A COMPARISON OF CORPORATE GOVERNANCE SYSTEMS IN THE U.S., UK AND GERMANY

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Abstract

This paper compares corporate governance principles in the U.S., UK, and Germany. The U.S. and UK represent shareholder models of ownership and control whereas in Germany a stakeholder approach to corporate governance provides greater input for creditors, employees and other groups affected by corporate decision making. Recent changes in the U.S. and UK as evidenced by the Sarbanes-Oxley Act and a variety of reports including the Cadbury Committee Report recognize the importance of a more independent board of directors, completely independent audit committee, and strong internal controls. In Germany, some of these initiatives have been suggested as well. The U.S. can learn from their British counterparts and endorse governance advances such as to separate out the role of the chair of the board of directors and the CEO. Other changes that would strengthen governance in the U.S. include to: limit the number of boards on which a person can serve; recognize the rights of stockholders to nominate directors; and give shareholders a more direct role in board oversight. The U.S. should consider adopting some of the German attributes in their governance system by incorporating employees and employee representative groups into the oversight process. After all, it was the employees that worked for Enron who suffered the most as a result of corporate fraud including a loss of jobs and the near wipe-out of their 401K retirement plans.

Keywords: agency theory, corporate governance, Sarbanes-Oxley, stakeholder theory, Germany, United States, United Kingdom

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Introduction

The collapse of BCCI in the late 1980s, that caused a financial panic spanning four continents and engulfing the Bank of England, was the impetus for the 1992 *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Committee). The Committee investigated accountability of the Board of Directors to shareholders and society. The report and associated "Code of Best Practices" made recommendations to improve financial reporting, accountability, and board of director oversight. Ultimately, a Combined Code on Corporate Governance (Code) was adopted and it is now a securities listing requirement in the UK (www.ecgi.org/codes.html).

Accounting scandals at companies in the U.S. such as Enron, WorldCom, Tyco, and Adelphi, illustrate the failure of corporate governance systems. In each case, senior executives and board of director members did not live up to the legal standard of "duty of care" that obligates top corporate officials to act carefully in fulfilling the important tasks of monitoring and directing the activities of corporate management. Moreover, the "duty of loyalty" standard that mandates not using one's corporate position to make a personal profit or gain was violated by top officials at each of the companies.

The Sarbanes-Oxley Act ("the Act") was adopted by Congress and signed into law by President Bush in August 2002 as a response to these and other corporate failures. The question is whether the Act goes far enough in making changes in the corporate governance system in the U.S. to adequately protect the interests of shareholders, creditors, employees and others who expect top management and board officials to safeguard corporate assets and who rely on these parties for accurate information about corporate resources.

The failure of Parmalat, an Italian company, led to a series of initiatives in the European Union (EU) to modernize corporate governance systems that bring member countries closer to requirements of the Act. Still, differences exist that can impede efforts to converge corporate governance systems and facilitate the flow international investment capital.

The purpose of this paper is to identify the differences in corporate governance systems in the U.S., UK, and Germany that result from historical differences in each country and different methods of financing business operations. These countries have been selected because they represent three of the most advanced in terms of developing effective governance systems. Also, while the U.S. patterns its system after the common law approach formed in the UK, the German system is based on Roman civil law. These systems are followed by many countries around the world and they provide a basis for the comparisons.

The paper proceeds as follows. The foundations of the shareholder-oriented and broader stakeholder-oriented systems of corporate governance are discussed in the first section including agency theory and employee governance considerations. Next, the components of corporate governance in the U.S. are explained. This is followed by a description of recent changes in corporate governance in the U.K. The discussion of the components of corporate governance in Germany that follows emphasizes differences with the U.S. in the control and financing of business. The following section provides a list of differences in corporate governance in the U.S., and the UK and German systems, that should be considered by regulators in the U.S. as part of any effort to facilitate the convergence of international corporate governance systems. The final section presents concluding comments.

Foundations of corporate governance systems

Typically, the phrase "corporate governance" invokes a narrow consideration of the relationships between the firm's capital providers and top management, as mediated by its board of directors (Hart 1995). Shleifer and Vishney (1997) define corporate governance as the process that "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."

Goergen et al. (2004, 2) point out that a corporate governance regime typically includes the mechanisms to ensure that the agent (management) runs the firm for the benefit of one or more principals (shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business). The mechanisms include internal ones such as the board of directors, its committees, executive compensation policies, and internal controls, and external measures that include monitoring by large shareholders and creditors (in particular banks), external auditors, and the regulatory framework a of securities exchange commission, the corporate law regime, and stock exchange listing requirements and oversight.[1]

Agency Theory

In whose interests should corporations be governed? The traditional view in American corporate law has been that the fiduciary duties of corporate managers and directors (agents) run to the shareholders of the corporation (principal). Those who argue for the primacy of shareholder interests in corporate governance systems typically cite the famous dictum from *Dodge Bros. v Ford* that "the corporation exists for the benefit of the shareholders" (Boatright 1994 and Goodpaster 1991) as evidence of a restraint on the discretion of management. It follows from agency theory that the fiduciary responsibility of corporate managers is to the shareholder. Shareholders receive returns only after other corporate claimants have been satisfied. In other words, shareholders have a claim on the corporation's residual cash flows.

Since the shareholder's claim is consistent with the purpose of the corporation to create new wealth, and the shareholders are allegedly at greater risk than other claimants, agency theorists reason that corporate directors are singularly accountable to shareholders (Brickley et. al. 2001). According to Hawley et al. (1999), the central problem in corporate governance then becomes to construct rules and incentives (that is, implicit or explicit 'contracts') to effectively align the behavior of managers (agents) with the desires of the principals (owners). However, the desires and goals of management and shareholders may not be in accord and it is difficult for the shareholder to verify the activities of corporate management. This is often referred to as the agency problem.

Agency Costs

A basic assumption is that managers are likely to place personal goals ahead of corporate goals resulting in a conflict of interests between stockholders and the management itself. Jensen & Meckling (1976) demonstrate how investors in publicly- traded corporations incur (agency) costs in monitoring managerial performance. In general, agency costs also arise whenever there is an "information asymmetry" between the corporation and outsiders because insiders (the corporation) know more about a company and its future prospects than outsiders (investors) do.

Agency costs can occur if the board of directors fails to exercise due care in its oversight role of management. Enron's board of directors did not properly monitor the company's incentive compensation plans thereby allowing top executives to "hype" the company's stock so that employees would add it to their 401(k) retirement plans. While this had occurred, the former CEO, Ken Lay, sold about 2.3 million shares for $123.4 million.

Overcoming the Agency Problem

The agency problem can never be perfectly solved and shareholders may experience a loss of wealth due to divergent behavior of managers. Investigations by the SEC and Department of Justice of twenty corporate frauds indicate that $236 billion in shareholder value was lost between the time the public first learned of the fraud and September 3, 2002, the measurement date (www.sec.gov).

[1] Other mechanisms exist including the corporate dividend policy, the market for corporate control, and product-market competition but these are not addressed in the paper.

Executive Compensation

One of the most common approaches to the problem is to tie managerial compensation to the financial performance of the corporation in general and the performance of the company's shares. Typically, this occurs by creating long-term compensation packages and by the possibility to issue stock options related to the firm's stock price. These incentives aim at encouraging managers to maximize the value of shares.

Controlling Management through Board of Directors' Actions

The stockholders select the board of directors by electing its members. Managers

- that do not pursue stockholders' best interest can be replaced since the board of
- directors can hire and fire management. However, the accounting scandals taught us that boards can be controlled by management or be inattentive to their oversight responsibilities. For example, Andy Fastow, the now indicted former chief financial officer (CFO) of Enron, directly or indirectly controlled many of the special purpose entities that he set up. Yet, Enron's board waived the conflict of interest provision in the company's code of ethics to enable Fastow to wear both hats.

The Role of Institutional Investors

In response to concerns about the size of executive pay packages, institutional and other influential shareholders have become more active in seeking a stronger role in the director nominating process. New rules adopted at MCI (formerly known as WorldCom) require the board to solicit director nominations from holders representing at least 15 percent of its shares. Marsh & McLennan Cos. agreed in March 2004 to nominate a director recruited by institutional investors after months of negotiations. The U.S. government joined the effort when on May 1, 2003, the SEC (Series Release No. 34-47778) solicited public response on the adequacy of the proxy process with respect to the nomination and election of directors. On July 15, 2003, the Commission published on its website (http://www.sec.gov) a summary of the comments most of which criticize the current process for the nomination and election of directors Exchange Act Release No. 34-48301). Two particular areas of concern are the nomination of candidates for election as directors and the ability of security holders to communicate effectively with board members.

In response to these concerns, on October 8, 2003, the SEC proposed rule amendments that would, under certain circumstances described below, permit shareholders representing at least 5% of voting shares to put their own board nominees alongside management's choices on a company's official ballot (Series Release No. 34-48626). The proposed rules stop short of giving security holders the right to nominate directors. Instead, the proposed requirements would apply only to those companies at which one of two triggering events has occurred and would remain in effect for two years after the occurrence of either or both events. These events include: (1) the withholding of support for one or more directors from more than 35 percent of the votes cast; or (2) a request by a security holder or group of security holders owning more than 1% of the company's voting securities for one year, supported by more than 50 percent of the votes cast, that the company become subject to the alternative nomination procedure.

The Accounting System as a Monitoring Device

The accounting system should help to prevent and detect fraud including false and misleading financial reports, asset misappropriations, and inadequate disclosure. Internal controls are established by management to help achieve these goals. The accounting statements that are prepared by management report the financial results in accordance with generally accepted accounting principles (GAAP), and the external auditor renders an independent opinion on those statements.

Internal Controls

Management has a stewardship responsibility to protect company assets. An important component of internal control is the processes in place to safeguard company assets. As the recent scandals indicate, however, even the best internal control system will fail if top management overrides the controls or the directors turn away from their responsibilities. For example, top executives at Tyco and Adelphia used hundreds of millions of dollars from interest-free loans for personal purposes. The board at each company claimed to have been uninformed about the nature and purpose of the loans. In at least one case (WorldCom) members of the board also received similar favored treatment.

Audited Financial Statements

The financial reports can be used to mitigate the conflict between owners and managers posited by agency theory. If owners perceive that accounting reports are reliable, then management should be rewarded for their performance and for helping to control agency monitoring costs.

While the management is responsible for the preparation of the financial reports, publicly-owned companies must hire independent auditors to render opinions on the fairness of the presentations in the financial statements. The auditors fail in their oversight role when they ignore management's manipulations of the financial statements or its unauthorized use of company resources, as was the case in all of the aforementioned accounting scandals.

Constituency Statutes

The shareholder model relies on the assumption that shareholders are entitled (morally, not merely legally) to direct the corporation because their capital investments provide ownership rights that are an extension of their natural right to own private property. The debate over whose interests should be emphasized in corporate decision-making that began shortly after Berle and Means (1932) wrote *The Modern Corporation and Private Property* flared up again in the 1980s as states began to pass corporate constituency statutes. Constituency statutes allow corporate officers and directors to take into account the interests of a variety of corporate stakeholders in carrying out their fiduciary duties to the corporation. The statutes suggest that a corporation may be run in the interests of groups other than shareholders.

McDonnell (2002) points out that while the statutes seem to have appeal to advocates of employee involvement in corporate governance, they were passed in response to the takeover wave of the eighties, and critics charge their main effect is to "entrench incumbent managers." McDonnell believes (2) they are a "poor substitute for direct employee involvement in corporate governance" because constituent groups can't sue under the statutes. The contractarian point of view, which has found its way into corporate law scholarship through the infusion of economic thought, challenges the long-standing belief that shareholders have a right to expect that their property will be managed in their interest. The contractarian view portrays the corporation as a nexus of contracts between various parties which interact through the corporation, potentially including employees, customers, suppliers, creditors, local communities, and the state and national economies. According to this perspective, the corporation is merely a convenient legal fiction which may help structure these interactions.

Stakeholder Theory

Freeman's (1984) seminal book on stakeholder theory posits that successful managers must systematically attend to the interests of various stakeholder groups. This "enlightened self-interest" position has been expanded upon by others (Donaldson and Preston 1995 and Evan and Freeman 1983) who believe that the interests of stakeholders have intrinsic worth irrespective of whether these advance the interests of shareholders. Under this perspective, the success of a corporation is not merely an end in itself but should also be seen as providing a vehicle for advancing the interests of stakeholders other than shareholders. Boatright (1994) suggests that the shareholder-management relation is not unique because the fiduciary duties of officers and directors are owed not to shareholders but to the corporation as an entity with interests of its own, which can, on occasion, conflict with those of shareholders. Further, "corporations have some fiduciary duties to other constituencies, such as creditors (to remain solvent so as to repay debts) and to employees (in the management of a pension fund)" (403).

Employee Governance

McDonnell (2002, 13) supports employee governance as a way to ensure that corporations are governed in part in the interests of employees. He identifies three approaches: employee share ownership; electing employee representatives to the board of directors; and employee involvement in quality circles, work councils, or the like. He believes that employee involvement in corporate governance can work as a potentially powerful additional mechanism to control managerial opportunism and to direct the corporation towards greater efficiency. Boatright (2004, 16) addresses whether employee governance conflicts with shareholder governance and concludes these two forms of governance are not conflicting. Instead, they are "complementary and mutually beneficial." The strength of shared governance is that "the two groups make decisions on matters where they have superior information and an incentive to increase the value of the firm." He also believes that their respective forms of governance support the needs of each group "to protect their firm-specific assets and to satisfy their risk preferences." Historically, the shareholder model of corporate governance has been followed in the U.S. and UK whereas German companies adhere to a stakeholder model. The latter considers corporate governance to be more than simply the relationship between the firm and its capital providers. On this view, corporate governance also implicates how the various constituencies that define the entity serve, and are served by, the corporation.

Shareholder model in the U.S.

The following brief summary of how the shareholder system operates in the U.S.

The Objective and Conduct of the Corporation

The American Law Institute's *Principles of Corporate Governance* (The Principles) (1994) take as a basic proposition that a business corporation through its activities of producing and distributing goods and services and making investments, should have as its objective the conduct of such activities with a view to enhancing corporate profit and shareholder gain. This economic objective should be carried out with a long-term perspective that generally depends on meeting the fair expectations of constituency groups such as employees, customers, suppliers, and members of the communities in which the corporation operates. Thus, the "responsible maintenance of these interdependencies" gains recognition only within the larger context of enhancing long-term value for the equity owners. Given the impracticality of direct shareholder review and the constraints on the efficacy of financial markets, the effectiveness of board operations and how committees carry out independent responsibilities take on greater importance.

Role of Senior Executives

In the U.S., while the role of top manager typically is vested by the board in the CEO, the Principles permit that function to be vested in a group of senior executives. For example, in Germany, the "management board" operates collectively to carry out the responsibilities of top management. A "supervisory board" oversees their efforts primarily on behalf of the shareholders and employees. While the functioning of this two-tier system will be explained later on, it is important to emphasize now that nothing prevents U.S. corporations from considering such a structure.

Functions and Powers of the Board of Directors

The primary function of the board of directors is the selection of the CEO and concurrence with the CEO's selection of the company's top management team. This includes monitoring the performance of the CEO, determining compensation, and reviewing succession planning. Other important responsibilities include: to select and recommend to shareholders for election an appropriate slate of candidates for the board of directors; to evaluate board processes and performance; to review the adequacy of systems to comply with all applicable laws/regulations; and to review and, where appropriate, approve major changes in and the selection of appropriate auditing and accounting principles to be used in the preparation of the corporation's financial statements. In practice, this function often will be delegated to the audit committee.

Committees that Enhance Governance

Typically, there are three main committees that support the work of the board of directors of a publicly-owned corporation including the audit committee, nominating committee, and the compensation committee. While this paper focuses on the work of the audit committee because of its critical role in ensuring the reliability of financial statements, it is important to point out that the nominating committee of the board in many U.S. companies has assumed the responsibility of reporting on corporate governance practices.[2]

According to the Principles (110-113), the independence of board decisions is enhanced by having a majority of the directors "free of any significant relationship with the corporation's senior executives." These outside directors should not have any "close personal relationships with senior executives and no "consulting or other relationships with the corporation that provide a significant portion of the director's income." The audit committee should be composed of at least three independent members "who are neither employed by the corporation nor were so employed within the previous two years."

Audit Committee

The functions and powers of the audit committee relate to its relationship with the external auditors and include (ALI, 115-120):

- recommend the firm to be employed as the corporation's external auditor and review the proposed discharge of any such firm,
- review the external auditor's compensation, the proposed terms of its engagement, and its independence,
- serve as a communication link between the external auditor and the board,
- review the corporation's annual financial statements, the results of the external audit, the auditor's report, and management's responses to audit recommendations,
- review any significant disputes between management and the external auditor that arose in connection with the preparation of those financial statements,
- consider, in consultation with the external auditor, the adequacy of the corporation's internal controls,
- consider major changes and other major questions of choice respecting the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements, when presented by the external auditor, a principal senior executive, or otherwise.

Sarbanes-Oxley Act of 2002

The following discussion emphasizes the major provisions of the Act that affect public companies. These can be divided into three groups based on whether they affect the responsibilities of top corporate officials or board members, the audit committee, or the preparation of financial reports.

Top Corporate Officials and Board Members

The CEO and CFO must certify in a statement that accompanies the audit report the appropriateness of the financial statements and disclosures and that they fairly present, in all material respects, the operations and financial condition of the company. A violation of this provision must be knowing and intentional to give rise to liability. Management should make an assessment of internal controls and disclosed its

[2] See, for example, the Governance Principles issued by General Electric's Nominating and Corporate Governance Committee www.ge.com/en/spotlight/commitment/governance_principles.html.

findings in an "internal control report" that the auditors will review. It is unlawful for any officer or director of a public company to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading. If a company is required to prepare a restatement due to "material noncompliance" with financial reporting requirements, the CEO and CFO must reimburse the company "for any bonus or other incentive-based or equity-based compensation received" during the 12 months following the issuance of the non-compliant document and "any profits realized from the sale of securities" of the company during that period. Officers and directors are prohibited from buying or selling company stock during blackout periods when employee sales and purchases are restricted. Any profits resulting from such sales can be recovered from the offending party by the company. If the company fails to bring a lawsuit or prosecute diligently, a lawsuit to recover the profit may be instituted by an owner of company securities. [It is worth noting that Enron employees were locked-out during a ten day period when the stock price was declining about $10 per share.]

Generally, it is unlawful for a public company to extend credit to any director or executive officer. [The CEOs at WorldCom, Tyco and Adelphia abused their authority in granting themselves hundreds of millions of dollars of loans without the approval of the board of directors.]

Audit Committee

Each member of the audit committee of the board must be independent of the public company defined as: "Not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer or any of its subsidiaries."

The audit committee is required to be directly responsible for the appointment, compensation and oversight of the auditors including resolution of disagreements between management and the auditors regarding financial reporting, and the auditors must report such disagreements directly to the audit committee. The audit committee should establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters and any confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters.

The board must notify the SEC of pending investigations involving potential violations of the securities laws, and coordinate its investigation with the SEC Division of Enforcement.

Financial Reporting

Each report that is required to be prepared in accordance with GAAP must "reflect all material correcting adjustments" that have been identified by the auditors. Each annual and quarterly financial report must disclose all material off-balance sheet transactions and other relationships with unconsolidated entities (related parties) that may have a material current or future effect on the financial condition of the issuer. [By some accounts Enron created more than 3,000 special purpose entities that were kept off the books of the company to hide debt and inflate profits.] While it may be too early to know if the Act will positively influence corporate governance in the U.S., a survey of 310 senior executives around the world conducted by the Economist Intelligence Unit and sponsored by KPMG (2003) indicates strong support for recent U.S. efforts to improve corporate governance.

	Germany	U.K.	U.S.
Which of the following countries has done most to improve standards of corporate governance over the past year?	7%	16%	71%
Which of the following countries has the farthest to go in improving standards of corporate governance?	7%	6%	23%

One possible interpretation of the results is that corporate governance systems in the UK and Germany began to strengthen even before the Sarbanes-Oxley Act was adopted and now the U.S. is playing catch-up.

Recent changes in corporate governance in the UK

Given the similarities in legal system between the U.S. and UK[3], this section will focus primarily on recent changes in the UK that might be adopted in the U.S.

The Cadbury Committee recommendations for disclosure of directors' emoluments led to the Greenbury Report in 1995 that established extensive disclosures on directors' remuneration to be found in the annual reports of UK companies. The Hempel Report in 1998 confirmed much of the work of Cadbury and Greenbury and it led to *The Combined Code on Corporate Governance* (Code) (2003). Compliance with this Code is a Stock Exchange requirement.

[3] For a discussion of these issues, see Christopher Nobes and Robert Parker, *Comparative International Accounting* (7th ed. 2002) and Clare Roberts, Pauline Weetman and Paul Gordon, *International Financial Accounting: A Comparative Approach* (2nd ed. 2002).

The Code requires that the annual report of a major UK company should contain a report from the Remuneration Committee, a statement on Corporate Governance, a statement on internal controls, a statement on the going concern status of the company, and a statement of the directors' responsibilities. The following is a list of requirements that differ from those in effect enacted in the U.S.

The chair of the board should meet with non-executive directors without the executives present.

Led by the senior independent director, the non-executive directors should meet without the chair present at least annually to appraise her performance and on such other occasions as are deemed appropriate. The roles of the chair and CEO should be separated. The division of responsibilities should be clearly established, set out in writing, and agreed by the board. At least half of the board, excluding the chair, should comprise non-executive directors determined by the board to be independent.

The board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns that have not been alleviated by top company officials.

Shareholders should be invited specifically to approve all new long-term incentive arrangements and significant changes to existing schemes unless prohibited by the Listing Rules.

The Listing Rules require a statement to be included in the annual report relating to compliance with the Code. Some of the important provisions follow.

- An explanation from the directors of their responsibility for preparing the accounts and a statement by them about their reporting responsibilities;
- A statement from the directors that the business is a going concern, with supporting assumptions or qualifications as necessary;
- A report that the board has conducted a review of the effectiveness of the group's system of internal controls;
- A separate section describing the work of the audit committee in discharging its responsibilities;
- Where the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an external auditor, a statement of the audit committee explaining the recommendation and the reasons why the board has taken a different position; and
- Of particular note is the requirement that UK directors have responsibilities that, in the U.S., are the sole purview of management including the preparation of financial statements and review of internal controls. Also, the Listing Rules require a Corporate Governance Report to be included in the annual report and there must be a "Statement of Compliance" whether the company meets the provisions of the Combined Code on Corporate Governance.

Stakeholder model in Germany

Three characteristics of the German stakeholder model of corporate governance that distinguish it from the U.S. model are: (1) the pattern of ownership and control; (2) a
two-tier board of directors' system; and (3) employee codetermination.

Ownership and Control

Jackson et al. (2004, 6) point out that corporate ownership and control in Germany is marked by three features including high ownership concentration, the predominance of strategic ownership ties, and the importance of banks in external financing and monitoring.

Ownership Concentration

Ownership concentration is high in Germany and minority shareholders play a limited role. According to data for the year 1999 released by The *Bundesbank*, non-financial corporations held 29.3 percent of the equities, banks and insurance companies owned 22.5 percent individuals, investment firms and others (13.6%), individuals (17.5%), foreigners (16.0 percent), and the government (1.0 percent).

Ownership is closely related to strategic interests of other organizations. Pyramidal conglomerate holding companies (*Konzern)* and dense-bank industry networks are both important. The ownership stakes reflect strong involvement with particular enterprises, unlike the more diversified and liquid trading of institutional investors (Jackson et al., 7). German universal banks play an integral role in monitoring corporate performance. Banks are closely linked to business through credit, large equity stakes, the exercise of proxy votes, and supervisory board representation (Edwards and Fischer 1994). The role of banks and the mixing of debt and equity ownership differs from the U.S. where, historically, banks have been prohibited from owning large stakes in corporations as a result of the passage of the Glass-Steagall Act that grew out of the Depression-era notion that it was best to separate the roles of banker and broker. Even though Glass-Steagall was repealed by Congress in 1999 ending restrictions on direct ownership of U.S. equity by banks, the differences in pattern of ownership between the U.S. and Germany persist.

Two-tier Board

A distinguishing characteristic of German corporate governance is the two-tier board of directors system. The Management Board (*Vorstand)* is charged with managing the enterprise for the benefit of a wide array of interests. The Supervisory Board (*Aufsichtsrat)* represents the shareholders and employees. This board consists of non-management members and it appoints, supervises and advises the members of the Management Board on policy but does not participate in the company's day-to-day management. In relying on a two-tier structure, Germany has formalized the distinction between managing the company and supervising the management of the company. According to Goergen et al. (17), the management board is legally entrenched with terms typically lasting for five years. Only the supervisory board can remove the members of the management board. The supervisory board members also are rooted in to their responsibilities with contracts up to five years and options to renew. Therefore, a new controlling shareholder might have to wait to replace board members.

Codetermination

Germany has a strong employee codetermination program. Work councils have extensive participation rights and employees are represented in the corporate boardroom. Typically, employee representatives (either company employees or union representatives chosen to represent employees) make up half of the representatives of the Supervisory Board. Consequently, these employees do not meet either the SEC's or the New York Stock Exchange definition of "independent directors" because of their material relationship with the company.

Stakeholder Monitoring

The German system of corporate governance builds on insider relationships while the U.S. system relies on external participation. Schmidt (2003, 9-11) identifies three groups of powerful and influential stakeholders on the supervisory board. The first are shareholders that own large blocks of stock (25 percent or greater) that give it the power to veto important decisions. The most likely "blockholder" is another business enterprise. The second group of blockholders is wealthy families, often those of the company's founder. The third are financial institutions, especially the big commercial banks such as Deutsche Bank and Dresdner Bank.

Role of Banks

Shleifer and Vishny (1997) argue that large creditors fulfill a role similar to large shareholders because these creditors have large investments in the firm and therefore a strong incentive to monitor the firm's management.

In Germany, the banks owning shares in listed firms are frequently also the main bank (*Hausbank*) of these firms. Where there is a danger of bankruptcy and the bank faces a refinancing demand by the firm, its creditor claims may encourage the bank to make the firm file for liquidation whereas the equity claims may lead the bank to revolve its loans. These conflict of interest decisions are made more difficult when intricate control-based networks (which may also comprise banks) exist such that banks decision may be influenced by the objectives of the network/ conglomerate (Goergen 19).

When a bank also is a shareholder of the borrower, this information helps to determine whether the need for external funds is due to temporary illiquidity or bad firm management. A possible downside is that banks may emphasize their creditor relationship with the borrower to the detriment of shareholders. For example, a bank might encourage borrowers to assume more debt, pay higher interests rates on their debt, or undertake less risky projects than would be optimal from the point of view of shareholders.

Banks in Germany frequently exert control by directly participating in the management of their borrowers through representation on a borrower's supervisory board. One advantage of bank involvement is that it mitigates problems stemming from information asymmetries. Through the extensive information gained from their lending activities, banks gain valuable information that might not be available to other stakeholders. Unfortunately, there is no guarantee that a company will disclose everything to the bank and that the bank will use the information wisely as the Parmalat scandal demonstrates. The loss to banks that loaned money to Parmalat is in the billions including $647 million of total exposure for Bank of America. While banks were lining up to do business with the company, some investment bankers raised questions about the size of Parmalat's debt.[4]

Codes of Best Practice

The Baums Government Panel urged the federal government in 2000 to begin drafting a "Transparency and Disclosure Act" that would include tightening the fiduciary duties of the management and supervisory board members by extending their civil liability from the current standard of "willful intent" (similar to fraud) to also include "gross negligence" (constructive fraud or "reckless disregard" in the U.S.). Furthermore, the number of external supervisory board positions that a supervisory board member could hold would be limited to five in order to strengthen to independence of supervisory board members.

The Panel also recommends improving transparency standards, such as for management stock option plans and for the shareholdings of members of the management and supervisory boards, as well as increasing the duties of the management board to provide information to stockholders.

On February 26, 2002, the German Justice Ministry issued the *Combined Code on Corporate*

[4] "The Milk Just Keeps on Spilling," *Business Week*, January 26, 2004, pages 54-58.

Governance (2003) that establishes recommendations which go beyond legal regulations. Under the "comply or explain" principle, both the Supervisory Board and the Management Board must declare annually whether these recommendations have been met and the disclosure must be made available to the shareholders. The Management Board must state in the notes to the financial statements that the compliance statement has been given and made available to the shareholders (Institut der Wirtschaftsprufer 2003). While German companies are not required to have audit committees, the Code does recommend that the Supervisory Board should set up an audit committee.

Evolutionary Change

Recent trends indicate an increased reliance by German companies on equity financing through both domestic and international capital markets as a result of increased cross-border merger and acquisition activity. The resulting broadening of the shareholder base in German companies has created a subtle shift towards an equity culture. Privatization of state-held ownership interests in companies such as Deutsche Telekom and the maturing of family-owned companies' need for capital have led to growth in the number of shareholders (both domestic and foreign) in German companies from 3.2 million at the end of the 1980s to about twice that amount today (Siebert 2004, 23). This increase in shareholding and the participation by individuals directly or through intermediaries such as pension funds is expected to continue in the future. The result may be to exert financial market-type pressures on the corporate governance system creating conflicts between the interests of public investors and German cultural traditions such as collectivism in decision-making and uncertainty avoidance.

While one might expect Germany's emphasis on employee rights in corporate governance to increase agency costs, Jackson et. al. (41) argue this might not be the case "because work councils may work in coalition to promote greater accountability and thereby actually decrease agency costs by monitoring managerial pay, fighting for transparency,…and also siding with shareholders in corporate restructuring."

Differences in corporate governance systems

The Sarbanes-Oxley Act should be viewed as a first step in bringing about improved corporate governance in the U.S. Given the movement toward internationalization of the accounting profession as evidenced by the recent adoption of a requirement in the European Union that companies doing business in the EU must use international accounting standards effective in 2005, the time is right to turn our attention to the convergence of corporate governance systems.

Compliance with Sarbanes-Oxley outside the U.S.

The SEC eliminated a potential conflict for German companies in complying with the Sarbanes-Oxley Act by allowing non-management employees to serve as audit committee members. SEC Commissioner Paul S. Atkins, in a speech to the 2nd German Corporate Governance Code Conference on June 26, 2003, noted that while these employees would often not meet the SEC's definition of independence, the Commission "has no interest in creating conflicts with local law, especially when these employees actually represent non-management interests."

To facilitate compliance with the Act by non-U.S. issuers, the SEC made two accommodations regarding the relationship between the audit committee and external auditor.

One is to allow shareholders to select or ratify the selection of auditors and the other is allowing alternative structures such as boards of auditors to perform auditor oversight functions where such structures are provided for under local law. This remainder of this section outlines additional steps that are needed to further the goal of converging corporate governance systems around the world. These include:
(1) Ensure compliance with the "best practices" of corporate governance;
(2) Enhance shareholder democracy;
(3) Foster employee participation in a more representative and effective governance process.

Compliance with Best Practices

The compliance report required by the Listing Rules in the UK ensures that constituency groups are informed how the principles of the Combined Code on Corporate Governance have been applied. The following provisions of the Sarbanes-Oxley Act should be addressed in a compliance report that would be included in the annual filing of financial statements with the SEC.

- *Certification of the financial statements.* This would be an informational item reminding the public of the responsibilities of top management for the accuracy and reliability of the financial statements.
- *Management's report on internal controls.* This also is an informational item since the report appears elsewhere in the annual filing.
- *Audit committee responsibilities.* A description of these responsibilities should include the independence of committee members, its oversight of the financial reporting process, and any important communications with the external auditors that reflect management's receptivity to recommended changes in the accounting principles and financial reporting practices.
- Management Remuneration. The following issues should be addressed in the compliance report or

in a separate report made by the compensation committee.
- Whether there have been any loans to top executives during the year; and any other form of compensation or business relationship with top executives that might qualify as a related party transaction.

Shareholder Democracy

The following recommendations should help to enhance shareholder interests by strengthening governance systems.
- Separate out the dual roles of chair of the board and CEO. This feature has been adopted in the UK and seems to be an essential requirement of promoting independent oversight.
- Limit the number of boards on which a person can serve. Given the increased responsibility of boards of directors and, especially, audit committees, an individual should not serve on more than five boards.
- Recognize the right of stockholders to nominate directors. The SEC proposal makes it easier for shareholders who are dissatisfied to nominate their own candidates but it does not recognize it as a basic right – a right that should exist by virtue of the shareholders ownership interest in the corporation.
- Give shareholders a more direct role in board oversight. Shareholder representatives should be given the right to become actively involved in overseeing how the company is run by being allocated a number of seats on the supervisory board that would appoint the executive board as explained below.

Employee Participation in Corporate Governance

A two-tier board system should be established, such as the one in Germany, to facilitate employee participation in decision-making, help to manage the information flow, and improve board efficiency.

Supervisory Board

The supervisory board should include an equal number of shareholder and employee representatives. A minority of the total membership should be divided equally between insiders and outsiders. The primary responsibilities of the board should be to:
- Appoint and dismiss members of the management board;
- Determine management remuneration;
- Review and approve the compliance report;
- Review and approve accounting principles and the financial statements;
- Work with the external auditors on matters relating to the financial reports; and
- Establish committees as needed to carry out these and other responsibilities including the nominating committee, remuneration committee, audit committee, and employee development and retirement committee.

Management Board

Representation on the management board should consist of members of top management, including the CEO, CFO, and chief operating officer. Other members should be independent of management. An independent member of the board should serve as its chair. The primary responsibilities of the management board would include:
- Prepare the financial statements and management report;
- Monitor the internal control system including risk assessment;
- Report to the supervisory board on operational strategies and major questions about corporate planning, financial and investment activities, and human resource issues;
- Report to the supervisory board the profitability of the business particularly the return on equity;
- Report to the supervisory board on business development.

Concluding comments

The EU experience with failures at BCCI and Parmalat brought to light weaknesses in member countries' corporate governance systems. The changes that have been implemented in countries such as Germany and the UK are, for the most part, consistent with requirements of the Sarbanes-Oxley Act. Also, the SEC has adopted an accommodating stance with non-U.S. firms enabling them to apply for exemptions because of conflicts with local law. Still, the U.S. has much to learn from corporate governance systems followed in the UK and Germany. Shareholders are concerned about good corporate governance because of its connection to their expected returns. Employees consider employee governance to be an essential component of employment security. Management's goal should be to develop the systems that enhance employee participation and contribute toward improving long-term share value.

A dual board approach to corporate governance adds needed checks and balances to help ensure the integrity of the process and monitor whether the corporation pursues its strategic objectives in an ethical manner. A corporate governance system based on these principles would build on the positive changes already made since Sarbanes-Oxley, and it better represents the interests of those who provide the capital and labor inputs so essential to success.

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