

# Good Corporate Governance: How effective is the strategic supervision of two-tier boards? An empirical study of German DAX-companies

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## Abstract

Monitoring and control in the typical European two tier-system of corporate governance are in the hands of the members of the supervisory board. In times of global financial crisis the need of an efficient governing body is worldwide newly discussed. Boards nowadays still raise information that orients at the past. Therefore corporate governance is mainly past-oriented and passive. The current situation shows that excellent corporate governance needs a sustainable, wholesome and future-oriented perspective. This implicates that 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.

## Introduction

Not only in times of a financial crisis the work of the (supervisory) board is one of the best known and observed Corporate Governance mechanisms worldwide (Eulerich&Schulz, 2010, Thomsen, 2008, Adams, 2005). The general public associates good Corporate Governance with good work within the board. Therefore especially the boards' role of supervising the companies' operative success and strategic long-term-planning determines the efficiency of good Corporate Governance. But the fast changing environment with increasing dynamics on the (financial) markets and growing uncertainty minimizes the 3-5 years lifecycle of corporate strategy down to 1-3 years (Eulerich&Schulz 2010). Furthermore some spectacular insolvency of huge companies, the supervisory board became subject of an excited public debate. For this reason the boards' work of supervising the decision-making-process of corporate strategy and the strategy itself is getting more and more decisive. To ensure that the interests of stake- and stockholders are observed, the effectiveness and efficiency of the supervising process has to be guaranteed.

Considering the strategic uncertainty within the decision-making-process the classical approach to corporate governance and two-tier-boards in Germany is challenged by the urgent need of a pro-active and future-orientated supervision. This empirical research study proofs the ability of the supervisory board to control, monitor, forecast and direct the management board in a pro-active way .

The remainder of this paper is structured as following: A brief introduction is followed by a description of the current debate on strategic corporate governance mechanism in the German two-tier-context. The utilized empirical approach and the data of the study are presented in the third section, before the main results are discussed. The paper ends with a conclusion and critical outlook on further research questions.

### **State of the Art**

An overview of the board system as the worldwide dominating Corporate Governance mechanism, according to Thomsen (2008), Monks and Minnow (2001), Young (2003) and Roe (1994), could differentiate the board activities like this:

■ **Appointing, evaluating and dismissing board members**

The selection, evaluation and if necessary the replacement of the CEO or other board members is an essential function. In this context the negotiation of the CEO remuneration and the nomination of new board members can also be mentioned.

■ **Coordinating the interests of the shareholders and stakeholders**

The second section of board activities coordinates shareholders' and stakeholders' interests, by ensuring the lawfulness of the different company activities and an appropriate risk management. The board has to facilitate good shareholder relations regarding to established stakeholder policies. The board members professional network can also form and support other business relationships.

■ **Controlling and monitoring the financial and strategic situation of the company**

The third relevant field of activities concentrates on the evaluation of the financial situation and the strategy of the company and all strategic business units. The board advises the management on their chosen strategy and controls the major strategic decisions, such as M&A-activities, capital investments, etc. These functions could be extended by an active role within the strategy discussion.

Overall the board-system and structure differs across the world and is determined by the national context. German speaking countries, (i.e Germany, Austria and Switzerland) are typical representatives of a co-determined two-tier-board-system. In contrast to the board's tasks in a monistic system, the supervision of stakeholders' interests and companies' strategies and performance differs in two-tier board systems. The German Corporate Governance system is such a dualistic system with a two-tier (management and supervision) board and a long-established co-determination between shareholders and employees within the supervisory board (so-called "Aufsichtsrat"), which dates back to the 1870's (see figure 1). Within these board structures an overlap between non-executive and executive directors is legally prohibited. While the management board – consisting only of inside directors - manages and represents the company, the supervisory board – consisting entirely of outside directors - consults, controls and monitors the management board's work and the whole company's success. The labour participation allows the employees and the trade unions to elect up to the half of the board members in public companies (Baums, 1999). This is leading to large supervisory boards with an average size of 15 members (Andres et al., 2006).

To support the function of approving the strategic decisions of the management board, the supervisory board has a large range of formal power and a job that consists besides the supervision of the already told 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).

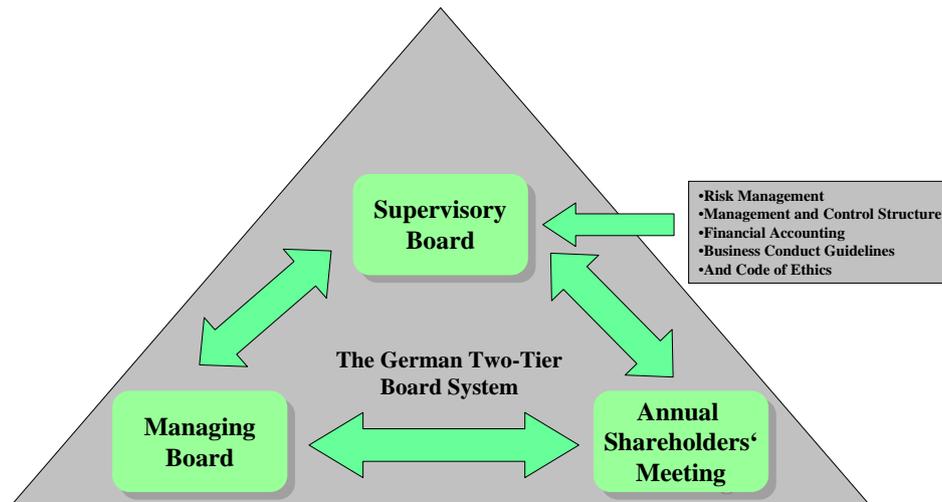


Figure 1: The German Two-Tier-System

Because of the non-homogenous composition of the German supervisory boards in reference to management-experts and non-management employees or labour union members the board structure could be characterized by a noticeable difference between the professional history and background, business administrative know-how and work experience of the board members. This fact considerably complicates, control, monitoring and consulting of the other board members “Vorstand” during their major decision processes. Especially the representatives of the employees’ side within the board decide rather with a low-risk perspective than the shareholders’ side. Therefore Thomsen (2008:196-198) calls the German Corporate Governance system “conservative”, “low risk-taking” and “more sceptical to economic reform”.

To concretize the research question of this paper it is necessary to recapitulate the present state of knowledge about the efficiency of supervisory boards work in Germany. So far only two German research studies focussed on the efficiency of the supervisory boards and their strategic supervision. While Jürgens, Lippert and Gaeth (2008) followed the research question: “How to design the structure of German supervisory boards and the corporate governance process?” the work of Grothe (2006) was led by the research question: “How to ensure strategic corporate governance in the German two tier-system and which interaction processes between the two boards are required?”.

The results of both studies on German Corporate Governance practice in two-tier boards show that the work of the supervisory board shows the following characteristics (Jürgens et al., 2008; Grothe, 2006):

- The board’s work is based on past performance and especially concentrates on annual financial statements.
- The work is internally focussed. No use of external information, reports, or consulting. Even external public financial reports of competitors are rarely considered.
- This orientation leads to passive actions. No usage of their denial of agreement especially in strategic subjects

But the surveys of both studies were completed in advance of the financial crisis (in the years 2005 and 2007). Thus, recent developments were not included. Therefore we integrated their research questions to concretize our approach.

## Data Collection, Sample and Methodology

The following empirical study was funded by of the Hans-Boeckler-Foundation, one of the leading research sponsors in Germany. The project examined how the financial crisis and the public cry for more strategic corporate governance did modify the work and the effectiveness of German supervisory boards. Therefore the objectives were to describe and understand the supervisory board practice on Corporate Governance and strategy in times of a fast-changing environment and huge market dynamics and to prove whether changes of the board work improve the supervision.

The chosen methodology is a qualitative and as well a quantitative approach. In addition to semi-structured interviews as a qualitative approach, a quantitative questionnaire given to our interview partners was utilized. Therefore we were able to provide both, descriptive statistics as a result of our quantitative questionnaire and qualitative statements of the board members' interviews. The qualitative part of the study used face-to-face interviews with (vice-) chairmen of German supervisory boards. The interviews lasted for two hours on an average. The duration of the project was from 12/2009-03/2010. We concentrated on the leading German stock index DAX30 but also collected data from M-DAX and S-DAX, the two smaller indices.

In order to examine the supervision in the German two-tier-system, our research approach focussed on two different levels of analysis. The first level includes the board structure with regard to the Supervisory Board's self-image and the organizational structure of the supervisory board. The second level comprises the interactions between the supervisory board and the management board. To integrate these two levels, our questionnaire was split into the four parts with the target to evaluate the effectiveness of the supervisory board's functions.

The empirical analysis on the effectiveness of the strategic supervision in German Two-tier-boards comprises 24 semi-structured expert interviews with supervisory board chairmen of German DAX-Companies. The sample consists of 13 (43,3 %) of the DAX30-Companies and 24 (18,4%) of the 130 biggest German DAX-Companies.

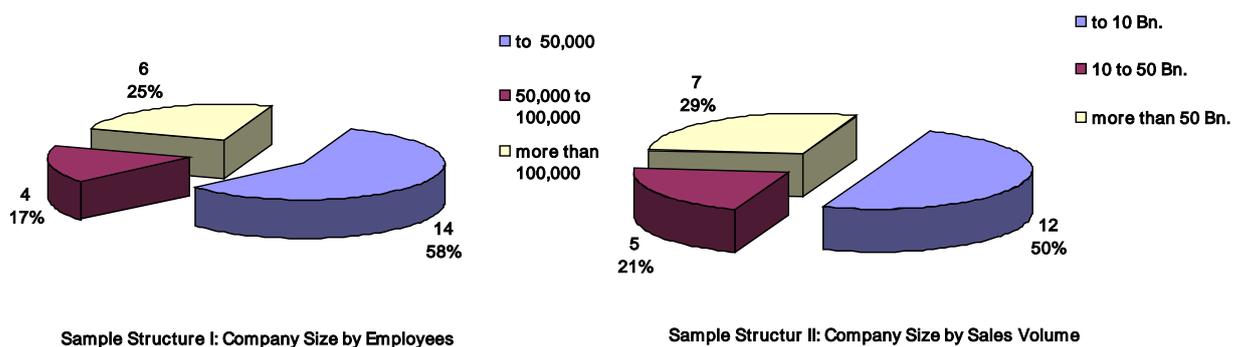


Figure 2: Sample Structure

The sample structure can be separated by the company's size measured by the number of employees or by their sales volume in billion Euros. 42% of the interviewed companies employ a workforce larger than 50.000 employees and 50% of our data sample has a total sales volume of 10 Billion Euros or more.

## Main Empirical Results

### 4.1. Main results of the section “supervisory board’s self-image”

While both Grothe (2006) and Juergens et al. (2008) state that supervisory boards act passively within the strategic definition and strategic supervision, our data could not prove these results, like shown in the following figure.

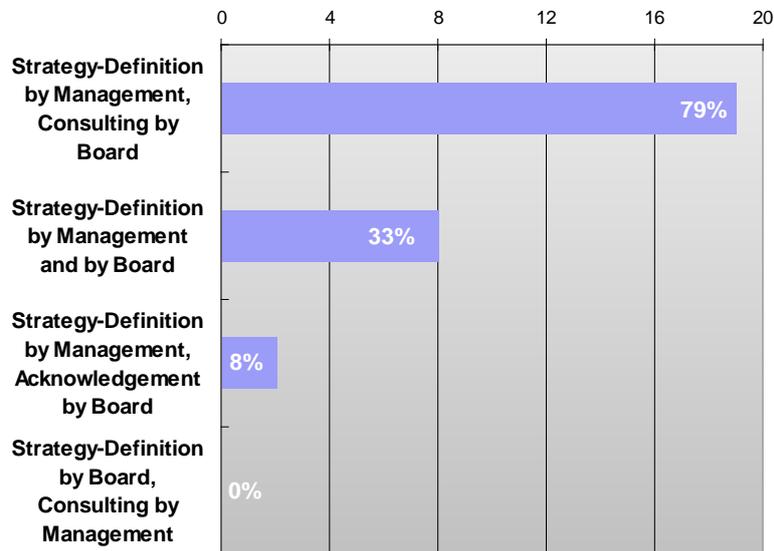


Figure 3: Main Result: Supervisory Board’s Self-Image

In today’s fast-changing environment the corporate strategy is still defined by the management board, but the passive and past-oriented role of the supervisory board has changed. The supervisory board is deeply involved in the strategy definition process. The required active supervising role of the board is characterized by an intensive „dialogue“ between the managers and the supervisory board instead of an external supervision (79% of our interview partners). Thus nowadays the supervisory board acts as a consultant for the management.

### 4.2. Main results of the section “organizational structure”

Before the great depression of 2008 the organizational structure of the supervisory board was dominated by an inflexible supervision process with a fixed board meeting schedule. For this reason upcoming strategic and operative problems and crises could not be supervised in an effective way. The knowledge of the last two years influenced this fact. In case of a potential crisis the board meeting schedule is changed immediately and a holistic supervision process is set up. This finding was formulated by 67% of our interview partners. In this context our interview partners additionally explained, that the supervisory board members are more sensitized because of their negative experience with strategic uncertainty in the crisis.

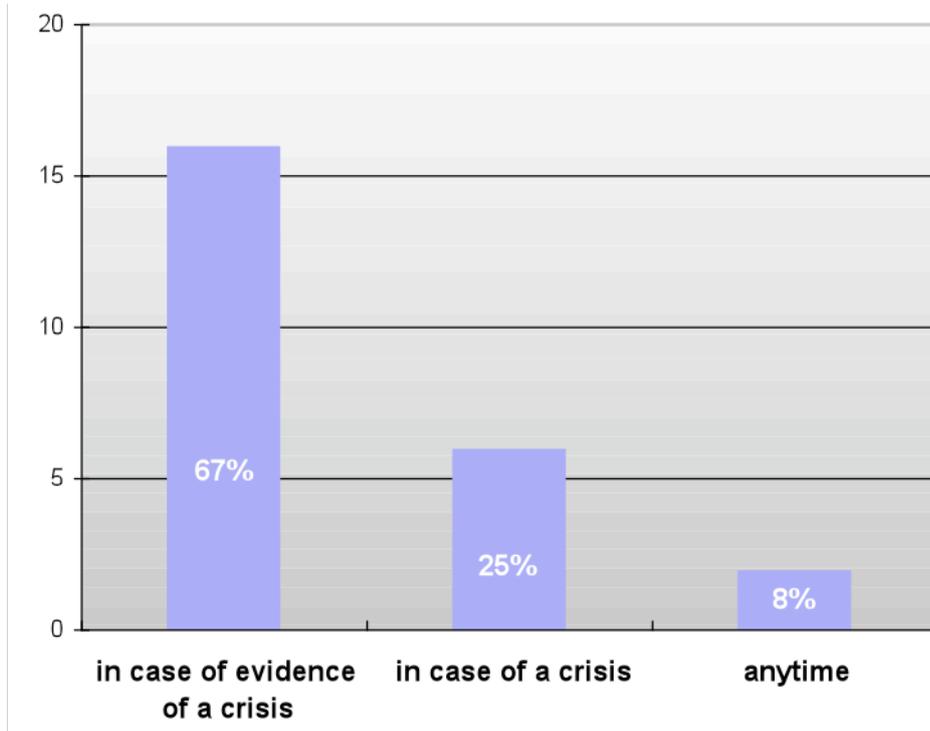


Figure 4: Main Result: Organizational Structure

#### 4.3. Results of the section “exchange of information between the board members”

The two state-of-the-art studies stressed that the supervisory boards are focussed on internal and not on external information or data. This dramatically changed within the last two years. We inquired 15 different sources of internal or external information. Our results revealed that three of the Top-5 information sources are nowadays external. The board members mainly rely on their personal network and their private contacts, but external information is getting more and more relevant to them. Especially research institutes and financial statements of their competitors are of an enormous importance. On a scale from “1=never used” up to “5=frequently used” the external sources were evaluated with an average of 3.9.

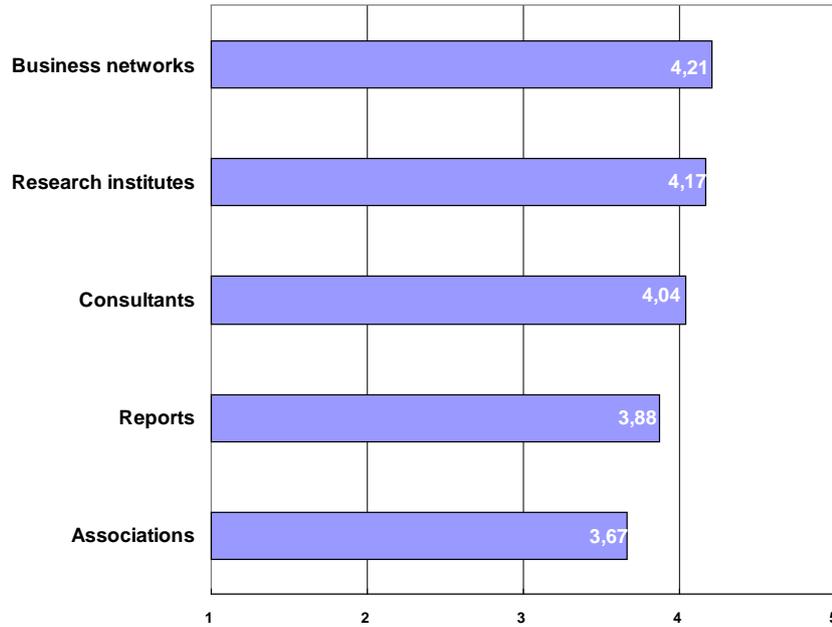


Figure 5: Main Result: Exchange of Information between the Board Members

#### 4.4. Results of the section “changing perspectives of the supervision”

The last section of the questionnaire concentrated on the changing perspective within the supervisory board as an institution on the one hand and the changing perspective of the single board member’s supervision perspective on the other hand. While Grothe (2006) and Juergens et al. (2008) detected a clear board alignment only to supervise based on financial ratios this study can detect another main perspective of supervision (see figure 6).

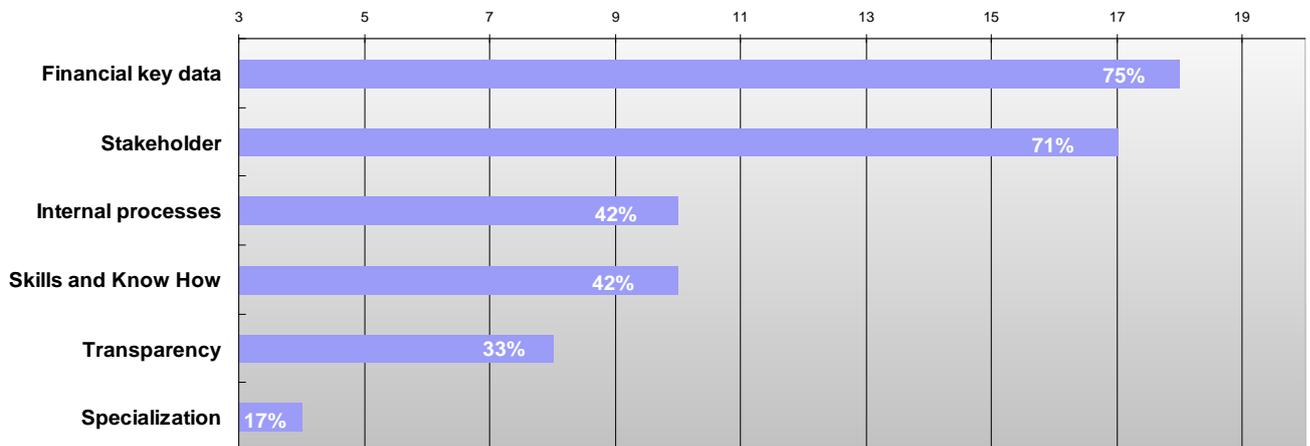


Figure 6: Main Result: Changing Perspectives

The financial ratios are with 75% of the experts’ answers still the dominating factor to guarantee a working supervision, but the stakeholder-perspective is taking the second place of the important supervision perspective with 71%. This is a dramatic change in the perception of the wholesome governance aspect in terms of environmental demands that are included in the board-supervision. Also the following of the German Corporate Governance Code (GCGC) advices to become internally more efficient and effective is of increasing interest, as well as the awareness that board members need a set of joined communication and team work

skills. The concentration only on financial ratios identified in both other studies could not be confirmed.

## 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 crisis the need of an efficient governing body is worldwide newly discussed. State of the art-studies show that boards 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. This research project tried to validate the current situation and practice of German supervision inside two-tier-boards of German DAX-Companies. The outcome is illustrative: All major outcomes of the previous studies to this topic can be rejected by our data.

The identified supervision process in German boards shows that:

- The supervisory boards work in a pro-active way to support the management board specially within their strategic decision making process.
- The board members are still focussed on financial data, but a stakeholder perspective is the second important source of supervision.
- The boards are loosing their past-oriented focus and try to anticipate the strategic development of the company.

These results could allow the statement that the work of the boards did change:

- Due to the financial crisis
- Due to the public cry for efficient supervisory mechanism
- Due to the urgent need for a better holistic Corporate Governance.

The aim of this paper was to challenge the current state of the art perspective that focus on board practice before the financial crisis. Thus the question of “How effective is the strategic supervision of two-tier boards?” can be answered in a comparatively way, comparing the activities before and after the crisis. Our data can proof that a shift has taken place from past to future orientation, from ex post to ex ante, from internally focus to wholesome. Board activities today fit better the demands of the fast changing and uncertain environment. The effectiveness is raised substantially. But the risk of overloading the boards with more and more tasks and perspectives is high. 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. Instead of overloading boards the need to guide and direct them via a modern tool is also stated by the interview-partners of the sample. Future tasks for research and practitioners will be to develop such a tool.

This project is also in need of a further evaluation in an international context: Can this change in corporate governance mechanisms and board activities be detected and proved worldwide or is this change-development a German phenomenon? On the other hand further research has to address the sustainability of the change. Will boards in times of economic stability return to the past-oriented and passive way? Or is the corporate governance system advancing to implement permanently a wholesome and future-oriented perspective?

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