MARTIN HILB

New Corporate Governance

Successful
Board Management Tools

New Corporate Governance

Martin Hilb

New Corporate Governance

Successful Board Management Tools

Martin Hilb
University of St. Gallen
IFPM Center for Corporate Governance
Dufourstrasse 40 a
9000 St. Gallen
Switzerland

Cataloging-in-Publication Data
Library of Congress Control Number: 2004110250

ISBN 3-540-21399-6 Springer Berlin Heidelberg New York

This work is subject to copyright. All rights are reserved, whether the whole or part of the material is concerned, specifically the rights of translation, reprinting, reuse of illustrations, recitation, broadcasting, reproduction on microfilm or in any other way, and storage in data banks. Duplication of this publication or parts thereof is permitted only under the provisions of the German Copyright Law of September 9, 1965, in its current version, and permission for use must always be obtained from Springer-Verlag. Violations are liable for prosecution under the German Copyright Law.

Springer is a part of Springer Science+Business Media

springeronline.com

© Springer Berlin · Heidelberg 2005
Printed in Germany

The use of general descriptive names, registered names, trademarks, etc. in this publication does not imply, even in the absence of a specific statement, that such names are exempt from the relevant protective laws and regulations and therefore free for general use.

Hardcover-Design: Erich Kirchner, Heidelberg

SPIN 10997536 42/3130-5 4 3 2 1 0 – Printed on acid-free paper

Contents

Foreword .... **vii**

0 Introduction **1**
- 0.1 Background 3
- 0.2 Objectives 7
- 0.3 Approach 8
- 0.4 Definition of terms 9
- 0.5 The “New Corporate Governance” framework 11

1 Situational dimension **15**
- 1.1 External business context 18
  - 1.1.1 Institutional context 18
  - 1.1.2 National context 21
  - 1.1.3 Normative context 27
- 1.2 Internal business context 36
  - 1.2.1 Ownership 36
  - 1.2.2 Board configuration 44
  - 1.2.3 Organizational complexity 50
  - 1.2.4 Board role players 52
  - 1.2.5 Degree of internationalization 57
  - 1.2.6 Mix of board functions 62

2 Strategic dimension **67**
- 2.1 Targeted and diverse board team composition 70
- 2.2 Critical but constructive culture of trust 82
- 2.3 Networked board structure 87
- 2.4 Stakeholder-oriented board success measures 91

3 Integrated board management dimension **99**
- 3.1 Targeted selection of board members 103
- 3.2 Targeted feedback for board members 116
- 3.3 Targeted remuneration of board members 128
- 3.4 Targeted development of board members 140
- 3.5 Integrated board-management committees for large firms 151

4 Controlling dimension ... 155
4.0 Integrated Audit & Risk Management Committee ... 157
4.1 Auditing function of the board ... 162
4.1.1 Cooperation with the external auditors ... 163
4.1.2 Cooperation with the internal auditors ... 164
4.2 Risk management function of the board ... 165
4.3 Communication function of the board ... 174
4.3.1 Internal communication between board and management ... 174
4.3.1.1 Objectives of board communication policy ... 175
4.3.1.2 Board communication strategy ... 176
4.3.1.3 Board communication tools ... 178
4.3.2 External communication between board and stakeholders ... 182
4.4 Review of board success ... 186
4.4.1 Controlling function of the board ... 186
4.4.2 Self- and external evaluation of the board ... 190
4.4.2.1 Goals of board review ... 190
4.4.2.2 Instruments for self- and external review of boards ... 191
4.4.2.3 Procedure for self- and external evaluation of boards ... 203

5 Conclusions ... 209
5.1 Implications for practice ... 211
5.2 Implications for teaching ... 212
5.3 Implications for research ... 212

References ... 215

Index ... 229

Foreword

Ten years ago I started to offer annual doctoral seminars in corporate governance and seminars for chairmen 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.

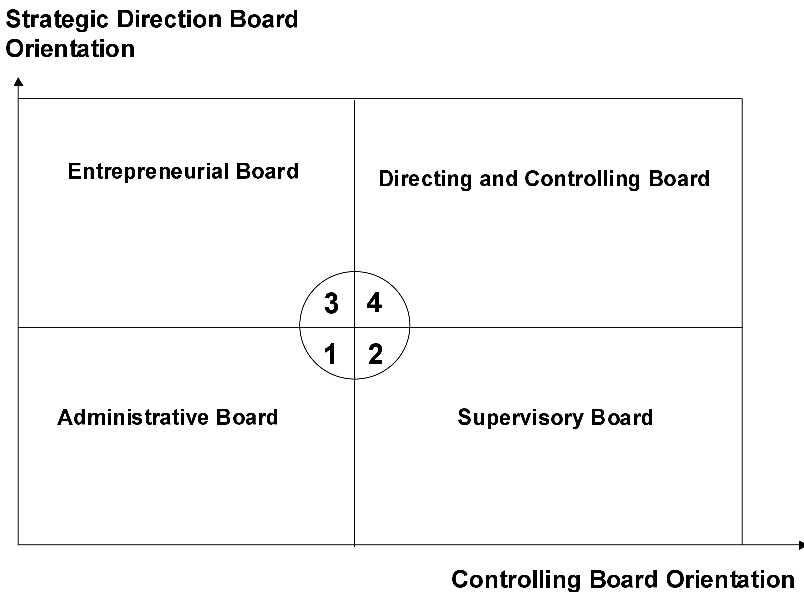

Fig. F-1. Development levels of boards

Since then the subject of corporate governance has become highly topical world-wide because of the many corporate crises that have occurred - in both countries that promote shareholder-value governance approaches[1]

---

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

(such as the USA or Australia), and countries that strive for stakeholder-value governance approaches[2] (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 "*glocal*, both-and" 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 nations[5]), 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 each board to determine the manner in which stakeholders share in firm success, according to that firm's requirements. For example,

---

[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).

– 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].

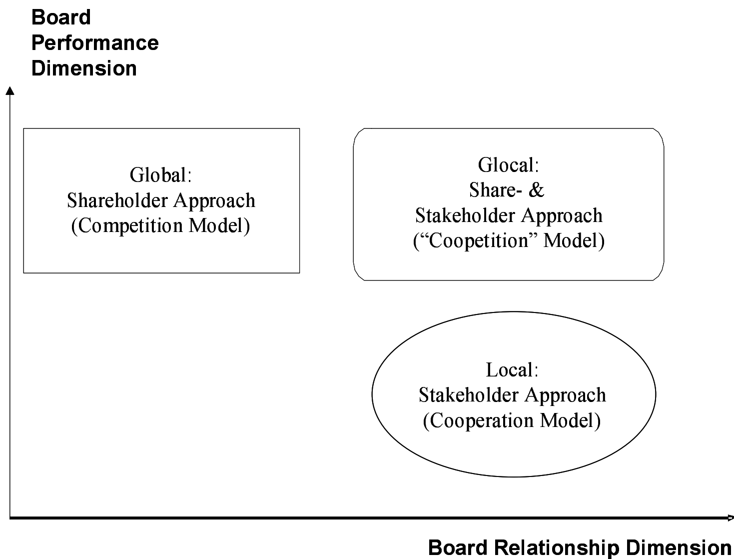

Fig. F-2. Models of corporate governance

In response to the growing interest in corporate governance I founded the IFPM-HSG Center for Corporate Governance, in order to focus my research, teaching and consulting activities, in a targeted way, on this integrated approach.

I then started work on this book, and in this regard, I would like to thank all the people who made contributions to its completion. Firstly, I thank the chairmen who have given me the mandate to implement new board

6 See Stewart (1991).
7 Such as that developed by Hilb (2003).

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 English version, and Jean-Claude Gonzalez for the professional translation and preparation of the French version of this book.

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, March 31st 2004

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 chairmen and CEOs in particular[8].

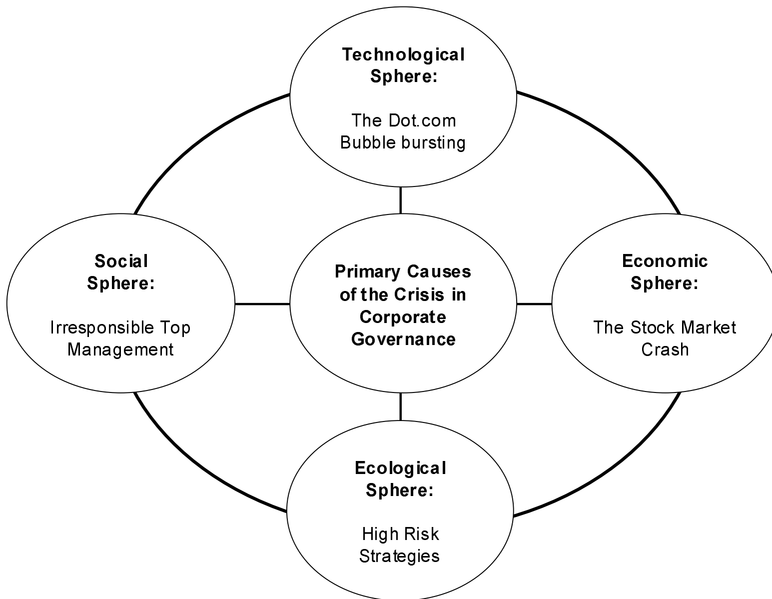

Fig. 0-1. Primary causes of the crisis in corporate governance

---

8 Taylor (2003: 1)

1. **In the technological sphere,** the main driver of the corporate governance crisis was the bursting of the dot.com bubble. The speculation in high-tech companies on stock markets 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 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 USA, 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 USA 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 and ecological spheres** numerous corporate collapses (such as Swissair), or strategic mistakes (such as Vivendi-Universal or AOL Time Warner), have shown that boards had 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 required 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 misman-

---

9 Taylor (2003: 3)
10 Business Week (September 23, 2002:14)
11 Ward (2003: 224)
12 Gladwin et al. (1995)

agement cases presented. Indeed Henry Mintzberg described this use of stock options as "legitimized corruption" in some large listed companies in North America and Europe.

> 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 uni-dimensional way. For example, the oft 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 Aguilera 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, i*nstitutional 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-typology[22]; one that can serve as a compass to orient users of the model presented in this book (see Figure 0.3).

- **In theory and teaching,** a limitation of corporate governance can be described as follows[23]: "One short-coming 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

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)