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A EUROPEAN VIEW

The Corporate Board in Transition

by BOHDAN HAWRYLYSHYN, Director, CEI (International Management Institute), Geneva

Boards of directors used to be peaceful corporate sanctuaries. Their importance, their intensity of involvement varied across companies and countries. Some were merely ornaments at the top of the corporate structure; others exercised the ultimate powers of decision in all key areas of corporate life. Some boards met to have a good lunch, exchange business gossip, and perform the necessary legal formality of approving what had already taken place. Others met frequently, scrutinized voluminous reports and proposals, and made decisions that determined the future health and performance of the corporation. In most cases, the boards felt secure and unchallenged, both in their status as the supreme governing organ of the corporation and in their right to perpetuate themselves.

In the seventies, all boards came under pressure, as a number of factors converged. After several decades of expansion, successful innovations, and profits, many corporations had to jam on the brakes and adjust to a leaner life. But society's expectations, which had matured in the heydays of growth,

could no longer be nourished easily.

Workers expected increasing wages, job security, improved working conditions, and more say in management. Customers began to compare advertised promises against the performance of products—and grumbling increased. Communities whose very existence depended on corporate decisions wanted to be counted in. Home country governments, under pressure of inflation, unemployment, budget, and balance of payments deficits, demanded greater corporate compliance with their policies.

Host country governments wanted the subsidiaries of foreign corporations to march more to the tune of their national objectives and less to the rhythm of foreign-based corporate headquarters. Caught between market downturns and rising constituency demands, some corporations could not adjust and went off the rails. Others, in their anxiety to continue to perform well, resorted to such expedients as swapping corporate favors or greasing willing hands. News, spreading quickly, was often blown out of proportion; and the boards, as

the bodies ultimately responsible, frequently looked pale under such circumstances: not sufficiently informed, not sufficiently knowledgeable, or not sufficiently assertive.

It is against the above background that I shall review the nature and direction of changes in boards—both changes that have taken place and those which are necessary or likely. My approach grew from a discussion with former colleague Dr. I.J. O'Connell, then a CEI faculty member who carried out research on boards in six European countries; he is now professor and dean of the Graduate School, Bentley College, Waltham, Mass.

Responsibilities

Boards first emerged as a group of owners or as direct nominees of the owners to whom they owed their sole responsibility. Board members were the custodians, protecting property, preserving assets. The responsibility was discharged by appointed managers, whose achievements were summarized in an annual report and presented to the assembly of owners. This was the pure shareholder era of corporate life.

The Corporate Board in Transition

With time, ownership spread and became diluted. Shareholders grew numerous, buying and selling at will their piece of ownership. Most of them were known only to the company computer. Thus, the links between the owners and their representatives on the boards became fragile. And as corporations, having become big and potent, took on lives of their own, their perpetuation became more important than the maximization of dividends or share prices. The boards gradually shifted their commitment to the corporation itself and away from its owners, the shareholders. Legally, things did not change; the instruments remained. There were still annual reports and the annual shareholder assemblies with their proxy mechanism that facilitated the self-perpetuation of the boards.

Recently, new claimants, who represent more organized constituencies, have begun to appeal to the media, to the general public, and to governments. While their nature and power vary, the labor constituencies have been quite significant. In such countries as Germany or the Scandinavian nations, powerful unions have obtained the right for employees to be represented on boards. The rationale is that workers, who will often stay with an enterprise throughout their working lives, are more affected by board decisions—and thus have a greater stake in them—than are anonymous shareholders who unload their shares at the slightest negative signal from the stock market. In some cases, where the very survival of a community depends on board decisions to expand or close down an operation, local authorities also feel that they have a critical stake in corporate affairs and therefore should have a say through boardroom representation (e.g., Gothenburg

and Volvo's operation located there.)

In the U.S., minorities, feeling that they supply much labor but are not asked for many ideas, have aspired for board representation. Consumers, for example, having been told that they are ultimate decision makers because they vote with their dollars, have learned that such voting does not always result in better, safer, or cheaper products. The promise of a more direct vote in the boardroom has seemed an attractive alternative.

Thus, the stakeholder era has been born. This is the newest corporate incarnation. If we accept the notion of board responsibility to stakeholders rather than just to shareholders, what is the nature of that responsibility? Clearly, the interests of different constituencies vary and sometimes even clash, such as higher wages versus cheaper products. So one responsibility of boards must be to reconcile such interests. To achieve this, the various stakeholder representatives must accept the fact that their primary responsibility is to facilitate the effective functioning of the corporation. They cannot be spokesmen acting within the narrow mandate of their constituencies; rather, they must function with the understanding that, while taking into account the interests of their constituency, they will seek to make those interests compatible with the basic requirements of corporate health: innovation, ethical behavior, profitability. Philosophically, the Dutch have advanced the furthest along this line, establishing the balance between conscience and constituency; each board member must act for the good of the corporation according to his good conscience, taking into account his constituency's interests while not being a mere spokesman for them.

If one accepts the stakeholder concept, then new instruments and

new institutional interfaces are required for the board to fulfill its responsibilities to these various stakeholders. Annual reports, which used to focus on sales, operations, and financial aspects, will now have to be addressed—as is often the case already—to different constituencies with different content. Workers' councils, meeting with relevant public authorities, may be as necessary as present encounters with financial analysts.

Roles

As responsibilities change, so must the roles of the boards, the things they actually do. When the responsibilities were mainly of a custodial nature, the main tasks of boards were verification of results, hiring, rewarding, or sanctioning senior managers.

As enterprises grow in size and complexity, there is a shift of loyalty and commitment away from owners and toward the corporation itself. This has involved the boards more in the decisions about future actions. However, given the professionalization of management, only the inside board members tended at first to initiate decisions. The outsiders provided information about markets, suppliers, sources of credit; they gave some advice and "ratified" decisions submitted for formal approval by management. Since those in executive positions controlled inside information and had more directly relevant expertise, they assumed more power and boards became their captives. This was facilitated by the practice common in North America of the chairman also being the chief executive officer.

With loss of management control in some large corporations, with unethical behavior in others, and with board members disclaiming

responsibility in many such instances, pressure emerged to review the duties of boards. It seemed advisable to separate direction, supervision, and evaluation from the actual implementation of decisions. Thus, the board would define the mission and objectives of a corporation, establish policies, monitor their implementation, evaluate the performance of the corporation—including that of the chief executive officer—and, ideally, assess its own performance. But to carry out such an evaluation effectively, the roles of the chairman and CEO must obviously be separated. It is difficult to preside over one's own judgment, particularly when it is carried out by one's subordinates.

The Structure

Boards were created originally as single entities and long tended to operate as such. When greater pressure was placed on performance, special committees evolved, such as executive, personnel, and compensation. Then, regulatory bodies demanded the creation of audit committees to ascertain greater accountability.

Some countries, such as Germany, went further. They imposed by law two-tier boards, one supervisory and one management. The Germans felt that this would automatically separate direction and evaluation from implementation, making boards more independent of management and therefore more accountable. Elsewhere, as in Sweden, there is only one board; but since only the managing director in corporate management can sit on the board, and he does not act as its chairman, there is an approximation of the German practice. In North America, the trend is in the same direction. There is a rapid shift toward

appointing a majority of outside members and separating the roles of chairman and CEO, a recent case being that of IBM. Such a shift towards de facto, two-tier boards will be further accelerated because such a structure can accommodate more readily the various stakeholder representatives on the boards, without impeding the functioning of the corporation.

Composition

Once the owners, or "their" men, would sit on the boards. When the boards were pulled into the decision-making process, "management's" buddies often were invited to join the board. The process of accession shifted from one of appointment to that of co-optation by the boards.

Since boards will now be more representative in order to legitimize the corporation vis-a-vis its various constituencies, the trend is bound to be toward stakeholder representatives getting on boards through a more genuinely elective process. The two-tier boards, or their equivalent, will become the general pattern in order to accommodate this. This supervisory board without executive members will meet less frequently, decide on major investments, make dispositions of profits, and appoint top executives. This will, in turn, keep the board out of the implementation function and reduce the potential area of conflict between constituency representatives.

Boards must not only be independent in order to be accountable and credible, they must also be competent, or they will not give proper direction to corporate activities. Two-tier boards assure independence, but they do not guarantee competence, which requires knowledge of markets, products, technology, industry structure, competition, and trade patterns.

These requirements imply effort and time, and anyone who sits on a board will thus need to reduce his board memberships in order to commit more time to each individual board. In the long run, it probably means professional outside board members. To create such a pool, earlier retirement by top executives may be desirable.

Conclusions

Like any organism, a board consists of several components which have to be compatible. When one component changes, the other must follow. Corporations function in social/political contexts which, as they evolve, place new demands on corporations. As the corporation's supreme governing body, the board must respond to such demands, accepting new responsibilities. As responsibilities change, so must the roles, the structure, and the composition of boards. Only the harmonious evolution of all of these aspects can assure both greater acceptability of and smooth functioning by boards. Token minority representation or audit committee location will not suffice.

After examining the experience of various countries, one can deduce the general direction of change:

- Increased board responsibilities to sectors of the population affected by the activities of the corporation.
- Sharper segregation of direction, monitoring, and evaluation implementation.
- A more truly elective process.
- A two-tier structure or its equivalent.
- Separation of the duties of the chairman of the board and the chief executive officer.

Individual countries and companies may move at a different pace, but they are likely to move in these general directions.

