareholders, separate questions (e.g. management of meetings with the board, representation of shareholder interests) can be developed, and irrelevant issues can be left out.

Corporate Governance Survey Self-evaluation by members of the board

Evaluation criteria of the board		Importance				Satisfaction			
		Very important	Important	Unimportant	Very unimportant	Very satisfied	Satisfied	Unsatisfied	Very unsatisfied
1	Guiding principles of the board								
1.1	Clarity of vision and values								
1.2	Clarity of value creation process								
1.3	Involvement in strategy formulation								
1.4	Long-term success-measurements (standardized)								
1.5	Lead in innovation by board								
1.6	Early-warning competence of the board								
1.7	Shaping of the company's future by the board								
1.8	Regular assessment of rate of achievement								
1.9	Leadership by financial benchmarks								
1.10	Consideration of Swiss Code of Best Practice								
1.11	Consideration of SWX Corporate Governance Rules								
1.12	Consideration of OECD Principles of Corporate Governance								
1.13	Coherent insider rules								
2	Board culture								
2.1	Team-spirit of the board								
2.2	Culture of trust within the board								
2.3	Skills to consider the opinion of management								
2.4	Constructive communication with management								
2.5	Participative decision-finding approach								
2.6	Code of ethical conduct								
2.7	Checks and balances throughout the board								
3	Board structure								
3.1	Enforcement of strategy-compliant company structure								
3.2	Delegation of authority to senior management								
3.3	Optimal number of board members								
3.4	Effective decision-implementation								
3.5	Effective control of implementation								
3.6	Effective performance of audit committee								
3.7	Effective performance of nomination and remuneration committee								
3.8	Effective performance of business safety and risk committee								
3.9	Articles of Association								
3.10	Supervision of control mechanisms of the group								
4	Board composition based on competence								
4.1	Balanced composition based on key competence (research, marketing, finance, operations, HR, risk management)								
4.2	Balanced composition based on market know-how								
4.3	Balanced composition based on product know-how								
4.4	Balanced composition based on internal vs. external know-how								
4.5	Integration of New Economy into business process								
4.6	Independence of board members								
4.7	Concept for future composition of board								

Fig. 4-26. The copyright protected board questionnaire (adapted to suit the needs of a particular firm)

Evaluation criteria of the board		Very important	Important	Unimportant	Very unimportant	Very satisfied	Satisfied	Unsatisfied	Very unsatisfied
5	Board meetings								
5.1	Leadership role of chairman								
5.2	Chairing of board meetings								
5.3	Optimal use of relevant communication technologies								
5.4	Impact of chairman on group strategy								
5.5	Control tasks of chairman								
5.6	Optimal number of meetings of Audit Committee								
5.7	Optimal number of meetings of Nomination and Remuneration Committee								
5.8	Optimal number of meetings of Business Safety and Risk Committee								
5.9	Initiation of use of external consultants by board								
5.10	Records of board meetings								
5.11									
6	Board and Senior Management								
6.1	Professional selection of board members								
6.2	Professional selection of senior management								
6.3	Fair performance evaluation of board members								
6.4	Fair performance evaluation of senior management								
6.5	Performance-based compensation of board members								
6.6	Performance-based compensation of senior management								
6.7	Executive training of board members								
6.8	Executive training of senior management								
6.9	Coaching of senior management by board								
6.10	Performance-related compensation scheme for board								
6.11									
7	Responsibilities of board towards stakeholders								
7.1	Optimal representation of shareholders interests								
7.2	Optimal representation of interests of key customers								
7.3	Optimal representation of interests of personnel								
7.4	Optimal handling of public relations								
7.5	Risk management								
7.6	External audit								
7.7	Internal audit								
7.8	Communication between external and internal audit								
7.9	Prepared response to potential take-over offer								
7.10									
8	Performance evaluation by Board								
8.1	Constructive success-evaluation of the Board								
8.2	Evaluation of internal control procedures								
8.3	Evaluation of communication processes								
8.4	In-depth, regular evaluation of company performance								
8.5	Reporting to investors								
8.6	Communication with customers								
8.7	Communication with employees								
8.8									
9	What is the greatest strength of your Board?								
10	What is the area most in need of development on your Board?								
11	How would you propose that the development area be addressed?								

Thank you for your valuable comments

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Fig. 4-26. Continued

The Subsequent Measures

I propose that the results be presented first to the chairperson, then to the board team and finally to the management team. Discussions of the results are held at each level and address the following:

- survey objectives
- survey method
- survey results
- and an action plan for improvements.

My deficit method of presenting results has the advantage that the graphics are simple and impressive:

$\text{Desired (importance) profile} - \text{Current (satisfaction) profile} = \text{Deficit profile}$
--

Differences between the results of individual board members and the averaged results for the full board, and differences between current and previous survey results can be analyzed for importance, satisfaction and areas for development.

The Shared Development, Introduction and Assessment of the Action Plan for Improvement of Governance, Following the Feedback Results

The shared development and realization of an improvement action plan can determine the success or failure of the corporate governance survey. Boards that do not demonstrate the necessary readiness to change should not take the survey. If the diagnosis is not followed by interventions aimed at improving the situation, the consequences can be very negative: expectations that are not met can lead to frustration among the board members.

To illustrate this point, the following paragraphs depict a positive example from my own experience.

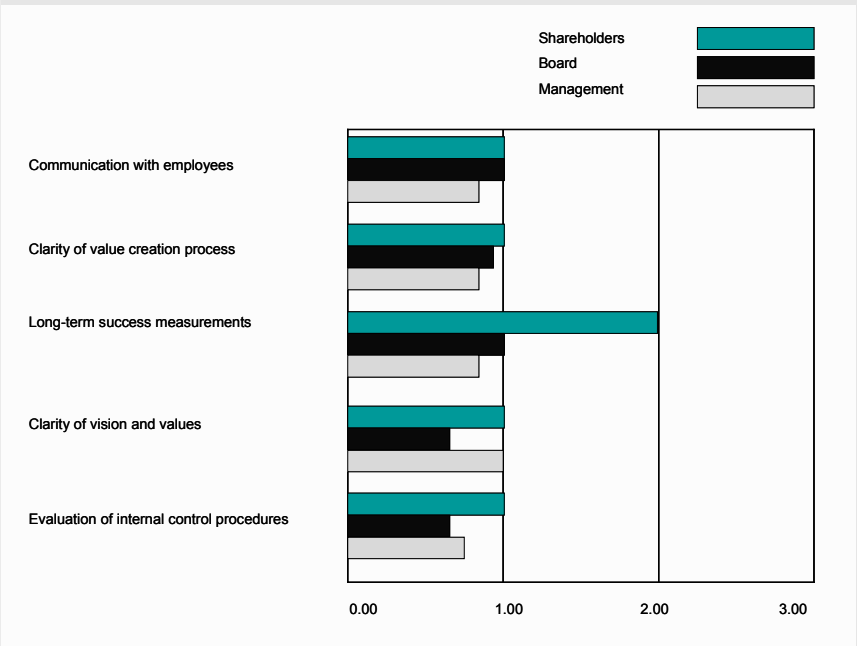
Illustrative case study for Part 4: Keep it Controlled

(All names and dates have been changed in this “living” case).

You receive an offer from Michael Miller, Chairman of the board of the MCI International Hotel Group, to conduct a 360⁰ board evaluation from the perspective of the board, the top management and the three main shareholders (all of whom are big international private equity firms).

You conduct the survey based on a questionnaire (see Fig. 4-26) adapted to the needs of the company.

You presented the results to the Chairman and then to the entire board as follows:



Question A: What would you as a consultant to the board, recommend?

Thereafter, an action plan was developed and implemented by the Chairman.

The survey was done three times and each time it resulted in significant improvements of Corporate Governance Practice of this company.

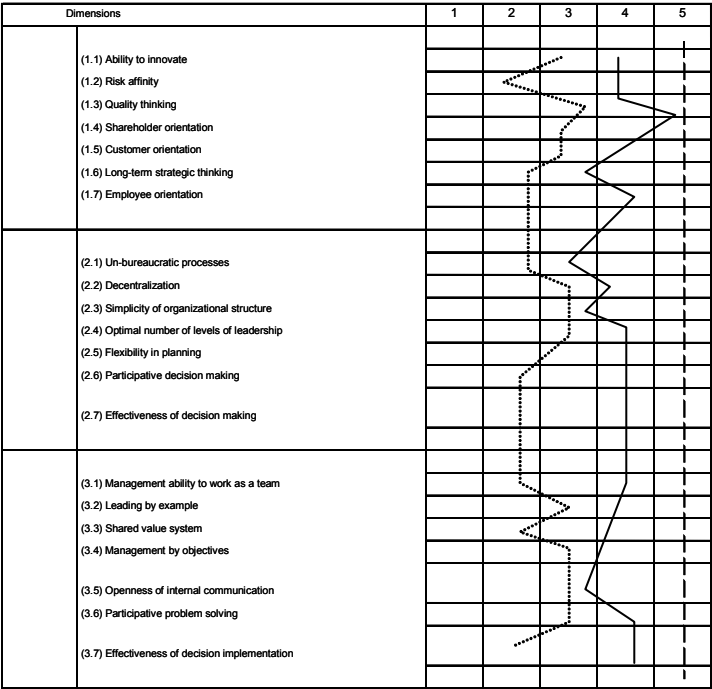
After 6 years, the company was sold to an international investor for 5 times the price of acquisition 6 years ago.

Question B: What is the most important lesson learnt from this case?

In Fig. 4-27 I show the results of a self-evaluation by the top management and the external evaluation of the management by the board. (Software used in this process has been developed as an e-tool).²⁹⁰

Questionnaire

Please indicate your rating of the company, where 1 = non existent and 5 = very well developed



Thank you for your cooperation!

- Legend: 1) Evaluation of mgmt by the board
2) Self-evaluation by mgmt
3) Desired profile

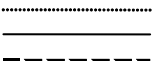


Fig. 4-27. Short questionnaire for a self- and external evaluation of the management

²⁹⁰ Hilb, et al.(2003).

4.4.2.3 Procedure for Self- and External Evaluation of Boards

The procedure is based on my “8 W” concept for board evaluation and encompasses, on the one hand, the board policies regarding:

1. board guidelines (**Where?**)
2. board culture (**How?**)
3. board structure (with **What?**)
4. board meeting management (**Why?**)
5. board diversity (from **Where?**)

and on the other hand, the board factors:

6. board champions (**Who?**)
7. board stakeholders (for **Whom?**)
8. board feedback (with **What** success?)

These components should answer the eight central questions of board management. Based on this concept, I have developed a simple evaluation framework and tested it in practice.

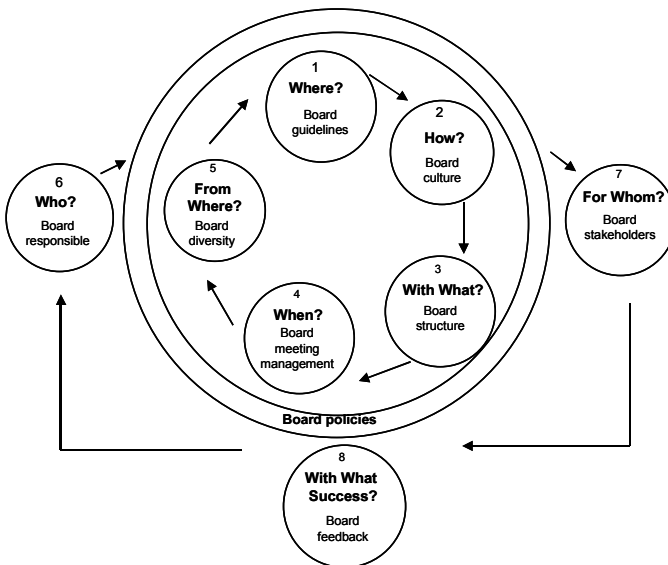


Fig. 4-28. Self- and external board evaluation framework

Both instruments outlined in this chapter incorporate three features:

- determining the difference between importance and satisfaction (or the deficit) on factors relevant to board success
- self- and external evaluation of individual board-members on transparent evaluation forms, and self- and external evaluation of the joint board team on green evaluation forms and
- brief presentation of results and discussion firstly with the chairperson and afterwards with the full board, and then the joint development of an action plan.

How are such instruments applied in practice?

I propose proceeding as follows every two years (at the start of a regular board meeting, for example):

1. each board member receives a board evaluation form (a form printed on green paper and a transparent form)
2. board members are asked if additional company specific factors should be considered. If so, these factors are added in empty fields included for this purpose
3. each board member fills out the importance side of the questionnaire, followed by the satisfaction side of the questionnaire and finally the open-ended questions (see the example questionnaire in Fig. 4-26)
4. the green questionnaire is separated from the transparent form and put in a box
5. I analyze the green forms outside the board meeting room while the board members draw lines between factors that they judge as very important and the satisfaction value assigned to those factors on their transparent forms (the longer the line, the greater the deficit that the board member perceives). Each board member makes notes on a separate sheet and creates his or her board deficit ranking
6. after lunch or dinner, I present the results of the self- and external evaluation to the chairperson, and then to the board and the management teams, including:
 - a ranking of importance
 - a ranking of satisfaction and
 - a ranking of deficits.

Afterwards, I distribute (on red paper) profiles of average importance and average satisfaction from the point of view of the board members and (on blue paper) profiles of the average importance and satisfaction from the point of view of the management.

7. each board member compares the average profiles with his/her own profile on the transparent sheet; the importance and satisfaction profiles, the average board deficit profile, the average management deficit profile, and her/his own board deficit profile.
8. in the subsequent discussion, measures for improvement are worked into an action plan, specifying who does what and by when, to overcome the greatest deficits in the current board practice. In addition, the greatest obstacles to the interventions are identified and plans are made to overcome those obstacles.
9. the board survey is repeated every two years in order to monitor the success of the interventions introduced in a targeted way.
10. the board's self-review is the most valuable assessment. Depending on the context, individuals or groups besides the management can be involved in a 360° feedback process (see Fig. 4-29).



Fig. 4-29. 360° board feedback possibilities

For board development, the following formula applies:

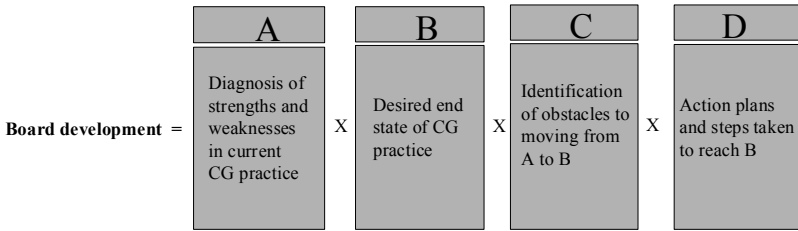


Fig. 4-30. Formula for board development

The results of board evaluations conducted during the course of the last two years can be summarized as follows:

CG practice Ranking	Firm	Branches	Highest deficit value ²⁹¹	Number of deficits > 1
1	A	I	0.9	0
2	B	II	1.0	1
3	C	V	1.0	1
4	D	III	1.3	2
5	E	IV	1.4	2
6	F	V	1.4	2
7	G	IV	1.4	5
8	H	II	1.4	7
9	I	III	1.5	10
10	J	II	1.6	11

Fig. 4-31. Results of board evaluations conducted during the last two years

There are four points that attract attention in these results:

1. There does not seem to be a dominant industry context.
2. All companies (with the exception of company 7 and 9) belong to the most successful companies in their industry.
3. The best positioned boards (1, 2, 3 and 4) show deficits mainly in the field of controlling, e.g. in the implementation of decisions. The companies placed in the middle of the field reveal a deficit in issues related to the shaping of the future of the company. The lowest ranked board reveals the greatest deficit in the culture of trust in the board.

²⁹¹ In general, where deficit values between importance and satisfaction are greater than 1, there are important opportunities for board development.

4. It is interesting that the best-ranked board in Fig. 4-31 has room for improvement in its corporate governance transparency, whereas the company ranked last belongs to the group of leading companies in reporting transparency.

When in the worst case, as already mentioned, one of the four development factors (see Fig. 4.30) is non-existent ($= 0$), no board development happens. This means for example that even if the level of dissatisfaction has been diagnosed without a doubt and the ideal state is known, there is no development if no real steps for improvement are taken.

The importance of this last development factor (action) can be illustrated by the tale of the three frogs:

Three frogs fall into a milk urn.

- The first of them is a pessimist and thinks, “There’s nothing we can do” – so he does nothing and drowns.
- The second is an extreme optimist, saying, “No problem” – he also does nothing and drowns.
- The third is an optimistic realist, who reasons “You can never know what will happen, but the most important thing is to have a target and to do something!” He wants to get out, so he thrashes about for two hours. The cream turns into butter, and he jumps out!

PART 5

Conclusions

In conclusion, I want to highlight the implications for practice, teaching and research.

5.1 Implications for Practice

The dot.com hype, the crash of financial markets, high-risk corporate strategies, the top executive value mindset and the momentous and numerous corporate crises lead to a switch from first-to-worst for many companies within a short period of time.

The experience in many countries showed that awards such as chairperson or CEO of the year are no guarantee of future success, nor can they prevent sudden corporate failure.

The current danger consists of some sort of over-regulation in the development of laws and guidelines, as most countries have done following the recent crises.

As I described in Sect. 4.4, I have been conducting self- and external reviews of boards for some years. I remember a case of a medium-sized, publicly listed company that fulfilled all best-practice recommendations and that was highly rated according to a university study.²⁹² In reality, this company had a clear culture of mistrust within the board and, although it had excellent individual board members, the board as a whole demonstrated a low collective IQ.

Another listed company was a leader in its industry and had excellent board evaluations according to the 360° feedback process followed by the board. However, its management and main investors were among the “black sheep” in terms of corporate governance transparency guidelines on business report quality.²⁹³

What does this mean? Soft laws neglect the decisive soft dimension of companies.²⁹⁴ Successful companies have at the top of their boards and their management, human entrepreneurs (with cool heads, warm hearts and working hands) who succeed in building small boards, committees and management-teams with diverse know-how and team members playing

²⁹² Meyer (2003).

²⁹³ Meyer (2003).

²⁹⁴ “The governance debate is too much about ticking boxes. What really counts are skills and behaviors inside the boardroom” Carter and Lorsch (2004:220).

different roles and displaying competence, commitment and integrity.²⁹⁵ These human entrepreneurs strive to be role models for shareholders, customers, employees, and the public and belong to the most important “contributors to wealth and employment in virtually every country.”²⁹⁶

5.2 Implications for Teaching

There exists an excess of courses and literature on corporate governance based on a “one-size-fits-all” board approach.

It is important to resist this misconception. Different corporate governance approaches have to be applied based on the size, sector, culture, ownership structure, legal form, stock-exchange requirements and development stage of the company.

This is why IFPM Center for Corporate Governance at the University of St. Gallen in Switzerland (www.ccg.ifpm.unisg.ch) conducts targeted board programs such as:

- corporate governance for chairpersons of small- and medium-sized companies
- educational governance for school board chairpersons
- bank governance for bank boards
- hospital governance for hospital boards
- public governance for boards of public companies and
- cooperative governance for boards of cooperatives.

5.3 Implications for Research

As the latest literature and current conferences on the subject of corporate governance reveals, many special issues are well researched, but the research is usually completed in isolation of other issues. There is a lack of integrated corporate governance concepts.

²⁹⁵ See Brabeck, in Noetzli (2004:20f).

²⁹⁶ Neubauer and Lank (1998:11).

With this book on “New Corporate Governance,” I attempt to introduce a more integrated approach and put it on the agenda – leading from supervision and administration to direction and control.

Twenty-nine doctoral students from 21 countries are currently working with the Center for Corporate Governance in a web-supported research network (www.c-governance.com). This network meets regularly for either virtual discussion forums or face-to-face discussions.

My current corporate governance research and consulting activities have revealed that the success of companies depends on the targeted selection of the board members, on the composition of the board team; and on the competence, availability, commitment and integrity of the board members.

The optimal functioning of boards from the point of view of shareholders, customers, employees and the public is only possible if boards are guided by principles that are both legal and legitimate. There are two dimensions along which board actions can display integrity:

- the strategic direction function and
- the strategic controlling function.

In this book I have introduced a “both-and” approach that I call “New Corporate Governance.” With this approach I am trying to overcome the “either-or” thinking that currently dominates corporate governance theory and practice, based on the principle espoused by F. Scott Fitzgerald that:

“The test of a first-rate board intelligence is the ability to hold two opposing ideas in mind at the same time, and still retain the ability to function.”

Successful boards strive to deliver simultaneously:

Both		And
Shareholder value		...value for clients, employees and the public
Entrepreneurial action		...checks and balances
Legality		...legitimacy
Short-term results		...long-term sustainability
A culture of trust		... controls
Global integration		...local adaptability
Comprehensive transparency		...necessary confidentiality
Performance orientation		...cooperation
Strategic direction		...monitoring
Keeping its nose in		...its hands out of company activities.

It remains to be seen if boards have the will and resources to transform themselves into true directing and controlling teams; changing their orientations from corporate governance to corporate *control-preneurship*. The result of this challenge will determine whether companies will be among the winners or the losers in the face of global change.

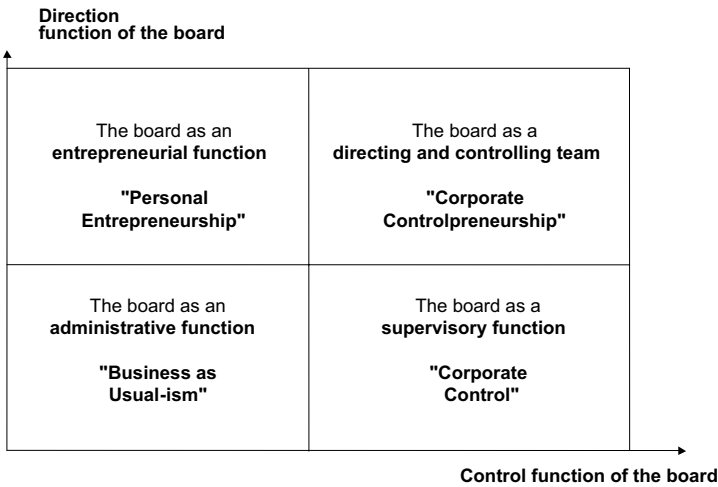


Fig. 5-1. From administrative or supervisory board, to strategic direction and control; from administrative governance to corporate controlpreneurship

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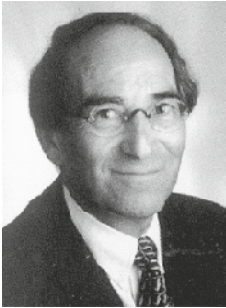
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