Boards of Directors Models and Role in Corporate Governance

UDC: 005.742:005.25

Mr Jelena Nikolić[1], Mr Jelena Erić[2]
[1]*Faculty of Economics, University in Kragujevac*
[2] *Faculty of Economics, University in Kragujevac*

The main role of the board of directors as an internal corporate governance mechanism is to define the strategic orientation of a corporation, to provide monitoring and control of management in order to satisfy the owners' and key stakeholder's interests. Generally, there are two basic types of boards: one-tier and two-tier boards. The composition and leadership structure are different depending on the type of board. These factors determine the way the board functions.

1. Introduction

In the conditions of separation of ownership and control, the owners' interests differ from those of the managers, hence the owners do not have an adequate control over the managers operations. If both parties wish to maximize the benefit, it is assumed that the managers will not always act in line with the owners' interests. A potential conflict of interest between the owner and the manager becomes an important issue in the corporate governance domain [9].

A balance between the owners' and the managers' interests can be achieved by implementing various mechanisms of corporate governance. Acting as internal corporate governance mechanisms, boards of directors form a link between those who have the capital, i.e., the owners and those who employ this capital to create value, i.e., the managers [12].

The basic role of the board of directors is to ensure that managers manage in the owners' best interest, not in theirs. The composition, the leadreship structure and the activities of boards of directors differ depending on the type of these boards.

The subject of this research is the analysis of the role and importance of boards of directors in the context of one-tier and two-tier board of directors implementation. The goal of the research is to implement a comparative analysis of structural characteristics and the manner in which one-tier and two-tier boards of directors function, to point out to their basic advantages, weaknesses and potentail improvements.

2. Role and importance of boards of directors as internal corporate governance mechanisms

According to the OECD, corporate governance is a system by which corporations are guided and controlled and represents a set of relations between the board of directors, the management, and the shareholders [13]. Strictly speaking, corporate governance can be understood as a set of internal arrangements that define relationsips between the owner and the manager.

The World Bank defines corporate governance from two different perspectives. From the viewpoint of the social perspective, corporate governance is oriented towards company survival, growth and development simultaneously taking the responsibility for corporate control. From the corporate perspective, however, what is important is the relations between the owner, the manager and other stakeholders (employees, customers, suppliers, competitors, investors and the society). Corporate governance is seen as a set of relations between different participants in determining the company orientation and performance [12].

Corporate governance is engaged in achieving the goals that are in the company's interest, controlling the results achieved and in the management accountability to well informed and actively involved owners [9]. The major concern is how to make managers manage in the interest of the owners and not exclusively in their own interest.

To find the answer to this quaestion it is necessary that corporate governance mechanisms be analysed. The role of the corporate governance mechanisms is to balance the owners' interests with those of the managers. Since managers are prone to maximizing their own interests that need not always coincide with the owners' interests, it is necessary that the owners should be in a position to enquire into and control the managers' activities.

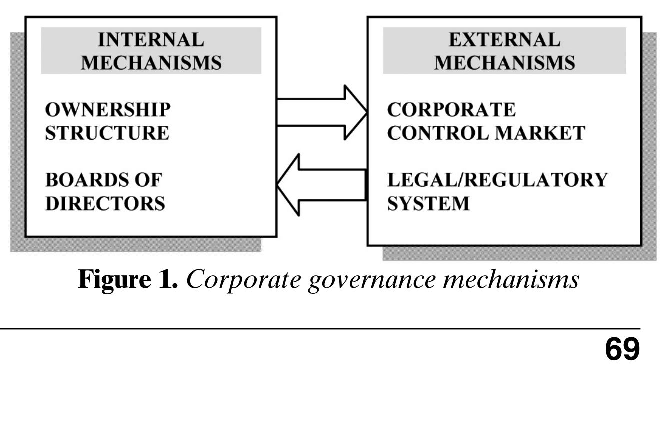

Figure 1. *Corporate governance mechanisms*

The major purpose of the corporate governance mechanisms is to provide the balance and check the management behaviour. Two types of mechanisms are found in literature: internal and external. The internal mechanisms include the ownership structure and boards of directors, wheras the corporate control market and the legal system make up the external mechanisms [2]. Internal and external mechanisms are interdependent, and the ownership structure as an internal mechanism has an impact upon the functioning of the board of directors and external mechnaisms. If ownership is dispersed, the role of the corporate control market as an external factor becomes most important. In case the number of owners is smaller, manager control is the responsibility of the board of directors as an internal mechanism [2].

The board of directors is a management body appointed by the shareholders' assembly, formed by the owners, to manage the company. Its role is to ensure a long-term development of the company, bringing different interests into balance [9]. As seen in Figure 2, the board of directors makes a link between those who own the capital, i.e., the owners, and those that employ that capital to create value, i.e., competent managers. This is actually a link between a small, powerful group that leads the company, and a large, varied group whose job is to assess whether the company is successful in business doing [12]. The importance of boards of directors is recognized in that they have to achieve two opposing, however, complementary goals: profitability and social responsibility of the company.

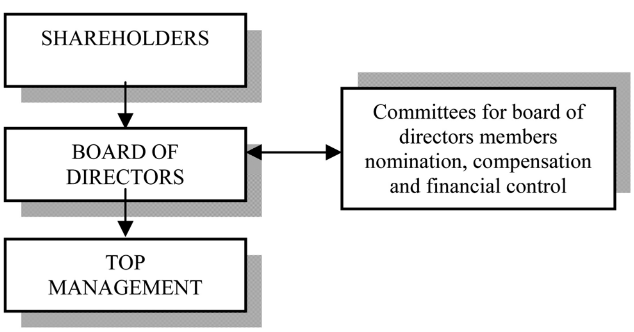

Figure 2. *Corporate governance structure*

The basic role of the board of directors is to ensure a strategic management of the company, appoint and monitor the management and take adequate responsibility as regards the owners [1]. Three key roles of the board of directors are perceived in the given context: the role of support, the role of control, and the strategic role [17]. The role of support refers to company representation, building good reputation, establishing relations with stakeholders and councel provision for top managers. The role of control means appointing, dismissal and assessing managers, i.e., supervision and control over the managers' activities in order that the owner's interests be duly protected. The strategic role refers to the problems of strategic positioning of the company in a competitive environment. Burns (2009) highlights an increasing importance of the strategic role of the board of directors, insisting that boards of directors should play an active role in the strategy defining and implementation processes [3].

The role of boards of directors in the transition conditions, the condition this country currently is too, does not mean only the maximization of short-term results and an assessment of the managers' work; it is primarily reflected in the strategic accountability of the boards of directors. The task of the board of directors is to make hands-on decisions, define a long-term strategy of the company, appoint, dismiss, control and evaluate the managers' performance.

The composition and functioning of boards of directors differ in dependence on the type of the board of directors. Generally, there are two basic types of boards of directors: one-tier and two-tier boards of directors [11]. In order that the functioning and the performance of boards of directors be improved, it is necessary that a comparative analysis should be conducted of basic characteristics, differences and similarities, advantages and disadvantages of one-tier boards of directors, on one hand, and two-tier boards of directors, on the other.

3. One-tier board of directors model

The Anglo-Saxon countries, the U.S.A., Cnada, Great Britain, Australia, and New Zealand employ the model of one-tier board of directors. A one-tier board of directors is in charge of the following:

- defines the corporate goals, strategy, and plan;
- nominates, selects and evaluates the CEO;
- proposes prospective members of the board of directors;
- evaluates the work of the board of directors;
- sets the managers' compensations; sets financial goals and performs the financial control of the company [12].

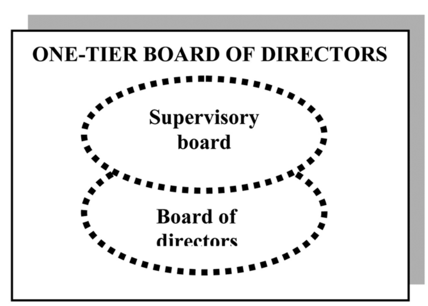

Figure 3. *One-tier board of directors model*

A conclusion can be drawn on the basis of Figure 3 that the members of the board of directors are also members of the supervisory board, which means that the same individuals are responsible for both the management and the supervision. There are two types of one-tier board of directors:

- The model of executive board of directors, most frequently employed in family owned companies, when the family members are members of both supervisory board and the board of directors, simultaneously;
- The model of non-executive board of directors, dominant in the U.S.A., where the majority of members of the board of directors are independent [8].

The basic flaw of the model of one-tier board of directors is an explicit risk of a high concentration of power in the hands of the CEO, as supervisory boards are exclusively administrative in character. To overcome this flaw, boards of directors appoint a leader from among the independent members of the board of directors. He chairs the meetings of the board of directors in the situations when one and the same person holds the position of the president and a CEO (*chief executive officer*).

1. *The composition of boards of directors*, defined through the ratio of the numbers of internal and external members indicates the extent to which boards of directors are independent [17]. The inside members (*inside directors*) are the top management elected into the board of directors because they are an important source of information on the company's daily operations. The outside members (*outside directors*) have specific knowledge and competencies, offer useful advice to the company, however, they can be top managers in other companies at the same moment.

A general classification into inside and outside members has to be brought into accord with different terminologies certain countries adopted: in Canada, such classification distinguishes between connected and non-connected members, in the U.S.A., Australia, New Zealand the members are classed as independent and dependent, while in Great Britain members are classed as executive or non-executive. The board of directors should include a large number of outside, non-connected members independent of the management and with no other interests or relations that may affect their capability of acting in the company's best interests. In case the structure of one-tier boards of directors is dominated by inside, executive members, this may result into a conflict of interests between the management and the shareholders [9]. The one-tier boards of directors with a higher percentage of executive members threaten the independence of the board of directors and the company performances too. This means that a positive correlaton can be created between the composition of the board of directors with a large number of independent, outside members and the company's financial performances. In the given contex, one-tier boards of directors should include a larger number of outside, non-executive members, for the folowing reasons [11]:

- Because of their experience and knowledge;
- Because of the personal contacts through which they can provide external resources;
- Because they are independent from the CEO;
- Only the non-executive members can ensure an adequate review and balance as regards the management.

The empiric research results, however, are often contradictory and ambiguous, hence it is difficult to draw relevant conclusions on the impact of the board of directors composition upon the company's financial performance. A meta-study on boards of directors has not been able to reveal a precise relationship between the changes in the board of directors composition and the financial performance achieved [6]. This means that there is no significant correlation between the independence of the board members and the company's performance. No general conclusions can be drawn in terms of defining their relationship.

2. *The leadership structure of boards of directors*, described as a relationship between the CEO and the president of the board of directors, has an impact upon the formal autonomy of boards of directors. One-tier board of directors can have separate positions of CEO and the president of the board of directors. Similarly, a duality of the CEO and the president of the board of directors is allowed [11]. In 93% largest American companies the president of the board of directors is also a CEO, which means that he/she is in a position to assess his/her own business performance [12].

The autonomy of the board of directors is questioned when the role of the CEO as the president of the board is dual. The duality of positions results in a diffusion of the roles of the board of directors and a violation of the control role exerted by the non-executive members. Maassen lists **five** major arguments in favour of the separation of the roles of the CEO and the president of the board [11]:

- Implementation of the dual structure may result in the fall in the share prices if investors understand it as a negative signal. The reaction on the share market will be negative if the CEO has, at a position of the president of the board of directors, made a decision in favour of his personal interests and endan-

gered the interest of the company in general;
- Implementation of the dual structure may result in an inadequate review of the executive members' shares, whereby the company may be exposed to risk;
- The company profitability improves considerably when the president of the board of directors is independent.

A general attitude the literature reveals is that the president of the board of directors should be independent and that this independence can help ensure the balance in the board.

The empiric research results further show that the bankrupt companies were mainly characterised by a dual leadership structure [18]. Actually, the separated responsibilities of the president and the CEO result in a positive market reaction as well as in high company performances. The companies in which these two functions are separated achieve higher performance in comparison with the companies that implement the duality of the presidential and the CEO positions and appoint an independent member to hold the role of an informal vice-president [4].

To improve the performance of one-tier boards of directors it is necessary that attention should be paid to certain possible cases of *abuses the members of one-tier boards of directors may commit*. They may:
- Reduce the value for the owners through issuing shares at discount value or through selling the property to friends at a more favourable price than real one;
- Derive some personal benefits;
- Control autonomous consultants through extra perks or through negotiations on the compensation they are to receive;
- Control and affect the work of auditors through the appointment of auditors and setting the financial compensation for them;
- Tamper with financial statements;
- Issue biased reports on their own activities and control the activities of the shareholders' assembly;
- Hold informal meetings with influential people that support the work of the board of directors.

3. *The audit committees* of one-tier boards of directors are corporate governance mechanisms that protect the shareholders' interests and are responsible for the supervision of the management. The members of the audit committee are the non-executive members in charge of auditing, internal control and financial reporting. The audit committees that consist entirely of non-executive members support the independence of boards of directors and improve the implementation of other mechanisms meant to protect shareholdres' interests.

4. Two-tier board of directors model

The continental European countries (Germany, Finland, Poland, Slovenia and the Netherlands) prefer the model of a two-tier board of directors that consists of a supervisory board and a board of directors.

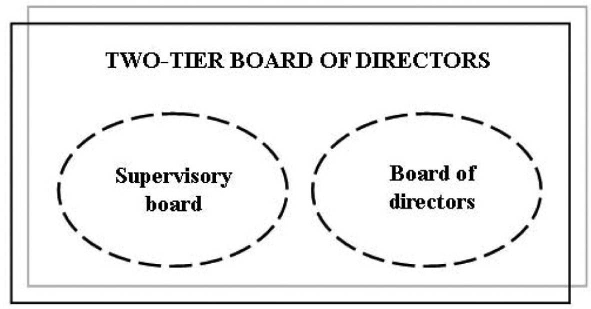

Figure 4. *Two-tier board of directors model*

The supervisory board consists exclusively of outside members who advocate the interests of the employees, the state, or the institutional investors. The members of supervisory boards can also be financial institutions and they are the basic mechanism of control. The task of the supervisory board is to monitor the work of the managers and make decisions on a long-term development of the company. The board of directors consists of executive members, that is, the management of the company with no authority to participate in the work of the supervisory board [8]. The members of the board of directors cannot simultaneously be members of supervisory board. The board of directors and the supervisory board meet several times a year, exchange relevant information and find mutual solutions.

The basic advantage of two-tier boards of directors is the balance between the powers of the board of directors, on one hand, and the supervisory board, on the other, that is, between the management and the control processes. The key characteristics of two-tier board of directors are the following [11]:
- The management function is separated from the control function;
- The allocation of responsibility between the supervisory board and the board of directors is clear;
- The supervisory body is not under the direct influence of the management authority.

1. *The composition of two-tier boards of directors* includes executive and non-executive members whose roles and responsibilities are different. The executive members exercise their roles in the board of directors, whereas the supervisory board is composed of non-executive members exclusively [8]. In two-tier boards of directors, the rights and responsibilities of executive members differ from those of non-executive members. The task of the board of directors is to initiate and implement strategic decisions, whereas the supervisory board controls the members of the board of directors. Supervisory boards are absolutely independent in conducting control of the work of the management as long as there is no overalpping of membership in the supervisory board and the board of directors.

In the developed countries, the empirical research results reveal a strong impact of the composition and size of two-tier boards of directors upon the company performances in the conditions of financial crisis and unexpected changes on the markets [15].

2. The leadership structure of the two-tier boards of directors is specific, since the duality of the positions of the CEO and the chair of the board of directors is not possible. Executive members cannot chair the supervisory board, that is, the CEO cannot simultaneously be in a position of the president of the board of directors. Contrary to the dual leadership structure the implementation of which results in the concentration of power, the independent leadership structure of the two-tier board of directors has a favourable impact upon the agency problem reduction [11].

The president of the board of directors' leadership skills, knowledge and competencies are an important effectiveness factor of the board as well as of a successful company performance [10].

***3.** The committees of the two-tier boards of directors* consist of executive and non-executive members, due to which the roles of the committees in the two-tier boards of directors can differ from those of the one-tier boards of directors.

The most important differences between the models of two-tier and one-tier boards of directors are presented in Table 1. Modern literature generally recommends the implementation of the two-tier boards of directors, where the supervisory board and the board of directors are separated. Such companies are believed to be characterised by a higher strategic, not only financial accountability of boards of directors, which menas the maximization of short-term results and the assessment of managers' performance. Both models, however, can serve as basis for creating a sound corporate governance system, depending on the institutional framework in which the companies operate.

ONE-TIER BOARDS OF DIRECTORS	TWO-TIER BOARDS OF DIRECTORS
Dispersion of ownershi and control	**Concentration of ownership**
Separation of ownership from control	**Integrating ownership and control**
Poor incentive for investors to be involved in the control process	**Control from the part of banks, partners and employees**
Climate in which hostile takeovers are not unusual	**Aversion towards hostile takeovers which are rather rare**
Other stakeholders' interests are not taken into account	**Other stakeholders' interests are taken into account**
Investor engagement is regulated by law and is related to formulating long-term strategies of the company	**Investor engagement is allowed only in case of obvious financial failures**
Takeovers may lead to forming monopoly	**Insider system may lead to secret agreements**

Table 1. *Differences between the one-tier and two-tier board of directors models*

In addition to the models of one-tier and two-tier board of directors, a specific *board of directors model in Japan* deserves to be paid attention to. Important members of boards of directors in Japan are the banks and they play an important role in financing and functioning of large corporations and offer useful financial advice. A majority of Japanese companies are organized into business groups, the so-called *keiretsu*. Business groups are the groups of companies operating in different markets under a unified control [2]. The members of the group are companies of various sizes , usually large corporations with a dominant role in the business group. In joining forces they tend to form and internal capital market within the group to finance their members in the conditions of crisis, or an internal labour market from which a selection of personnel could be made on the basis of their performance [16].

A specific feature of boards of directors in Japan is that they have a larger number of members in comparison with one-tier and two-tier boards of directors and that they are composed largely from internal management. The basic control mechanism are actually the company or the relevant buisiness group members themselves.

Each of the abovementioned models of boards of directors has its own advantages and disadvantages. Table 2, the Appendix to this papper, presents an international comparison of features, functions and types of boards of directors [8]. A conclusion can be drawn that:

- a large number of countries implement a one-tier board of directors;
- a large number of companies do not allow the duality of the CEO and the president of the board of directors positions;
- the number of employees included in the boards of directors is small;
- the number of outside members included generally exceeds 50%;
- the average size of the boards of directors is 9 to 13 members (the number is generally odd, because of voting when making decisions);
- the stress is on the function of control of the boards of directors.

5. Conclusion

The basic problem of corporate governance is how to have managers manage in favour of the owners' interests, not exclusively in their own. The key role in solving the conflict of interest between the owners and the managers belongs to boards of directors, whose task is to make current decisions, define the company strategy and control and assess the managers' performance.

One-tier and two-tier board of directors differ in the manner in which they operate and the role they play. The one-tier board is characterised by a high concentration of power, since the same members can be both members of the board of directors and of the supervisory board. In case of the two-tier board of directors, members of the board of directors cannot be members of the supervisory board at the same time; these boards are characterised by the balance of power and the management processes are separated. There are no firm arguments, however, in favour of either of the types. Both models have their advantages and disadvantages and can be implemented under certain circumstances.

The results of the research in the developed countries should be a useful framework for the companies in this country in their future development. A question, however, can be raised as to whether, and to which extent, the principles of successful performance of boards of directors in developed countries can be implemented in the conditions at home. This primarily depends on the overall economic environment, as well as on the extent to which the recommendations for the improvement of corporate governance can be adjusted to the specific historical, cultural and political milieux of this country.

Character.	USA	Canada	Australia	France	Germany	Italiy	Great Britain	Netherlands	Switzerland
One-tier/two-tier board of directors model	One-tier board of management model	One-tier board of management model	One-tier board of management model	One-tier/two-tier board of management model	Two-tier board of management model	One-tier board of management model	One-tier board of management model	Two-tier board of management model	One-tier board of management model
% separated roles of CEO and president	15%	66%	70%	0%	100%	100%	90%	100%	63%
% Outside members in board of directors	77%	80%	75%	82%	100%	73%	50%	100%	89%
% z employees in board of directors	Not present	Not present	Not present	Present	Present	Not present	Not present	Not present	Not present
Board of directors size	13 members	12 members	9 members	13 members	15 members	11 members	9 members	7 members	9 members
Board of directors function	Control	Management and control	Control	Control	Control	Control	Management and control	Control	Management and control

Table 2. *International comparison of characteristics, functions and types of boards of directors*

REFERENCE

[1] Babić, V., (1998) Strategijska odgovornost upravnih odbora u procesu transformacije preduzeća, in Stefanović, Ž., (red.) Upravljanje ključnim aspektima transformacije preduzeća, Ekonomski fakultet, Kragujevac, str. 54-61

[2] Babić, V., (2006) Korporativno upravljanje u uslovima koncentracije i disperzije vlasnistva, in Babić, V., (red.) Korporativno upravljanje u tranziciji: vlasništvo, kontrola, menadžerske kompetencije, Ekonomski fakultet, Kragujevac, str. 1-33

[3] Burns, M. L., Kim, B., Prescott, J.E., (2009) The Strategic Role of the Board: the Impact of Board Structure on Top Management Team Strategic Action Capability, Corporate Governance: An International Review, Vol. 17, No. 6, pp. 728-743

[4] Daily, C. M., Dalton, D.R., (1994) Bankruptcy and Corporate Governance: The Impact of Board Composition and Structure, Academy of Management Journal, Vol. 37, No. 6, pp. 1603-1617

[5] Daily, C. M., Dalton, D.R., (1995) CEO and Director Turnover in Failing Firms: an Illusion of Change, Strategic Management Journal, Vol. 16, No. 5, pp. 393-400

[6] Daily, C. M., Dalton, D.R., Ellstrand, A.E., Johnson, J.L., (1998) Meta-analytic review of board composition, leadership structure and financial performance, Strategic Management Journal, Vol. 19, No. 3, pp. 269-290

[7] Hans van Ees, Gabrielson, J., Huse M., (2009) Toward a Behavioral Theory of Boards and Corporate Governance, Corporate Governance: An international Review, Vol. 17, No. 3, pp. 307-319

[8] Hilb, M., (2006) New Corporate Governance, Springer Berlin Heidelberg, New York

[9] Ingley C.B., Walt N.T., (2004) Corporate Governance, Institutional Investors and Conflict of Interest, Corporate Governance: An International Review, Vol. 12, No. 4, pp. 534-551

[10] Leblanc, R., (2005) Assessing Board Leadership, Corporate Governance: An International Review, Vol. 13, No.5., pp. 654-666

[11] Maassen, G., (2000) An International Comparasion of Corporate Governance Models, Spencer Stuart, Elst

[12] Monks, R., Minow, N., (2002) Corporate Governance, Blackwell Publishing, Oxford

[13] OECD, (2003) Stability Pact-Sout East Europe Compact for Reform, Investment, Integrity and Growt – White Paper on Corporate Governance in Sout East Europe, www.oecd.org/dataoecd/9/21/20490351.pdf

[14] Rechner, P.L., Dalton, D.R., (1991) CEO Duality and Organizational Performance: A Longitudinal Analysis, Strategic Management Journal, Vol. 12, No. 2, pp.155-160

[15] Rose, C., (2005) The Composition of Semi-Two-Tier Corporate Boards and Firm Performance, Corporate Governance: An International Review, Vol. 13, No. 5, pp. 691-701

[16] Stefanović, N., Stefanović, Ž., (2004) Struktura korporativnog upravljanja, in Babić, V., (red.) Korporativno upravljanje u tranziciji: vlasništvo, kontrola, menadžerske kompetencije, Ekonomski fakultet, Kragujevac, str. 1-33

[17] Zahra, S.A., Pearce, J.A., (1989) Board of Directors and Corporate Financial Performance: A Review and Integrative Model, Journal of Management, Vol. 15, No. 2, pp. 291-334

[18] Zardkoohi, A., Kang, E., (2005) Board Leadership Structure and Firm Performance, Corporate Governance: An International Review, Vol. 13, No. 6, pp. 785-799