The Board of Directors and its Role in the Corporate Governance System - Considerations about the Control Model - A Research Note

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Abstract

The paper examines the corporate governance mechanism of the control model (or insider control system) by looking at both the motivation for management to deviate from following their principal's wishes and whether the supervising body, the board of directors would correct them. Some opportunistic actions deriving out of the principle-agent relation between owners and management are preventable; others are not and can only be minimized by a strong participation of the owner in the affairs of the company.

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1. Introduction

It is a feature of most large capital companies, that ownership of capital and the authority to act on behalf of that capital is separated and especially where the majority of shares are publicly quoted, questions about effective monitoring of the management are particularly relevant (Alchian and Demsetz, 1972; Jensen and Meckling, 1976; Fama and Jensen, 1983). Not only should capital be used according to the wishes of the owners, but also opportunistic behaviour by the management should be curbed. The main problem that governance addresses is that of agency arrangements and the problems that arise when owners delegate to managers within organisations. With their privileged access to information the manager may act on their own behalf and neglect the needs of the owners (e.g. Ang et al., 2000).

Competition of among corporate governance systems has led to the dominance of two systems: the market (or outsider control) model and control (or insider control) model. The market model consists of one board using the market to judge the performance of management. This system mostly in use in Anglo-Saxon countries differs from the control system in use in continental Europe. Here, the management is monitored by a board of directors, who acts as an additional agent for the owners. The board is basically concerned with all aspects of management and finances. What should enable the board to fulfil its task is its knowledge about the business and its superior access to information, granted by the law. The control system is still the alternative in absence of a strong financial market, but can a board have the same information as the market? Following various scandals in German enterprises[4], the question is asked whether the board is really acting as an agent for the investors or if it follows some other agent[5].

This article focuses on the control system and examines whether the board of directors, together with the auditor as an additional agent is in a position to ensure effective monitoring of the management. It is the aim of this article to analyse the weaknesses of the collective monitoring institutions and to critically ask if regulation could help to improve the situation.

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[4] See Peemöller and Hofmann (p.2005: 80-122) with an overview.
[5] For Criticism of the board of directors see Fischbach (p.2003: 1) and Schwalbach (p.2004: 186).

2. Methodological Critique of Previous Contributions

The body of research on the relationship between ownership and control under corporate governance research has grown rapidly in the last years (Spira p. 2002: 9). Clarke (p.1998: 57) stated that increasing research interests and activities were taking place not only in the United States where the subject is well established as a significant focus of business research but also in Europe, especially in Germany (Gerum p. 2006: 25).

Most of the research is based on agency theory which understands management as an agent of the shareholders. Both the underlying assumptions and the theoretical approach has been criticized (e.g. Donaldson, 1990; Muth and Donaldson, 1998; O`Sullivan, 2000) due to the limited view agency theory offers of organizations and the implied assumptions regarding opportunistic behaviour which could be controlled by incentives and control systems. Alternative approaches are offered by the stewardship theory (Donaldson and Davis, p.1991: 49) and stakeholder theory (Clarke, p.1998: 57). Stewardship theory adopts a very standardized understanding of actors which has already been criticised in the context of agency theory (see Böcking et al. p.2004: 427). Institutional approaches in organizational theory or resource theory offers further insights (Gerum, p.2006: 10), but generally it can be stated that research on corporate government lacks a comprehensive theory (Clarke, p.1998: 57; Leighton and Thain, p.1997: 29). Most agency theory based contributions focus on either the monitoring aspects such as the Anglo American type of audit committee[6] or the board of directors and try to analyse their effectivity and efficiency.

In Germany and Austria many contributions to this topic have applied a jurisdictional methodology, asking how the law could strengthen the position of the board of directors, attributing all failures to a weak position of the board (e.g. Strenger and Rott, 2004; Theisen, 2004). This approach has led to a surfeit of regulation, mostly triggered by current events which put pressure on the government to act[7] in order to build up trust to ensure ongoing investment within

[6] with an overview Spira (p2002: 15 -28).

[7] It can be seen on the numerous reforms of the board of directors in Austria (e.g. Insolvenzrechts-änderungsgesetz 1997; Gesellschaftsrechtsänderungsgesetz 2005) or Germany

its borders and to attract capital inflow from abroad. As these regulations are very often influenced by political considerations, many of them are failing to meet the requirements of a globalized economy or to integrate scientific theory and findings (Carver, p.2007: 1032). Where regulation is seen to be weak, it is remedied with even more regulation. These normative contributions fail to take into account the incentives of members of the board and do not understand the board as a collection of single individuals with their own preferences and agendas and their own views of the means to achieve them.

Recent empirical data has focused on the information needs of the board of directors (Ruhwedel and Epstein, 2003) and the audit committee as a governance mechanism of the supervisory board (e.g. Coenenberg et al., 1997; Fischbach, 2001; Köhler, 2004; Steller, 2007; Warncke, 2005) to enhance their ability to control the management, although the findings of such research are inconsistent. Other studies focus on the German particularities[8] or the information politics of enterprises in respect of good corporate governance (Theisen and Raßhofer, 2007). Also, these studies fail to prove the success of government regulation regarding both efficiency and reporting by management and the board of directors.

3. Theory and Methodology

Using principal-agent theory, **t**he starting point of our considerations is the connection between principal and agent. This rests on the assumption of opportunistic use of information deficiencies by the agents (Jensen and Meckling, p.1976: 308). In our case, as the board of directors acts as an agent for investors, conflicts can occur where the interests of principal and agent differ. Under the solutions proposed by principal agent theory, incentives and control mechanisms have to be in place to assure compliance of the agent. Non-compliance by the agent can derive from various reasons and is not limited to intentional wrongdoing. It can also arise from the inability of the principle to speak with one voice or to have consistent opinions over time.

(e.g. Gesetz zur Kontrolle und Transparenz 1998, Transparenz und Publizitätsgesetz 2002). For an overview see Nietsch (2005).

[8] see Gerum (p.2006: 48) with further evidence .

So far, there is no scientific evidence of the superiority of any of the systems in use (Shleifer and Vishny, p.1997: 774),[9] but there is an increasing dissatisfaction among investors with the activities of their board-members (e.g. Fischbach, p.2003: 1; Theisen, p.2004: 480; Ruhwedel and Epstein, p.2003: 166).[10] Which actions do these board members consider most appropriate and which activities are beneficial to them? In addition if they freely choose their actions, do they really harm the interests of the shareholders? To give answers to these questions, this contribution adopts a deductive, praxeological approach. This requires the understanding of board-members as self-determined actors with their own goals, who are free to choose their strategies to achieve them[11].

This article is not demanding more regulation but rather asks, if these pervasive regulations make any sense and therefore should give further insights in the weaknesses of the control-system.

4. The Governance of a Capital Company in the Control Model

The organization and the function of a capital company are shaped by a variety of interest and actors. One characteristic is the separation of administration and monitoring by the two institutions, management and board of directors. The management, which is appointed by the board of directors, runs and represents the company. The board of directors is entrusted with the supervision of the management. Its members are elected at the annual general meeting of investors. Its main tasks (legal functions) are as follows[12]:

- Election, appointment, dismissal and re-election of management
- Formal and material supervision of the management
- Acceptance of the financial statement, including proposals on the allocation of the unappropriated profits
- Submission of proposals for new candidates for the board of directors

[9] In this context Kaplan (p.1997:92) shows in his study that there is now correlation between a certain system and business performance.
[10] For Conflicts of interest within the board of directors and problems of participation at the example of VW see Hopt (p.2006: 3).
[11] As suggested by Mises (1998).
[12] For a wider representation of the board tasks see Hopt and Leyens (2004).

The supervision of management focuses on financial reporting by the management to investors. Additionally, a number of business transactions are subject to agreement of the board. Basically these are all transactions with material effects on the financial position and assets. The board also proposes the choice of auditor, although the final decision lies with the owners. In doing this the board also has to assure that the auditor is independent from the management.

Following DCGK[13] No. 5.3.1, the board should create committees to raise efficiency and effectiveness. One of these, the audit committee, is quasi obligatory for listed companies in the prime segment (AKIEÜ, p.2006: 1628). Its task is the preliminary audit of the financial reports and the appointment of the auditor for the board.

In view of the above, the authors would argue that the owner as the principal has three agents, the first of which is the management, which operates the company corresponding to the wishes of the owners, having the full authority to utilise the capital, theoretically leaving the owner in a much weaker position. To strengthen the position of the owner, two institutions are acting as an agent on his behalf, namely the board of directors and the independent auditor. Whereas the duties of the independent auditors are limited to guarantee the truthfulness and completeness of the reported information, the board of directors has a much more complex role to play.

4.1 The Management

The separation of ownership and control is due to the complexity of business models and a quickly changing environment, under which it was not practical for a single owner to operate.

Historically, this step was seen with suspicion by the owners, but they quickly adapted to their role to support the management on strategic decision-making and started to enjoy the fruits of their investments. As Lorenz von Stein summarized in 1868 (v. Stein, p.1868/69: 35), great amounts of capital were applied and given to educated managers. Their superior technical knowledge soon reached a level superior to that of the owner (v. Stein, p.1868/69: 35). The signal of the quality of the management's action was standardised information

[13] Deutscher Corporate Governance Kodex (German code of corporate governance)

regarding the employment of their capital and any payout (if the business was profitable). The reports the investors received were either periodical such as the annual financial statement or quarterly statements or they would consist of ad-hoc information. To assure readability and decision usefulness, these reports followed a standardised format. Parts of this information were subject to audits by the independent auditor to assure truthfulness and completeness. In recent times, trust in auditors has suffered severely due to collaborative action from management and auditors. The failure of this principal agent will not be discussed here.

There are several reasons why management might not comply with the wishes of the principal.

- The agent might be uninformed about the wishes of the owners
- The owner might be indifferent, but makes up his mind afterwards
- The agent acts opportunistically (Donaldson and Davis, p.1991: 50) and optimizes its own benefits (Jensen and Meckling, p.1976: 308)
- The agent acts with criminal intent

In most publicly owned companies, any majority investor will become involved with the governance of the enterprise. This majority allows the investor to influence the decision on who should be appointed to the board, rather than the management. The position of minority shareholders is more tenuous. Minority shareholders enjoy special rights in proportion to their stake in the company. It has to be questioned if these special rights really do pay off. If the majority owner is a strategic investor, he will be encouraged to maximize the earnings of the enterprise, which is also to the benefit for the minority investor. It is possible that the minority shareholder would vote for a short-run profit rather than long term. In this case the interests of the majority shareholder would count more as he has acquired a larger stake of the venture.

In modern publicly owned firms, many minority investors tend to buy shares for short-run earnings. The decision to invest derives partially from advice of third parties and the investors do not take any interest in the development of the company. These investors do not participate in the annual general meeting

(Schilling, p.2001: 149) but renounce the right. It is this lack of interest that prevents the management from following the wishes of these minority owners.

As they do not know what the investors want, management compensate for this lack of knowledge by the maximization of earnings. Merger and acquisition decisions are made despite thousands of employees getting dismissed. Thus, management receives incentives to maximize earnings in the short run, which also has the advantage of attracting new investors. Regarding earnings management, the management has a tendency to follow opportunistic cycles, as seen in political behaviour. These considerations, also called “big-bath strategies”, an attempt to write down the assets of a company at the beginning of their tenure to a minimum amount showing a very favourable development of profits during their term due to lower amortisation and depreciation charges. This behaviour is particularly significant if there are option plans in use to compensate the management for their activities.

Opportunistic behaviour is enabled by asymmetric information due to the inability of the principal to recognise the quality of the agent’s actions (Smith and Watts, p.1992: 275). Opportunistic behaviour of the managers can cause four generic problems for investors:

- Managers are not working hard to maximize value
- Managers know more about their quality and capabilities than the investors
- Situations in which investors and managers disagree
- Important managers could hold-up the investors by threatening to leave the company. (Kaplan and Strömberg, p.2004: 2177; Bassen et al. p.2006: 129)

The management could also act with criminal intent, by using money for other purposes than reported to the investor in order to receive private benefit from their actions. Due to the information asymmetry, they might be tempted to misuse the money entrusted to them.

After this compilation of possible failures to comply with the wishes of the investors, it should now be discussed what might happen to prevent the board of directors from detecting such actions and providing a remedy.

4.2 Board of Directors

The board of directors is an institutionalised governance mechanism designed to supervise the management as an agent of the investors. It is a visible control mechanism with the responsibility for certain control activities (Böcking et al. p.2004: 424; Baums, p. 1995: 11). As already mentioned, it is the board of directors' task to supervise financial reporting. There are also certain business activities which are subject to acceptance by the board. The material and structural organization of the board is not regulated by any legislation, with the exception of its functions and appointment of its members. This enables the board to execute its tasks without the approval of the shareholders and management. Thereby the separation of ownership and control is assured, at least theoretically (Theisen, p.2003: 290).

To ensure the execution of its task, the board has to invest material time resources. It does not need to conduct any audits itself, but has to analyse the findings of other auditing bodies such as the internal auditors or the independent auditors.

As audits are trust goods, there is no reward for increasing auditing activities. For his activities, the board member receives an agreed payment. As the quality of audit and control-activities are impossible to judge a priori, the board member receives an incentive to minimise his effort. Instead of investing more time in an existing engagement, the member of the board might accept another additional engagement in another company.

From the point of view of the board of directors, it is often argued that the engagement in a board of directors is seen as a part-time job (Lenfer, p.2005: 389; Potthoff, p.1995: 163). As the members of the board are often chosen to represent certain interest groups, the will to supervise might be limited (Theisen, p.2004: 488).

The inability of the board to supervise the management might also be rooted in a lack of competence and understanding of the business model (Schwalbach, p.2004:188). As the competence and ability of one potential member is difficult to judge before they start working, mostly proxies like formal education or years in service are used. Also SOX[14] tries to standardize this competence with regards to financial competence. If the owners are indifferent with regards to their board members, they tend to follow the suggestion of the management, which threatens the board's independence. A study revealed that just half of the proposals for new appointment to the board in the enterprises listed in the DAX-, MDAX- and TecDAX-segment came from the board itself (AKIEÜ, p.2006: 1627). Also the practice of contracting specialists for finding suitable candidate is declining (Deloitte Consulting, 2004). New members are chosen from other companies, which might result in an inappropriate knowledge of the business of the company. The lack of competence of parts of the board endangers performance as the board acts as a collective institution and the individual member has to argue his views against others.

A particularity of the Austrian and German system is its obligatory appointment of staff representatives into the board. This mixture of shareholder and stakeholder approach bears the danger of politically motivated action[15].

Additionally, the law demands a minimum of four meetings of the board a year – sometimes via videoconference which is quite low considering the size of the board with sometimes up to twenty members[16]. The board members are allowed to have up to ten (§ 100 AktG) (in Austria eight (§ 86 Abs. 4 AktG)) engagements at a time, which makes more regular meetings very difficult. Although the number of meetings is a weak proxy for the quality, it implies that continual supervision is unlikely to take place.

Like the management, also the board can adopt opportunistic behaviour or build a coalition with the management. In the short term, the investors have no ability to assess the behaviour, which might even promote criminal behaviour by certain members or the board as a whole.

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[14] Sarbannes-Oxley Act

[15] As seen at Volkswagen, the representative of the staff is also prone to intentional wrongdoing.

[16] According to the legal requirements for a supervisory board above a certain company size. (§ 95 AktG)

5. Analysis

A member of the board will invest sufficient time to satisfy the investors and thereby to ensure his re-election. This imposes a natural limit to the engagements the person can accept.

As multiple engagements and the ensuing limitations to the time directors can devote, are not visible to investors, they will mostly be revealed after a problem has arisen. Therefore, some voluntarily restriction would be beneficial[17]. Probably the strongest incentive for conscientious engagement by a board member is the possible damage to personal reputation, which would occur in the event of a situation in which he was seen to have failed to exercise necessary control. It would be desirable to establish a “watch list” of poorly performing members, which could be hosted by an investor association. Badly represented shareholders could propose certain individuals for this list; the association could then start to investigate.

Demands for greater personal liability of board members would not be feasible, as action would be hard to prosecute. However, further appointments or the re-election of such a person would be affected. It would be even more difficult to mandate a certain level of qualifications. The investors would probably not be able to make a judgement of the individual’s ability. From the management’s point of view, an inadequately qualified person would be beneficial, as little monitoring would be expected (Theisen, p.2004: 484). Attempts to demand certain work experience before allowing a person to run for board membership is nothing more than an attempt of standardization and not a guarantee of performance. Also, the threat of a loss of reputation would not work as the person themselves is not capable of performing better. Attempts to deter people by imposing fines for badly qualified potential members would not be purposeful, as these people are mostly not aware of their lack of qualification. Again if this were to be implemented, the courts would have to take some proxies like formal education or years of experience into consideration.

Additional danger stems from the temptation of members of the board to undertake opportunistic behaviour. To overcome problems of competence, the

[17] As proposed in DCGK No. 5.4.5. respectively ÖCGK No. C-57.

investors tend to vote for former members of management, as they have inside information and are used to the culture and structure of the enterprise. These former members of the management now suddenly have to control management decisions in which they themselves had been involved. Additionally, these senior managers tend to develop their own successors, thus there is an informal connection between management and the agent in charge of controlling management. This has now been addressed by a minimum time in between acting as manager and accepting appointment as board member.

The question of how much the members of the board should earn has been the subject of discussion both by the public and the media. There is little consensus on the appropriate amount, appropriate and the supervision available will only come at a cost (Schwalbach p.2004: 190). Additionally, any potential liability has to be reflected in the amount.

The corporate governance codex suggests paying a fixed and a variable part of these earnings[18]. The variable elements should reflect the participation and performance of the member in the subcommittees (AKEIÜ, p.2006: 1629). This would necessitate a clearly defined set of requirements in respect of personal performance and achievements which would be very difficult to specify. To make any judgement on individual performance, it would be necessary to develop an objective measurement system, which will be hard to find (Theisen, p.2004: 483). Empirical research shows that these requirements are mostly not available (Oechsler, p.2003: 311) and that the selection process of supervisory boards is not transparent and appears not to be very professional (Schilling p.2001: 149). If earnings reflect the time required to fulfil the task, it would be reasonable to assume that at times, the payment would be inappropriate. Therefore, it is suggested that to pay higher salaries for board members in German companies would be to place higher incentives to encourage stronger engagement (Theisen, p.2004: 483). This also implies that the qualification of the members would meet the requirements and therefore a proper

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[18] As demanded by the German Corporate Governance Codex No. 5.4.7 DCGK

incentive is needed to achieve this objective. As empirical work has revealed the lack of written requirements, these demands have to be challenged[19].

Potential for conflict arising from the independence of the board from management is a consideration arising from the variable component of the member's financial compensation. Especially, if these variable components are related to earnings or other elements which can be influenced by financial politics and for which the management receives benefits, too. Stock options for members of board are therefore very dangerous.

Additionally, in Austria and Germany board membership is seen as an additional occupation, which is very attractive for individuals from various parts of society like politicians, managers of other enterprises, bankers, etc. Therefore, the composition of the boards mostly reflects the interests of certain groups and does not follow competitive conditions.

As board members lack the power to influence business transactions (at least theoretically), it would only be possible for them to carry out fraudulent activities in conjunction with the management. Here, criminal actions are defined as an agreement to carry out illegal activities in order to receive personal benefit in return. One example of this would be a deliberately misleading communication to investors. Such actions would involve the agreement of a substantial circle of members of management and board. The coordinative actions would be over-boarding, so it is very unlikely that they would all agree on the distribution of the profit. Additionally, at least on the medium term, the independent auditor would either have to be misled or involved. Despite detection by the independent auditors, considerable loss might have occurred for the investors. Such activities are subject to prosecution by the courts.

To meet expectations, the board has to raise its proficiency (e.g. audit personnel) despite higher costs. Thus, the question of the willingness to pay has to be answered by the shareholders. Thus, the board of directors as a coordinating and centralized supervisory board seems to be the best solution. Especially where there exists a transparent election of the board members based on their qualifications, a transparent reporting on board activities and its

[19] Following SpencerStuart (p.2004:21) not more than 22 % of companies listed in the DAX-, MDAX und TecDAX segment have written requirements for their board members.

committees. Taking this information into consideration, the investor could assess the effectiveness of the board. However, the investor will always have to accept a residual risk, inherent to every investment decision and reflected in a risk premium.

6. Conclusions

Our considerations tried to show that the only possible solution to fight the principal agency problem is transparent reporting on the work of the board of directors. This includes the job specification, the appointment of its members or the engagement of the members in other boards. This transparency requires the active participation of the investor, as it would be useless otherwise. Some of the problems are solved by voluntary restrictions on the members of the boards, as seen in many Corporate Government initiatives all over Europe. Thus, it is possible to find a solution in accordance with the particular features of a company. This generates a constant debate about the conduct of the board. The threat of losing reputation must be kept alive through scrutiny by the investors. What exists at present is an expectation gap between the wishes of the investors and the real ability of the board of directors. This gap cannot be closed by the state, which is acting politically and following different ideologies. A state whose only intention is to fight the information asymmetry between a principal and an agent without pursuing any other political interests is rarely in existence. The state should therefore focus on the protection of private property rights.

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