

Strategic Corporate Governance in Times of Financial Crises

Marc Eulerich^a and Anja Schulz^b

^a Chair for Strategic Management, Technical University of Dortmund, 44227 Dortmund, Germany, marc.eulerich@uni-dortmund.de

^b Mercator School of Management, University Duisburg-Essen, 47057 Duisburg, Germany, anja.schulz@uni-due.de

Abstract

Directing, monitoring and control in the typical European two tier-system of corporate governance lay in the hands of the members of the supervisory board. In times of global financial crises the need of an efficient governing body is worldwide newly discussed. Boards nowadays still raise information that orients at the past. Institutionalized corporate governance therefore is mainly past-oriented and passive. The current situation shows that good corporate governance needs a sustainable, wholesome and future-oriented perspective. Strategy formulation, implementation and control cannot be concentrated on the management level alone. It is also part of the boards work. This paper will conceptualize a corporate governance mission statement that is facing the challenges of the fragile economic system of today and also address the problem of board-overload. Therefore a Supervisory Board Scorecard (SBS) will be developed to empower the supervisory boards according to a nowadays needs without overloading them.

1. Introduction

The work of (supervisory) boards is the best known and observed corporate governance mechanism worldwide (Thomsen, 2008; Adams, 2005). There is a common shared consensus that boards have an important role to play in corporate governance. Sometimes it seems that the concept of boards and corporate governance is one and the same. Boards have enormous formal power. All important decisions must be made or at least approved by the board members. Classically board jobs consist of a wide range of assessing the companies' performance, checking the accounts and hire or fire the top management (Bennedsen et al., 2006; Huson et al., 2004). Modern corporate governance approaches call for more advanced board duties such as developing entrepreneurial leadership, developing strategy proposals, setting values and standards for the company, meeting with major shareholders and being able to critical self-evaluation (Adams&Ferreira, 2007; McNulty et al., 2005; Westphal&Khanna, 2003). An international study of PricewaterhouseCoopers (2005) shows that already the workload and time spend on board-related issues is increasing for the board-members over the past few years. The danger of overload is therefore widely discussed (Lohse, 2006; Hermalin&Weisbach, 1998; Aghion&Tirole, 1997).

In nowadays times of financial crises companies are facing a fast changing environment with increasing dynamics on the (financial) markets, growing uncertainty and a public cry for government actions and new legal forms. The classical approach to corporate governance and

boards is challenged by the urgent need of a modern control system that is more active and future-orientated.

So far only two German empirical research studies do exist that proof that the German two tier system is lacking the ability to forecast and direct the management board in a pro-active way.

This paper is structured as following: After this brief introduction we will outline the state of the art debate on strategic corporate governance mechanism in the German context. Aft this we will discuss the need for empowerment of the supervisory boards with typical constraints and develop a new approach on the capabilities of supervisory boards that will be supported by a Supervisory Board Scorecard (SBS). This SBS will face the needs of time and know how constraints of board members and will overcome them. The paper will end with a conclusion and critical outlook on further research questions.

2. State of the Art

Boards are the generic corporate governance mechanism worldwide. According to Monks and Minnow (2001), Young (2003) and Roe (1994) activities performed by the (supervisory) boards worldwide are:

- Evaluate the financial situation and strategy of the company
- Select, evaluate and if necessary replace the CEO and other chief executives
- Negotiate CEO pay
- Nominate new board members
- Control major strategic decisions such as M&A-activities, capital investments, etc.
- Establish stakeholder policies
- Advise the executives on strategy and other policies
- Ensure lawfulness of company activities
- Ensure appropriate risk management
- Facilitate good shareholder relations
- Form and maintain business relationships

To these more or less classic board functions Thomsen (2008) add service functions such as advice giving and input to strategy discussion and networking.

The board-form of this institutionalized corporate governance system differs from nation to nation and is embedded in the national context. Germany, Austria and Switzerland have traditionally mandatory two-tier board systems. That means that public companies have a supervisory board (so-called “Aufsichtsrat”) and a management board (so-called “Vorstand”). Their roles resemble those of non-executive and executive directors in the UK or USA. But there is one difference: An overlap between the two boards is legally prohibited and they are independent. Still the supervisory board is responsible for almost the same functions as boards in the anglo-american world (Prowse, 1995). It shall review the performance of the public company, it shall monitor the performance of managers and replace them if necessary, it shall ratify major decisions such as M&A-activities. One German speciality is that employees have the legal right to elect up to the half of the board members in large public companies still the shareholders maintain a voting majority. This is leading to large supervisory boards with an average size of 15 members (Andres et al., 2006). In addition to the employee representation in the supervisory board, most of the decision concerning labour issues must be discussed in

work councils. The “Vorstand” on the other hand is the collective decision-making body assigned by the “Aufsichtsrat” (see figure 1). It is normally headed by a CEO.

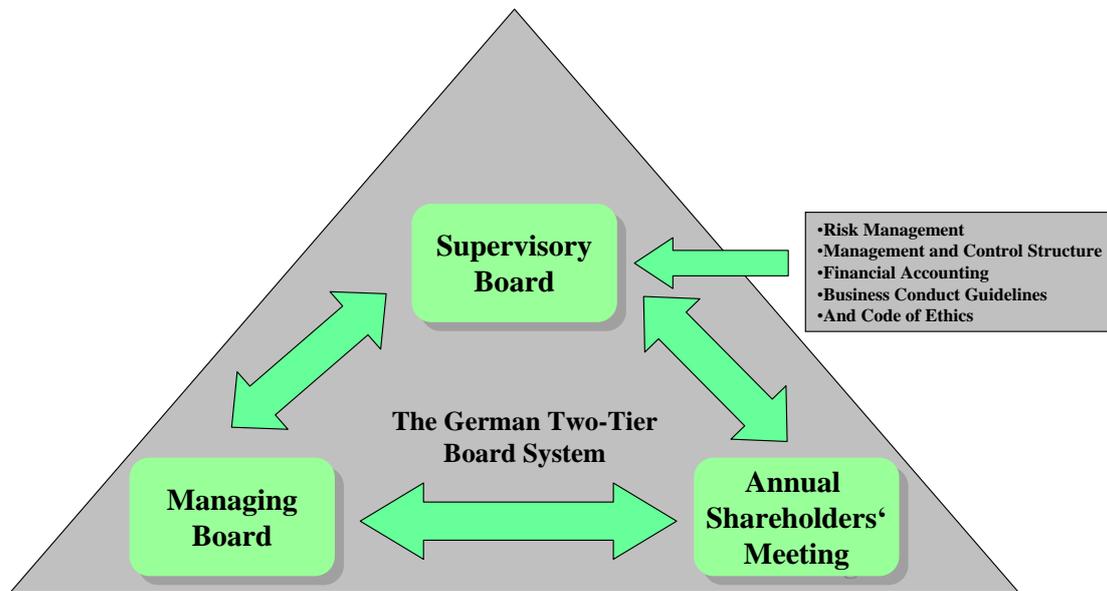


Figure 1: The German Two-Tier system

The German corporate governance system reflects the German view of how a company should be run and how the relationship between business and society shall function (Charkham, 1994; Charkham&Simpson, 1999). “Private ownership is not a goal in itself, but is subordinate to the public interest. Ownership involves obligations as well as rights. The purpose of a company is to provide goods and services for the population: not to make money. These views – though difficult to verify – seem consistent with a strong industrial tradition in German business” (Thomsen, 2008:196). This industrial tradition promotes long-term thinking, stakeholder interest and as one of the main goals the survival of the corporation. This view is translated into long terms of contracting the executives who often continue after retirement as supervisory board members. One can argue that firms with extent employee representation carry the risk of lower performance and lower risk-taking in general. Employees seem to have a major interest in protecting their jobs and so they would want the companies to be less risk-taking. Therefore Thomsen (2008:196-198) calls the German corporate governance system “conservative”, “low risk-taking” and “more sceptical to economic reform”.

So far only two German research studies do exist that focus on the performance of the supervisory boards and their strategy bias. Jürgens, Lippert and Gaeth (2008) follow the research question: “How to design the structure of German supervisory boards and the corporate governance process?” The authors conducted a quantitative survey of 1.145 supervisory board members and triangulated their findings with 11 additional qualitative interviews. The work of Grothe (2006) is led by the following research question “How to ensure strategic corporate governance in the German two tier-system?”. The author is taking a qualitative approach and conducted a qualitative study, based on interviews of supervisory board-members of the leading 45 German corporations listed in the German DAX.

The current research results on corporate governance Practice in the German two-tier system show that the work of the supervisory board is characterized by the following attributes (Jürgens et al., 2008; Grothe, 2006):

- Orientation of the board is based on past performance, especially annual financial statements.
- Orientation is internal focussed. No use of external information, reports, consulting help. Even external public reports are not considered very often.
- Orientation leads to passive actions. No usage of their denial of agreement especially in strategic subjects

German supervisory boards are non-homogenous in their composition of management-experts and non-management employees. That means here people are gathered together which have different job backgrounds, business administration know how and experience according to monitoring, management replacement, control, ratification of major decision. According to an international study of PricewaterhouseCoopers (2005) they are small entities who meet between six and eight times per year. A normal meeting will take up to whole day, but sometimes is during only 3-4 hours. The work-load of board-related issues is stated between 180 and 200 hours a year. Therefore the boards work does account for only minute fraction of the overall business activities. “This does not necessarily mean that boards are useless, but rather that their contribution is limited. In fact – much like penicillin – they may be essential for limited range of very important tasks, and companies might find it difficult to function without them” (Thomsen, 2008:105).

Academics do debate vividly worldwide and over decades how much empowerment and how much overload the corporate government system “boards” can handle (Thomsen, 2003; Lorsch&McIver, 1989). It’s a typical field of tension between what boards should do (undertake entrepreneurial leadership, strategy proposals, set values and standards for the company, meet with major shareholders, self-evaluation) and what boards classically do (checking accounts, assess performance, hire or fire management).The call for greater board involvement is challenged by the time and know how constraints of the board members.

3. Discussion

The challenges in times of financial crises are the super fast changing environments, the increasing dynamics of the financial markets and the massive impact on other markets, the growing uncertainty and the overall public cry for governmental actions and new legal forms to secure business activities. On the other hand – like all crises – this financial crisis does generate chances for new financial opportunities and innovations. The corporate consequences are manifold. Top-managers are in the very center of public interest, their salaries, their decisions and the corporate performance are closely watched and judged. CEOs step back from long-term strategies, adjust the corporation goals according to new demands. Strategies become more short-term oriented, even more focussed on the shareholder value, the financial ratios and the operating figures.

The German research projects so far show that German supervisory boards who shall direct, control and supervise the management is past-term oriented, passive and internally focused (Jürgens et al., 2008; Grothe, 2006). Because of the financial crises the demands on the supervisory boards are shifting rapidly. Strategy formulation, implementation and control cannot be concentrated on the management level alone. To become a fitting part of a new and

modern corporate government system a supervisory board nowadays has to become more pro-active, sustainable focussed and future-oriented (see figure 2).

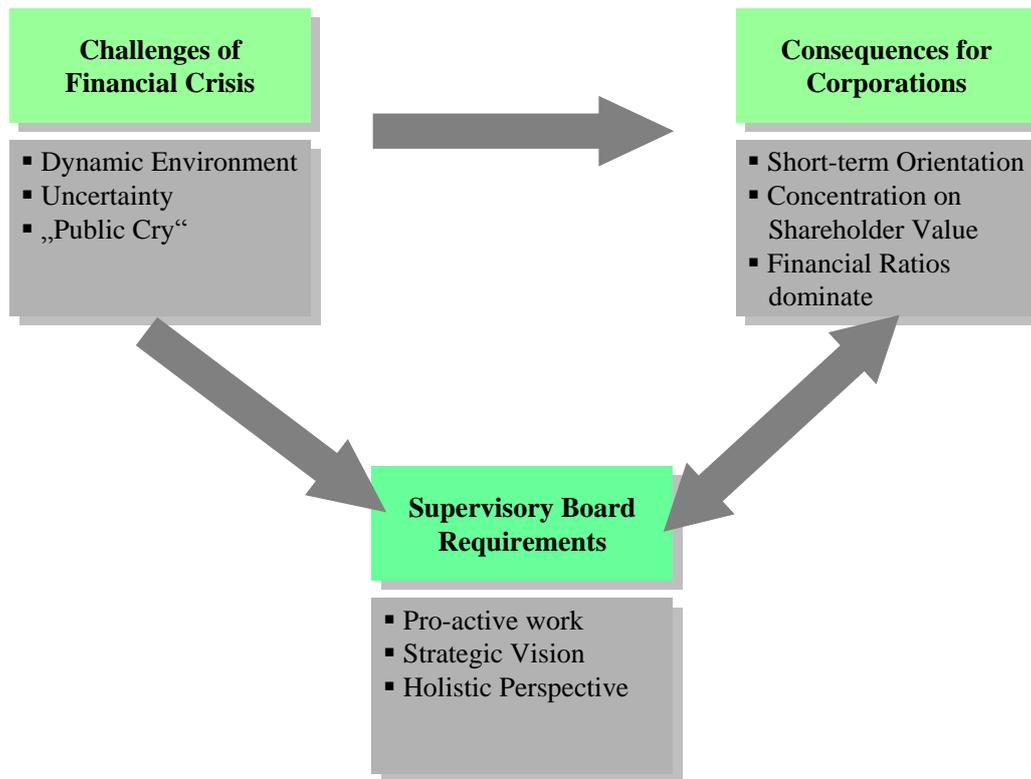


Figure 2: Challenges for the Supervisory Board in Times of Financial Crisis

The problem is already lined out: Supervisory boards today are facing challenges and new needs of corporate governance actions. Still their time line and know how to do so are limited. The risk of overloading the boards with more and more tasks and perspectives is high. Therefore instead of overloading boards the idea to guide and direct them via a modern tool will be outlined as followed.

3.1. Development of a Supervisory Board-Scorecard for strategic corporate governance

The additional benefit of a Balanced Scorecard (BSC) as a performance-measurement and strategy-implementation tool is well known in practice. Using a scorecard combines strategic objectives, corporate alignment and an adequate allocation of resources. The objective of a Balanced Scorecard for the Supervisory Boards is the control and supervision of superior corporate governance and the integration of a strategic perspective in the German two-tier board system.

Because of the dominant role of the supervisory board in times of the financial crisis and the public corporate governance-discussion a Supervisory Board-Scorecard is a good means for resolving the traditional conflicts and problems of the past performance-oriented work of supervisory board members. It defines the strategic contribution of the superordinate corporate aim „excellent corporate governance“, by the selection of relevant strategic perspectives, which direct the board members' attention to their essential managerial-, advisory- and supervisory-function (Nagy, 2002; Kaplan&Nagel, 2004). Furthermore all decision-oriented information will be filtered out, which are necessary for a pro-active corporate governance (Nagy, 2002).

The Scorecard also influences the organizational structure of the supervisory board in a positive way, because it organizes the work of the different committees efficiently, identifies lack of information and illustrates where necessary strategic information are still needed. Hereby the typical use of a Balanced Scorecard as a Performance-Measurement-Tool not only allows the evaluation of the supervisory board but also ensures a strategic corporate governance.

A common understanding of the corporate strategy and the allocation of decision-oriented information is an essential presupposition for the advisory, control and valuation of the business operation among the supervisory board with respect to the long-term shareholder-value-generation and the “public cry” for a settlement of stakeholder interests. The reception of a Balanced Scorecard would inform the board members continuously and in a more effective manner about their own company and would help them (to) focus on their strategic corporate governance.

The development and the usage of a Supervisory Board-Scorecard have got different advantages:

- Increase of the engagement in the board with regard to their task fulfillment
- Prioritization of the relevant strategic objectives
- Facilitation of a permanent discussion culture within the board and among the supervisory and the executive board-members
- Support of the organizational arrangement and the underlying processes
- Guarantee and control of an effective strategic corporate governance

In order to reach these SBS-objectives, the traditional Balanced Scorecard has to be modified within its different perspectives.

3.2. Defining the perspectives for strategic corporate governance

The general objective of scorecard perspectives is to visualize both, operative and strategic management processes from different angles in order to sufficiently meet all stakeholders’ interests (Kaplan&Norton, 1992:38; Weber&Schäffer, 1999:154). By definition, classical perspectives are to a certain extend flexible, fulfilling individual and target-orientated criteria for their specific range of application. Fostering all business processes positive corporate governance supports productive value creation and fair-minded distribution of resources to the stakeholders. Thus, as a prerequisite for application of a scorecard to control and supervise excellent corporate governance traditional standards already have to be expanded during the phase of choosing appropriate perspectives.

Identifying the strategic objectives within the individual perspectives can be regarded as „the core of a Balanced Scorecard“ (Horváth&Gaiser, 2000:26).

Subsequently for the application at hand, a strict operationalization of the superior objective “positive corporate governance” is utilized within management and board (Michel, 1997:279). To do so, a focus on those mechanisms affecting the decision-making in terms of a stakeholder-orientated corporate governance is suitable (Mann, 2003:78). In other words, both bodies of the dualistic model have to concentrate on the stakeholders’ requirements when identifying strategic objectives. During this process, different possible layouts and designs discussed in the literature are considered. Whereas in Germany to achieve a good corporate governance, the layouts and designs have to especially take into account the German Corporate Governance Code (GCGC). A complete achievement of objectives results in the

abolishment of diverging interests between stakeholders and the board or respectively the management (Schmidt, 2001:23). The different perspectives as well as the design in regard to the GCGC are exemplified in the following figure (figure 3).

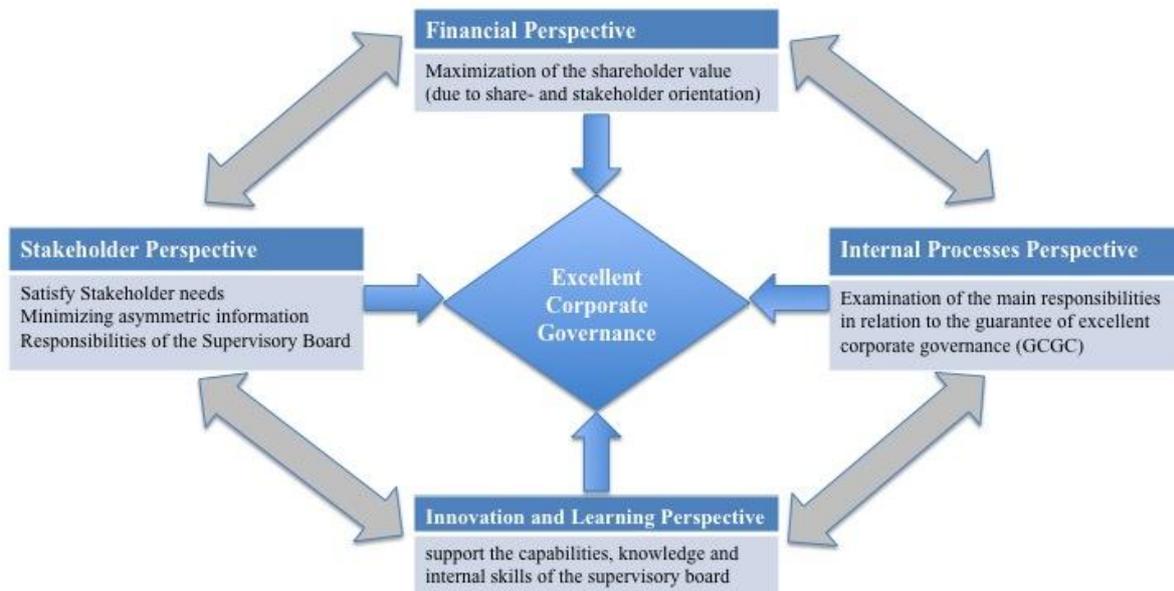


Figure 3: SBS-perspectives

Financial Perspective

Trying to align the monetary objectives and indicators by which executive management and board govern the organization, the financial perspective – due to shareholder and stakeholder orientation - should be based on target values of the classic BSC like maximization of the shareholder value. Being interlinked to value-orientated measurements, the design of this perspective is highly constrained by the firm’s specific environment, hindering a distinct derivation of general strategic objectives. Nevertheless, the global superior intend of sustainable value creation, has immediate impact on an organization’s corporate governance.

Differences intrinsic to each firm and its specific environment, are especially originate from the definition of inferior objectives, which are primarily determined by criteria such as organizational structure or the allocation of financial resources.

Stakeholder Perspective

The coherence of good corporate governance and fulfillment of the stakeholders’ interests – fundamental to the SBS – refers to the coherence of customer orientation and achievement of financial targets, as the degree of meeting the stakeholders’ interests can be regarded as a measurement of good governance. In other words: the customer perspective converts into the stakeholder perspective, generally expressing the responsibility of the board against the stakeholders. Taking a center stage as an intermediary between management and stakeholders, the board thereby eases information asymmetry (Kaplan&Nagel, 2004: 9).

Thus, the stakeholder perspective of the board scorecard focuses on objectives the board has to realize to settle the stakeholders' requirements. Essentially the objectives are arranged in alignment to the three principal tasks of the board: advisory, supervision and control.

Subsequently the first strategic objective refers to the advisory function of the board. Although the derivation of a strategy, its implementation and internal communication is in the management's authority, the board is required to supervise the progress of implementation and the inherent risk. Additionally the board separately examines whether the strategy at hand meets the stakeholders' interests.

Internal Process Perspective

In comparison to the original Balanced Scorecard there are just a few structural changes in the internal process perspective. The objective of this perspective is the examination of the main responsibilities of the supervisory board in relation to the monitoring and guarantee of excellent corporate governance. One main aspect that has to be considered for an enhancement of the flow of information to the whole board is the formation of committees. In scientific discussions, a significant role of these committees regarding to the ability to cope with tasks was revealed (Grothe, 2006).

This circumstance is illustrated in the organizational arrangement of the internal process perspective. Especially the constitution of the committee that is intended to be implemented is significant. The supervisory board is entitled to decide which organization, which composition of members and which functions will be selected. As long as a minimum of two members is given, the size of the committee can be defined as well. Thus random decisions can be avoided and realistic formation of options can be ensured (Köstler et al., 2006).

In the political and scientific discussion about corporate governance, as well as in the media, a recommendation for the formation of committees has been given for the following areas (Schwalbach, 2004):

- personnel and compensation committee,
- financial and audit committee,
- strategy committee and
- corporate governance-committee.

The implementation of committees within the internal process perspective follows the regards of the German literature of two-tier boards (Grothe, 2006; Diederichs&Kissler, 2009).

The adjustment of these different committees plays a crucial role for the organizational structure of the supervisory board. Besides the efficiency improvement the committees contribute a strategic benefit for the control and supervision of German companies. Although it has to be considered that the implementation cannot be perceived as common solution. Especially in terms of listed companies, excellent corporate governance can be highly reasonable. But the implementation of committees is significantly depending on the size of company and consequently depending on the size of the supervisory board. However, the formation of committees is explicitly recommended by the German Corporate Governance Code (DCGK, 2009).

Innovation and learning perspective

The innovation and learning perspective integrates all processes and objectives that support the capabilities, knowledge and internal skills of the supervisory board. This perspective is needed to allow the board members to use all strategic relevant information to achieve the

ambitious aim of excellent corporate governance. Especially the link between the intangible assets of the whole board and the discussion culture within the board provides and assists the monitoring role of the non-executive directors. The following figure integrates the different perspectives within a single strategy map (figure 4).

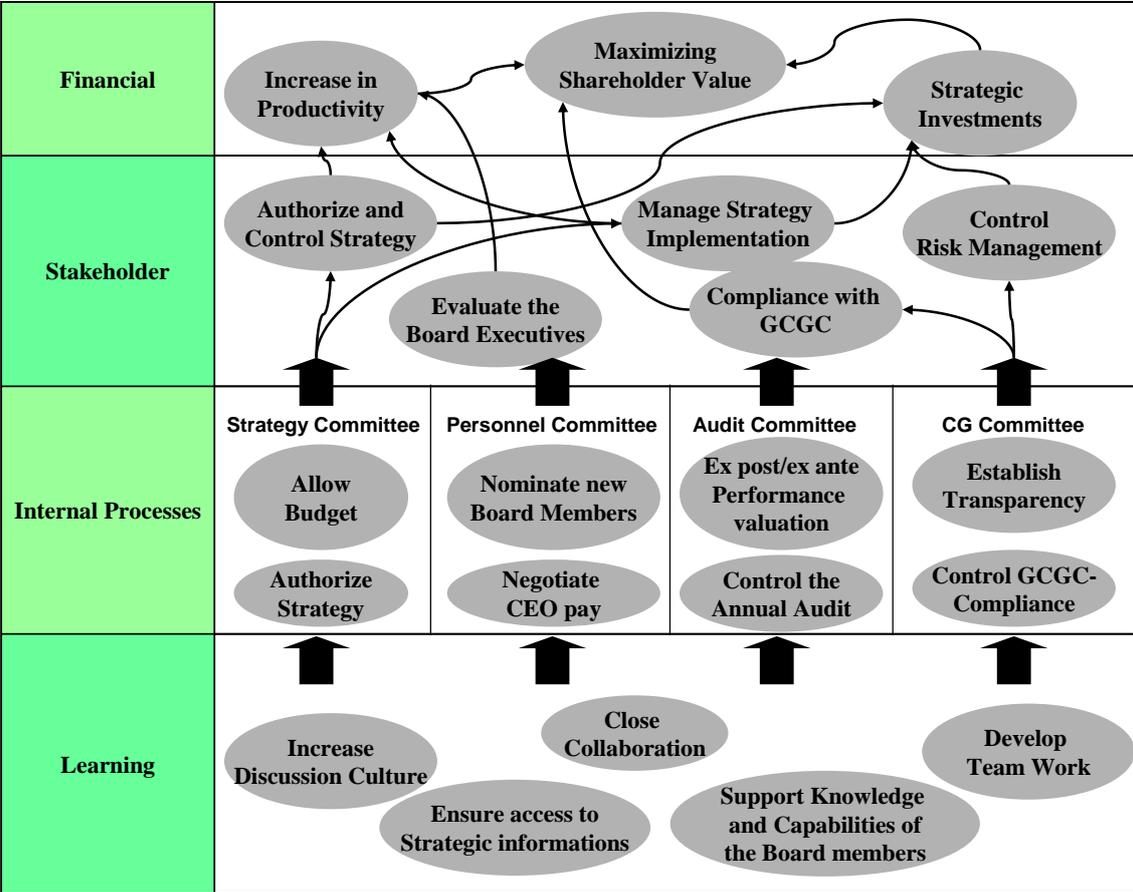


Figure 4: Strategy Map for a Supervisory Board Scorecard
 The SBS guarantees the systematic information flow from management to the supervisory board, the installation of a long-term perspective which is integrating all stakeholders and the possibility to adjust to fast changing environments.

4. Conclusions

Monitoring and control in the typical European two tier-system of corporate governance lay in the hands of the members of the supervisory boards. In times of global financial crises the need of an efficient governing body is worldwide newly discussed. Boards nowadays still raise information that orient mostly at the past. Institutionalized corporate governance therefore is mainly past-oriented on financial ratios and passive. The current situation shows that good corporate governance needs a sustainable, wholesome and future-oriented perspective. Strategy formulation, implementation and control cannot be concentrated on the management level alone. It is also part of the boards work. Facing these worldwide demands for a new system of good and modern corporate governance the need for corporate government tools for boards is highly visible. Following here the advantages generated by a scorecard the adoption of this management tool for boards is leading to the desired results. Scorecards are the classical approach for successful performance-measurement and strategy-

implementation. Scorecards have proofed their road capability and are well-known in the management and employee-sphere. Especially for the German context the establishment of a sustainable stakeholder-perspective is of importance, combined with the process-perspective and a learning-perspective. With the help of a Supervisory Board Scorecard (SBS) the financial perspective as well will be integrated in the directing work of the boards which now can contribute to the overall strategy of the corporation. Thus corporations in dynamic environments will get a solid base for good corporate governance.

Still this new instrument has to be proved in practice. Also the development of best-practice scorecards seems to be fundamental. Future research projects in the context of the enhancement of the German two-tier system shall address the following issues:

- SBS-perspectives. The chosen SBS-perspectives need a critical evaluation of experts and supervisory board members. In a quantitative as well as qualitative approach the perspectives shall be analyzed.
- SBS-information. The SBS is in need of a new form of information flow from the corporation to the supervisory board. Therefore the SBS has to be critically checked if the data are available in time and complexity.
- International dimension. Is the SBS approach transferable to the one-tier system of the Anglo-American world?

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