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A Comparison of Corporate Governance Systems in Four Countries

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Abstract

Companies in different countries are operating in different cultural, legal, social and economic environments. As a result, each country has developed its own corporate governance system that serves its business operations best. As the globalization of business speeds up in recent years, it is unknown whether there exists one best corporate governance system for all countries. The purpose of this study was to compare the corporate governance component factors in Germany, the United States of America, Switzerland and France. The four countries were selected because they are adopting different corporate governance models. Their corporate governance component factors can be classified into three groups: those related to top management organization, the board as whole, and individual board members. From these comparisons, we found that although these countries are adopting different corporate governance models, they have developed some mechanisms (such as committees) to narrow down the differences. Therefore, we may conclude that the corporate governance systems adopted by different countries are converging.

A Comparison of Corporate Governance Factors in Four Countries

1. Introduction

Corporate governance can be viewed as a process by which directors control and direct the management of a company to achieve the best returns to its owners (Wong and Yeung, 2000). Consequently, directors play an important role in determining the effectiveness of corporate governance. It is therefore important to understand how directors execute their duties, especially for their monitoring functions. However, companies in different countries are operating in different cultural, legal, social and economic environments, thus leading to the development of different corporate governance systems. The purpose of this study is to compare the corporate governance component factors in four countries: Germany, the United States of America (US), Switzerland and France. The focus is on comparing the monitoring features of the boards of directors (boards) among German share corporations (Aktiengesellschaft), US listed corporations, Switzerland share companies and French listed corporations (société anonyme).

The reason for choosing German share companies and US listed corporations is that they adopt two very different board models: the one-tier and the two-tier models. The one-tier model (also call the sole-board model) combines the monitoring and the executive functions of a company and assigns all these duties to one board. On the other hand, the two-tier model assigns these functions to two independent boards: the supervisory and the management boards. These two board models are typical corporate governance structures for most listed corporations in the world. In particular, the US is adopting the one-tier model, whereas Germany is adopting the two-tier model. France is selected because she allows her

companies to choose between the two board models. Switzerland share companies are even more flexible and free to choose any corporate governance models, not limited to the above two boards. In addition, the legal environments of the selected countries are also very different. German share companies are governed strictly by their corporation laws, whereas US listed corporations are given extensive autonomy by their corporation laws to determine their governance systems. Switzerland and France are just in between.

This study may contribute to understanding the corporate governance systems in countries under very different corporation laws and adopting very different board models. This understanding is helpful for policy makers to evaluate the advantages and disadvantages of implementing a particular philosophy on their corporation laws and adopting a particular board model.

This study starts with a brief review of the prior research on the corporate governance systems in a variety of different countries. It then analyzes the structures of German supervisory boards (Aufsichtsrat), US boards, Switzerland boards (Verwaltungsrat) and French boards (conseil d'administration and conseil de surveillance). From these analyses, this study attempts to identify the key features of these structures that may make the monitoring functions of the boards more successful.

2. Prior Research

Although several studies have examined corporate governance systems, most of them focus on the system of a particular jurisdiction only. Very few compare corporate governance systems across different countries. Among these few, for example, Bleicher, Leberl and Paul (1989) conduct two extensive research projects to compare the legal requirements and the actual practices of the corporate governance systems among listed corporations in Germany, the US and Switzerland. They recommend that some monitoring practices for these

companies be developed (Bleicher et al., 1989, p. 259). They conclude that the professionalism of corporate managers in these three countries has been improving. This professionalism enables these managers to be immune to the influence of various monitoring mechanisms. On the contrary, the professional development of the boards lags a lot behind that of their manager counterparts (Bleicher et al., 1989, p. 265). Coupled with an increasingly complex and dynamic management process, a monitoring gap between managers and the boards emerges. To narrow down this gap, policy makers in these countries should think about whether they should expand the monitoring roles of non-manager members in the boards (Bleicher et al., 1989, p. 260). Since policy makers of a particular jurisdiction can choose the best board model from two most popular ones—the two-tier system and the one-tier system—to tailor for her particular needs and environments, this results in a convergence in the ultimate monitoring goals of these two corporate governance systems. Bleicher et al. (1989, p. 266) consider the structures and preconditions, not the institutional setting, of the monitoring mechanisms as the major problems of how to close this gap. They suggest that the following measures can be implemented as the first step to close this gap (Bleicher et al., 1989, pp. 267-272):

- to improve the composition of the boards,
- to impose more duties on the boards,
- to expand the duties of care and to increase the liability of monitors, and
- to conduct audits on the performance of managers by external auditors.

Bleicher et al. conclude that the monitoring goals and measures adopted by all the countries studied by them conform with their propositions. Only the constitutional structures of these countries differ.

Charkham (1994) describes the corporate governance systems of five major industrial societies: Germany, Japan, France, the US and the United Kingdom (UK). His discussions focus on the structures and practices of business organizations and their business environments. He establishes two basic principles of good corporate governance: dynamism and accountability. An enterprise is said to be dynamic if its corporate governance system allows its managers to run the enterprise as they wish without undue fear of displacement, government interference or litigation. The principle of accountability refers to the situation where while managers of an enterprise are free to exercise their power to make any decisions and to take any courses of actions that they consider to be the best for the enterprise, the outcomes of these decisions and the actions taken should meet at least certain pre-defined standards. When these outcomes cannot meet the standards, appropriate remedial actions can be taken in a timely way (Charkham, 1994, p.354).

Charkham suggests that there is virtually no government interference policy in the UK, very little in Germany, many in France and the most in Japan. He ascertains that the US is adopting specific pork barrel politics (Charkham, 1994, p. 356). This means that US politicians act in the best interests of their voters in order to win their support in the next election. Litigation is only common in the US. Derivative lawsuits¹, class actions² and contingency fees³ are unique to the US. The threat of litigation keeps US managers on their toes and makes them acutely conscious of the possibility of any potential lawsuits. In other countries litigation is much less prevalent. Finally German and Japanese systems are more effective against mismanagement. Therefore, the decisions of German and Japanese managers are far less influenced by the potential responses of stock markets and the threats of takeovers (Charkham, 1994, p. 358).

Charkham (1994, p. 361) concludes that although German and Japanese corporate governance systems are not perfect, they in general emphasize more accountability. In

particular, he considers that with all its faults and failings and with its tendency towards rigidity, German system works more consistently (Charkham, 1994, p. 363). He also considers that the Anglo-US-French cultures are more tolerable for either small or large businesses to deviate from their corporate governance standards temporarily.

Jud (1996) analyzes the roles of shareholders' meeting (Generalversammlung), the board (Verwaltungsrat) and auditors (Revisionsstelle) on monitoring Switzerland listed companies. He compares these mechanisms with those in German and US listed corporations. He addresses mainly the following three issues (p. 3):

- What are the most important monitoring roles of shareholders' meeting, the board and auditors as considered by law-makers, managers, legal researchers and the general public?
- How do companies perform these monitoring roles and what are the monitoring mechanisms adopted by them? and
- How likely can the monitoring mechanisms improve the performance of a company and what is the best way to estimate the likelihood?

Jud (1996, p.314) concludes that Switzerland boards should fulfill their monitoring roles by first establishing suitable organizational structures (including an effective internal control system) and selecting the most capable senior executives (e.g., chief executive officers and major division heads), and then through direct audits and controls. Monitoring roles refer to not only the observance of the law, statutes, regulations and directives, but also the efficiency of managers as measured by certain technical, social and managerial criteria (Jud, 1996, p. 323). Only when the monitoring functions of all supervisors and their divisions in a company are optimally coordinated can the monitoring gaps be narrowed down or even completely removed. Thus, monitoring a company is an integrated concept, linking

the monitoring actions of individual supervisors and their divisions to a company network of monitoring (Jud, 1996, p. 340).

3. Overview of the results

Corporate governance systems underline all the important features of a board and its members that may contribute to the long-term success of a company. The systems are determined by three groups of corporate governance factors: (1) corporate governance factors related to the organization of the top management, (2) corporate governance factors related to the board as a whole, and (3) corporate governance factors related to individual board members. Each of these groups contains a series of major corporate governance factors as summarized in Figure 1 and further discussed in more detail in the next sections.

[Figure 1 approximately here]

4. Corporate governance factors related to the organization of the top management

4.1. Extent of regulations

The extent of regulations governing the operations of a company in a particular jurisdiction is an important factor determining the corporate governance system of the company. This factor delineates the extent of freedom enjoyed by a company to design its system, especially at the top level. When a company is operating in a legal environment full of strict corporation laws, it is very unlikely for this company to freely establish its own corporate governance rules specifically tailored to its needs. This is exactly the situation in Germany and France where a large number of corporation laws governing almost every aspect of the operations of a corporation have been enforced. In contrast, corporation laws in the US are comparatively less. This gives a larger extent of freedom for corporations there to design their own governance systems. However, this freedom is offset by a large collection of

leading case laws and the regulations imposed by other regulatory agencies such as stock exchanges. The number of Switzerland corporation laws is just in between.

However, the frequency of companies fallen into financial difficulties seems to be unrelated to the amount of these laws. To implement monitoring effectively and efficiently, monitors should select the best approach from the available ones rather than relying on these laws (See Schneider, 2000, pp. 105-108; Bleicher et al., 1998, p. 24; Chmielewicz, pp. 11-24).

4.2. Consideration of different stakeholders' interests

The importance of stakeholders' interests in a company is taken differently in the four selected countries. Most corporations in the US regard shareholders' interests as the most important. Maximization of shareholders' value is one most commonly found corporate objective in corporate charters. Managers are also evaluated on the basis of how well they have contributed to improving shareholders' values. In contrast, when making important corporate decisions in the three continental European countries, managers need to consider different stakeholders' interests and balance these interests when conflicts arise. It is particularly the case in Germany where the co-determination law requires the supervisory board of a large company to be composed of both shareholder and employee representatives. Senior executives in all these four countries have no obligation to consider the interests of parties other than stakeholders, unless this requirement has been specifically spelt out in their laws (Schneider, 2000, pp. 108-119).

4.3. Separation or aggregation of the executive and monitoring functions

As mentioned earlier, the one-tier and the two-tier models are two common board structures. Companies adopting the one-tier model assign both their executive and monitoring functions to the only board. As a result, conflicts of interests may arise when board members pursue

their self-interests at the expense of the interests of the company, leading to the agency problem. This problem is commonly found in the US and France. In contrast, companies adopting the two-tier model separately assign their monitoring and executive functions to two boards: the supervisory and the management boards. The major advantage of this model is that the supervisory board is highly independent of the management board (Schneider, 2000, p. 124). The functional separation of these two boards avoids conflicts of personal interests of managers with interests of their companies.

Although separating the executive and monitoring functions of a company is a desirable board feature, it does not necessarily mean that the two-tier model is always superior to the one-tier model. In fact, the one-tier model also has desirable features. One major advantage of the one-tier model is that the board can make timely decisions more easily because its members are more knowledgeable and better informed than the members of the supervisory board in the two-tier model. This advantage is particularly important when a company is struggling for survival in a capacious business environment.

Another advantage of the one-tier model is that only a small number of capable board members are required to manage all the important functions of a board. Thus, whether a board can function well may depend, to a large extent, on whether a company can recruit qualified professional managers to join its board. However, a strong leader may dominate the whole board, leading to higher risk of making wrong decisions. Also, the consolidation of the executive and the monitoring functions in one board may give an unclear picture to outsiders on how the board members share the responsibilities of each function.

Although the one-tier model consolidates the executive and monitoring functions in one board, in practice, the executive function of most large corporations in countries adopting this model, such as those in the US, is totally delegated to executive managers. The board has de facto changed to a pure monitoring board (Schneider, 2000, p. 129). For example, audit

committees are used by US boards as a monitoring mechanism. Similar practice can be observed in Switzerland and French corporations. Thus, corporations adopting the one-tier board model have already established some mechanisms to separate these two functions, albeit to a less extent than those adopting the two-tier model.

4.4. Collegial or directorial board structure

The internal organization of a board can be classified into two structures: collegial and directorial. In the collegial structure, board members may prevent the emergence of a dominating leader by mutual monitoring and self-control. When the board is making a decision, all its members can share the facts related to the problem. They then examine all the possible alternative solutions in detail. Finally, they make the decision by consensus. Therefore, this structure provides a good environment for continuous implementation of the company policies (Potthoff, 1996, p. 262).

In contrast, the directorial board structure establishes a clearly defined board hierarchy that specifies the responsibilities of each member. This structure has the advantage of reacting quickly to a changing business environment because each member can handle her problems faster without referring to the opinions of other members. However, when problems become more and more complicated and involve the expertise of several or even all members, it is difficult for any one of them to have the necessary knowledge and ability to solve the problems alone.

4.5 Summary

The dilemma of adopting the one-tier model is to find a balance among the possibility of the emergence of a consciously strong leader, participation of committed outside directors and monitoring of managers by these directors.

The US board model is incompatible with German co-determination law, because in Germany the employee representatives are not executive managers and the co-determination happens in the supervisory board only.

The one-tier model, especially the US board model, has not demonstrated its ability to avoid crises and collapses of companies better than German two-tier model (e.g., the collapses of Polly Peck and Maxwell).

More and more dual structures are being developed in those large corporations adopting the one-tier model by creating committees and delegating majorities of directors' monitoring duties to those committees. This delegation leads to a separation of monitoring and executive functions similar to the two-tier model (Schneider, 2000, pp. 134-135; Semler, 1995, p. 40).

5. Corporate governance factors related to the board as a whole

5.1. Board size

The relationships between the size of a board and its effectiveness can be delineated by an inverted U curve (see Figure 2). As the number of board members in a board increases initially, more ideas and knowledge can be added to the board and its effectiveness is improved. However, as more members are added to the board after a certain threshold, the problem of coordination and conflicts are turning more and more serious, and offset the benefit of additional ideas and knowledge contributed by the additional members. As a result, the board effectiveness will be jeopardized.

[Figure 2 approximately here]

Table 1 compares the board sizes of companies in the four selected countries in 1996. As shown, the average board size is the smallest for Switzerland listed companies, whereas the average size of German supervisory boards is the largest. Thus, it seems that German supervisory boards are more likely to suffer from the adverse effects of being too large. However, it is unknown what is the threshold of board size beyond which board effectiveness may decline. Also, this threshold may differ across different countries and even among different natures of businesses.

[Table 1 approximately here]

A research study conducted by Leimkühler in 1993 about the board size in Germany suggests that the possible adverse effects of too large a board on board effectiveness seem to be limited to a comparatively small number of corporations. Only 96 out of the 562 listed corporations in Germany had a supervisory board with more than 15 members (see Table 2). Therefore, the remark that their supervisory boards are in general inefficient and inflexible as a consequence of their large size cannot be substantiated.

[Table 2 approximately here]

5.2. Number of board meetings

Table 3 shows the frequency of (supervisory) board meetings in the four selected countries. US boards on average have the largest number of board meetings, whereas German supervisory boards have the fewest. One possible reason for this difference is that the meetings of US boards serve both the executive and monitoring functions because they have only one board in a corporation. A larger number of board meetings does not necessarily lead to a more effective board, if the meetings are conducted in a way to serve only the form rather than the substance. Instead, the effectiveness of board meetings depends more on such

factors as the way in which the meetings are conducted, the intensity of discussions, and how problems are handled. Thus, the frequency of meetings alone does not automatically lead to better monitoring. To improve the monitoring effectiveness of the boards, it is necessary for members of the supervisory boards in the two-tier board model, and committee members and the board chair in the sole-board model to do a more intensive work.

[Table 3 approximately here]

5.3. Composition of the board

Figure 3 shows the composition of (supervisory) boards. German supervisory boards are unique because of her co-determination law, which requires these boards to be composed of an equal number of representatives from shareholders and employees. Shareholder representatives come mainly from two sources: internal and external representatives. Internal representatives of shareholders are shareholders by themselves and represent shareholders in shareholder meetings with authorized voting rights from those shareholders they represent. External representatives of shareholders are not shareholders of the company but are members of the (supervisory) board. However, they represent the interests of shareholders in the board and they vote on behalf of shareholders. Employee representatives in France can be appointed to a board if the articles of incorporation of a company allow it to do so. For corporations in the public sector their membership is determined by law.

[Figure 3 approximately here]

The co-determination law in Germany is generally accepted and highly respected by the public at large. Consequently, this law is considered as assistance rather than a threat to management. This structure has the advantage of resolving conflicts between management and employees. Incisive management decisions can be realized with and not against the employees (Bertelsmann Stiftung and Hans-Böckler-Stiftung, 1998, p. 17; FörSchle, Glaum

and Mandler, 1998, p. 899). Through the participation of employee representatives, employees may have better understanding of the reasoning behind management decisions. Consequently, their resistance to those decisions can be minimized.

5.4 Information to the board

Information provided to the board by managers is an important factor determining the success of cooperation between the board and managers, as well as the effectiveness and efficiency of monitoring by the board. Because of their positions, chief executive officers control the content and type of information provided to the board, especially in the one-tier model. In practice, information available to board members can be very different from one company to another, depending on factors such as firm size, complexity of organizational structure, ownership structure, etc.

In Germany managers' duties of reporting to their boards have been documented in detail in the laws. In other countries, however, the formats and the contents of reports given to a board leave to the hands of managers. Even with the German corporation laws specifying what kinds of information should be reported to the board, it does not necessarily lead to better information available to the supervisory boards in Germany than that given to corresponding boards in countries with no such a law. The reason is that the legal duties of reporting in Germany ensure only the minimum amount of information that should be provided to the boards (Schneider, 2000, pp. 160-162). Companies in countries with no such a law may voluntarily disclose more information than companies in Germany.

Another issue is the rights of receiving information and inspecting documents. These rights can be divided into the rights of individual board members and those of the board as a whole. Individual board members of German supervisory boards have no right of inspecting company documents, whereas Switzerland board members can inspect these documents only

with permission of their presidents. The rights of individual board members in the US and France have been specified in their laws. However, it does not necessarily mean that monitoring in these two countries is better than in countries with no such laws. The quality of monitoring depends to a large extent on whether board members exercise those rights.

The reliance of a board on its managers to provide information is a core problem of all board models. Even the laws of a country stipulate managers' duties to supply all the important information to a board, this does not ensure that the information supplied is properly used. Even worse is that managers hold back some important information in violation of their legal duties. Without sufficient information, a board may not know how to ask questions to uncover the real problems of its company. We suggest the following to improve the information flow from managers to their board. These suggestions can be applied to all board models:

- a) an intensive dialogue between the chair of the (supervisory) board and managers,
- b) sufficient and timely information provided to the board,
- c) imposing legal duties on managers to provide all important information to the board as mandatory,
- d) standardizing reporting and information systems to improve the access of information by the board, and
- e) establishing of a back office⁴ to prepare better information for to the board.

Another suggested mechanism that can improve the efficiency and effectiveness of monitoring by a board is to impose the requirement of obtaining consent from the board for all the important transactions with high uncertainties or risk. For example, if the planning of a company is classified as such a transaction, then managers are required to report extensively about its details to enable the board to make a decision. Consequently, the board

is informed about the future development of the company much earlier (Schneider, 2000, pp. 176-178).

Remedies to insufficient information provided by managers under the laws vary across different countries. Legally enforceable reporting by managers is only possible in Germany and France, whereas for US and Switzerland corporations, legal proceedings are not a helpful means of exercising this enforcement, because the power of managers is delegated by the board. Provision of information, as enforceable under a civil action, may not necessarily be useful because this action will ruin the cooperative relationship between the board and the managers. A possible solution is to influence the behavior of managers by giving them incentives connected to shareholders' value. With these incentives, managers are more likely to make decisions in the best interests of shareholders (Schneider, 2000, pp. 191-194).

5.5. Selection, nomination and succession planning of management

Selection, nomination and succession planning of executive managers by a board are perhaps the best monitoring tools to avoid managers from committing serious mistakes. Instead of evaluating what managers have already done, these tools can be more effective because they are future-oriented monitoring mechanisms. By selecting the best managers, the board is more confident that the selected managers will make right decisions in the future. Therefore, the selection criteria have shifted from the traditional expected performance to a validity and requisite check of the quality of applicants and whether they will make similar decisions as the board will do. For this reason, these monitoring functions must be performed by the board. However, in many cases managers will look for their board's compromise on their plans before hand to avoid misunderstanding. The chief executive officer (CEO) of American Express, for example, has taken up the position for more than 16 years. Although he, similar

to all other CEOs, does not like too critical board numbers, he managed to make friends with some of his board members. He then worked closely with them and relied on them as a bridge to work with other board members (Monks, 1995, pp. 372-385).

The annual performance appraisal of managers in the three European countries, especially their chief executive officers, has not been given the same importance as that in the US. Nevertheless, this appraisal can still serve to improve the performance of both managers and the board. Therefore, the composition of managers is an essential factor determining the success of a company. The selection of qualified managers and the timely replacement of unqualified ones can be used to prevent a company from committing unnecessary serious mistakes (Schneider, 2000, pp. 183-186).

At the same time, the possibility of replacing unqualified managers is an effective monitoring mechanism to penalize those with poor performance for all board models. However, the regulations of replacing existing senior executives in the four selected countries in this study differ substantially. These regulations include the right to replace poorly performed managers and whether it is necessary to provide a statement of reasons for the replacement (Schneider, 2000, p. 187).

5.6 Risk management systems

Risk management refers to the activities of monitoring, controlling and defending risks according to plans. These activities may include risk avoidance, risk reduction and risk limitation (active risk management), risk shifting and risk providence (passive or reactive risk management). The main task of a risk management system is to recognize as early as possible the developments that may endanger the survival of a company. With this early warning signal, it is possible for the company to take suitable measures to avoid liquidation (Scharpf, 1997, pp. 739). Figure 4 shows the elements of a typical risk management system.

[Figure 4 approximately here]

Elements of a risk management system, such as an internal control system, an early warning system and controlling, serve mainly for managers to handle the operations of a company, but this system can also be used for performing the monitoring functions by of a board. An early warning system for the purpose of monitoring should at least search for soft signals that may have an influence on the planning of a company. In contrast, an internal control system, the internal audit department and controlling provide past and present information. For example, the board may ask the internal audit department for information related to the legal and statutory regulations. In the US and Switzerland it is possible to structure the internal audit department to report directly to the board or one of its committees such as the audit committee (Schneider, 2000, pp. 204-208).

The board needs to ensure managers not to make serious mistakes with significant adverse effects to their companies. Even small mistakes may be very harmful if they occur very frequently. The signals provided by a risk management system should be consolidated in the planning and decision support systems of the company. In this sense such a system can be used to monitor the strategic decisions of the company. This system thus enables the board to better fulfill its monitoring functions.

5.7. Committees

A board can be more efficient to perform its duties by establishing committees to handle some specific types of these duties. Each committee is established with some specific purposes in mind and its members are supposed to have the necessary knowledge and expertise of handling the issues encountered by the committee. It is therefore much easier for its members to get down to their problems in more details and to discuss the issues in more

depth. Consequently, the committee can solve problems much faster than if the board handles these problems itself.

Table 4 shows the average number of committees in corporations in the four selected countries in 1996. US corporations are on the top of the list with an average of 5.1 committees per company, followed by German and French corporations with an average 2.3 and 2.2 committees per company, respectively. There is no comparable information for Switzerland. Eighteen out of 27 Switzerland corporations analyzed have executive committees (Verwaltungsratsausschuss). The Switzerland executive committee is only a smaller picture of all the committees established by the board (Verwaltungsrat). Committees serve to provide flexibility to the board. One possible reason for US corporations to have a larger number of committees than German and French corporations is that the US adopts the one-tier model and most of the monitoring functions of her corporations are delegated to different committees. The results of Table 4 show that US corporations have taken all the advantages of committees to compensate for the shortcomings of their corporate governance systems.

[Table 4 approximately here]

There are many different types of committees. An overview of these types of committees is shown in Figure 5. Among all the committees listed in Figure 5, audit committees are the most popular in the US. Their primary task is to audit the operations of a company and to monitor the performance of its management. Therefore, members of audit committees must be independent of management. In practice, most of the members are independent outside directors. Their monitoring duties focus mainly on accounting and financial matters, and the adequacy of the internal control systems. Other functions include participation in nomination of external auditors, determination of audit fees, and discussion of financial statements and the results of annual audits with external auditors. In addition, the

committees coordinate the work of external auditors and the internal audit department in conducting annual audits. The roles and functions of the audit committee is comparable to the finance committee (Finanz- oder Bilanzausschuss) in Germany and the accounting control committee (Revisionsausschuss) in Switzerland (Schneider, 2000, p. 219).

[Figure 5 approximately here]

Since US audit committees perform partially the functions of managers and partially the roles of monitoring, the functions of these committees are the most extensive compared to the corresponding committees in Germany and Switzerland. Specifically, while German finance committees focus only on monitoring because of the separation principle, the functions of Switzerland accounting control committees are just in between. French audit committees perform the role of consulting only and are not allowed to perform any duties of managers (Schneider, 2000, p. 221).

There are several major advantages of establishing audit committees. First, they can improve communication between external auditors and the board. Second, they can optimize the use of the limited available monitoring resources. Third, they can improve the finance and accounting knowledge of the board. Fourth, they can better prepare for the board meetings. Fifth, they can enhance the independence of external auditors. Sixth, they can improve the access of information by the board. Finally, they allow the board to focus more on improving the quality of monitoring.

In sum, by sharing part of the duties of the board, audit committees can improve the information provided to the board and thus narrow down the information gap between the board and managers. The formation of a team of professionals with expertise in accounting and finance leads to have better understanding of the problems and better solutions. As a result, audit committees can contribute to raising the effectiveness and efficiency of monitoring by the board.

5.8. External auditors

External auditors perform an important function of assisting the board in monitoring managers' performance, especially in the accounting and financial matters. Thus, the board can focus more on monitoring the operations and strategies of a company.

During audits, external auditors review the operations of a company and the performance of their managers. Auditors are required to report their findings about the possible adverse development that may endanger the future of the company. However, the actual monitoring of the performance of managers rests on the hands of the board. This function of external auditors is the same for all the four selected countries examined in this study.⁵

In the three selected European countries the boards receive detailed audit reports from auditors, whereas auditors' reports in the US are usually very brief. Only in some exceptional cases auditors in the US will issue their reports in more details. Besides the duty of issuing these reports, auditors in all four countries are required to attend and present their reports in board meetings or board committee meetings. For example, in Germany conducting a board meeting to discuss the annual financial reports of a company and its auditors' report is a legal obligation. This meeting offers a good chance for the board to obtain more information about the company and the performance of managers, and to exercise more effective monitoring. In this meeting, auditors can directly answer questions raised by board members. Thus, misunderstanding of the reports and the causes of the reported results can be removed easily through open discussions. At the same time, with face-to-face discussions, board members can have a better understanding about auditors' personality and characters. This understanding may enable board members to have better

ideas of auditors' style of expression and thus a better picture of their reports (Schneider, 2000, p. 230).

Audit reports present the economic situation of a company differently in different countries. For example, German auditors must provide to the management board (Vorstand) an opinion on the financial performance and position of a company on the basis of the information they have obtained during the course of their audits. By the same token, French auditors (commissaires aux comptes) must audit the management report and analysis (rapport de gestion) and special planning documents, and report the economic situation of a company. However, auditors in Switzerland do not have this obligation because its corporation laws do not require auditors to audit management report and analysis (Jahresbericht). In the US, auditors are required to report the results of their audits about the economic situation of a company. In particular, auditors are required to indicate whether the financial statements of a company are true and fair because US auditing standards require auditors to audit these statements in accordance with the principle of true and fair presentation (IDW Institut der Wirtschaftsprüfer in Deutschland e.V., 1999, p. 241 (245); AICPA, 1998, p. 937 AT § 400.25; Opitz, 1992, p. 84).

Auditing and reporting of the future viability of a company (i.e., going concern in the US) are also different among these four countries. For example, it is explicitly stipulated in German corporation laws that auditors must give an explicit opinion on the functioning of the early warning system of risks in the audit report. However, there is no such legal obligation in the other three countries, even though the internal control systems are audited in these countries. In the US, when auditors do not mention about the possibility of any going concern problem in a company, they imply that the company is viable; otherwise, auditors are required to highlight this problem in their reports.

Auditors' obligation of reporting the going concern problem is limited to recognizing the facts that may endanger the survival of a company during the audits. This obligation can be enforced by the fraudulent and illegal acts. In particular, French auditors (commissaires aux comptes) have the obligation of reporting this problem to the works council⁶ in accordance with the warning procedures. Besides reporting to managers, the French auditors have to report to the board and in the shareholders' meetings about the development and the existence of any facts that may endanger the survival of a company. In other countries, auditors are not required to report to the works council.

The findings of auditors during the audits enable the board to monitor managers' performance much easier, especially through the analysis of audited financial statements. As a result of the audits auditors manage to give an opinion about the economic situation of a company and the appropriateness of the major business decisions made by managers. However, the primary function of auditors is to determine whether the financial and accounting records of the company are properly prepared. Only by accumulating sufficient evidence can it be possible for auditors to determine whether the major business decisions made by managers, as documented in the records of the company provided to the auditors, are in the best interests of the company. It is not the role of auditors to check directly for any systematic offence committed. Instead, the board should take up this responsibility.

Cooperation between the board and auditors is an effective monitoring instrument of the board. Through this cooperation auditors draw the attention of the board to those major events and problems in the last financial year for monitoring. However, there is a limitation on using this mechanism as a monitoring means because the board relies on the plausibility of auditors' judgement on identifying those important issues worth of the board's attention.

The extent of cooperation between the board and auditors depends on how auditors audit company's records, how managers report to the board, and how the board uses auditors'

results in its monitoring. The participation of auditors in the financial statements meetings of the board or the meetings of audit committees offers particular help, because board members can directly ask auditors questions about the issues that auditors have knowledge. In addition, as stipulated in the auditing standards, the board may ask auditors to report the financial positions of the company in more detail.

Financial statements and audit reports are two important sources of information to the board. From reviewing this information, the board may find the needs to demand additional information and undertake further actions. After reading financial statements, management's report and analysis, and audit reports, board members have to make their judgement on the validity of these documents. Only when board members have carefully examined all these reports can these members be eligible for extending their support on these reports. However, it cannot assume that all board members are accounting experts. Consequently, check lists, similar to those used by financial analysts, can be used as a guide for helping these members to form their judgement.

6. Corporate governance factors related to individual board members

6.1 Selection procedures for board members

In all board models the existing board members and managers are most influential when selecting new board members because they have the right to nominate candidates. In practice the selection decision is dominated by managers alone, although they should make the decision in the best interests of shareholders. These procedures seem to be the best because only the board and managers can determine whether a candidate is qualified for the position. Nevertheless, large and institutional shareholders should also have their influence on the selection (Schneider, 2000, p. 248; Korn and Ferry, 1996, p. 20).

6.2 Criteria of selection

Empirical studies have shown that personality, knowledge, independence and availability of time are the most important criteria for selecting board members (Bremeier et al., 1994, pp. 126-129; NACD, 1996, pp. 7-14; Egon Zehnder International, 1996, p. 6). In most cases, effective monitoring requires board members to understand their monitoring roles. Personality, character and independence are the most important attributes determining the monitoring quality of board members. For example, independent board members with courage and moral characters are considered as necessary for performing their monitoring roles properly. However, these attributes are hardly found even among existing board members (Schneider, 2000, p. 254; Bremeier et al., 1994, pp. 46-50).

The demand of time for each mandate⁷ increases in all countries because of increasingly complex business environments as a result of business expansion and globalization of markets. This could lead to a decreasing number of mandates that can be taken up by a board member because of increasing demand of time and technical knowledge. Only when board members reduce their number of mandates can these members escape from the responsibility of preventing their companies from falling into crises and bankruptcies. To select qualified board members, it is necessary to ensure their commitment and make them understand clearly their responsibilities and roles. These requirements again relate to their personal qualities and their willingness to accept responsibilities (Schneider, 2000, p. 263; for a statutory limitation see NACD, 1996, p. 12).

6.3 Importance of board chair

When board chairs are also managers of their own companies, they are said to have dual roles. These chairs are assumed to monitor themselves. Board chairs with dual roles in the one-tier model are more powerful than the corresponding board chairs in the two-tier model. In the

two-tier model this concentration of powers vested in one person is impossible because the requirement of separating monitoring and executive functions has been stipulated in the corporation laws. For example, for those French corporations organized according to the one-tier model (*société anonyme á conseil d'administration*), board chairs with dual roles are governed by corporation laws. In the US and Switzerland, board chairs possessing dual roles are allowable under the laws. In fact, they are quite popular in practice.

Because of the possession of superior powers compared with other board members, board chairs with dual roles should have some special attributes, such as the abilities to organize, lead and communicate, and the ability to understand human behaviors. Similar to managers they should be forward looking. Personal characteristics, technical knowledge and availability of time are all the important attributes that these chairs should have to enable them to lead the boards to function successfully. Also, an optimal composition of a board in terms of its members' profiles can make the board handle technical issues more effectively and efficiently (Schneider, 2000, pp. 268-272; Corn, 1978, p. 4).

6.4 Attributes of board members

Board members may have very different profiles because they may come from different professions such as entrepreneurs, professional non-executive directors, bankers, experts, politicians, employees and labor union representatives. Whether they can meet the requirements of a board depends on whether they possess some specific attributes. As discussed previously, there are three basic attributes of a qualified member of a supervisory board: independence, technical knowledge and availability of time. Table 5 lists out how good each professional group can meet the requirements of these attributes. It can be seen from the table that professional non-executive directors seem to have, in general, the best overall combination of these attributes.

[Table 5 approximately here]

On the basis of the results in Table 5, it is possible to give the following advice on the best composition of a supervisory board. The chair should be a professional non-executive director who is supported by a panel of specialists. For example, a banker can be helpful for advising financing issues. A lawyer can be helpful in handling business and company laws. An auditor can be an appropriate adviser in accounting and auditing matters. Issues related to production can be passed to an engineer adviser. For matters related employees, an employee representative, a former labor-relations director, or in some special cases a labor union representative can offer particular help. Professional non-executive directors and entrepreneurs possess good entrepreneurial and general business knowledge and are thus most appropriate for giving business advice (Schneider, 2000, pp. 280-281). Care should be taken when nominating a candidate to a board. Consideration should be given to how good the candidate will contribute his expertise knowledge to the board, but not solely to which professional group she comes from.

6.5 Liabilities

Directors in all the four selected countries have nearly the same legal obligations. These obligations include the duty of loyalty and the duty of care as a proper and conscientious supervisor should have. Likewise, these countries also have similar possibilities of sanctions, such as refusal of discharge, recall, nomination of special auditors as well as criminal law and civil penalty law sanctions. However, there are differences in applying and enforcing these liabilities among these four countries (See Schneider, 2000, pp. 282-284 for more details). Even though the rules of liability are necessary for arousing monitors' awareness about their obligations, the success of monitoring depends ultimately on the performance of the monitors.

6.6 Compensation

Although the mentality of board members to perform their official duties plays an important role on determining their monitoring performance, the amount of compensation may also contribute to improving this performance. If this amount is a factor improving monitoring performance, then larger amount is expected to have potential reinforcement for better performance. However, their relationship may not be linear. The exact form of the relation for a particular company may depend on many factors, such as its board structure, and legal and business environments, to mention just a few. If we know the relationship, it is possible to use some schemes of compensation to achieve certain performance level. The components of compensation in the four selected countries are summarized in Table 6.

[Table 6 approximately here]

The relation between fix and variable components of compensation is different among these countries. The variable portion of total compensation for US boards tends to be higher than that for their European counterparts. For example, in Switzerland the compensation for board members is normally a fix amount. It is also possible to improve the performance of board members by using proper incentives related to certain indicators. For example, an effective incentive can be established for board members by treating them as independent entrepreneurs who are interested in the long-term success of a company. In this situation, stocks or stock options that can be exercised in the future at present prices can be used to serve this incentive purpose. Also, meeting attendance fees can be used to encourage board members to attend and even actively participate in board meetings. Since different positions in the board, such as board chairs, committee chairs and other members, may assume very different responsibilities and take up different amount of workload, these differences should be taken into account when determining their compensation. To avoid conflict of interests and maintain independence in appearance, the amount and structures of compensation given

to each member should be properly disclosed in public documents such as annual reports or filings with government offices (Schneider, 2000, pp. 285-289).

6.7 Performance assessment

A periodical performance assessment of the board and its members could contribute to better monitoring. This assessment can be used to identify which members have met their preset goals and to give these members proper feedback for future improvement. The assessment can also be used to remind board members of their responsibilities to protect shareholders' interests. If the assessment suggests that the performance of the board is good, then this result may be the best indication of the success of the board.

Performance assessment has long been developed in the US. It is a common practice there to perform annual self-assessments by board members. Although performance assessments have also been used in Germany and Switzerland, they are still not so popular as in the US yet. Information about France is unknown (Schneider, 2000, pp. 290-291).

7. Conclusion

In this study, we have compared major corporate governance factors of four countries: the US, Germany, France and Switzerland. Our focus is on the monitoring features in the boards. These comparisons unveil that it is very difficult, if not impossible, to tell which board model is the best in all cases. Each of these models seems to have both advantages and disadvantages. The appropriateness of these models depends largely on factors related to legal, cultural, social and economic developments of a particular country. Since the adoption of social and economic freedoms, the US has fewer regulations governing the operations of her corporations than the three continental European countries. In particular, Germany has the largest number of corporate governance regulations among the four countries because she

adopts the philosophy of trying to regulate most of the things, including the governance system of a corporation. Similarly, since French government adopts the principle of centralization, it is very unlikely for individual French corporations to establish tailor-made governance systems. On the contrary, Switzerland corporation laws give more flexibility to companies there to design their own governance system, because Switzerland government adopts a more liberal mentality for businesses.

When we look at a corporate monitoring system in a particular jurisdiction from the angle of her corresponding corporation laws and the ideas behind these laws, we may always find the system close to perfect because these laws are ideal on theory. However, when we look at the implementation of these laws in practice, the story can be very different. One reason is that these laws are executed by the agencies of corporations (i.e., managers) who are looking for all possible ways, within the constraints of these laws, to pursue their personal interests even at the expense of shareholders'. Consequently, the qualities of these agencies essentially determine how effective the monitoring systems are, not the laws imposed upon them.

The key to success in effectively monitoring managers is determined above all by the personal qualities and mentality of monitors, although other elements such as the board model adopted, cooperation among members in the organizations, formation of committees, adoption of compensation schemes, possibilities of lawsuits, etc. may also have an effect on the monitoring. For example, it is possible to improve the information accessible by board members and the efficiency of the board as a whole through identifying agenda to be dealt with in board meetings, by establishing committees to share the jobs of the board and to increase its productivity, or through the cooperation with external auditors. Implementation of effective compensation schemes can also provide incentives with a positive effect on the quality of this monitoring. Perhaps the best mechanism for effectively monitoring is to

implement proper nomination procedures for new board members and annual performance assessment of managers and these board members. Only when they follow closely the necessary ethics and moral requirements can mismanagement be avoided.

In practice, the gaps between the two major board models have been narrowing down over time. For example, many corporations adopting the one-tier model establish committees to single out the monitoring function from the executive function of the board. The purpose of this mechanism is similar to that of the supervisory board in the two-tier model in which the separation of the monitoring and executive roles is specifically stipulated in the laws. In the one-tier model, the separation is institutionalized by appointing senior executives to the board to handle policy execution, but at the time various committees are also established to monitor this execution. For example, audit committees in the US serve the purpose of this separation. However, the use of committees as a monitoring tool is not the feature only found in the one-tier model. It is also gaining popularity among corporations adopting the two-tier model to form committees as well. As a result, the top level of most multinational corporations adopting the two-tier model is commonly composed of managers, the (supervisory) board and committees. Therefore, the structures of the biggest corporations around the world are now converging regardless of which board models they have adopted.

Globalization of markets and internationalization of the operations of many large companies lead to increasingly complex operations of big businesses. To monitor effectively and efficiently, the board should be future-oriented when undertaking its monitoring activities. It is no longer sufficient to use historical information contained in financial statements, for example, as a basis to monitor companies. It does not mean, however, that this kind of information is not useful. Instead, this information should be used only to evaluate the current positions of companies. More attention should be given to future-oriented information, such as company planning or leading market indicators. These types of

information can be more useful for monitoring the potential risks encountered by the companies. For example, discussions of future plans by management may provide an early warning signal of possible crisis and represent direct recognition of it.

The type of information provided by managers is another factor determining how successful the cooperation between the board and managers will be. There is no generally accepted practice on what kinds of information should be provided to the board. The information provided depends on the individual needs of board members. Therefore, the relative power of managers and the board chair may determine the amount and the types of information that should be provided to the board. Personal characters of both managers and board members may also affect this cooperation.

Managers and the board should not take each other as enemies. Instead, they should consider each other as complement similar to Yin and Yang in the Chinese philosophy. They should work together to establish a constructive and effective governance system that can serve their companies the best. The board should play its role as an adviser for managers to implement the policies and conduct the business of a company. The board should also support managers' conscience of doing their best jobs at the same time. These duties of the board are universally true and independent of the legal systems in which the companies are operating, because finally there is only one kind of management and one kind of monitoring system that can survive – i.e., the effective one.

Notes

- ¹ A derivative lawsuit is a special juridical procedure in US court. This lawsuit gives shareholders of a company the right of a juridical procedure at the court against members of the board of directors. The members must have breached their duties as directors and led to significant damage suffered by these shareholders.

- ² Class action is a civil action/lawsuit made together by a group of at least two persons at the court.
- ³ Contingency fees are a scheme of compensation for lawyers agreed with their clients. Under this scheme, lawyers will get their compensation from their clients only when they win the lawsuits; otherwise, they will get nothing. In Germany, lawyers are not allowed to make such an agreement with their clients.
- ⁴ A back office is an office behind board members. It is composed of a group of people or a department to offer support to (supervisory) board members to do their jobs. The office has all the needed instruments and equipment for providing this support. A back office for part-time board members is normally located in the neighbourhood of their full-time offices. However, this office may also be located near the company to be monitored. Bankers often establish this office in their banks and use the office to acquire, prepare and analyze information for board meetings. These banks may ask some of their departments, such as research department, financial analyses department, legal department, etc., for help.
- ⁵ See for Germany § 317 par. 1 sentence 3 HGB (Commercial Code); for US SAS No. 82, Consideration of Fraud in a Financial Statement Audit; for Switzerland OR 729b; for France Art. 230-1 Loi, Art. 251-1 Décret.
- ⁶ Works council is a staff committee in a company. The council seeks better working conditions, and more interests and rights of workers. Therefore, it is working closely with the labor unions. In Germany, the co-determination law specifies the regulations for the formation of this council.
- ⁷ Mandate refers to a seat in the board, a task for the board, or an authorization given by the board. Similar to lawyers who have a mandate for their clients at the court, board members also have a mandate for shareholders in the board.

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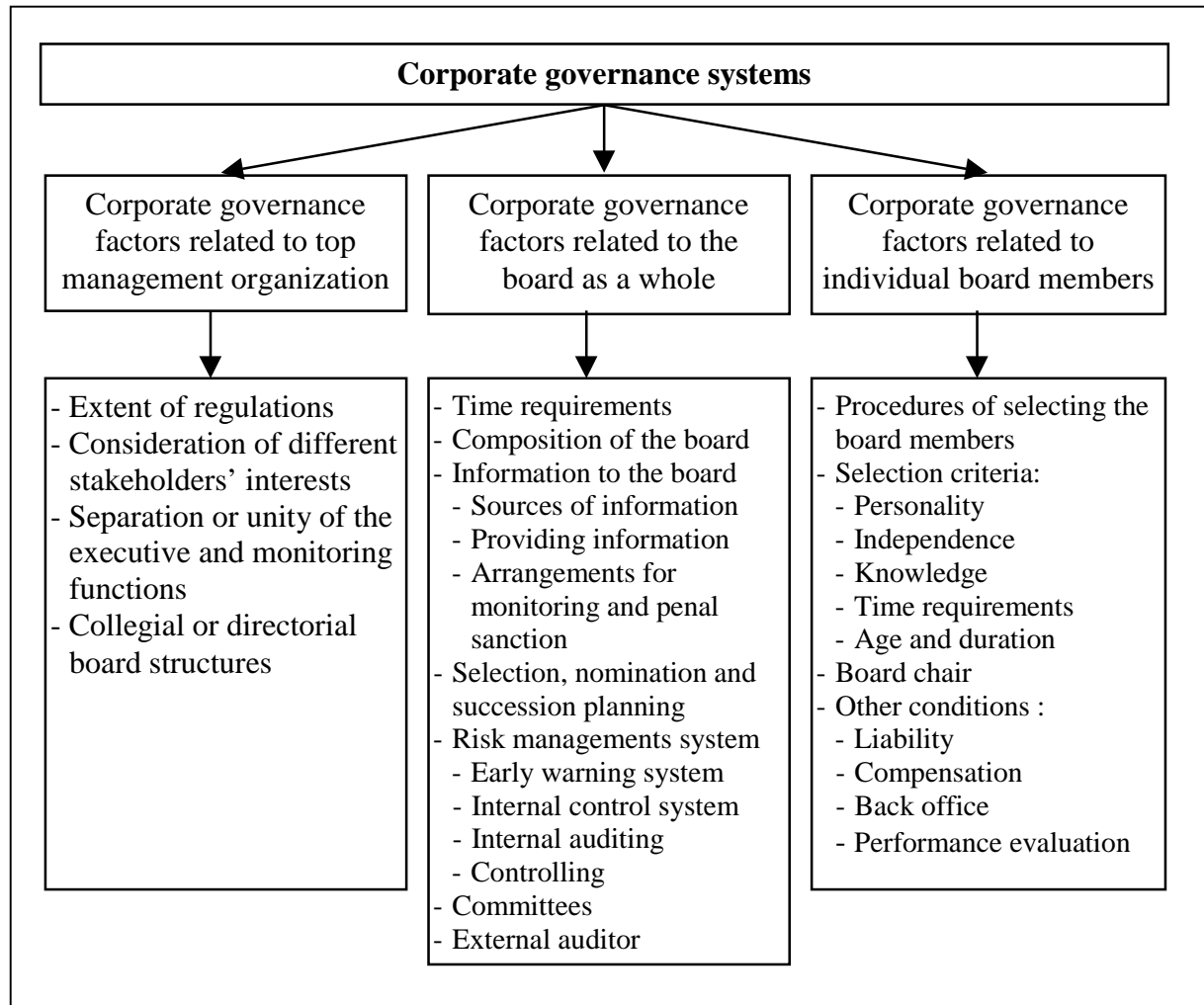
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Figure. 1: Classification of corporate governance component factors



Note: Although we try our best to identify all the component factors of a corporate governance system, we cannot assure that those factors listed in this figure are exhaustive.

Figure. 2: Relationship between number of board members and the effectiveness of the board

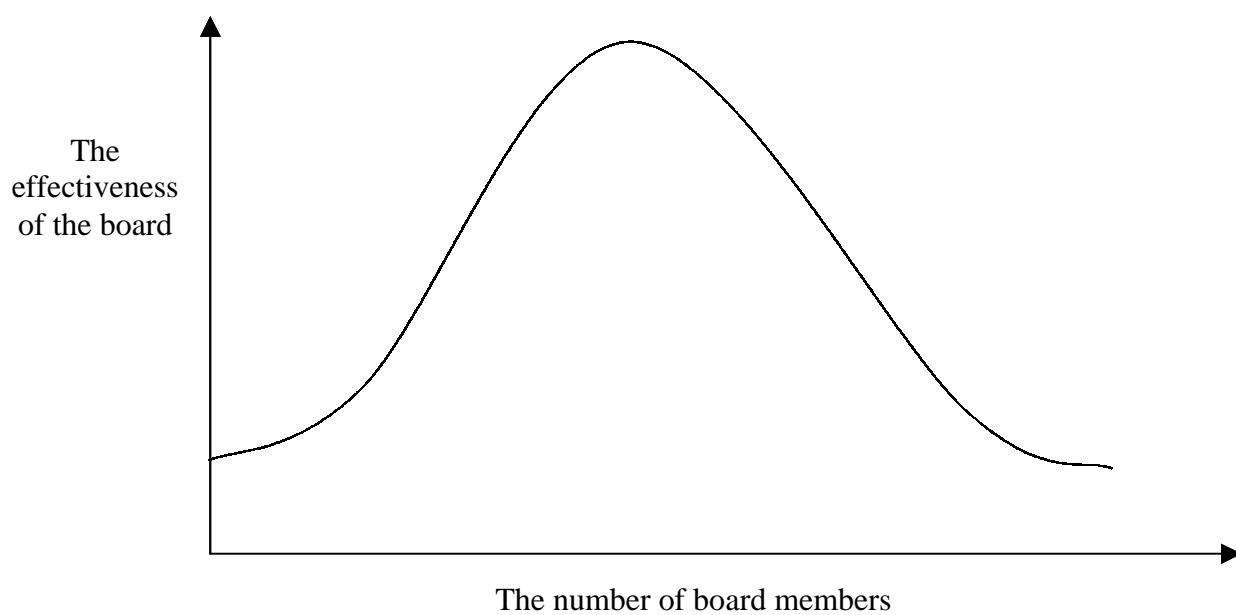


Figure 3: Composition of the (supervisory) boards and reasons for nominating their members

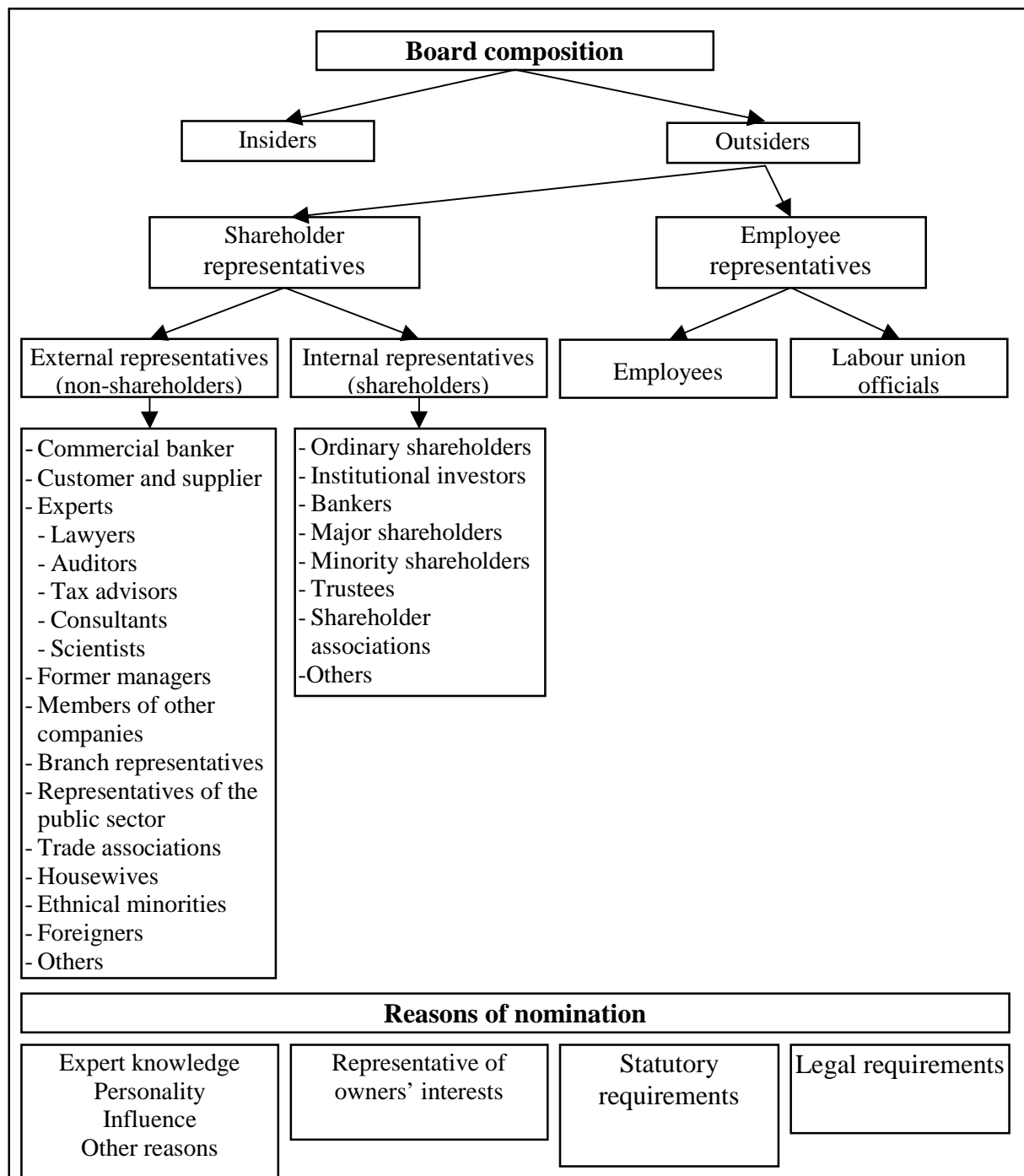


Figure 4: Elements of a typical risk management system

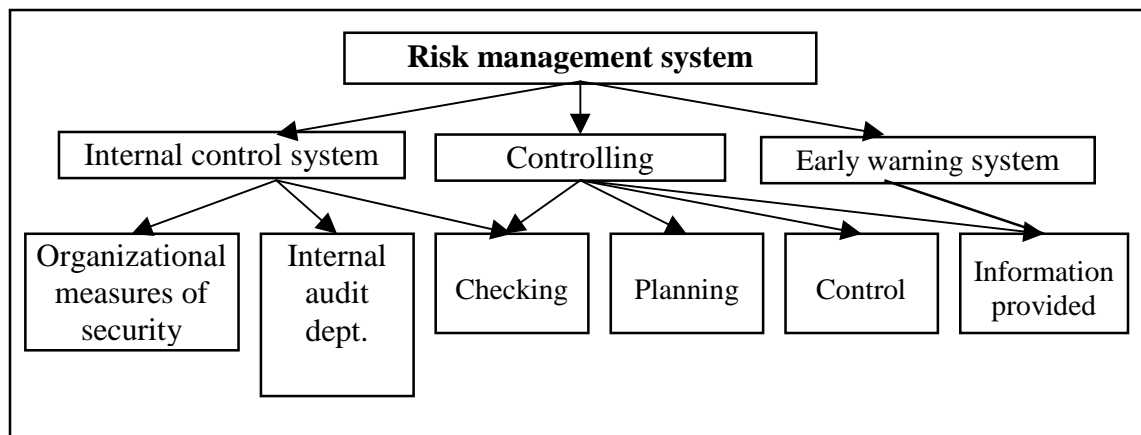


Figure 5: Committees

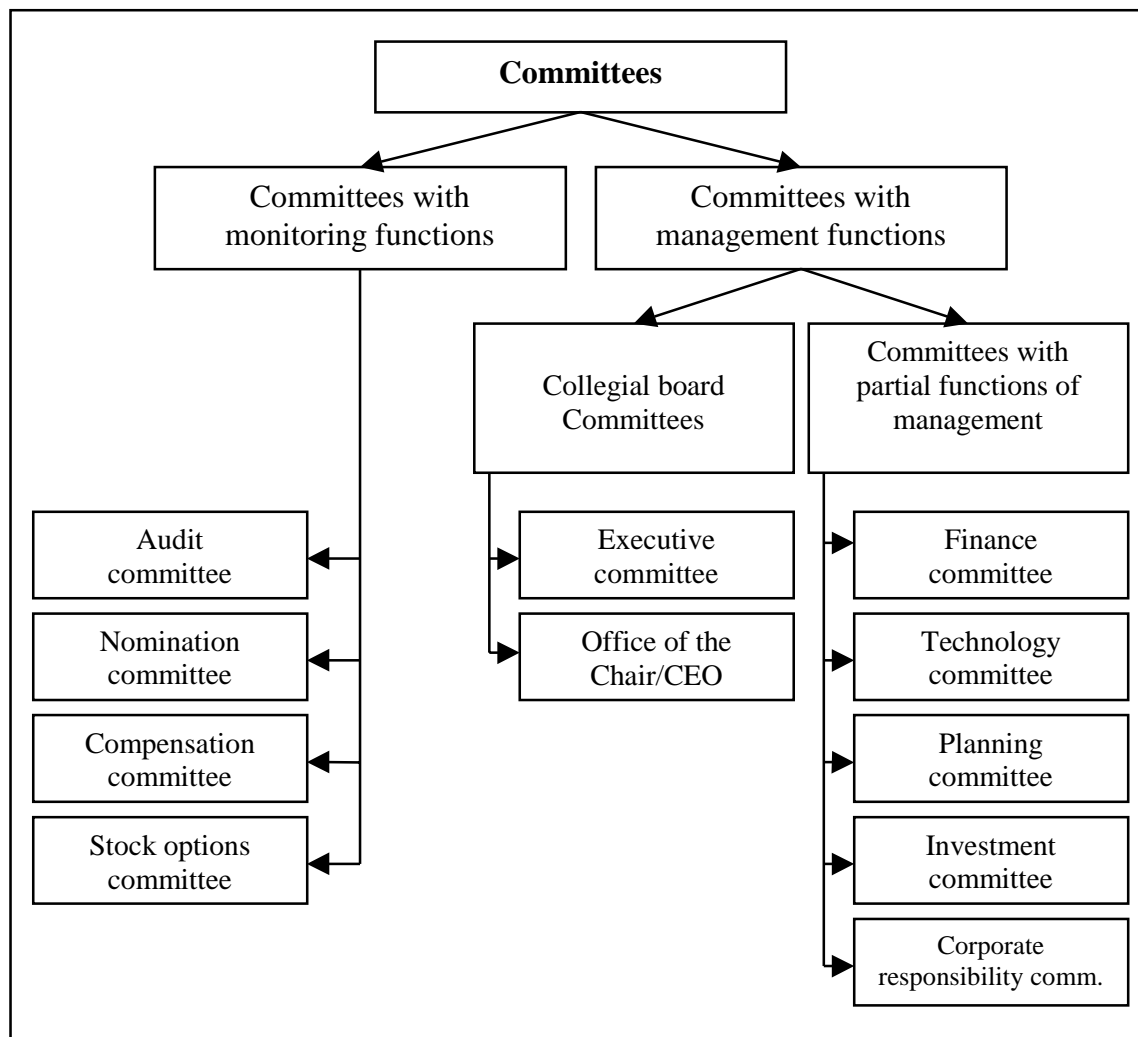


Table 1. Size of monitoring boards in 1996

Number of board members	Germany		USA		Switzerland		France					
							Total		One-tier model		Two-tier model	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
< 9	2	5.3	2	2.0	11	40.8	4	6.7	1	2.1	3	25.0
9-15	15	39.5	88	88.0	12	44.4	44	73.3	35	72.9	9	75.0
> 15	21	55.2	9	9.0	4	14.8	12	20.0	12	25.0		
	38	100.0	100	100.0	27	100.0	60	100.0	48	100.0	12	100.0
Min.	6		8		6		4		5		4	
Max.	20		20		26		24		24		15	
Average	15.3		12.8		10.7		13.2		13.9		9.7	

Sources: Spencer Stuart Executive Search Consultants (1996a; 1996b; 1996c; 1996d).

Table 2: Average size of German public corporations in 1993

Number of members	Registered capital of German public corporations							
	< 3 M DM		3-20 M DM		> 20 M DM		Total	
	No.	%	No.	%	No.	%	No.	%
< 9	27	100.0	156	87.2	102	28.7	285	50.7
9-15	0	0.0	21	11.7	160	44.9	181	32.2
> 15	0	0.0	2	1.1	94	26.4	96	17.1
	27	100.0	179	100.0	356	100.0	562	100.0
Min.	3		3		3		3	
Max.	6		16		21		21	
Average	4.3		5.66		11.89		9.39	

Source: Leimkühler (1996, p. 305 and p. 308).

Table 3: Number of meetings of the supervisory boards in 1996

Number of meetings	Germany		USA		Switzerland		France					
							Total		one-tier model		two-tier model	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
n/a	1	2.6	0	0.0	2	7.4	1	1.7	1	2.1	0	0.0
2-3	10	26.3	0	0.0	2	7.4	4	6.7	2	4.2	2	16.7
4-6	27	71.1	16	16.0	20	74.1	52	86.6	42	87.5	10	83.3
> 6	0	0.0	84	84.0	3	11.1	3	5	3	6.2	0	0.0
	38		100	100.0	27	100.0	60	100.0	48	100.0	12	100.0
Min.	2		4		2		2		3		2	
Max.	6		18		7		7		7		6	
Average	3.8		8.9		5.1		4.5		4.7		3.9	

Sources: Spencer Stuart Executive Search Consultants (1996a; 1996b; 1996c; 1996d).

Table 4: Number of Committees in four countries in 1996

Number of committee	Germany		USA		Switzerland		France					
							Total		one-tier model		two-tier model	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
n/a							3	5.0	1	2.1	2	16.7
0	2	5.3					13	21.7	8	16.7	5	41.6
1	9	23.7					8	13.3	8	16.7		
2	11	28.9	1	1.0			20	33.3	18	37.5	2	16.7
3	12	31.6	7	7.0			15	25.0	13	27.0	2	16.7
4	3	7.9	30	30.0			1	1.7			1	8.3
5	1	2.6	28	28.0								
6			17	17.0								
> 6			17	17.0								
	38	100.0	100	100.0	27	100.0	60	100.0	48	100.0	12	100.0
Min.	0		2				0		0		0	
Max.	5		10				4		3		4	
Average	2.3		5.1				2.2		2.1		2.8	

Sources: Spencer Stuart Executive Search Consultants (1996a; 1996b; 1996c; 1996d).

Table 5: Attributes of board members for different professional groups.

Professional group	Requirements		
	Independence	Technical knowledge	Available time
Entrepreneurs	Sometimes	Good overall	Little
Professional non-executive directors	Good	Good overall	A lot
Bankers	No	Special knowledge in financing	Little
Experts	Sometimes	Special knowledge in their fields	Little
Politicians	No	Special knowledge in dealing with government officials	Little
Employee representatives	Good	Extensive knowledge in operational matters	A lot
Labor union representatives	No	Special knowledge in personnel matters	A lot

Source: Schneider (2000, p. 281).

Table 6: Components of compensation to board members

Compensation type	Germany	USA	Switzerland	France
Retention fees	Fix	Fix	Fix	Fix
Additional stock based compensation	Yes	Yes	Seldom	Sometimes (only for stock options)
Meeting attendance fees	Seldom	Yes	Seldom	Little
Committee fees	N/A	Yes	N/A	Yes