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Corporate Governance:
Stakeholder versus Shareholder Value

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Prohlášení

Prohlašuji, že jsem diplomovou práci vypracovala samostatně a použila pouze uvedené prameny a literaturu.

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Corporate Governance:

Stakeholder vs. Shareholder Value

Abstract:

The focus of this thesis is comparing the two main approaches to corporate governance, namely the stakeholder and the shareholder concept. After some general definitions and theory, we look at the history and current practice of corporate governance in the United States and Germany. Further, based on the concept of complementarity and consistency, we will show why we disagree with the hypothesis of a "natural" tendency for convergence of the two corporate governance systems. Finally, we try to classify the state of Czech corporate governance according to the same criteria we use to classify a system as being more shareholder or stakeholder-oriented.

Abstrakt:

Cílem této diplomové práce je srovnání dvou hlavních směrů corporate governance, a to konkrétně stakeholder a shareholder konceptu. Představíme si několik hlavních pojmů a teorií a poté se podíváme blíže na historii a současný vývoj corporate governance tak, jak je praktikována v Německu a USA. Dále pak na základě konceptu komplementarity a konzistence ukážeme, proč nesouhlasíme s hypotézou "přirozené" tendence ke konvergenci obou systémů corporate governance. Nakonec se pokusíme vyhodnotit současný stav corporate governance za pomoci podobných kritérií, které jsme použili pro klasifikaci systému dle shareholder nebo stakeholder orientace.

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1 Introduction

"We need to breathe to live but we do not live to breathe."

The purpose of a corporation can be expressed quite similarly. A company needs profits to exist, but does not exclusively exist to create profit. This view has been advocated by many authors[1] dealing with corporate governance and even by companies themselves and is strongly connected to the concept of stakeholder value. In contrast to this concept, there exists the so-called shareholder value strategy[2], which focusses mainly on creating shareholder wealth through a rising stock price.

Thus, the dilemma whether to choose the option of the dominating shareholder theory or whether to decide for its main challenger, the stakeholder theory, has dominated the debates on corporate governance over the last two decades.

Yet, shareholder value, a term originally specific to the corporate governance of American companies, has been rapidly gaining ground in European board rooms, even though it has not yet taken root in the major economies of the European Union except in the UK, where the shareholder-oriented system traditionally prevails.

When dealing with the question of the superiority of one of those systems, one would have to take into account all the important issues playing an essential role in corporate governance. Since this is a rather complex task, we will shift our focus to the main ones for now.

There is no doubt about the importance of financial investments carried out by shareholders. Without shareholder equity, firms could hardly start a business in any functioning legal environment. Referring to the motto above, while capital is essential it takes much more for a corporation to be successful. The firm definitely needs the funds to exist, but things other than mere financial value can be important for the company as well. First, we will briefly address some

[1] See Schmidt (1997), for example.
[2] The term as well as the broad concept was invented by Rappaport (1986).

general issues related to corporate governance in chapter 2. Thereafter, chapter 3.2 deals closer with the stakeholder approach while chapter 3.1 will present the shareholder value concept in greater detail. This constitutes the theoretical part of this work. Then, in chapter 4 we will present some historical facts in order to see how those concepts have evolved in two exemplary countries, the USA and Germany. Afterwards, the current practice of corporate governance in both countries and their main features and crucial differences will be discussed in 5.

Why is it interesting at all to compare the two systems? Mainly, we could ask whether one system is superior in terms of the resulting economic outcome. We argue that neither of the two concepts is superior per se. Rather, multiple consistent systems exist which lead to similar desirable results. But what exactly constitutes a consistent system? This issue will be addressed in chapter 6.

Finally, in chapter 7, we will look at some of the previously discussed characteristics of the two corporate governance models, in particular, corporate funding methods and supervisory board composition in the Czech Republic. Based on the selected observable and quantifiable features, we will examine whether there is a tendency of the Czech Republic to follow the path of the stakeholder or the shareholder model.

2 What Is Corporate Governance and Why Do We Need It?

Historically, dealing with questions of corporate governance dates back to famous classical economists such as Adam Smith, who had already raised concerns about the relationship between a firm's owners and the people making executive decisions. Certainly, one of the most important contributions was then published by Berle and Means (1932), who brought to popular attention the separation of ownership and control in U.S. corporations. They outlined that virtually no large corporation was controlled by its owners. Instead, managers were paid to make the most important decisions. This was due to a strong dispersion of ownership between small investors. After the major industrial development many corporations became so large, that they simply could not be owned by few large-scale investors. Hence, many small investors were not able to accurately monitor the actions of those administering the company. This finding was considered so important that it was named the Berle-Means problem.

Corporate governance anywhere, in developed countries, as well as in emerging markets, plays an essential role in the long-term national development. It seemed to be almost forgotten until the East Asian financial crisis in 1997 and 1998 finally drew attention to the poor protection of investors and weak corporate governance performance in the emerging markets[3]. In addition to that, some economists argue, that other factors such as the worldwide privatization wave, the growth of private savings and the pension fund reform are responsible for the revival of corporate governance. Furthermore, the hostile takeover wave together with the mergers in the 1980's and the latest corporate governance failures in the United

[3]Three years before the Asian growth reached its "peak", Krugman (1994) had predicted a similar outcome. He attributes the roots of the crisis to the wrong concept of sustainable growth. Because other factors, necessary for the countries' productivity long-term growth, were forgotten, Asia's massive factor mobilization alone turned out to be an insufficient source of growth in the long run.

States have triggered the debate on corporate governance practices anew [4]. We will return to the latter reason in chapter 4.1 where corporate governance in the United States will be discussed in greater detail.

But what exactly is corporate governance? In the following section we will introduce some broad definitions of that term.

2.1 *What Is Corporate Governance?*

The definitions of corporate governance vary. The broad definition of *"corporate governance refers to the private and public insinuations, including laws, regulations and accepted business practices, which together govern the relationship in a market economy, between corporate managers and entrepreneurs ("corporate insiders") on one hand, and those who invest resources in corporations, on the other."*[5] Here, not only the shareholders, as suppliers of equity finance, are meant by investors. Any group investing its financial as well as human capital, assets or ability into the corporation is taken into account. Thus, employees, creditors, suppliers, etc. are also covered by this definition.

According to Shleifer and Vishny (1996), corporate governance deals with the methods in which suppliers of finance assure themselves of getting a return on their investment.

Zingales (1997) promotes the definition of *"...corporate governance as the complex set of constraints that shape ex-post bargaining over the quasi rents generated by a firm."*. He conditions the requirement of corporate governance system with two assumptions, both regarding the problem of bargaining. First, some quasi-rents must be generated. Otherwise, there would be no room left for bargaining, as the competitive market would eliminate it. Secondly, he assumes that the perfect quasi-rents allocation is not ensured ex-ante, else there would be no potential

[4] For more details see Becht, Bolton, and Röell (2002)
[5] Oman (2001)

for bargaining[6].

2.2 *Why Do We Need It?*

Why are we concerned with corporate governance? Why is it interesting and necessary at all? The answer lies in the nature of contracting between different parties needed to run a functioning company. Since real transactions, such as the input of specific human capital or the purchase of a specific machine, are usually not standardized (Williamson (1985)), they cannot be traded easily on any free market. Once, a contract has been agreed upon, the buyer and seller are "*...trapped in a situation of bilateral monopoly*"(Zingales (1997)). Naturally, the question arises how the surplus generated through the agreement should be distributed among the participants. At first glance, it seems that this problem can be dealt with easily by agreeing beforehand to a contract that lays out how to split up the surplus. And indeed, it would be easy if every state in the future could be anticipated and adequately contracted upon. But this is obviously not the case in the real world where most things are not foreseeable and therefore cannot be taken into account in the initial agreement. We then speak of incomplete contracts which leave room to exploit the incompleteness ex post. Thus, we need to impose some rules or authority to limit the opportunity of exploitation and secure the party which would be disadvantaged. Without such rules or authority, an otherwise efficient transaction may not be carried out.

Another important real-world problem is the existence of asymmetric information. That situation is present when one of the contract partners has access to superior information concerning possible future states and the related outcomes, whereas the other partner is lacking that knowledge. A famous example is the information advantage of managers in contrast to the shareholders, especially if

[6]Quasi-rents are defined by Zingales (1997) as the difference between what two parties can produce together and what they can obtain in marketplace. Quasi-rents are usually generated first after settling the agreement for a business and irreversible investments where sunk, therefore they can only be divided ex-post.

the latter are widely dispersed. Also, the creditors mostly suffer from inferior information concerning future prospects and investment profits and may therefore be reluctant to provide a loan.

To mitigate this problem there are multiple forms of regulation which are subsumed under the term corporate governance. First, we have national laws concerning business regulation or other institutional rules regulating the labor market or protecting shareholders, for example. Still other laws try to set incentives by encouraging or discouraging certain actions like hostile takeovers. In several countries[7] some popular defense measures taken by the incumbent management elsewhere are forbidden by local law in order to prevent the management from protecting themselves against hostile bids.

2.3 *Conflicts of Interest*

Despite the different definitions, the problem hidden behind corporate governance is still the same. Financial research on corporate governance refers to it as the "principal-agent problem". Jensen and Meckling (1976) were one of the first to analyze this issue as they introduced the idea of the separation principle and the resulting conflicts of interest. They view the firm as a nexus of contracting agency relationships where one or more *principals* delegate another person, *an agent*, to perform services on their behalf. Thus, each of the agents provides the firm with specific assets, such as human capital, time, skills, capital and other resources for which they expect an adequate remuneration in exchange.

The main feature of agency theory are the diverging interests of principles and agents. The most popular example of principal-agent theory is the conflict between owners and managers. Shareholders as the principals provide the firm with the necessary financial sources, and in exchange, they expect the company to maximize their profits in form of risk-adjusted return on investment. Therefore,

[7] This is the case especially in those countries, which are seen as being more market-driven.

shareholders are wealth maximizers. Those directly in charge of their investments and controlling the shareholders wealth are managers, who again provide the firm with their know-how and specific skills. Managers, in a way, are maximizers as well. They try to increase their power, remuneration and status at the costs of net income maximization. According to Jensen and Meckling (1976), managers tend to make decisions in order to gain fringe benefits which is certainly not in the interest of shareholders. The term "fringe benefit" describes the cases where managers, maximizing their own utility, make unprofitable decisions for the enterprise. This could range anywhere from purchasing expensive office equipment to making an inefficient acquisition based on a manager's personal motive and agenda rather than on sound economic analysis.

Rajan and Zingales (1997) assume a positive correlation between the inefficient managerial *power-seeking* and the diverse investment opportunities of a company's division. Furthermore, they find a negative correlation between the value of a diversified company and the diversity of the investment opportunities of the firm's divisions. Generally, managers tend to increase the size of the firm, since that makes them more important and valuable to the company which in turn is reflected in their payoff. Thus, it depends on the prevailing governance system whether those kinds of activities will be discouraged by aligning the company's decision-making with the interests of its shareholders or supported by organizational inertia[8].

Overall, stakeholders provide the company with their human capital, real capital and other input factors, that are then invested into the enterprise. In fact, stakeholders give up the right of disposal over their input factors in return for some form of remuneration. Employees demand wages, creditors intend to earn interest on their loans, suppliers want adequate prices for their goods, and so forth. For these purposes, three types of rights of disposal are discerned by

[8] The relation between managerial incentives and the control structure is discussed in Tirole (2001), for example.

the related theory[9]:

I. *Usus:* The right to utilize a good.

II. *Abusus:* The right to change a good.

III. *Fructus:* The right to the revenues derivable from the right of disposal of a good.

Intuitively, those who take one of the biggest risks by giving up the rights of disposal are creditors and shareholders by delegating the decision power to the managers. Thus, *usus* and *abusus* over the input factors are transferred to the managers. Despite the comparative advantage of the risk diversification possibility, shareholders are the only stakeholder group, which in case of default has residual claims only after all other claims have been satisfied. In this spirit, Williamson (1985) perceives the shareholders' relationship with the firm as unique. They place all their investments under a risk of loss, while the other suppliers of non-financial capital can keep their productive assets even in the case of bankruptcy.

Therefore, many economists argue that the main purpose of corporate governance is to protect the common stock finance suppliers, as they are the only stakeholders that are not adequately protected through a contractual relationship with the company and need the protection assured by control (Shleifer and Vishny (1996)).

A supportive background with well-functioning corporate governance institutions should minimize the problem of separation of management and finance, assuring the investors to get a return on their financial investments[10].

In contrast to that, a substantial number of other studies contradict the statements on prioritization of the manager-owner problem in the agency theory. For

[9]The theory of rights of disposal can be found in works of de Alessi (1990), and Richter and Furubotn (1999), for example.

[10]Suggested formal and informal rules and generally accepted practices can be found in *"A list of institutions of corporate governance"* released in Oman (2001)

example, Zingales (1997) argues that in a world of incomplete contracts, where most of the decisions are made ex-post, contractual relationships of stakeholders are no longer an advantage since incomplete contracts imply the existence of unprotected parties among other interest groups as well. Moreover, he disputes declaring the human capital investments as inferior to financial investments and treats both, the stakeholders human and financial capital as equally valuable. Within his argumentation he refers to Blair (1995) to impeach the proposition, that the fund providers investments would be superior in their nature to the human capital[11].

However, the divergence of interests between shareholders and management is reflected in the divergence of profit as well. The difference between the profit achieved if all the stakeholders acted in the interest of the shareholders and the profit gained in case of the agent's opportunistic behavior is usually referred to as utility loss in the principal-agent literature[12].

Through the asymmetric information distribution, actions of the stakeholder groups' participants are not clearly observable. Therefore, interest groups of the corporation anticipate ex-ante with the possibility of bad outcome for them ex-post and try to adjust the contracts in a way that would protect them from losses. For example, the principals usually try to minimize the number of opportunistic actions taken by the agents by devoting some agency costs to monitoring or ex-ante bonding of the agent as an interest alignment mechanism.

Typically, a special design for the contract is necessary to achieve that goal. For example, one could think about letting the managers participate in the firms' development. Very often this is implemented in form of stock options, which may constitute a substantial part of the managers earnings. However, in the world of incomplete contracts, where it is very hard to predict all possible outcomes of the particular relationship with the stakeholder, one can only try to optimize the

[11] Blair (1995) argues that the quasi-rent produced by specialized human capital can often overestimate the quasi-rent generated by physical capital.

[12] See Hill and Jones (1992) for example.

contract based on one's experience and the priorities of the enterprise.

Compensation contracts are indeed one way to create direct incentives for the agents to act in the equity providers' interests. Nonetheless, this creates less than optimal risk sharing[13]. Therefore, other corporate governance control mechanisms have been outlined such as hostile takeovers, proxy fights, boards of directors, etc. (Grossman and Hart (1980), Baker, Jensen, and Murphy (1988), Shleifer and Vishny (1996)).

Yet in reality, when ownership is not concentrated, another level of interest conflict occurs in the form of collective action problem among the shareholders[14]. Such a dispersion of control rights spread between a large set of claimants can lead to free-rider problems causing inefficient operations[15]. Therefore, the most quoted features of an effective corporate governance mitigating the problems are: transparency, accountability, fairness and responsibility all of which are also demanded in the principles of corporate governance of the OECD[16].

Another important term is asymmetric information which is a widespread problem observable in almost any kind of decision making process concerning multiple groups of agents. Hence, corporate governance arching over the multitude of interest groups is not an exception. Promoters of the stakeholder value model as well as those of the shareholder value model face the same kind of problem, namely the actions of the members of one interest group are not perfectly observable for the other interest group. The fact that there are multiple conflicts of interest within the broad stakeholder value approach should be intuitively clear by looking at the definition. Hence, it is even more difficult to find an appropriate balance.

[13] see Baker, Jensen, and Murphy (1988) e.g.

[14] Dispersion of the ownership in privately owned companies conforms to the theory of effective markets: Investors refuse to hold a larger stake in a company in order to diversify the risk and maintain the liquidity of their investment in exchange for control. Moreover, dispersed ownership could be caused by the relative size of the company versus the investor's wealth, or could even be due to the regulatory framework in the particular country.

[15] For more on free-rider problems I refer to Grossman and Hart (1980)

[16] OECD (1999).

In contrast to that, in the shareholder value oriented model the asymmetric information is mainly reflected in the traditional owner-manager conflict, where the owners face the problem of how to ensure that the managers of the company act in their interest.

In a simplified model, the conflict of interests arises between the agent (the manager of the company) and the multiple principals including the shareholders, creditors, and other groups engaged with the company. Employees, for example, are interested in higher wages and accurate working conditions[17]. Creditors are primarily interested in getting their loans repaid. This often leads to different assessments about investment opportunities since the management has an incentive to undertake projects that are too risky[18]. Suppliers want higher prices for their goods and maybe a stable long-term relationship. Furthermore, customers are interested in lower prices and a product with high quality. Ogden and Watson (1999) studied the relationship between good customer relations and shareholder value for the example of the UK water industry. They find that satisfying the customers' needs leads to an increased shareholder value although profits are reduced in the period when the improvements are carried out. Eventually, the local community, which provides the infrastructure needed to establish the firm, demands taking care of the environment. All that has to be taken into account, such that in the end preferably everyone is satisfied. Obviously, this task is not easily accomplished. Especially, if we think of a profit maximizing organization as a company listed on any stock exchange where investors are closely following their records and decide accordingly whether to invest or not.

[17] On the one hand, this is costly and reduces the profits of the firm, while on the other hand it could also be beneficial for both if productivity can be increased to outweigh the costs.

[18] A creditor does not profit from very high gains which occur with low probability but does suffer when he loses his loan. Hence, he prefers projects with less risk but higher probability of repayment.

3 Stakeholder and Shareholder Approach

In this thesis, making a simplifying assumption, corporate governance will be defined as bipolar, according to the interest groups prioritized.

The first wider one is the stakeholder approach, known from Japan and most of the European countries and Germany in particular. The stakeholder model interprets the purpose of the corporation as serving a wider range of interests. In contrast, the shareholder approach promotes primarily the stockholder value, trying to maximize the corporation's value for its shareholders. This second perspective, the narrower shareholder value, is mainly represented in the United States and United Kingdom.[19]

As the applied corporate governance differs in its form and features in each of the countries, the conflict of interest between the corporate governance players varies as well.

3.1 *Shareholder Approach*

"The corporate governance framework should protect shareholders' rights."[20]

The term "shareholder value" may have been the by far most commonly used phrase in business and management theory of the last two decades. Since Rappaport (1986) invented this term it quickly became a dogma for almost every management in Anglo-Saxon countries. Later in the 1990's this ideology conquered continental Europe but did not prevail as the leading concept of corporate governance.

The Anglo-Saxon approach tries to determine the enterprise value from the equity providers perspective, referring to shareholder value as the cash value

[19] At the same time, there exists a somewhat contradictory view to the mainstream literature. Edwards and Fischer (1994) for example impeach the distinction between market oriented and bank oriented systems. They give an example of Germany, where is only insufficient evidence on such a high extent of bank-controlled and monitored companies.

[20] OECD Principles of Corporate Governance

of all the surplus funds potentially distributable to shareholders in the future. Furthermore, the Anglo-Saxon corporation's organization is built on the notion of Adam Smith's *invisible hand*. His theory is applicable to both the economy and the firm as well. Market participants ensure the functioning of the economy by following their own interests. In a similar manner, the company is expected to pursue the shareholders interest in order to increase the stock value. Disturbances are resolved by the market. If the managers are performing poorly the market itself ensures the control and discipline mechanism. In Anglo-Saxon countries, the managers are supplied with large amounts of freedom as the control and discipline mechanisms are already embodied in the market.

Generally, the focus of this concept is maximizing cash flow to the stock owners of a company. This can be achieved either through dividends or stock price appreciation. Obviously, the degree of success is relatively easy measurable according to the shareholder value concept. Simply spoken, the shareholder value model examines how much a company is worth from the shareholder's perspective. Hence, following this ideology, the management has the task to improve by those measures and exclusively serve the interests of the shareholders. Other interests which are in conflict with those of the firm owners are therefore subordinated.

From an economic welfare point of view one can derive the plausibility of the shareholder value concept. Since every other stakeholder group, such as employees or creditors, have contractual agreements with predetermined payments, it would be socially optimal to maximize the residual payment to equity owners.

If shareholder orientation leads to the desired result of value maximization for the owners is a question addressed by Hecking (2002). In his empirical research he tries to examine to which extent shareholder value orientation explains shareholder value creation. For his regression analysis he takes 38 sample companies, using the shareholder value orientation as the independent variable in order to explain shareholder value creation. He comes to the conclusion that shareholder value orientation is favorable since companies with the correct shareholder value approach tend to outperform the other firms[21].

3.2 *Stakeholder Approach*

"*Good corporate governance helps... to ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate, and that their boards are accountable to the company and the shareholders. This, in turn helps to assure that corporations operate for the benefit of the society as a whole*". [22]

In the pluralistic approach, all stakeholders are viewed as the essential elements of the company's value creation. Hackethal, Schmidt, and Tyrell (2002) view firms as pools of contracts, where rents and quasi-rents are generated by pooling and employing resources. Decisions on how large these rents should be, have to be made in the future. Moreover, these future decisions will influence both, the size of the total rent and the way in which they are to be distributed. Groups or individuals, that have either a material or immaterial "stake" in the corporation, are denoted as stakeholders [23]. In contrast to the shareholder concept where shareholders are *the* only relevant group, here, shareholders are considered to be just *one* important group of all the stakeholders related to the company. Those stakeholders then not only participate in the business but influence it as well and thus they induce the success or failure of the corporation. Generally, having a stake in a business involves making some specific resources (capital resources, human resources, goodwill resources, information, know-how, etc.) available.

The expression "stakeholders" refers to the wide range of constituencies mentioned above, who have a legitimate claim on the corporation[24] resulting from the

[21]For more details on the data, applied valuation methods, and the corresponding regression results see Hecking (2002).
[22]Preface, OECD Principles of Corporate governance (1999). OECD member countries consist of both, stakeholder and shareholder models.
[23]Freeman (1984)
[24]Freeman (1984)

existing exchange relationship. In fact, no ultimate definition of the stakeholder set can be given, since any group or person could represent some kind of interest in the specific company. Intuitively it is then clear that this unlimited number of stakes can never be saturated due to the scarcity of exchangeable goods. Therefore, one of the key tasks of the company's management is to be able to recognize which stakeholders and to which extent they should be taken into account. For this purpose, Schaltegger and Sturm (1994) attempt to identify "critical" stakeholders which are such interest groups that can hardly be replaced or would be too costly to substitute. Moreover, stakeholders also differ according to the size of their stake in the company. Williamson (1984) outlines the stakeholder's stake as an increasing function of the amount of specific assets[25] invested into the enterprise, that bind him to the firm. The larger the stake of the stakeholder in the company, both in terms of power and in terms of his investment, the larger are his demands on control mechanisms and effective corporate governance that should protect his resources invested in the company.

Figure 1 illustrates the most typical potential stakeholders related to the corporation.

As can easily be seen, outlining the interest groups in a pluralistic view of corporations is mostly intuitive and does not underlie any strict definition. Basically, the interest groups included are those directly (employees, management, as the company's body) or indirectly (creditors, suppliers, as company's limbs) affected by the economical situation of the corporation and should therefore be taken into consideration as well. All of them have one thing in common, though. They are all supplying the company with crucial resources (contributions) and in return they all require their interests to be met (by inducement)[26]. However, the task to define or calculate the stakeholder value is not that straightforward[27].

[25]Specific assets are the assets that are hardly replaceable or not replaceable at all and that are crucial to the existence of firm. More details on this topic can be found in Williamson (1984)
[26]March and Simon (1958)
[27]In monetary terms, only the shareholder-enterprise relationship is characterized by the mutual cash flow. In other stakeholder-enterprise relationships, the money flow is only one-sided in

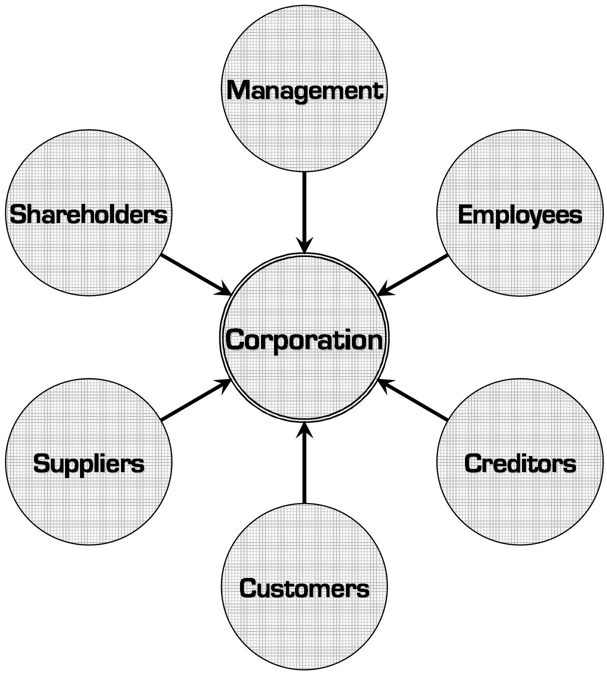

Figure 1: Several interest groups related to the corporation

Charreaux and Debrières (2001) give a quantitative definition of the stakeholder value and its associated measure based on a total amount of the rent created by the different stakeholders. Welge and Al-Laham (1992) suggest a method that values different stakeholders and the extent to which interests should be integrated into the corporation's strategic planning and corporate governance. For that purpose, they characterize the potential stakeholders, their goal structure, their power structure and the risk they are undertaking. Then, after listing all the potential stakeholders, their *goal structure* is determined through their specific objectives. For example, the goal of a customer is to receive a high quality product, the goal of an employee might be job security and so forth. The goal structure is closely related to the *power structure* which describes the extent to which the particular stakeholder can influence the decision making process of the corporation. Here, four types of power are suggested. First, the *integration power* of the stakeholder indicates the discretion in corporation's decision making, then the *retaliation power* denotes the stakeholder's capability to undertake

exchange for some real asset or specific resources possible penalty measures in case the corporation is not ready to fulfill his demands. Through the *substitution power* the stakeholder can sever the business link to the company if he feels the current relationship is damaging[28]. Finally, the *coalition power* enables the stakeholder to enforce his interests through a coalition with other influential interest groups. Furthermore, the authors also consider the risk taken by the stakeholders themselves. They argue that the risk or, in other words, the stake of the interest group committed to the company is positively correlated with the claims of the firm's stakeholders. After defining all the interest groups with regard to their goal structure, power structure and their risk, the authors finally determine the relevancy of the particular stakeholders. Eventually, all the characteristics mentioned above are weighted and assigned to the relevancy matrix in order to find out to what extent the stakeholders' claims should be considered.

Many different studies contributing to the stakeholder value debate have so far mostly come to one broad consensus: the fact that the economical importance of stakeholder relationship has a growing tendency. Despite the fact that the companies are still primarily concerned with the profitability of their investments rather than with the profitability of the stakeholder relationships, overall, many corporations direct their interests towards employees and suppliers rather than towards creditors. Thus, measuring the stakeholder value will be gaining further importance with the company and its investors.

Figge and Schaltegger (1999) see the stakeholder value as the relationship between stakeholders and the corporation and evaluate each stakeholders' contribution to the enterprise[29]. They try to develop an analogous approach to

[28]The possibility to substitute, the so-called exit option, is actually inconsistent with the pure stakeholder model. The substitution power better fits the outsider model as introduced by Franks and Mayer (1995)

[29]In their study, they distinguish between the *stakeholder-oriented enterprise valuation* and the *enterprise-oriented stakeholder valuation*. The former is to be understood as the value of the company from the stakeholder's point of view, the latter is the basis for their stakeholder value derivation. This approach views the stakeholders as the valuation object, valuated by the company, respectively the management.

shareholder valuation[30]. They make an attempt to assess the stakeholder's importance to the enterprise through the so called *"Return on Stakeholder"* (RoSt) ratio[31] that gives the measure of a stakeholder relationship profitability for the company. Together with the market RoSt[32] they calculate the RoSt differential in order to find out the stakeholder value added in relative terms. In other words, this value compares relative payoff of the company resulting from the specific stakeholder-enterprise relationship to the market average. Multiplying the calculated surplus return with stakeholder costs eventually yields the absolute stakeholder value added, which is the surplus cash value the company earns on the particular stakeholder relationship compared to stakeholder returns of similar companies[33]. However, this is just one possible technique how the abstract stakeholder value could be translated into numbers.

Figge (2002) extends the stakeholder valuation concept. Following the main argument of Schmidt and Weiss (2003) that the different interest groups in a company should be complementary, the analysis also reveals whether the stakeholder combinations are value-adding or value-subtracting. The main driver for the co-dependance of the stakeholders is the specialization of the capital (real as well as human capital) that they invested into the company. Shareholders require from the management that it should take care of their investment maximization; managers need the human capital of its employees for the company to grow; employees need the shareholders' real capital for the company to be started, and so forth. Hence, the mutual co-dependency of the particular stakeholders results in complementarity[34]

Furthermore, in his analysis, Figge (2002) introduces a new tool, the stake-

[30]For example, similar to the cost of equity in Anglo-Saxon model, they define the opportunity costs as the utility costs incurred by not choosing a different company.

[31]This enterprise-stakeholder ratio measures a proportion of the economic profit versus stakeholder costs.

[32]The market RoSt is simply the RoSt earned by the market participants on average or simply the opportunity cost.

[33]For a numeric example and more details on this study I refer to Figge and Schaltegger (1999).

[34]Complementarity on a macroeconomic level will be discussed in greater detail in Chapter 6.

holder value matrix, indicating both the monetary stakeholder value for each single stakeholder group and the value adding stakeholder combinations. Stakeholders as rationally acting market participants, maximizing their profit, stay within the business as long as it is profitable for them. Together with the company, they all build an interdependent chain of relationships while trying to achieve their own goals. Therefore, identifying the value of what the stakeholder contributes to the company is crucial for the company to optimally allocate its scarce resources.

3.3 *Comparison of the Two Concepts*

Simply spoken, shareholder concept is rather a valuation method attempting to determine how the value gets created and how it can be assessed while at the same time ignoring who has created it and to whom and how it is being distributed. In contrast to that, the stakeholder approach emphasizes that there are other interest groups, which are essential for the corporation's success. Nevertheless, both models, despite being so controversial on one hand, seem to be correlated to some extent.

On the microeconomic level each company can freely decide about its internal policy of corporate governance. At least in theory, the companies are mostly aware of the possible conflicts of interest, when concentrating on the shareholder value only and, vice versa, on stakeholder value. Figure 2 depicts four different approaches to the corporate governance strategy and the associated value priorities. The worst outcome the corporation can get, is the case where the value of both groups is reduced (lower left area). Another possibility is shifting value from one group to the other, which is captured in the upper left area and the lower right area. An example for the case where value is shifted from shareholders to stakeholders (lower right area) is a wage increase above a corresponding productivity increase due to higher motivation. This would lead to a higher stakeholder value because employees would benefit while shareholders would be at a disadvantage since additional wage costs would eat into additional profits. For the opposite case, a value shift from stakeholders to shareholders (upper left area), multiple examples exist: an increase in dividends while working conditions are worsening or simple worker lay-offs in order to reduce costs. Those three cases are viewed as unsustainable value, whereas the best strategy would be to increase both the shareholder value as well as the stakeholder value such that both of those representative interest groups were better off at the end. Therefore, companies following shareholder value approaches must still be able to manage their resources efficiently. Indeed, efficient strategic management and efficient company financing should be the key challenges for the companies in order to increase both the shareholder and the stakeholder value. Only in that case would we use the term sustainable value.

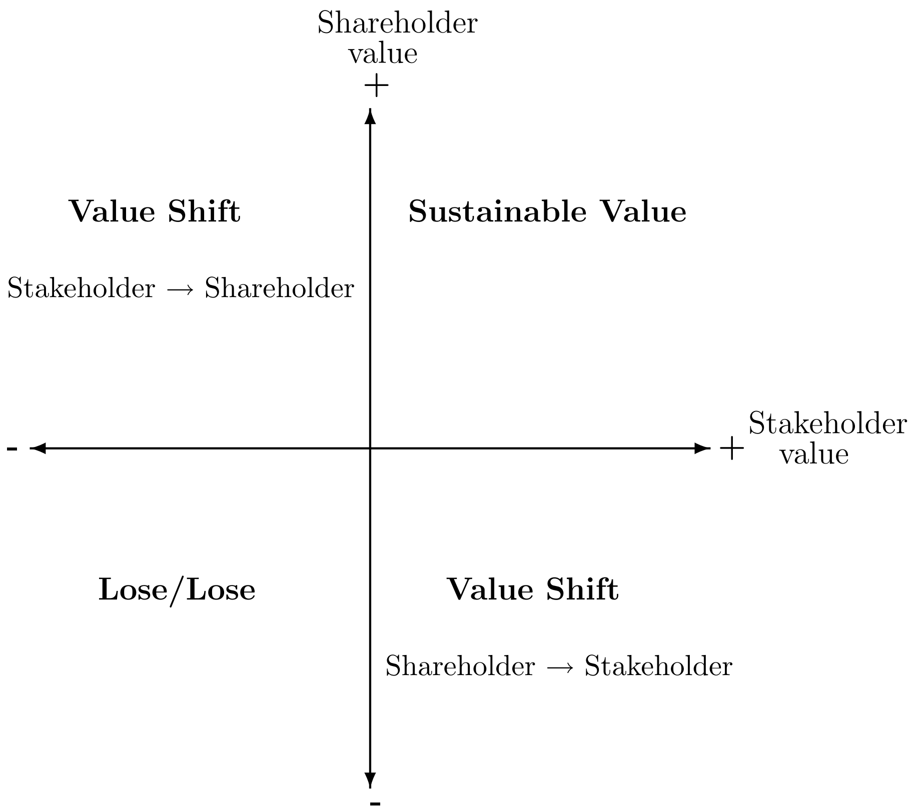

Figure 2: Possible outcomes of a value shift

4 Roots of Corporate Governance in the US and Germany

Previously, we presented the main framework for two different strains of corporate governance. Here, we will try to clarify how those frameworks have evolved throughout history. Therefore, we will first take a look at the USA as the showcase for a shareholder oriented system and then Germany as an exemplary country with stakeholder orientation.

4.1 *Corporate Governance in the US*

The shareholder model discussed in chapter 3 can be described, for example, by the way corporate governance has been practiced in the US. Some typical features of US corporate governance that are to be introduced in the following paragraphs are:

- the strong orientation towards shareholder value,
- highly liquid and well-developed stock markets,
- a largely dispersed ownership structure,
- the one-tier system concerning corporate control[35].

Nowadays, the US is regarded to be a place with one of the most liquid markets. Nonetheless, this has not always been the case.

American Corporate governance has its early roots in the nineteenth century. Probably the most revolutionary corporate changes the US experienced happened between the years 1880 and 1930[36]. The beginning of that period was characterized by family controlled industrial corporations. Widely dispersed stockholdings

[35]The American board system will be discussed in chapter 5.1.

[36]See Roy (1997)

and managerial hierarchies occurred only rarely. The history of American corporate governance dates back to the late nineteenth century, when "family" businesses were established on the basis of inside capital provided by family members of the entrepreneur and other business-related acquaintances. Further development of the company was ensured by plowing back the retained earnings as long as the company partners had enough funds. Once the corporation grew beyond financial feasibility and managerial organization of the single owner or the whole consortium, or they were about to retire, a problem of further management and financing occurred. Here, the most acceptable solution for the original owners that would ensure the corporation's prosperity and preserve former managerial organization, arose in the form of an emerging market for securities where they could sell their well-performing corporation. Thus, many companies following the dominant trend to go public actually gave a rise to the securities market in the United States at the turn of the century[37].

The development of corporations in the late 1890s and early 1900s had similar patterns in the majority of industrial countries, including USA, Germany and Japan. The patterns were characterized by a social reorganization within the corporations. The transformation process included developing and exploiting the productivity of the resources and promoted cost reduction as well as the generation of higher quality products, which required additional organizational innovation[38].

During the late 1890s and early 1900s, Wall Street (New York Stock Exchange and New York investment bankers) was also already engaged in the business, but only marginal, as the first IPOs were placed within the group of the wealthiest clients, insurance houses or within the investment bank itself. A capital market for securities emerged in the US to facilitate the separation of stock ownership

[37] More on this topic can be found in the works of Navin and Sears (1955), or Lazonick (1992), who defends the implication that the expansion of the companies implied the industrial capital market and not vice versa.

[38] Chandler (1977)

from strategic control, since it offered American households liquidity of the stakes they held in publicly traded corporations but did not require any commitments of their effort, time or additional resources to ensure the corporation's successful operation. As can be seen from figure 3, the revival of security trade was obvious only a few years later. Thus, the first two decades of the new century, American corporate governance was characterized with a prompt increase in the dispersion of stockholdings as the successful enterprises were searching for more capital enabling them to grow further.

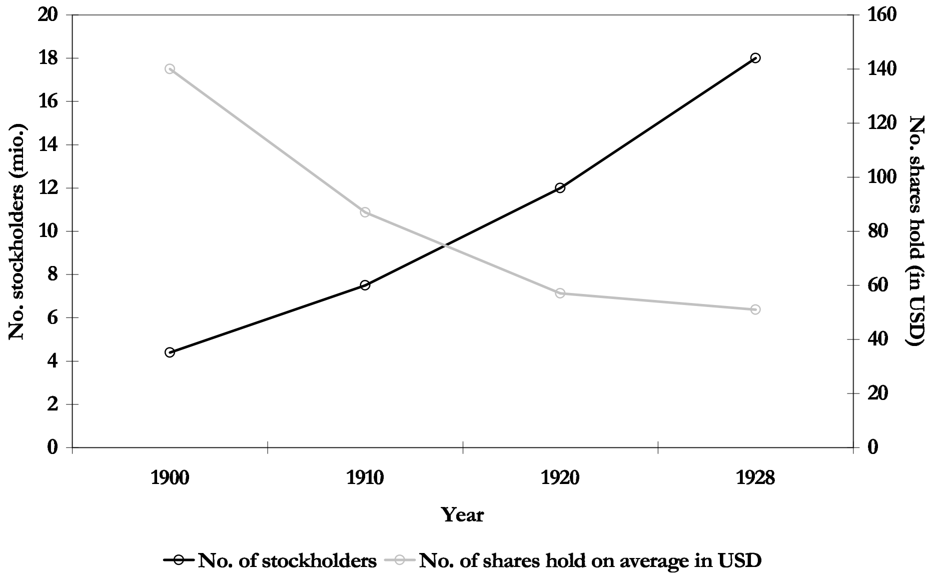

Figure 3: History of equity dispersion during the period 1900 - 1930

More and more people were attracted by the liquidity of the traded companies and their high levels of profit generation enabling continuous dividend payments. The life cycle of traded corporation was simple: higher returns allowed the corporations to make dividend payments which helped convince shareholders of the liquidity of their investment and which in turn helped the company earn higher returns since they were provided with the necessary capital for further investment.

Indeed, during the early 1920's, these corporations transformed the US to the most powerful industrial country in the world. Moreover, Wall Street played a very important role during this process. Wall Street supported the corporations in building investors' confidence in their liquidity and high profitability. In fact, the major investment banks encouraged the investments by identifying and promoting the companies that presented high and continuous return generation ability. Thus, Wall Street has deeply participated in stock market rooting and liquidity creation, by bringing new buyers together with liquid investment options[39].

Prosperous enterprises, high returns and continuous dividend payments ensured the managers that no group of stockholders would be likely to challenge the current managerial control of the company's resources. The only possible threat was represented by the preferred stock holders acting more like creditors than speculators. They monitored managerial performance in greater detail than common stock holders in case some dividend payments were suspended. Hence, at the beginning of the century there was a tendency to promote the common stock by granting their holders more votes per share than was given to the owners of preferred stock holdings. Managers simply enjoyed the heterogenous ownership structure of the investors. It was a specific device how managers could assure themselves their positions and power, since the dispersed stockholdings provided the investors with insufficient voting power to challenge the management.

However, in relative terms, new equity issue played only a minor role in financing new assets throughout the whole twentieth century. Yet, according to Allen and Gale (1994), in terms of direct finance of the American corporations over the last few decades (i.e. summing up all the external funds raised), approximately 50% of the external funds has been obtained through the sale of securities like bonds and stocks. By way of comparison, in other countries the same kind of financing pattern accounted for only 10% of the external funds. In the 1930s bonds and stock accounted for far more than 50% of external financing.

However, when focusing on the new equity issue only, it is obvious, that rather than being financed by issuing equity, major corporations financed themselves

[39] Michie (1987).

either through retentions, which have always represented the biggest part of corporation investment sources, or through corporate debt. Funds raised through equity issue were used to finance already made investments or to restructure the balance sheets of indebted companies[40] by paying back the debt. Therefore, a wave of increased IPO activity has not necessarily been an indicator of corporate innovative investments. By the means of IPOs, investors are purchasing a claim to the future corporate earnings, based on the investments in productive assets, realized mostly beforehand. For almost a century, high returns to shareholders have been sustained in the US. According to Goetzmann and Jorion (1999), US equities earned a real return of 4.32% during the period 1921-1996. Shareholders realized more than fifty percent of the real returns on equities in the form of dividends. Indeed, dividend payments accounted for 4.84% of the total compound return of 8.22% per annum. that US stocks earned during the period 1921-1995[41].

Most of the US corporations in the late nineteenth and early twentieth century through the 1970s followed the corporate governance principle called *retain and reinvest* (Lazonick and O'Sullivan, 2000). For most of the time, the prevailing trend was to plow back the company's earnings mostly in the form of physical capital reinvestments and to invest into corporation's human resources by retaining the current employees and searching for complementary labor force.

Such a strategy was implemented especially by the giant American companies that were able to create immense revenue streams stemming from the achievements accumulated in the previous years of operation. After the massive expansion of corporations, by the 1960s, the US economy was occupied mainly by a few very large corporations, employing a tremendous number of people and, based on the capabilities accumulated over the years, generating huge revenues. This broadly used *retain and reinvest* strategy has led to corporate growth, however

[40]Debt drawn increases leverage, for example computed as the ratio of total liabilities over the sum of net equity and total liabilities. If a company uses its funds from new equity issue to pay off its debt, this will improve its liquidity, by decreasing the total liabilities and simultaneously increasing its equity.

[41]Goetzmann and Jorion (1999)

not forever.

Few years later, especially during the 1970s this principle started interfering with the economical background of the companies, first affecting the size and later impacting the competitive environment. Suddenly, the companies through acquisitions and mergers grew too big. They became too "diversified" in their products and business orientation (not concentrating enough on their core business), as well as too dispersed geographically to be able to keep the strategy to *retain and reinvest* profitable for the company. The resulting poor performance was aggravated by the enhanced competition in the markets which further lowered the corporations' profits[42]. New information and communication technologies as well as international and national deregulation tendencies led to a gap between the potential and actual corporate performance which was becoming more and more visible.

As a response to the corporate sector problems stemming from immoderate centralization and fierce competition, the agency theory, a new approach towards corporate governance, was introduced by some financial economists. One of the first and maybe one of the most popular publications in that field was Jensen and Meckling (1976). Proponents of the agency theory postulated that in terms of corporate governance managers were just the agents of the shareholders, who were the principals. Furthermore, the agency theorists proclaimed that corporate managers, undisciplined by the market, behave opportunistically and abuse their power over the resources allocation to increase their own wealth and utility primarily instead of acting in the stockholders interests. Therefore, agency theorists called for a functioning takeover market that would represent a natural market control mechanism, disciplining the managers of poorly performing corporations, whereby the performance was measured by the shareholders' rate of return[43].

[42]More detailed analysis of corporate governance development in USA can be found in O'Sullivan (2001)

[43]Jensen and Meckling (1976)

This development triggered the shareholder value orientation and the growing capital market dominance. In the 70s and 80s the power of capital markets and, thus, the stockholders as well were further enhanced by the raise of institutional investors where ownership was transferred from individual households to institutions, such as pension funds, life insurance companies and mutual funds. Simultaneous with the growth of institutional investors giving potential to corporate performance improvement through takeovers and LBOs that they initiated, US capital markets were becoming increasingly powerful. Moreover, the evolving takeover market gave again rise to junk bonds[44] as an expensive instrument to finance management buyouts of the previous conglomerate divisions, leaving them highly indebted. Takeovers were viewed as an efficient way to draw out free cash flow from companies (Jensen (1989)) or to force out the corporations assets that were inefficiently managed by the incumbent managers.

It is clear that corporate governance structured the way it used to be until 1980, respectively the 1970s, when agency theory became popular, gave only little incentive to be concerned with shareholders interests. On the contrary, instead of pursuing the objectives in the shareholders interests, the managers felt they should be representing the company rather than the owners[45]. Therefore, they cared more about equally satisfying the interests of all the stakeholders, not only those of the shareholders.

The majority of the control mechanisms were indeed established but only rarely put in practice. Thus, the available market control mechanisms such as hostile takeovers, raiders and proxy fights remained inactive. These kinds of mechanisms governing the companies and managers appeared first in 1980 in the form of a large wave of takeover and restructuring activity in reaction to the fail-

[44] Junk bonds, as a financing instrument were known already in the early 1890s to finance some of the American growth industries, however, they faded away during the Great Depression. Junk bonds were government or corporate bonds rated low due to high risk. For more on high yield junk bonds, see e.g. Altman (2001)

[45] The loyalty of management towards the corporation instead of the shareholder is discussed in Jensen (1988), or Donaldson (1994)

ure of internal governance mechanisms of US companies. While the corporations were becoming larger and the management incentives together with their ownership shares weaker, the stockholder dispersion was growing. Boards were acting inefficiently in carrying out their duties by supporting the management rather than protecting the shareholder rights. Finally, the corporate mismanagement was reflected in very low stock price performance in the seventies, as can be seen in table 1. This compelled the capital markets to react.

	1950-59	1960-69	1970-79	1980-89	1990-99
Payout ratio[a]	47.9	40.5	42.9	51.6	58.5
Total Stock Yield[b]	17.7	6.6	-1.7	11.7	15
Stock price Yield[c]	14.8	5.8	1.4	12.9	15.5
Dividend Yield[d]	4.9	3.2	4.1	4.3	2.5

[a] Corporate dividends as a percentage of corporate profits after tax with inventory valuation and capital consumption adjustments.
[b] Stock price yield plus dividend yield adjusted by the year-to-year change in the consumer price index CPI.
[c] Annual increase in Standard & Poor's composite index of 500 stocks in percent.
[d] Dividend-price ratio for the 500 stocks in Standard & Poor's composite index, based on annual averages of monthly data.

Sources: US Congress (1992: 366, 378, 397, 403; 2000: Table B-88). As compiled by O'Sullivan (2001)

Table 1: **Corporate performance**

As a result, the US for the first time in its corporate governance history experienced a period of heavy use of leverage and hostility. The companies as they were borrowing to finance takeovers, repurchasing their own shares or were simply taken private through leveraged buyouts were strongly indebted with debt frequently accounting to 80% of total net equity. High indebtedness should help reduce the excess capacity stemming mainly from changes in technology and regulations. Debt service payments disciplined the managers to distribute the generated free cash flow efficiently rather than encouraging them to treat capital as costless (after leveraged buyouts and hostile takeovers the company usually had to find a way to generate sufficient cash to cover the interest payments).

Many corporations took some defensive measures and restructured their balance sheets to prevent the hostile takeovers by making themselves less attractive to the raiders.

In the following decade, corporate strategy slightly changed the direction of its development. The US corporate governance strategy was characterized by an obvious shift away from retaining both financial means and human capital within the corporation towards releasing them to capital and labor markets, a strategy of downsizing and distributing. On average, the merger activity was on a comparable level in the 1990s, though now, hostile takeovers were not seen as something bad any longer[46] but were actually viewed as an efficient method to undermine inefficient conglomerates. The US boards, managers and institutional shareholders had definitely learnt a lesson from the previous years realizing how LBOs and other market-driven control mechanisms can punish them for too much inefficiency.

The corporate governance seemingly began to take some shape after the chaotic period of the 80s and other corporate mechanisms such as executive stock options, larger involvement of shareholders and the board of directors gaining importance. The trend towards shareholder value creation and increased capital market influence was also obvious in the corporations' self-reorganization. For example, according to the number of mergers and divestitures, it apparently was the external capital markets that made decisions about capital reallocation. Furthermore, the corporations were gravitating towards decentralization, and most of them started a process of labor force restructuring by reducing the number of jobs which formerly offered stable employment[47].

[46] The former attitude towards hostile takeovers was somewhat ambiguous. Corporate raiders and aggressive bidders were criticized for destroying traditional firms and jobs simply for pure profit-seeking.

[47] During that time many well-paid and stable jobs, especially the manufacturing and mostly the unionized ones, were eliminated. See Lazonick and O'Sullivan (2000) and O'Sullivan (2001) for particular figures.

Allegedly, the main goal and responsibility of US corporate managers should primarily be to act in the interests of shareholders and thus create value for shareholders. Hence, the overlap of the strategic US corporate managers' interests with the demand of the capital market has become the defining feature of the market-oriented US corporate governance system.

The emergence of a powerful market for corporate control gave more collective power to the stockholders by emphasizing the corporate stock yields and market values.

One typical feature of the US corporate sector was expressed already by Manne (1965) who argued that it is the ability of different management teams to compete for the control of assets that makes the US corporate style so specific. He saw the process of takeovers and acquisitions as chance or challenge for the most qualified teams to win control over assets and decide for investments. This way of creating a market mechanism in order to discipline managements can be generalized for the Anglo-Saxon style countries.

Nevertheless, such a high disciplining activity would not be feasible without another important feature forming the US corporate governance which is the availability of information. For a corporate system, such as the American, broad information availability (minimally meeting the SEC requirements) about publicly listed corporations is crucial. Therefore, transparency or a large amount of information including extensive accounting reports made available to the investors is an important attribute of the US market. It helps all the market participants by making decisions about investment allocation. Furthermore, it informs both the monitoring market, consisting of many investors eager to fill the gap between potential and real performance of the promising corporation, as well as the incumbent shareholders themselves who will use all the information available to decide whether to sell or not.

4.1.1 *Major Acts Regarding US Legislation*

The US is one of the few large industrial countries which is not dominated by several large banks. In fact, quite the contrary is true. The US has had an aversion to dominant financial institutions and, thus, an attitude preferring banking system decentralization has prevailed. In that spirit, an act distinctively shaping the US banking system, the *Glass-Steagall Act* of 1933, came into force strictly separating investment banking from commercial banking. Thereby, traditional commercial banks, defined as institutions providing the clients with deposit and credit transactions, were prohibited from holding shares in nonfinancial companies with the one exception of stock that was obtained as a by-product from a distressed loan, in the form of convertible securities, for example. However, in order to prevent prolonged equity holdings by US banks, limits are imposed on how long a bank may hold equity securities. (Until 1980 National banks were limited to hold equity for no longer than five years; since then, the limit on how long a bank can hold the stock has been ten years[48].). Furthermore, the US bankruptcy law states that the claims of banks or any other creditor exercising effective control over a debtor firm through equity holdings will be given less priority in case of financial distress relative to other lenders. This explains why banks refuse prolonged equity holdings in corporations.

Learning a lesson from the Great Depression, to which banks were considered to have contributed, the Glass-Steagall act was a milestone in American corporate governance history and by far the most distinctive feature compared to the German financial system. As the system was lacking few dominant banks, investment banks, dealers and brokers took over the investment activities.

Investment bank activity should cover all other investment operations such as stock emissions, security trading, etc. The logic behind this act was to prevent the banks from a potential conflict of interests stemming from aligning commer-

[48] A discussion about this topic can be found in James (1993)

cial and investment activities[49], construed on the previous empirical evidence of universal bank's security affiliates frauds. More than six decades later the Glass-Steagall Act was de facto abolished by the *Financial Modernization Act* of 1999.

Learning a lesson from previous corporate collapses in the United States, some steps have been undertaken to standardize the corporate governance to a certain extent. One of the most important events was the *Sarbanes-Oxley Act* including the proclamation of the analysts independency and the partial standardization of corporate governance.

American government introduced the Sarbanes-Oxley Act 2002 in order to increase the accountability of directors and executive officers and, at the same time, enhance the obligations on financial information disclosure. Further, increases the requirement on the auditor's responsibility and strengthening their independency.

In order to strengthen the independency of research analysts and to manage the conflicts of interests the Security and Exchange Commission (SEC) approved rule changes introduced by the New York Stock Exchange, Inc. (NYSE) and the National Association of Securities Dealers, Inc (NASD). The rule regulates both the communication between the analyst, the investment bank and the company subject to a research report as well as the analyst's remuneration.

Finally, new standards and changes have been approved by the NYSE board of directors regarding the corporate governance practices of NYSE-listed companies. As recommended by the report, a majority of the board of a listed company should be comprised of independent directors[50].

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[49] If bank activities are not separated it is possible or even likely that a bank acts simultaneously as lender, shareholder and underwriter for new security issues.

[50] Independency in terms of no material relationship with the company, neither directly nor a as a shareholder, officer, partner, auditor and so forth.

4.2 *Corporate Governance in Germany*

As an example for a stakeholder model, we will now turn to Germany which is frequently regarded as a stakeholder approach dominated country. Some typical features of German corporate governance that are to be introduced in the following paragraphs are:

- the institutionalized co-determination rights for employees,
- the two tier system concerning corporate control[51],
- the very strong position of big banks, playing a dominant role in corporate funding as well in the monitoring of corporations,
- the underdeveloped state of stock markets, as the stock market capitalization is very low relative to the country's GDP,
- a concentrated ownership structure, as German cross-equity holdings create a system of large corporate integration often critically called the "*Deutschland AG*".

Similar to the US, organizational control in Germany before the war enabled the managerial insiders to gain control over the resources and the allocation of returns. Historically, the main advantage of the German economy was the extent to which it managed to cement the link between the German industry and technical education. Later on, this feature played a critical role in establishing the nation's competitive advantage in metals, heavy machinery, chemicals and electrical machinery. Reflecting the need for engineers, by 1900, many German companies had built managerial hierarchies within the corporations which were controlled by technically skilled managers. This helped maintain the control over the enterprise in the hands of the families as many of the technically skilled engineers were both, the owners and managers of their businesses or, if not owners

[51] The German board system will be discussed in chapter 5.1.

directly, at least somehow family related. Thus, in Germany, family controlled enterprises were more pervasive than they were in the US.

Perhaps one of the most distinctive features of German corporate governance evolution was the close relationship between major German banks and German industrial corporations. In particular, mainly since the second half of the nineteenth century German banks were partly acting as venture capitalists by providing the enterprises with financial commitment for investments used to develop a functioning corporation comparable to risk capital in the US. Banks established departments that were supposed to help them monitor and evaluate the operational performance as well as technological and organizational capabilities of their obligor. Furthermore, in order to minimize the information asymmetry, avoid distorting the overall picture of the corporation and remain informed on the strategic decisions the clients were supposed to provide the banks with seats on their supervisory boards. After the banks had managed the transformation from ventures into prosperous businesses, they would sell the corporation's share to the public. This step had a double impact. First, it supplied the company with sufficient cash inflow, enabling them to cover their debt service costs[52]. Second, in many industrial companies, this started the process of separation of ownership and control. Banks would initially maintain the corporation's shares in their ownership in order to sell them later when they felt it would be profitable.

In comparison to the US banks, which were restricted by the Glass-Steagall Act until 1999, German banks were making profit on both current account transactions and securities trading. In fact, during 1885 to 1908, securities business accounted for approximately one fourth of the credit bank's gross profit[53]. Maintaining such a twofold relationship with the client offered the banks very advantageous access to insider information regarding their clients. This way, the bank, as a provider of credit, could also accurately assess the risks of financial distress. Further, it helped the bank in evaluating the client's financial strength

[52] More on this topic, see for example Pohl (1985) or Riesser (1931).
[53] O'Sullivan (2001)

and eventually their attractiveness to portfolio investors.

Big banks tried hard to establish a good reputation of high-quality security issuers. By any means, they would seek liquidity and profitability for the stocks they issued. Therefore, if the stock prices declined repeatedly the banks would rather repurchase the shares they had previously issued to hold the stock price above the minimum price limit in order not to tarnish their reputation (Riesser, 1931). Furthermore, the banks, in order to attract new investors and retain existing ones, would promote stable corporate dividend payments as well as earnings retentions which were meant to fund further corporate investment, ensuring long-term growth.

Throughout German corporate governance history, German banks would also frequently use proxy voting as a tool to gain more voting power over the enterprise, which gave them more control over the enterprise. Proxy voting is based on each shareholders right to empower a third party[54] to exercise his voting right at the stockholders' meeting. On the one hand, this puts pressure on the management since a large number of votes are concentrated in few voters' hands. On the other hand, it is not ensured that the bank uses its increased influence to act fully in the interest of every single shareholder.

By virtue of controlling the proxy votes in trust for their customers and by creating an industrial share market, it was the large banks who contributed to the separation of ownership and control in Germany. As the enterprises were growing, it became increasingly important for the main players to be skilled in technical and administrative corporation-specific matters in order to be able to allocate the resources efficiently. The large banks thus understood that it was unavoidable to share control with the executive management of the company since it was they who knew the corporation best.

Nevertheless, not all of the German corporations favored the considerable influence of large banks. Many of them preferred the financial commitment of

[54] A third party can be any credit institution, commercial shareholder's representative or any other authorized person.

families rather than banks and therefore tended to retain earnings[55] to avoid bank influence[56].

From 1918 until 1933, during the Weimar Republic, many powerful enterprises, using their easy access to financing opportunities, created large industrial conglomerates by investing into an enormous expansion of their production and by buying stakes of other corporations, thereby enhancing the number of cross shareholdings and directorates among corporations. Those kinds of conglomerates with diversified production, which were mostly financially motivated, transformed into huge empires with unrelated or only partly related business activities (for many of them it was the overdiversification that led them into financial distress).

Even after the Second World War, strong inter-company links prevailed among the corporations in the West German ownership structure. By 1960, for example, the non-financial corporations owned 35.7% of total stock which made them the largest stockholder group. That was still the case in 1984 when the number of shares held by the enterprises had only slightly risen to 36.1%[57]. The second shareholder group which retained its higher share (of direct stockholdings) were banks[58], holding 10.3% in 1984 (Edwards and Fischer (1994)). In fact, banks were more powerful shareholders than the number of their direct shareholdings would suggest. Stronger voting power was achieved by the already mentioned proxy votes, exercised on behalf of their depositors[59].

As far as the funding pattern is concerned, in Germany, as it was the case in other industrial countries, internal sources constituted the main financing source. A second main source of external financing were banks. In the case where the management of the obligor underperformed, banks were seen as a more gentle

[55] In section 5.3 we will more closely deal with financing patterns in Germany and the USA. There, we will see that internal financing has been the main source of corporate funding in both countries.

[56] Feldenkirchen (1991)

[57] EF1994.

[58] Investment funds are included, since the vast majority of funds is owned by banks.

[59] For more details on the impact of proxy votes I refer to section 5.3.1.

intervention alternative compared to the costly and usually disruptive takeovers. Even despite the reopening of capital markets in 1956, the proportion of bank financing in relation to total external financing was relatively constant and exceeded 40% in each of the four decades over the period of 1950 to 1990[60], and no tendency of a long-term reduction was visible. Thus, bank financing constituted by far the largest portion of external investment financing, leaving bonds and equity behind.

The recent status of German corporate governance is somewhat ambiguous. Even though the shareholder view captured the minds of many managers during the nineties and especially at the end of the nineties during the big stock market boom, in reality the stakeholder system still prevails. As a reaction to the dramatic increase in equity issuance, initial public offerings as well as secondary equity offerings, shareholders received a larger amount of attention than ever before. The development of new equity issues as well as the merger activity is illustrated in table 2. The large wave of IPOs started in 1997, peaked in 1999 and ended after stock prices plummeted.

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
No. of IPOs	11	15	20	14	36	79	175	142	26	7
No. of Mergers	647	611	756	852	874	914	1014	753	1283	919

Table 2: IPO activity and merger activity in Germany

Mainly small firms saw their opportunity to receive the necessary capital for investing in projects considered to be too risky to be financed via credit. Also, the demand side welcomed the new investment opportunities because it promised high returns. Further, it became obvious that macroeconomic changes considering the German health and pension system demanded for a diverse and liquid equity capital market. Consider, for example, the pension system where the current

[60]Bank Financing/Total External Financing: 1950-1959: 48%, 1960-1969: 52%, 1970-1979: 41%, 1980-1989: 51%. Numbers are from calculation using the data of Edwards and Fischer (1994).

pay-as-you-go system was thought to be replaced by the funding principle in the near future[61]. This would additionally increase demand for lucrative long-term investment opportunities.

To create a more shareholder-friendly environment and to attract foreign investors in 2002 Germany published a *Deutscher Corporate Governance Kodex*. That charter was meant to address the view taken by many foreign investors that with respect to corporate governance Germany is a "...wild west without strong legal background"[62]. Before 2002 Germany lacked such an official framework which was part of almost every other mature capital market. The *Kodex* tries to clarify some of the most criticized aspects about German corporate governance, namely, the lack of transparency in Germany's corporate leadership, the lack of independence of the supervisory boards, the limited independence of the final auditor and the general tendency to disregard shareholder interests.

[61] There is still an ongoing political discussion about the reform of the pension system.
[62] Rüdiger von Rosen, "Corporate Governance: Eine Bilanz"; *Die Bank* 4/2001.

5 Country Based Comparison

We have defined two polar approaches of corporate governance. Which system is better, the market oriented Anglo-American or the long-term large investors system? This is probably one of the most frequently asked questions regarding corporate governance.

Debates in both the academic as well as the political arena concerning the question of superiority of either one of the approaches have been going on for many years. In the 1980s, the German and Japanese corporate governance systems with their long-term perspective looked attractive as the economies grew by a higher rate than the US. Furthermore, in both countries, global crises like the oil crisis had a much weaker negative effect on economic output and employment. This was due to an extensive social security system which had a dampening effect on the negative consequences of the crisis. Thus, during that period, the stakeholder approach was prioritized to the short-term perspective of the Anglo-American approach.

In contrast to that, by the end of the 1990s, after the costly post-reunification period of the German economy, an economic slowdown spread throughout Germany with a major impact on the whole part of former East Germany. At the same time, Japan experienced nearly a decade of economic recession. Suddenly, the American economy seemed to outshine both of them. Especially the soaring stock market and the uprise of the so called "New Economy", a term invented for companies in the Internet, Telecommunications and Biotechnology sector, were responsible that the American governance system was seen as favorable in the late 1990s. Since many of those mainly new firms exhibited great future risks about their profitability but also many chances, it was crucial that they had access to liquid equity markets in order to receive money to materialize their ideas. The US corporate governance practices were glamorized until one of the largest bankruptcies and US governance scandals, the Enron case, emerged.

Enron, once being America's seventh largest firm in terms of market capitalization in August 2000, became the largest bankruptcy reorganization in American history. Although financial fraud and roguery was largely to blame for the scandal, a system of corporate self-regulation considerably contributed to the event. Further, the shareholder value concept has received substantial criticism since it promotes beautifying balance sheets, understating liabilities and concealing risks contained in the operative process. All of that was part of the scandal which widened because attention was shifting to other firms who exhibited the same kind of dubious financial reports. An extensive documentation of the case and its causes and consequences can be found in Bratton (2002).

For this part of the study, we can only state, that the opinions usually differ over time and are positively correlated with the economic performance of the particular country, where the system has been "successfully" implemented and functioning most recently.

Yet, the shareholder approach gained more significance in Anglo-Saxon countries whereas the popularity of the stakeholder system is much higher in continental Europe. It is most characteristic for countries such as Germany, France and Japan, where corporations often aim to promote longevity, growth, and secure employment[63] which shall be discussed in more detail below. However, first we will we address the issue of corporate control structure in section 5.1.

5.1 *Who Exercises Control?*

Mechanisms of exercising control over the decision process in corporations varies substantially throughout the world. But there are two types of mechanisms which are mainly distinguished:

- the one-tier system with one executive body
- the two-tier system with an executive body and a supervisory body

[63]See Figure B.1 and **??** in the the Appendix.

In the US only one executive body, the board of directors, is necessary and commonplace even in large corporations while Germany favors the two-tier system where the management additionally is controlled by another board, the supervisory board.

5.1.1 *Board of Directors*

The board of directors is required by federal law to act in the best interest of the shareholders. They are in charge of overseeing the managements actions, removing or appointing the CEO and determine the managements compensation scheme in a separate compensation committee. Further, the audit committee is responsible for checking the firm's financial reports.

The median size of a board in the US is nine members who meet about six times a year. Although board size is certainly dependent on firm size to some extent, generally a larger than average board is associated with a higher degree of inefficiency.

A negative correlation between board size and Tobin's q as well as a similar negative correlation between board size and several accounting measures of profitability is found by Yermack (1996). Additionally, Eisenberg, Sundgren, and Wells (1998) find a negative correlation between board size and return on assets and operating margin for a sample of Finnish firms. In contrast, Bhagat and Black (1998) find that the inverse correlation between board size and performance is not robust to the choice of performance measure.

Why could it be advantageous for the firm that the board of directors consists mainly of independent directors as demanded by many academics and practitioners? Of course, one obvious feature of independency should be neutrality when evaluating the management performance[64]. In US-style boards where being a senior officer and being a board member can coincide, conflicts of interest are in-

[64]Especially in the audit committee, total independence should increase investors confidence in the credibility of the reports.

herent when a senior officer simultaneously acts as a supervisor. In case approval for important decisions is demanded, inside directors are certainly biased towards agreeing with what *they* themselves have previously suggested. Let us consider a board deciding about the removal of the current CEO. We would expect the likelihood of a removal to increase with the number of independent board members. And indeed, Weisbach (1988) found that boards with at least 60% independent members are more likely to replace the CEO. When looking at discretionary board tasks, often times results are in line with the expectation concerning the different behavior of majority-independent versus dependent boards. When it comes to the correlation of overall firm performance and board composition the results are rather ambiguous. According to Bhagat and Black (1999) it seems as if boards almost exclusively consisting of outsiders perform worse than their counterparts with at least some inside directors. This could be due to a lack of deeper knowledge about the firm which can only be provided by corporate insiders. Therefore, they conclude that if there exists something like an optimal board composition, including at least some insiders is a value adding strategy. On the other hand, firms where insiders are dominating the board are more likely to exhibit irregularities in their financial statements when compared to a matched sample of firms with boards dominated by outsiders (Beasley (1996)). One interpretation is that independency of the board reduces the opportunity for the senior management to commit financial fraud. But one could argue as well that a management which tends to commit financial fraud protects itself by not letting the board become too independent.

However, in general a mixture of insiders, outsiders and maybe some affiliated outsiders like former members of the senior management who are not involved in the present executive decision making but have substantial inside knowledge of the firm and the industry, may be an optimal solution from a theoretical point of view.

5.1.2 *The Two-Tier System in German Corporations*

In order to understand German corporate governance system, we need to briefly review the legal structure forming the background of corporate governance. The German legal system is based on Roman law, i.e. on a detailed codified civil law.

One of the main features distinguishing the corporations operating in a stakeholder environment is the allocation of roles in a joint stock company (*Aktiengesellschaft*[65] defined by the law (*Aktiengesetz*)). The role and power distribution in large German companies is linked to the prevailing stakeholder orientation. Unlike the American corporations, the German joint stock company consists of three authorities, (i) the supervisory board (*"Aufsichtsrat"*), (ii) the management board (*"Vorstand"*) and (iii) a General Meeting (*"Hauptversammlung"*).

Thus, as opposed to the monistic American system emphasizing the strong position of the Chairman in a publicly limited company, German corporate governance of the joint stock company is characterized by a two-tiered system separating the corporation's management from its controlling body, the supervisory board.

The management board is usually comprised of five to fifteen full-time members working on a full-time basis. The law gives the management board substantial power, assigning it with the task to manage the corporation and ensure its operation in their own responsibility. This is sometimes interpreted as acting in the interest of the enterprise, whereby a wider array of interests should determine how the large corporation is to be managed. This way, company management lies exclusively in the hands of the management board which represents the company and bears the responsibility of the enterprise for all of its actions.

However, the considerable powerful management board must regularly inform the supervisory board, its complement embodied in the German corporate governance, exercising control over the management. It is the supervisory board that

[65] For a more detailed description of German corporate law, please see Kübler (1998).

has to approve certain classes of decisions. Therefore, the joint stock company law explicitly forbids the concurrent membership on both of the boards[66]. The supervisory board must approve all major financing and investment decisions regarding the corporation. Furthermore, it appoints and dismisses the management board members for a regular five year term.

The composition of the supervisory board, consisting of nine to twenty-two members, is quite heterogenous. Yet, the majority of German large enterprises appointed one or few big stockholders, consisting of either other companies, banks, insurance companies or wealthy families. Generally, three groups of powerful and influential stakeholders are represented and active on a typical German supervisory board:

- Employee/union representatives
- Banks[67]
- Large shareholders

By law, the supervisory board is required to have both shareholders and employees' representatives. Thus, the typical German feature of co-determination system is evident in the supervisory board composition where the representatives of the firm's workforce can exercise their influence.

Even though the shareholders are supposed to be largely represented on the supervisory boards, one can only hardly say that German corporations represent private shareholders because still more than half of all outstanding shares are controlled by banks (corporation's commercial lenders) and by other companies. Indeed, those shareholders who do not belong to any of the *governing coalitions* of the three major shareholder groups hardly play an important role on German

[66]Hereby the separation of ownership and control as described by Fama and Jensen (1983) is formally achieved.

[67]Emmons and Schmid (1998) show that the banks' power can be derived from the number of seats on the supervisory board that are occupied by top bankers. Also, they are so widely represented on the boards mostly due to their status as a lender as well as a large shareholder and due to the proxy votes they command. For more on proxy voting we refer to section 5.3.1.

supervisory boards. In fact, considering the responsibilities of supervisory board members, German law encourages the subordination of shareholder interests to those of other stakeholders.

In international comparison, the German capital market, missing the features of a well-developed market, is characterized by a lower level of transparency and publicity and above all by very low minority shareholder protection. In contrast, protection of creditors is very strong which is reflected especially in German corporate law and accounting standards. Stated simply, German banks in comparison to their Anglo-Saxon counterparts are provided with ample scope for their business activities.

Since the end of World War II there have been only few hostile bids[68].

5.1.3 *Cross Holdings*

In addition to the previous discussion about the board structure, another feature is very typical of the German ownership structure as it exhibits substantial cross holdings. As table 3 indicates, the ownership structure of both stakeholder oriented countries Germany and Japan is quiet different than the one in the US and Great Britain, systems based on shareholder approach. More than 40% of the equity in German corporations is owned by other German companies as compared to 1.1% in USA. In international comparison, German cross-holdings are thus a predominant factor with respect to the ownership structure.

In OECD (1995), the cross-holding structure between both non-financial corporations mutually and banks and non-financial enterprises is explicitly recognized as one of the main features of German corporate governance aiming at ensuring a long-term relationship between corporations. Indeed, also banks and insurance companies are nested through cross-holdings and mutual seats distribution on their supervisory boards (Jürgens, Rupp, and Vitols (2000)). However,

[68]For example, in 1999-2000 Vodafone Air Touch acquired Mannesman, which is referred to as a successful hostile takeover attempt.

Shareholder groups	Germany	Japan	United States	Great Britain
Private Households	14.6%	22.2%	47.9%	29.6%
Companies	42.1%	31.2%	1.1%	4.1%
Banks	10.3%	13.3%	2.6%	0.2%
Governments and public authorities	4.3%	0.5%	0.3%	2.3%
Insurance companies and pension funds	12.4%	10.8%	29.8%	39.7%
Mutual funds and other financial institutions	7.6%	11.7%	12.1%	10.4%
Nonresidents-foreigners	8.7%	10.3%	6.2%	13.7%
Total	100.0%	100.0%	100.0%	100.0%

Source: Deutsche Bundesbank, Monatsbericht, January 1997; US Data from U.S. Census Bureau, Statistical Abstract of the United States

Table 3: Who owns private equity in selected countries?

at the end of the day, an exact estimation of cross-holdings is hardly possible since only equity shares accounting for at least 5% have to be reported[69] and the majority of German companies have issued mainly bearer shares which are easier tradable than registered shares.

Thus, the policy relying on long-term business relationship is implicitly supported by the incumbent corporate governance rules.

Despite the fact, that cross-holdings are quite common across the whole country, in German enterprises relatively few executives from other firms have a seat on supervisory boards when compared to other countries. This can be explained mainly by the typical German features of co-determination and by the extensive role of banks, where most of the seats on the supervisory boards are occupied by either employees or bank representatives as well as a few public shareholders. Thus, only a small number of seats remain available to outside representatives.

[69]§21 Wertpapierhandelgesetz (Securities Dealing Act).

5.2 *The Labor Market*

In this section we will try to explain some specific features of the labor market in the USA as well as Germany. Because American firms do not grant many rights to their workers we will concentrate on some general aspects of labor organization in the US. Later, we will focus on the German system of co-determination in a separate section.

While Germany has a highly regulated and inflexible labor market, in the USA, workers generally do enjoy much less protection against dismissal and are mainly interpreted as a pure input for the production process. In contrast, the German view takes into account more social aspects and sees the firm and its workers as a unit. Therefore, workers have much more rights to intervene in the company's decision process.

US boards usually do not exhibit worker representation on any board. Hence, workers can hardly influence the decision process. Moreover, US workers generally have less rights compared to German workers. Consider job protection, for example. For German firms it is not that easy to dismiss workers unless the company faces serious distress. And if they dismiss someone, the firms have to take into account a plethora of rules regarding who is allowed to be laid off. For example, married workers are advantaged over unmarried workers and so forth. In the US no such rules have to be obeyed. Workers are mainly judged according to their effort and their contribution to the result rather than their socio-economic status.

This lack of job protection correlates directly with the average job duration which is much shorter in the US. Therefore, the US labor market is also referred to as a "*hire-and-fire*" system. At first glance this seems to be negative but, on the other hand, unemployment duration is also much shorter in the US than in Germany (table 4). Generally the turnover is higher.

A reason for this substantial difference is the traditional strong position of

Duration	Germany	USA
< 1 month	5.78%	34.54%
> 1 month and < 3 months	12.51%	30.80%
> 3 month and < 6 months	16.87%	16.33%
> 6 month and < 1 year	16.98%	9.80%
1 year and over	47.86%	8.52%

Source: OECD

Table 4: Unemployment by duration

labor unions in Germany. They even have the right to negotiate collective wage agreements with the employers' association. Deviation from those agreements is only permitted in exceptional situations.

5.2.1 *Labor Co-Determination*

In international comparison, co-determination is a very distinctive feature of German corporate governance system. The dual structure separates control and management into two independent boards, supervisory board and management board[70] which is not unusual per se. Interesting is the composition of the controlling board. While in the Anglo-Saxon countries the board of directors, acting as the control institution, has the explicit responsibility to act in the shareholders' interests, the German supervisory board is committed to appointing employee representatives. Moreover, the stakeholder approach is also strongly reflected in the German labor law which is highly regulated. The duties of management board, supervisory board and general meeting are also legally embodied. Stated simply, co-determination involves selected representatives in decision making giving them information and consultation right as well as a veto right.

As we already pointed out, co-determination is given by law, as supervi-

[70]For more details see section 5.1.2 above.

sory boards are required to have not only shareholder representatives but also employee representatives. Based on this law, basically three regimes are distinguished[71]:

- A *full-parity* regime forms the oldest conception of co-determination. It arose after the restructuring of the German industry after the Second World War. Mining, steel and coal industry employees were represented by half of the seats on the supervisory board. The "Montan-Mitbestimmungsgesetz", a law enacting the parity in coal and steel industry corporation dates back to 1951.

  Under the assumption that the supervisory board members are equally comprised of one half employees and the other half shareholders, there has to be an extra neutral member who will decide in case of a draw. Therefore, the Montan co-determination is probably the most neutral one as the pivotal voter has to be unbiased, with single voting power.

- A *quasi-parity regime* is another form of co-determination on boards. The Co-Determination Act, dating back to 1976, states that the supervisory boards of a corporation with more than 2,000 employees, should consist equally of shareholders and employees.

  Moreover, here, the chairman's vote, who is non-neutral and mostly a representative of shareholders rather than employees, accounts for two votes in case of a draw. This right of the non-neutral chairman distinguishes the quasi-parity regime from the full-parity regime.

- A *one-third regime* resulting from the Works Constitution Law of 1952 applies to companies with more than 500 employees but less than 2,001. In this case, one third of the supervisory board should consist of employees.

Besides the representation on supervisory boards, every corporation with five or more employees, regardless of their legal form, is required to elect a *workers*

[71] Ehrentreich and Schmidt (1999)

council (the Works Constitution Law of 1972). The actual size of the workers council depends on the total number of people employed within the company[72].

In fact, the employees co-determination is dual, as their interests are represented on supervisory boards and in workers councils. Across the academic arena, it has been argued whether the co-determination is beneficial to both shareholders and employees, if laws are needed to force firms to engage in it (Jensen and Meckling, 1979) or whether it increases efficiency (Levine and Tyson, 1990) and so forth. However, the opinions and empirical results about the impact of co-determination on the economical performance of the company as well as its socio-economic consequences are mostly inconsistent as they vary not only in their conclusions but in their assumptions and research methods as well. Thus, a clear statement could hardly be made in this field[73].

The remaining areas which are not covered by legal prescriptions are then in many areas supplemented by prevailing case law. German labor law traditionally protects the employees from an easy dismissal and sets the crucial points of labor relations, and most importantly wages, in collective labor agreements. However, the most distinctive feature of German labor law is the fact, that it explicitly involves the employees in several operational and corporation-wide decision making processes[74].

5.3 *Corporate Funding Options: Capital Market vs. Banks*

So far we have conceived Germany to be the stakeholder-oriented economy, and the USA as representing the shareholder approach. Traditional comparisons of corporate governance focus among others on by whom and in which way the

[72]For 5-20 employees, the works council consists of one member; companies with a labor force of 7,001-9,000 employees elect up to 31 members. Two more members have to be elected for each additional 3,000 employees. An exact definition of this law can be also found in Works Constitution Law of 1972.

[73]Jürgens, Rupp, and Vitols (2000) and Ehrentreich and Schmidt (1999)revise some of the studies made over the years discussing the methods used and results obtained.

[74]For more details on German labor law I refer to Däubler (1998) and Kübler and Schmidt (1988).

financial resources are provided to the firms. As we have already mentioned above, the main source of financing remains to be the internal sources available to the firms in the form of generated or retained earnings. As far as the external funds are concerned, a corporation can make a choice between different kinds of financing tools and sources. The most common methods are either financing through a bank or capital market financing.

As table 5 indicates, retained earnings and internal financing funds represented the main sources of corporate financing in both countries, Germany and the United States.

	1980-84		1985-89		1990-94	
	Germany	USA	Germany	USA	Germany	USA
Internal Sources	79.7	89.6	89.3	103.7	71.8	109.8
Bank Finance	11.2	12.9	7.9	15.0	16.9	-4.5
Bonds	-2.1	10.9	0.6	24.8	-2.8	10.4
New Equity	-0.5	-4.8	2.3	-29.6	-3.1	-4.2
Trade Credit	-2.8	-1.7	-2.1	-4.7	2.1	1.4
Capital Transfers	9.7	-	8.2	-	9.6	-
Other	4.8	-0.6	-6.3	1.8	-0.9	-6.1
Statistical Adjustment	0.0	-6.4	-11.8	-11.1	6.3	-6.8

Source: Corbett and Jenkinson (1997), compiled from Table 3 and Table 6

Table 5: Net sources of finance in Germany and USA (in %)

Furthermore, the table reveals that in the US bond financing and bank financing were on a comparable level in the first half of the 1980s. However, since then, bond financing prevails among all external funding sources.

As far as internal funding is concerned, its importance is quite similar in Germany. This should not surprise us since internal sources are usually the cheapest sources of funding. Nobody demands a return in form of dividends or interest.

Financing through new equity issue traditionally plays only a minor role for industrial enterprises in Germany. Looking at the figures of German stock market capitalization to GDP in comparison to other countries, German capital markets obviously remained to be underdeveloped even by the end of the twentieth century. In 1998, the stock market capitalization to GDP was only 51.2% in comparison to Great Britain (174.8%) or the USA (157%)[75].

Thus, market-based systems, where firms are financed by a large number of investors and where takeovers represent a significant governance control mechanism, are compared to bank-based systems with relationship-lending, where banks are both, finance providers as well as the key corporate governance participants.

But why do the financing patterns vary across different countries at all? Besides other influential factors, these differences are frequently attributed to different investor rights protection. The degree and quality of investors protection (both, shareholders and creditors) seems to be fundamental to this distinction. The extent to which managers and controlling shareholders can expropriate the investors is determined by the prevailing legal environment of the particular country [76]. All external fund providers need legal protection and ensured effective enforcement to be able to function. Without any effective enforcement rights, the corporate insiders would not have an incentive to repay the creditors or distribute their profits to the shareholders as opposed retaining them.

Either pattern of financing will develop according to law determining how effectively individual investors are protected, giving them the right to recover their invested funds. The consequences of diverse legal environments are different funding standards resulting in unevenly developed capital markets, and respectively, banking relationships across the various countries[77].

[75]Deutsches Aktieninstitut 1999a. For a further comparison see paragraph 5.3.

[76]For a deeper analysis of the countrywide differences in laws, their enforcement and its reasoning we refer to La Porta, Lopez-de Silanes, Schleifer, and Vishny (2000).

[77]La Porta, Lopez-de Silanes, Schleifer, and Vishny (1997)argue that countries protecting shareholder rights have more listed securities per capita and stock markets of larger breadth than the countries lacking shareholders protection. On the other hand, countries that protect the creditors better have greater credit markets.

In Germany, where the shareholder rights are weaker while the creditors have extensive rights and are strongly protected by the law, a bank-dominated system has developed. In contrast to that, in the US legal system, creditors are subject to stronger regulation and are generally less protected than their German counterparts. To a certain extent, the US even prohibits governance by banks. Indeed, US shareholder rights protection encouraged the development of a liquid capital market (i.e. measured by the breadth of the market, determined by the number of firms and the new equity issues) and enhanced the active public participation.

Table 6 illustrates the difference between market-based and bank-based systems. It can be seen, that in the USA banks are relatively unimportant with a ratio of banking assets to GDP amounting to 65.8%, in comparison to Germany where the ratio of banking assets to GDP is five times higher[78]. In contrast to that, the equity market capitalization over GDP of 136.3% is almost three times the German ratio of 58.1%. We can compare these values to the data of 1992 when the German market value of shares of domestic companies as a percentage of GDP was 20% in comparison to 77% in the USA[79]. Moreover, in the third column of table 6, additional evidence for the bank dominance in Germany and the market dominance in the USA can be found. The ratio of bank assets to total financial assets, defined as bank assets plus bond assets and stock assets, is substantially higher for Germany compared to the US.

Thus, as can be seen, the capital markets in Germany are relatively underdeveloped.

Despite this common view, Corbett and Jenkinson (1997) provide some evidence questioning whether Germany really can be referred to as a representative bank-based system, with a proportion of bank-financed net funding of gross investment similar to the US. Generally, they find that firms in both countries predominantly used internal financing as the main source of funds.

[78]Note that in Germany 42% of bank assets are government-owned while in the USA the government owns no bank assets.

[79]Report of the German Stock Exchanges 1992, International Financial Statistics.

Country	BA[a]/GDP	MC[b]/GDP	BA/TFA[c]
USA	65.8%	136.3%	16%
Germany	313.3%	58.1%	63%

[a]Banking assets
[b]Market Capitalization
[c]Total financial assets

Data Source: Theissen (2003), Barth, Caprio and Nolle (2004)

Table 6: Comparison of banks and markets as of 2002

However, another important financing option in the Anglo-Saxon environment is venture capital or risk capital provided by individuals, so called "*business angels*". Those financing alternatives played a significant role in the rise of Silicon Valley as a high technology hot spot. Many of the young and unexperienced entrepreneurs had good ideas without money to realize them. Getting a loan was hard since expected future returns were far too uncertain for affordable credit conditions. Hence, equity was the only alternative and that is exactly what venture capital firms provide. Typically, they do not merely hold a stake of the new company but they also take part in the management using their managerial skills. Their final goal is the exit, in case of success often via an initial public offering. This kind of corporate financing seems especially important for premature companies or entrepreneurs intending to start a company characterized by large uncertainty about future cash flows. Next to the general argument that industries tend to cluster in certain areas, the financing environment may be of similar importance for a high-tech entrepreneur when it comes to choosing where to settle down.

5.3.1 *The Special Role of Banks in Germany*

The most significant feature of German financial system is the dominance of banks. In comparison to the Anglo-Saxon countries with their for many years separated investment and commercial banks (1933-2002), the German system is characterized mainly by *universal banks*[80]. The main essence of the universal banking system is that the same bank can contemporaneously act as a lender, shareholder, trader, underwriter and so forth. This includes the possibility of owning equity in a corporation which they are providing with credit at the same time. Hence, this partly reduces the conflicts of interest between shareholders and creditors since the shareholders and creditors are in fact the same stakeholder[81].

A bank with such a close connection to a firm is referred to as the "*Hausbank*" of the firm. A *Hausbank* is often the best informed market participant considering its client since it is involved in most of the financial activities of the client. The lending activity is normally called *relationship lending* (close relation between actors) in contrast to *arms-length lending* (no relation between actors).

Those universal banks not only participate in deposit and credit services provisions to households and nonfinancial corporations, they also underwrite initial public offerings (IPO) or seasoned equity offerings (SEO) as well as hold and trade all other securities. Stated simply, German universal banks may conduct all the activities of both U.S. commercial banks and U.S. investment banks as they were defined in The Banking Act of 1933.

Moreover, German banks are actively involved in the stock exchange organization (Seger (1996)). Since new security issues are underwritten mostly by banks, they control the access to capital markets in Germany. Hence, due to their broad commercial activities and established significant position in deposits and corporation financing, the banks are considered to be the single important element of the German financial system (Edwards and Fischer (1994)). Seger (1996) demonstrated the relevancy of credit institutes in Germany by regarding the ratio of the bank employees and the total number of people employed in the

[80] Edwards and Fischer (1994)

[81] On the other hand, reducing the agency problems by aligning the interests of large shareholders and creditors creates another kind of conflict. The interests of large shareholders and minority investors might not always be congruent, so large shareholders might use their position to undertake actions that could benefit them at the expense of minority shareholders.

whole economy, which is greater than in other countries. Here, an interesting development took place in the years between 1950 and 1988, where even though the number of physical branches dropped by one third, the number of banking offices doubled, hand in hand with an increase in personnel.

Thus, the universal banks play an important role in German corporate financing. The share of the German financial sector contribution to financial obligations of non-financial corporations lies far above average in comparison to other developed industrial countries (Mann (2003)). On the other hand, the securitization of obligations is much lower in Germany (Hackethal, Schmidt, and Tyrell (1998)), as only few of the large companies are rated and can trade its obligations directly on the capital market.

The perspective of corporate governance has evolved over the decades in Germany as well. The 1980s were characterized by the relationship-based approach of many German banks (e.g . Dresdner Bank, Deutsche Bank, etc.), hereby carrying a fitting name of "patient capitalists". Those banks provided corporations and its managers with the long-term support. Then, in the 1990s, it was again first the banks, Deutsche Bank in particular, which introduced the shareholder value in Germany.

In Germany, banks, insurance companies and other non-financial enterprises represent the largest group of shareholders. As was mentioned earlier, banks can hold shares in corporations twofold, (i) directly through the shares they acquired and (ii) via proxy votes from the private shareholders. Share ownership is a second channel through which banks can influence the corporation. Their huge voting power at the General Meeting is thus based on vote pooling, comprised of their own shares and frequently of an even larger number of proxy votes. The voting rights of banks in 24 out of the 100 largest German enterprises with dispersed ownership were analyzed by Baums and Fraune (1995). The banks own only 13% of direct voting rights. 10% of votes were hidden behind investments funds owned by banks and another 61% of voting rights were the proxies. Eventually, they conclude that the management boards in the tested enterprises such as Siemens, BASF or Bayer, are dominated by banks since on average only 16% of all votes were not controlled by banks (directly as well as indirectly). Besides the strong representation of banks at the General Meeting given by both direct and indirect shareholdings, many banks and insurance companies are also represented on supervisory boards.

5.4 *Some Concluding Remarks*

German corporate governance has tended to change the direction towards shareholder value in the past few years. The signs of the change has been diverse including deregulation of financial markets, more attempts of mergers and acquisitions and the debate on the new European corporate governance. Furthermore, as one of the mechanisms for enhancing transparency and the independency of the German supervisory board, Germany has introduced an official version of German corporate governance KODEX, addressing the most criticized and most sensitive issues of the German corporate constitution in 2002.

Despite the large hostile takeover of Mannesmann and some other takeover attempts at the beginning of the 90s , the market for corporate control is rather underdeveloped in Germany compared to the US. Even though over the years the number of traded companies has been slightly growing, for many companies going public is still not the most popular way to receive funds. Further, publicly traded companies do not release sufficient accounting and general information for many investors used to US disclosure practices[82].

All the above described distinctive features, cross-ownership structure, dominance of banks as well as co-determination raise a common question whether these specific characteristics of German corporate governance improve enterprise profitability or whether they deteriorate it instead. So far, there is no unanimous

[82]Only recently, the automobile producer PORSCHE refused to get listed in the DAX because of increased disclosure requirements.

answer as the studies and their conclusions vary.

Again, to summarize, recalling the German ownership structure, where the majority of outstanding stock is owned by *governing coalition* consisting of the three major shareholder groups, where more than 40% of the German stock is held by other companies who are interested in the firm's survival to maintain the inter-company commercial contracts, the perspective of effective public shareholder's interests protection and enforcement is weak.

6 Complementarity and Consistency

The standard definition of corporate governance, especially in Anglo-Saxon countries, tends to exclusively defend shareholders' interests. In this section, we will take a view of corporate governance as an indirect part of a financial system. We see the financial system more generally as an interactive system of supply and demand of capital disposal and other finance-related services. Supply is provided by the financial sector while demand comes from savings of private households and from capital requirement of the business sector. Above the system is the state: it is a capital-seeking party as well as a capital-supplying party and simultaneously functions as designer and regulator of the financial system. Corporate governance or the entirety of mechanisms and rules determining which interest groups have influence in which way on the crucial decisions of a corporation, is also part of the financial system of a country. We can mainly identify three cornerstones of a financial system from the viewpoint of a corporation:

- *corporate financing*
- *corporate control*
- *corporate strategy*

The legislation, the culture as well as labor and product markets jointly form the environment of a financial system.

6.1 *Graphical Illustration of the Complementarity Function*

Considering the question of the *appropriate* corporate governance system or a change towards approaching a different system, one has to take *all* factors which form the entire system into account. By factors we mean, among others, the already mentioned legal environment concerning corporate governance[83] as well

[83] As there are minority shareholder protection or creditor rights, and so forth.

as the structure of the labor market[84] and, of course, corporate strategy. Different managers often have different views about whom to serve, solely the shareholders or a wider range of different stakeholders.

The fact that *all* factors should be taken into account can be visualized through a function.

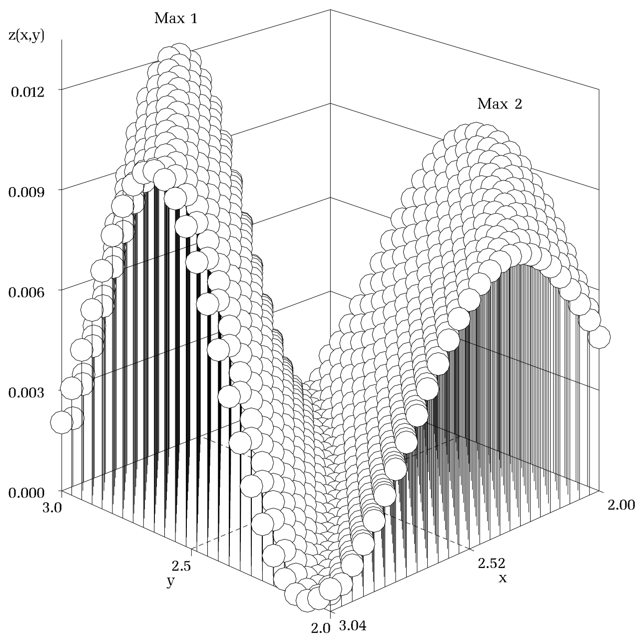


Figure 4: Output function $z(x, y)$

Figure 4 depicts quite well the problem of transition from one governance system to another. Here, $z(x, y)$ is a function where x and y represent some arbitrary elements[85] of the governance system, for example banking regulation and minority shareholder protection. z is the economic gain from a certain combination of the two variables. As can be seen in the picture, there exist multiple maxima which correspond to different values of x and y[86]. Now, consider the case where one is located at maximum 2 (denoted with Max 2). An increase or

[84]For example, a hire-and-fire system versus long-term commitment.
[85]In reality, there are of course more than just two elements but for obvious reasons this can no longer be visualized.
[86]Obviously, their corresponding values are of qualitative rather than quantitative nature, for example "weak minority shareholder protection" or "strict banking regulation".

decrease in either of the two factors x or y leads to a decrease in the output function z. Alternatively, one can alter the value of *both* factors which, making minor shifts, also decreases z but after crossing the valley one can reach maximum 1 (denoted with Max 1)[87]. Intuitively this could be understood as: If one intends to switch to a different corporate governance system, which is consistent in itself one should adjust *all* systemic elements quite extensively. That is, one should make big steps to cross the valley as fast as possible in order to avoid too large economic losses.

6.2 *Economic Consequences of Complementarity*

In previous sections we presented two corporate governance systems which have demonstrated to be functional and led to stable and sound economic performance in quite different ways. Europe and Japan on the one hand as well as the USA and UK on the other hand found their combination of different corporate governance elements to achieve substantial economic growth during the past decades. Despite some isolated setbacks like the recent corporate scandals in the USA or the lawsuit about granting massive terminal bonuses to the former CEO of the German Mannesmann corporation[88], the corporate governance system in both, Anglo-Saxon and European countries, turned out to produce desirable results.

We already pointed out the differences of the traditional, rather narrow shareholder concept and the broader stakeholder approach to corporate governance. Especially in the pluralistic approach where interests of non-investing groups are also considered, the question arises how firm value can be increased if all stakeholder groups are acting in their own interest at the expense of shareholder value. Hence, one should try to avoid dividing the authorities in a way which leads to

[87] At this point, it should be noted that there is no special reason why one maximum is higher than the other. They mainly represent some efficient factor combination leading to a well-functioning economic environment.

[88] In 2000, Vodafone took over its competitor Mannesmann after months of hard struggle. It was probably the most spectacular hostile takeover ever taking place in Germany.

sluggish and/or unfavorable decisions. How can then the functionality of the stakeholder approach be maintained?

Obviously, there have to be some internal mechanisms which take care of administering the corporation efficiently. Such corporate governance mechanisms, which are used by each stakeholder to exercise control and to protect their particular interest, together constitute a system. This system consists of multiple elements, which can take different values. A financial system here is understood as an ordered set of subsystems, the elements. Some of those elements are exogenous, i.e. predetermined for the corporation like the prevailing law, for example. Others can be freely chosen by the corporation like the corporate strategy. Complementarity[89] is the characteristic of the elements in a system. Complementarity exists if the presence or absence of an institution influences the efficiency or deficiency of another institution. If the elements of a system are complementary the whole system can be considered as consistent. Consistency is then a characteristic of the values of the different elements in the system and thus of the system as a whole.

Therefore, a national corporate governance which should be reasonably functional must be consistent, and respectively, must consist of complementary elements which fit together and form a consistent system. Such consistent systems have exclusively positive effects in economic terms.

Both, the market-oriented system practiced in the USA or the UK with its well-established capital market, dispersed ownership as well as an active market for corporate control and the more bank-oriented system practiced in continental Europe with fewer publicly traded companies, concentrated ownership and little engagement on the takeover market satisfy this consistency requirement if all elements are calibrated accordingly.

[89] The transition from the mathematic to the economic application of complementarity is formulated in greater detail in Schmidt and Spindler (2002).

6.3 *Externalization vs. Internalization of Information*

Now let us shift our focus to different options of corporate financing which will be distinguished with respect to their implied information distribution. We can distinguish two basic types of how company-specific information is treated, namely the internalization and the externalization.

In the case of information internalization, we first, have only a limited number of informed market participants and, secondly, the company can choose freely how many people are informed and who belongs to this circle of informed people. In contrast to that, in case of information externalization, relevant information about the company is disclosed to a broad public. This includes information about important financial company characteristics, for example earnings and investment plans, but additionally also long-term strategic plans and occupation of crucial management positions. On the one hand, a great advantage of externalization is the spreading of information through market prices. Competitive markets or organized capital markets in the ideal case play an important role in the aggregation of dispersed information signals and transport this information efficiently to the investor. Hence, externalization creates a transparency which to a great extent eliminates information asymmetries between investors and corporations. This, in turn, has a positive impact on the liquidity of various financing instruments and, more generally, reduces principal-agent conflicts. On the other hand, complete externalization with its high transparency and small degree of information asymmetry excludes the possibility of an information advantage leading to potential extra profits.

The previously considered distinction between internalization and externalization can be aligned with the distinction between a bank-based and a market-based system. Both types of information treatment take a certain institutional setting of the company's environment as given. Externalization needs the market, the capital market in particular, as an aggregation mechanism for information.

In such a capital market-oriented financial system importance is attached to a well-functioning, efficient and liquid capital market as well as outside financing through *many* investors.

In contrast, internalization implies an active role of a specialist, here the banks, in order to gather data, conduct extensive data analysis and keep the information secret. A close collaboration enables the bank to assess the current situation and the future prospects better than the market can. This system is characterized by banks playing a dominant role in financing and controlling corporations.

Every financial system has certain legal and institutional characteristics which are assumed to be complementary in order to ensure the functionality of the system. It depends on those characteristics whether the system converges to internalization or externalization of information. For example, if share ownership is widely dispersed and disclosure requirements are high together with a restriction to use insider information, the financial system gravitates towards information externalization corresponding to a more market-oriented profile.

The differences in the characteristics of both financial systems are also reflected in their policy of corporate financing. Here, complementarity is also required concerning different patterns of corporate finance, the financial sector structure and legal-institutional parameters.

6.4 *Corporate Control*

Independent from the corporate governance system chosen by the corporation, employees, creditors and shareholders are the most important and influential interest groups.

6.4.1 *Different Types of Shareholders*

Shareholders can generally be divided into two groups: the first group is interested in control and the second is interested in liquidity (Hackethal and Schmidt (2000)). Liquidity-oriented shareholders are mainly interested in uncomplicated trading and have only financial goals on their agenda. Moreover, they are interested in a functioning takeover market in order to discipline the management. As we have already discussed, if the executive board fails to manage the company well it will be reflected in the share price. A low share price increases the incentive to take over the company. Both parties are economically better off afterwards: the new investor with a value-increasing strategy can profit from the unused potential of the company and the existing shareholders are interested in a value-maximizing strategy as well.

Besides value maximization, liquidity investors demand the ability to quickly transfer their shares into cash without a substantial price decrease. So, the dispersion of share ownership and an active trading in the stock can serve both goals: liquidity is maintained and through the steady price updates investors gather information from every other market participant.

In this system, the management is only controlled through market mechanisms and acts predominantly autonomous. A main drawback of this modus is that a strategic investor is not necessarily found to realize the full potential of the firm. In that case, the management can act opportunistically.

The control-oriented shareholders are the antipole to the liquidity-oriented shareholders. They are not interested in the capital market indirectly exercising control. Instead, they themselves want to exercise direct control over the firm through taking influence on the management's decisions. Therefore, they acquire a large block of shares to receive enough voting rights and influential power. As a consequence their liquidity is reduced since large amounts of shares can only be traded at a discount. Another result of high ownership concentration is that the firm is not easily accessible for a potential bidder and, thus, for the market for corporate control. For this setting an internalization of information is desired since large shareholders can then use their informational advantage to protect their interests. This, in turn leads to an inequality between large investors and minority shareholders who are often only liquidity-oriented investors. If there are no explicit legal rules there exist no adequate mechanisms for minority shareholders to ensure that their demands are met. Again, large shareholders mainly have a long-term view considering the goals of the corporation and are mainly institutional investors who could have other stakes in the corporation as well[90]. Hence, a substantial divergence of interest can arise between large investors (not exclusively interested in short-term returns) and minority shareholders (only financial interests).

6.4.2 *Different Types of Creditors*

In section 5.3.1 it was already noted that one can distinguish between two forms of debtor-creditor relationship. They differ not only with respect to their goal but also in their function for the company. The bank can take the position of a *transactional lender* which is also called *arms length lending* relationship. Or in contrast, it can take the position of a *relationship lender*. The first type of creditor has a rather distanced relation with the company and is mainly interested in short-term lending. Arms length lenders do not need any control rights and their return is usually the common market interest rate. In case of bankruptcy such a bank has no incentive to engage in any action trying to prevent the firm from liquidation. It is in their interest to use the possibilities granted by law and contracts to end the relationship as fast as possible. Hence, the company faces the problem of not being able to restructure their debt in case of illiquidity. On the other hand, with this kind of relationship the company has a greater independence and greater flexibility on the capital market.

[90] Consider a bank, who is also a creditor, for example.

In the second approach, relationship lending, banks can be regarded as part of the companies corporate governance because of their significant influence. In Germany, where such a close relationship is predominant, a bank with such a close connection is called the *Hausbank*. They finance the company, often even own a certain stake of the firms assets and are present on the firms supervisory board. One advantage of acting not only as creditor is that in the case of financial distress, when the borrower has a cash shortfall, rendering him unable to pay debt service, the firms tend to change their investment policies following riskier projects, attracting more shareholders by paying dividends rather than the debt or acquiring more debt from other sources. However, banks holding equity in the obligor, thus, decrease the risk of their loss in case the borrower should default. The bank's losses on the client's loan are offset by gains on their equity that they own in the contracted company.

Generally, not only the bank but also the corporation as a whole benefits from such a close relationship. Banks which are also equity holders will be less likely to force the company into bankruptcy than the arms-length creditors[91].

A positive economic development of the firm is desirable for the bank since bankruptcy means losing the already invested money. Since the invested money are sunk costs the bank has an incentive for debt restructuring in times of financial distress.

As for large shareholders, relationship lending also permits internalization of information since there is less need for outside capital.

Relationship lending should allow a higher return for the lender since he not only finances the company but additionally acts as a crisis manager in the case of liquidity problems when restructuring measurements are necessary. Though the search for financial means is quite inflexible for the firm, it is protected from

[91] The *Hausbank* has to face a dilemma then. If it calls the loan, searching for a way out, it would lose on its equity position but it could get its money back. Whereas if the bank cooperates with the firm in finding a solution and the company succeeds in reversing the trend, the bank will gain.

getting liquidated in case of default.

6.4.3 *Differences in the Labor Market*

A third important factor is the organization of the labor market. Here, we can again distinguish two general approaches. The first is more market-oriented without significant job security rules. A firm operating in such an environment has the advantage of full flexibility concerning their labor force. They can adjust the quantity and quality of their labor force as needed in each particular economic setting. During boom times the number of employees usually increases whereas in recessions it is generally sharply reduced in order to avoid overcapacity. By doing so, an optimal cost-minimizing strategy can be implemented. Here, labor is traded like a commodity on free markets. Additionally, employees usually do not exercise any control over the decisions made by the management.

The second approach tries to bind the employee to the firm by allowing him to exercise control through representatives on the supervisory board. Furthermore, employees enjoy a relatively strong protection from being dismissed and special contracts, which are negotiated between representatives of labor unions and employers, guarantee certain wages. Hence, the market mechanism is largely abrogated. Although this approach is quite inflexible since firms can hardly adjust their labor force except in hardship situations, there are also advantages. Employees acquire firm-specific knowledge during their long-term employment. By binding the workers to the company, costs concerning training for new workers can be saved. Characteristics of such a system which would be consistent if appearing jointly are long-term relationships between employer and employee, incentives to gather firm-specific knowledge and assignment of some control to the employees.

Obviously, employees follow different interests than shareholders, so allowing them to partly exercise control does not fit quite well in a corporate governance system which aims to maximize shareholder value.

6.5 *Is the Financial System Consistent?*

Each setting for the three interest groups can be connected to either the shareholder approach or the stakeholder approach of corporate governance. In capital market-oriented countries like the USA or the UK we observe a combination of more liquidity-oriented shareholders together with a tendency for arms length lending relationship and a largely deregulated labor market with high fluctuations. On the contrary, in Japan and Germany we observe the three opposite characteristics, control orientation, relationship lending and labor co-determination. If these characteristics occur together with the legal system and the corporate strategy complementary we speak of a *consistent* financial system.

Both consistent systems thus differ in the qualitative value of their elements. Which system is superior cannot be unambiguously assessed. Hackethal and Schmidt (2000) propose the degree of stability and the general role of market mechanisms in a certain environment as an indicator of which governance system is superior. They find that in a stable environment where market mechanisms play a minor role the bank-oriented system prevails whereas in an environment earmarked with uncertainty the capital market orientation seems to perform better. Note that we already pointed out this fact in section 5.3 where the role of venture capital for financing *New Economy* firms was presented.

As an example for an inconsistent financial system, consider a country, mainly characterized through relationship lending, trying to implement a pure shareholder-oriented system. Shareholder orientation demands for externalization of information. This, in turn, does not square with a close bank connection since the relationship lender always has superior information about the firm and has no interest in sharing that information with the public investors. With respect to the current discussion, the question arises if Germany should adopt the Anglo-Saxon model. This does not merely depend on the economic success of the model country. Instead, one has to compare the costs related to the transition with the benefit of a system change and the degree of adaptability. But the potential transition from one system to the other cannot occur if only partial adjustments are made. Rather, it needs an all-embracing reform package where legal, economic and institutional reforms steer in the same direction. Even then it seems politically difficult to implement a new system without taking into account cultural aspects, traditions and the mentality of the relevant actors.

How substantial those cultural differences are, can be seen in figures B.1 and B.2. In a survey, senior managers in five different countries could choose between the following alternatives (figure B.1):

a) A company exists for the interest of all stakeholders (black bar)

b) Shareholder interest should be given first priority (grey bar)

While in Japan, Germany and France the opinion prevails that the company should act in the interest of all stakeholders, UK and US managers see the shareholders as the group that should be prioritized. Figure B.2 reveals additional evidence for an important divergence of attitude. Here, managers could choose between:

a) Executives should maintain dividend payments even if it means that they must lay off a number of employees to achieve that goal (black bar)

b) Executives should maintain stable employment even if if it means that they must reduce dividends to achieve that goal (grey bar)

Again, the majority of Anglo-Saxon managers preferred to dismiss workers in order to maintain dividends whereas continental European and Japanese managers favor to keep employment stable at the cost of dividends. This result is quite helpful in understanding how a certain corporate governance emerges in a particular social environment. If the survey is interpreted as being representative for the population of a country, the implementation of two different corporate governance systems seems reasonable. Further, this divergence in attitude gives us an idea as to why different corporate governance systems exist at all. Different social values in different societies are the key factors for the development of a sound corporate governance system. Without taking into account those society-specific elements the system could hardly work since it would not be broadly supported by the market participants. For example, abolishing the principle of co-determination in Germany or Japan would almost certainly lead to heavy protests by labor unions which are relatively powerful. On the other hand, in the US, cutting shareholder rights in favor of other stakeholders would not be well understood, either. Politicians will typically avoid such legal changes even if they think that they would lead to better operational performance. This also casts doubt on the theory that in the end world-wide corporate governance will converge to some optimal state. Speaking in the words of Coffee (1999) we could say that corporate governance is *...more the product of a path-dependent history than the "natural" result of an inevitable evolution toward greater efficiency.* Starting point of this history is usually the social setting out of which the legal, economic and institutional frameworks for corporate governance arise.

7 Which Way Did the Czech Republic Go?

Effective corporate governance has been perceived as one of the means for encouraging foreign investment in every emerging market including the Czech Republic. In particular, corporate governance has always played an important role: initially when the country went through the privatization process as well as thereafter.[92]

One point which is frequently stressed is the importance of legal protection for minority investors as a counterpart of concentrated ownership[93]. In Russia, for example, the few successfully privatized firms, turned out to be the ones where outside investors had gathered enough shares to replace or at least control the management. Legal protection of investors and concentrated ownership in form of large investors create another example of a two-dimensional complementarity system, as part of an effective corporate governance complex. The best combination of all components is specific to each country.

Investors in the Czech Republic have to face similar problem as well. Unfortunately, the minority shareholder rights still remain in the shadow of the majority shareholders. Gradually, after the transition in 1989, several laws and decrees were introduced in order to regulate the Czech securities market which since then were amended on several occasions, including: the Bonds Act (1990); the Commercial Code (1991); the Securities Act (1992); the Stock Exchange Act (1992); the Investment Fund Code (1992); and the Securities Commission Act (1998).

Up to this day, however, the voting process underlies the majority voting procedure, which, in comparison to cumulative voting[94], is disadvantageous for

[92] For example, the collapse of IPB represents one of the major corporate scandals in the Czech Republic in 2000. Among others, poor disclosure requirements allowed IPB to beautify its accounting and auditing results as well as granting loans without accurately assessing risks. Furthermore, it led to a shortfall of IPB's reserves by CZ40 billion, etc.

[93] Shleifer and Vishny (1996)

[94] In contrast to straight voting which can freeze out minority shareholders, the main effect of cumulative voting is to permit minority shareholder participation. If cumulative voting was mandatory in the Czech Republic legal devices would have been worked out for minority shareholders protection.

minority shareholders.

After we have studied the main features of stakeholder and shareholder models theoretically, historically and practically with the examples of Germany and the USA, a natural question might arise concerning the Czech Republic. Is the Czech corporate governance system stakeholder or shareholder oriented?

In order to answer this question, we need to look at some data that would help us classify the Czech corporate governance system. In the following section we will briefly revise a few of the characteristics of Czech corporate governance and the economy, mainly the role of the capital market and the way how Czech boards are constituted and structured.

7.1 *Corporate Funding in the Czech Republic*

Based on table 6, we have gathered similar data for the Czech republic, looking at the Czech market capitalization as well as banking assets relative to the GDP.

	2000	2001	2002	2003
Banking Assets/GDP	144.9%	130.2%	112.8%	106.8%
Equity Market Capitalization[a]/GDP	21.6%	15.6%	21.0%	26.7%
Total Market Capitalization[b]/GDP	35.7%	30.2%	37.4%	47.7%

Data Source: Own calculations based on the data from CNB, Czech Statistical Office and Prague Stock Exchange
[a]Equity market capitalization represents total shares traded on Prague stock exchange
[b]Total market capitalization represents the sum of total shares and bonds traded on Prague stock exchange

Table 7: Total market capitalization vs. banking assets as a share of GDP

Here, based on the evidence from 2000 to 2003, corporate funding in the Czech republic seems to be dominated by banks. Throughout the whole observed period, banking assets amounted to more than 100% of the GDP. At the same time, the ratio of equity market capitalization to GDP was on average only one fifth of the GDP. When taking bonds into account, too, we arrive at a mean of 38% (total market capitalization). Thus, the substantially higher ratio of banking assets to GDP is evidence for a predominantly bank-dominated system.

However, the data of the last two years reveal a trend towards increased capital market financing, especially financing through bonds together with a declining share of banking assets. This might be either a sign of a saturated credit market (banks can hardly acquire new solvent credit targets) or increasing trust in capital markets or both.

By habit, it is trust in banks and the underdeveloped state of the capital market that drives the decisions of the market players to turn to banks rather than to look for other financing sources (internal financing excluded). Since the Czech republic had no capital market before 1990 and banks were the prevailing source of finance it is reasonable to assume that market participants had more trust in banks than in capital markets. At this point, one would intuitively say that historically the Czech republic has been a bank-based market. But the real question is: whom did the market players really trust? Who was credible in the early nineties? Was it really the banks or was it just the "state" hidden behind the banks through its majority ownership share?

Despite the fact that the Czech Republic appears to be bank-dominated, creditor rights were insufficiently protected after the fall of the former communist regime. We can say that the Czech republic is a bank-centered country, however, we cannot say that Czech banks are as powerful as German banks. For most of the time, the banks were extremely exposed to the risk of the corporation's operations without having the possibility to really intervene.

7.2 *Czech Boards*

The commercial law of a country is probably one of the most significant determinants of its corporate governance system. Yet, the Czech commercial law seems to be too benevolent in the matter of internal control. Czech companies are allowed to choose between alternative models concerning board structure and appointment. Unfortunately, this is leading to more confusion rather than helping to establish appropriate corporate standards.

In the Czech republic, the internal supervision structure is represented by a two tier board, consisting of the following bodies (besides the General Shareholders Meeting):

- **Board of Directors**: the board of directors is required to have a minimum of 3 board members, unless the company has only one shareholder.

  The board of directors is the highest executive body of the corporation, entitled to sign contracts for the company and is responsible for all the business affairs.

- **Supervisory Board**: the supervisory board should have a minimum of 3 members. The number of supervisory board must be a multiple of three.

  The supervisory board is responsible for monitoring and controlling the actions of the board of directors.

At first sight, one would say that Czech boards are structured in a similar way as is the case in Germany[95]. But do the Czech supervisory boards really replicate the German supervisory boards? Or does this conformity only exist on the surface? In order to draw a better comparison, we should have a closer look at Czech supervisory boards.

Czech joint stock corporations are also characterized by two tier boards. In addition to that, as is the case in Germany as well, employees of companies with more than 50 workers are entitled to vote for 1/3 of the supervisory members who should then represent their interests. This feature is completely unknown in the USA where the employees are not represented on the boards at all.

Another feature we are interested in, is the so-called independence of the board members. Increasing the share of independent board members is one of

[95]See section 5.1.2

the recommendations of the corporate governance code based on the OECD principles:

"The supervisory board should consist of not less than 25% of independent members who are not related to the executives or shareholders or who work for the company or any subsidiary or holding company or are connected persons within the definition of Securities Act."[96]

In Germany, the law forbids the current management of any company to be appointed to the supervisory board. In contrast to that, US corporate governance principles require both managers and independent members to be represented on the supervisory boards. This is, however, given by the nature of a one tier system with a board of directors only which should concurrently serve as executive and controlling body. In this respect, the Czech system is not fully analogous to the German system since even though members of the board of directors are not permitted to have a seat on the supervisory board, leading officers who are *not* members of the board of directors can be members of the supervisory board.

Being interested in the current situation of Czech boards, we have run a cross-section survey of the statutes and supervisory boards of nine Czech companies from different industries and with different ownership structures. Table B.1 in the appendix reveals the results of our study. In table B.1, we have divided the supervisory board members into three groups which are defined as follows:

- *Employee representatives*: These members are elected by the employees of the company. Per law, a minimum of one third of the supervisory board members must be composed of employee representatives.

  In our survey, labor union members are also considered to be employee representatives, despite the fact, that they might have not even been elected by the employees.

- *Independent*: Independent members are all outside directors or other per-

[96] (Czech Securities Commission, 2001)

sons who have never been in the executive management or in the executive board of directors[97] of the firm in the past seven years[98].

- *Dependent/affiliates*: All supervisory members who have exercised an executive function on the board of directors or in the executive management of the firm in the past seven years are considered to be dependent of the company or affiliated with the company.

Czech commercial law permits that many important corporate governance issues are decided by the companies' statutes. For example, the company can freely decide who will appoint the supervisory board members and the members of the board of directors. Only one (Zentiva) out of nine companies empowers the general meeting to vote not only for its members of the supervisory board but for its board of directors as well[99]. Enabling the general meeting to vote for both its supervisory board and board of directors actually grants the shareholders with more voting power. Yet, in the remaining companies, the general meeting votes for supervisory boards and the supervisory board then elects the members of the board of directors.

The biggest existing restriction on the board members is that they are not allowed to be simultaneous members of both of the boards, board of directors or any other statutory board and supervisory boards. Otherwise, the members may float between the boards. In case that the former board of directors members is to be transferred to the supervisory board within a short period of time, it is questionable whether such a member can really exercise his monitoring and controlling role on the supervisory board properly and really act in the shareholders'

[97] Here Cesky Telecom is an exception to this rule. In our table, all five members of Cesky Telecom's supervisory board considered independent were previously (until the second half of 2003) on the board of directors. However, at that time, all of these former board of directors members did not have an executive function at Cesky Telecom's board of directors.

[98] The latest available annual reports that have been studied to confirm the independency or dependency or affiliated relationship, are dated to 1998.

[99] Originally, CEZ's general meeting also elected the board of directors. However, since 1999 CEZ has delegated this power to its supervisory board which now elects the members of the board of directors.

interests. It is more likely that this member will not be unbiased in his decision making process. In the end, the role of the supervisory board can be weakened by these kinds of members.

Supervisory boards of nine Czech companies that we have studied reveal the following results:

- Out of the total number amounting to 84 supervisory members of all nine companies more than one third are employee representatives (17 members). More than 45% (38 members) of all the board members are independent members, presumably representing the interests of the shareholders. Only 20% of the total members are regarded as dependent members.

  Hereby, our results are conforming the above mentioned OECD recommendations for the minimum 25% board members independency.

- The board composition is affected by the majority owner. Corporations like Komercni Banka, Ceska Sporitelna and PP, whose majority shareholders are foreign investors such as Societe Generale, Erste Bank and RWE, tend to differ in their structure from the other studied companies. Apparently, a large number of their parent companies' representatives dominates the boards. However, those representatives in most cases simultaneously exercise a high executive position within the parent company (they are either on the board of directors or part of the executive management team in the parent company).

  It seems as if fear from cross border risk would be reflected in the supervisory boards' composition and foreign investors would not really trust the independency of the members in the country where their subsidiary operates. Instead, they appoint one of their members of the executive team who should be monitoring the way their subsidiary operates behind the borders. Therefore, they "redefine" the term "independent directors" (as it is known from the corporate governance code mentioned above) and they regard their own directors operating across the border as independent, i.e. independently observing its subsidiary's operations abroad regardless of their position at "home".

Based on the relatively high ratio of independent supervisory board members, and based on the fact, that employees are represented on Czech boards, we find a tendency towards the German stakeholder approach with its two-tier board system.

7.3 *Some Concluding Remarks*

Overall, the picture of Czech corporate governance seems ambivalent, although both the corporate funding scheme as well as the board structure are clearly pointing towards the German system. Nevertheless, with regard to bank dominance we miss the presence of stronger credit protection. Moreover, as we have explained previously, the tendency towards bank financing is quite plausible since well-functioning capital markets are still in the phase of development. It is likely that we have to wait for another few years to see if capital markets can gain confidence and, hence, the trend towards capital market will be persistent. This argument goes hand in hand with the notion that additionally a certain "*shareholder culture*" has to be developed. This means that besides all economic aspects the stock market and securities trading must be widely accepted by market participants as a serious option to increase their wealth.

Looking at the structure of corporate control, especially the board structure, does not reveal much insight about the direction of Czech corporate governance. At first glance, it seems as if the German two tier system was intended. But, as we have pointed out, there is a crucial difference, namely the possibility for members of the management who do not serve on the board of directors, to have a seat on the supervisory board. However, the German board system still seems to be the antetype of the Czech board system.

As a result of this evidence we conclude that up to now the Czech system has more typical features of a stakeholder system. But it is by far not certain if this will continue in the future since the Czech Republic is just at the beginning of its development of a market economy. We suggest, according to the theory of complementarity, that whatever is decided about the further way of Czech corporate governance it should be aimed to create a consistent system.

8 Conclusion

For the past few years academics and politicians dealing with corporate governance have been arguing about choosing the right path. Two main streams of corporate governance, the shareholder and the stakeholder concept, have been proposed in the literature and were presented in this thesis.

Proponents of the shareholder approach argue that the enterprise should be run solely in the interests of equity investors, the *principals*, although they depend and rely on others in keeping their business functioning. Shareholders are portrayed as the only stakeholder group that invests their capital in the corporation despite the lack of any contractual guarantee of a specific return. Thus, shareholders, as the *residual claimants* carry most of the financial risk in case of loss or even default. Furthermore, as all requirements of the interest groups are eventually met and all of the corporation's stakeholders will receive the returns for which they have entered the relationship, the maximization of the shareholder value will result in the pareto-optimal economic performance for both the enterprise as well as the economy as a whole.

We have focused on corporate governance in both of the polar regimes and its different practices in different countries. In a brief historical overview we presented the development of governance in the United States which is considered a typical shareholder-oriented country. Then, as a contrast, we introduced the German system as an example of a classical stakeholder-oriented governance structure. A substantial difference in the history is the banking legislation. US banks were strictly separated to commercial banks and investment banks whereas the German law allowed large universal banks. Maybe this fact contributed to the different development of the countries' governance systems. At least for corporate funding this difference seems to be important.

A current feature of the US system is the most liquid stock market in the world together with a well-developed takeover market. Further, it grants almost no executive rights to employee representatives. Banks play only a minor role in corporate financing compared to the capital market. In Germany, banks are largely dominating the market for corporate funding and are often closely affiliated with their clients. Overall, banks in Germany play an important role in two fields. First, they are the dominant external financing providers. Second, based on their direct and indirect shareholdings they exercise a substantial amount of control. Finally, we have revised co-determination and the two tier system of internal control where employees have the right to elect half of the supervisory board members.

Having determined the main characteristics of both governance regimes, we tried to classify the Czech system according to its corporate governance features. The data on corporate funding revealed that banks largely dominate this area though a downward trend could be recognized for bank dominance, measured as the ratio of banking assets to GDP. Capital markets seem to be gaining significance since the ratio of market capitalization to GDP was rising in the last few years. Another feature is the board structure which is very similar to the German structure since the Czech Republic has a two tier system with a significant amount of employee representatives. Eventually, we concluded that the current Czech system is more stakeholder-oriented. However, since the Czech history of market economy is quite short there is much room for development and a final judgement cannot be made.

The modern debate about the superiority of either the shareholder or the stakeholder approach and the theory of "natural" tendency for convergence of the two corporate governance systems has been the trigger for this thesis. We presented evidence that convergence is not a "natural" necessity. Both systems have performed well in the past. Throughout the years, the systems have differed with respect to economic performance based on the particular economic environments. During the seventies, the stakeholder system in Germany could better absorb the negative effects of the world-wide economic crisis. In the nineties, however, it stayed behind the flexible shareholder system in terms of economic growth. Maybe this is the reason why in the past few years, in many stakeholder-oriented countries, a discussion has been opened between the academic and political arena whether to change the orientation towards shareholder value rather than retaining the current stakeholder system.

In light of this discussion, we have tried to emphasize the necessity of consistency of all the elements that constitute a financial system. One cannot easily change from one system to another. To avoid economic inefficiencies in the phase of transition, one has to shift *every* element in the desired direction. Otherwise, adjusting the elements only partially leads to a system which lacks complementarity of the elements, i.e. the elements do not fit together and may even contradict each other. Moreover, this transition should be accomplished fast in order to avoid economic losses. Hence, large steps should be taken instead of making a gradual adjustment. However, there are caveats as the culture of a particular country may conflict with the values of the new system which could lead to reduced motivation to participate in the economic process or, in the worst case, social unrest.

A Specific Valuation Methods

The shareholder value approach as a forward-looking valuation method has become a frequently used tool for enterprise value determination. All the expected cash flows in future periods are summed up and discounted by the weighted average cost of capital[100] (WACC). The current interest rate offered by the market as a rate of return can be used as an approximation as well.

Nevertheless, one should keep in mind that there are conflicting opinions about interpretation of shareholder value since it is often mistakenly understood as firm value. One argument opposing this claim is that the latter refers to the capital structure of the company consisting of *both* equity and total liabilities, whereas the shareholder value reflects the equity value only. Another argument is that not only equity providers are interested in the company, but the enterprise also has some value for the remaining stakeholders. Both arguments raise the question, whether these two values can be seen as identical[101].

A plethora of different methods exists all of which calculate the shareholder value. For example, the *Dividend Discount Model (DDM)* or the *Free Cash Flow to Equity Model (FCFE)* which are presented in detail in Damodaran (1996). Here, only three performance measures, maybe the ones most commonly used, will be briefly described.

I. *Economic Value Added (EVA)* is the financial performance measure based on the company's financial statements[102]. It basically measures the residual wealth of a company remaining after deduction of the debt service costs and equity costs from the firm's operating profit adjusted for taxes.

[100] WACC is defined as the weighted average of the costs of equity and the after-tax cost of debt(Ross, Westerfield, and Jordan, 2000). Inputs needed for the WACC calculation are the proportion of debt to equity, the stock's volatility measured by its beta, and the market risk premium.

[101] For more on this topic see Figge (2002)

[102] This risk-adjusted cash flow variable was developed by the management consulting firm Stern Stewart.

$$\text{EVA} = \text{NOPAT} - (\text{WACC} \cdot \text{TCI})$$

where NOPAT = net operating profit after tax, WACC = cost of capital[103] and TCI = total capital invested.

Thus, EVA is net operating profit minus the proper charge for the opportunity cost of total capital investments or an estimate of economic profit generated by the enterprise. Moreover, it indicates the amount by which earnings are greater or smaller than the required minimum rate of return that shareholders could receive by alternative investments with similar risk features.

II. The second commonly used approach for shareholder value calculation is the *Cash Flow Return on Investment (CFROI)*. CFROI is a performance valuation method measuring the cash flow return made on capital[104].

$$\text{CFROI} = \frac{(\text{EBIT}(1-t) + \text{NCC})}{\text{CI}}$$

where EBIT = adjusted EBIT, NCC = depreciation and other non-cash charges, CI = market value of capital invested, t = tax rate.

This performance metric translates a firm's financial results through a number of adjustments into cash flow return on investment measure, assessing the firm's economic performance (Helfert, 1994). After CFROI has been computed, it is compared to the company's inflation-adjusted cost of capital to determine the returns earned in excess of its costs of capital. Cash Flow Return on Investment is an adequate tool for comparison of companies running business in their own country as well as abroad, ignoring the geographic asset dispersion.

[103] For EVA purposes, the cost of capital should be calculated based on market values.

[104] CFROI has been invented by HOLT Value Associates, now a subsidiary of The Boston Consulting Group

III. Finally, a third method is the *Discounted Cash Flow (DCF)* approach, one of the most common performance measurers of the book value approach[105]. DCF estimates the value of an asset by discounting the expected future free cash flows[106] with an appropriate discount rate.

$$\text{Shareholder value} = \sum_{k=1}^{k=n} FCF_k \cdot \frac{1}{(1+i)^k} - D$$

where FCF = free cash flows, D = debt capital, n = number of periods, k = period, i = discount rate.

Hence, the shareholder value will be obtained by subtracting the debt capital from the net present value of of all the future free cash flows of the firm[107]. In comparison to the other two performance metrics, DCF is not that simple and easy to calculate as it is considered to be a more precise and complex valuation method (values calculated by EVA and CFROI are very often not perfectly correlated with DCF valuation method results).

[105] Discounted Cash Flow analysis and Peer Comparison (relative valuation) are methods commonly used by most investment banks and brokerage companies as can be seen from investment analyses they have conducted.

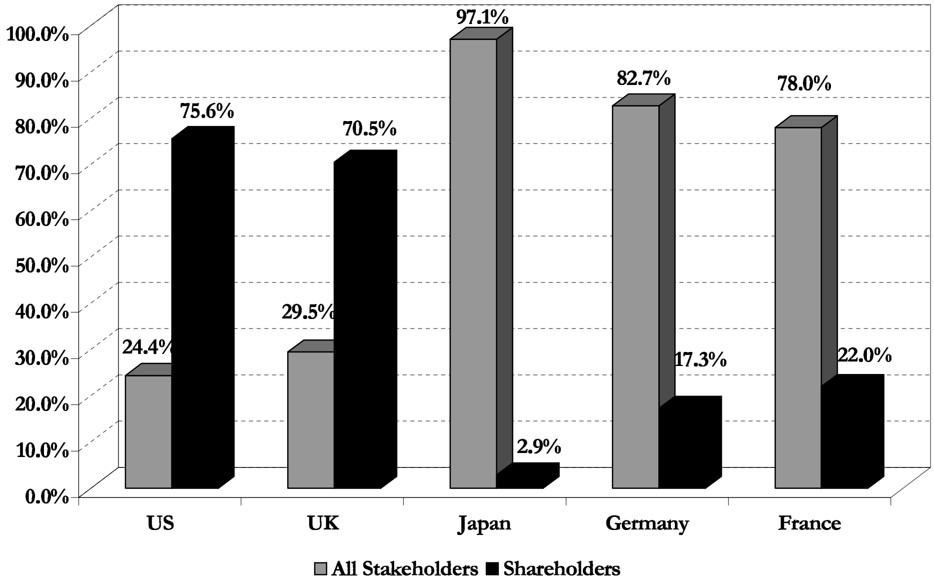
[106] Free cash flow is here understood as cash flow that is free to be distributed to creditors and stockholders since it is not used for increasing working capital or fixed asset investments.

[107] This methodology is called the *entity approach.* Alternatively, the shareholder value can be computed using the *equity approach* which in turn deducts the stake of stakeholders before discounting the free cash flows. The formula reads then as:

$$\text{Shareholder value} = \sum_{k=1}^{k=n} NFCF_k \cdot \frac{1}{(1+i)^k}$$

, where NFCF = net free cash flow and i = cost of equity.

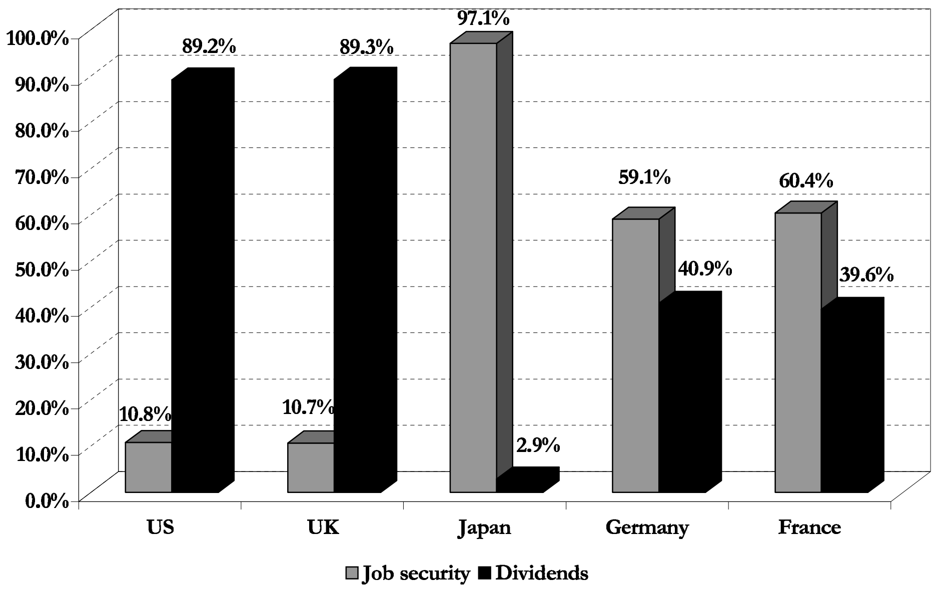
B Figures and Tables



Source: Masaru Yoshimori, Whose Company Is It? The Concept of the Corporation in Japan and the West." Long Range Planning, Vol. 28, No. 4, pp. 33-44, 1995.

From: F. Allan/D. Gale, Corporate Governance and Competition, 1999

Figure B.1: Whose interest should be given first priority?



Source: Masaru Yoshimori, Whose Company Is It? The Concept of the Corporation in Japan and the West." Long Range Planning, Vol. 28, No. 4, pp. 33-44, 1995.

From: F. Allan/D. Gale, Corporate Governance and Competition, 1999

Figure B.2: What is more important: Job security or dividends?

Name	Industry	Majority Owner	Supervisory Board Members (as of 31.3.2004)			Total members
			Employee representatives	Independent	Depenedent/ Affiliates	
Zentiva	Pharmaceuticals	Leciva CZ (98.5%), Zentiva B.V. (30.8%)	1	1	1	3
Komercni banka	Bank	Societe Generale S.A. (60.35%)	3	2	4	9
Ceske Radiokomunikace*	Telecommunications	Bivideon B.V. (71.9%)	2	4	0	6
Ceska Sporitelna**	Bank	Erste Bank (97.9%)	4	2	6	12
Prazska Plynarenska	Utilities - Gas	RWE (49.4%), Pražská plynárenská holding (50.2%)	3	2	4	9
Unipetrol	Utilities	FNM (62.99%)	4	8	0	12
Cesky Telecom	Telecommunications	FNM (51.1%)	5	8	2	15
CEZ	Utilities - Energy	FNM (67.61%)	4	8	0	12
Metrostav	Construction	Doprastav Bohemia (67.01%)	3	3	0	6
Total Members per Group			**29**	**38**	**17**	**84**

* Data as of 31.5.2003
**Data as of 31.12.2002
Data Source: Own calculations based on the data from annual reports, offical web pages, trade register and interviews.

Table B.1: Supervisory board composition of selected companies in the Czech Republic

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