

# **Converging Cultures**

**Trends in European Corporate Governance**

Corporate governance is a modern expression for an issue which companies have faced for decades – that of “accountability.” At its most basic level, it is about how those entrusted with day-to-day management of a company’s affairs are held to account to shareholders and other providers of finance; and whether the organisation has the appropriate corporate structures to underpin accountability.

Governance is also about communication, how the company presents itself to the wider world: to shareholders; to potential investors; to employees; to regulators; and to other groups with a legitimate interest in its affairs. As companies increasingly look beyond their national boundaries, selling their products internationally and seeking to raise finance on the global capital markets, this process of communication becomes crucial. International investors have also become more discriminating in their demands for information, and in relation to the standards of governance which they expect companies to adopt.

These pressures have been felt in the USA and in Britain for some time. They are now increasingly being felt throughout Europe. In the light of powerful socio-economic and political forces, such as privatisation and the shift towards pension provision through administered funds, investors who are not closely involved in the operations of companies assume greater importance.

These trends, and others, are discussed in this report. We have deliberately avoided a discussion of detailed legal corporate structures in each country, nor do we offer a “blueprint” of good governance practice. As this report will show, it is not possible merely to export such practices from one country to another. Rather, we have sought to describe the current trends in European governance as we see them.

**Two messages emerge loudly and clearly.**

**In today’s sophisticated environment, companies must “know their shareholders” and understand their motivations** – be they committed investors interested in securing long term shareholder value, or those with short term horizons. The same applies to other interest groups. Companies ignore at their peril the effects of their activities on employees, consumers and the environment.

**More importantly, there is evidence in today’s Europe of a convergence of corporate cultures which is the direct result of market forces.** All too often, regulators are tempted to seek a legislative solution to enforce harmonisation. In contrast, it is a relaxation rather than an imposition of regulation which will enable the most rapid emergence of a common European business culture.



Jermyn Brooks  
Chairman, Price Waterhouse in Europe

April 1997

**TWO TYPES OF CAPITALISM**

The background to change...

Historically, commentators have identified two broad types of business culture in Europe. The "Anglo-Saxon" model is characterised by large, liquid capital markets, a growing concentration of shareholding power by institutional investors; and a market for corporate control via takeover bids. The contrasting "continental" model is characterised by less liquid markets; and a greater concentration of shareholder power with banks, families and governments.

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**EUROPE'S GOVERNANCE DEBATE**

The pressures for convergence...

This traditional pattern is however beginning to break down, and we are seeing signs of a convergence of the two cultures. In Britain there is a perceptible shift in emphasis away from short term profit horizons on the part of management and investors, towards a commitment to enhancing long-term shareholder value. In continental European countries, there is a gradual merging of long and short term aims caused by the need to raise external finance and by privatisation programmes. There is also a loosening of corporate cross-shareholdings.

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**PENSION FUNDS**

In the longer term, the need to shift the burden of retirement costs from the state into the private sector will dramatically increase the volume of European funds flowing into the equity markets.

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**FOREIGN INSTITUTIONAL INVESTORS**

In the shorter term, governance structures are under pressure from cross-border investment. US investment institutions are taking a closer interest in the rest of the world, including Europe. American funds are taking a more proactive stance on governance issues, through one-to-one meetings with management and by initiating shareholder proposals. De-regulation of Japanese pension funds may also increase the extent to which foreign investors make their presence felt in Europe.

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**SHAREHOLDER ACTIVISM**

European companies are also feeling the need to respond to public comment from shareholders. This requires management to be aware of shareholder constituencies and to demonstrate and communicate a recognition of good governance.

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## THE STOCK EXCHANGE AS REGULATOR

Stock exchanges around the world are seen as playing a pivotal role in fostering good standards of governance, as a means of maintaining investor confidence in the capital markets. New markets, such as EASDAQ in Europe, specify minimum governance standards as a condition of admission. But this is countered by a fear that if an exchange introduces governance requirements which are too demanding, companies will seek a listing elsewhere. Some commentators suggest that this acts as a brake on the North American exchanges introducing more rigorous requirements for foreign companies seeking a listing there.

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## OTHER STAKEHOLDERS

There is growing awareness of the presence of other “stakeholders” in the governance process, and that companies need to demonstrate in their reporting their accountability to this wider constituency (for example to employees, customers, and suppliers). There is, however, a reluctance in some EU territories to see the same degree of compulsory employee representation as on German supervisory boards.

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The evidence of change...

## NEW GOVERNANCE COMMITTEES

Although problems of corporate accountability are not new, the “governance” debate has only recently crossed the Atlantic, stimulated by a number of prominent corporate collapses. There has been much interest in the UK Cadbury reforms, and similar committees have been set up in France and Holland, but this is allied to a growing recognition that solutions cannot simply be exported from one country to another. Governance initiatives must respect national cultural and historical differences. This is perhaps an argument for resisting, at European level, the imposition of any supra-national standard on corporate governance.

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## THE ROLE OF THE INDEPENDENT DIRECTOR

Companies have already recognised that some governance issues should be taken out of the hands of those responsible for day-to-day management of companies. We are starting to see an enhanced focus on the role of the independent director, and greater use of audit committees.

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## A COMMITMENT TO SHAREHOLDER VALUE

As management has become more responsive to the demands of equity investors, there is increasing emphasis in boardrooms on “shareholder value”. Companies are beginning to review their operations and concentrate on those core activities which they do best. The benefits are feeding through to improved business performance.

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<b>INVESTOR RELATIONS</b>	Taking steps to improve business performance is one thing. Making sure those messages are communicated to the capital markets is another. Companies now recognise that they must “know their shareholders” and anticipate their expectations.	<b>Page</b>  <b>30</b>
<b>FINANCIAL REPORTING CHANGES</b>	There is growing recognition by both the accountancy profession and regulators that, if companies are to be able to communicate with global investors, there should be a global accounting language. Many European companies are beginning to see the benefits of adopting an internationally recognised accounting framework, such as International Accounting Standards.	<b>31</b>
<b>NARRATIVE REPORTING TO ASSIST COMMUNICATION</b>	Increased financial disclosure in annual reports is being matched by expanded narrative reporting. This gives companies an opportunity to communicate their strategy and to explain how they have dealt with operational and financial risks. As companies become increasingly conscious of external scrutiny of their “licence to operate”, we are also seeing discussion in annual reports of environmental and ethical issues.	<b>33</b>
<b>EASTERN EUROPE</b>	Convergence – the next frontier?  Privatisation programmes have opened up the economies of Eastern Europe to western influences. However the authorities still have much to do before external investors have the same protections and level of confidence in governance structures they enjoy in other markets.	<b>35</b>

### ***There are two broad types of business culture in Europe***

In his recent influential book, a distinguished French businessman describes the future of the post-communist world in terms of a struggle between two different types of capitalism. On the one hand there is the "Anglo-American model" in which shareholders and short-term profits take precedence. On the other, there is what he calls the "Rhenish" model, in which "collective achievement and consensus are seen as the keys to long-term success".

The former style of capitalism is found in the USA and, to a large extent, in Britain; the latter in Germany, Switzerland and even in Japan. The result, as Michel Albert contends, is a struggle between two different types of capitalism. Hence the title of his book: "Capitalism against Capitalism".

We believe that, at least as far as Europe is concerned, this view of the world paints too gloomy a picture of confrontation between two incompatible business cultures. Of course, there are very real socio-economic and cultural differences within Europe. However, in a rapidly globalising economy with cross-border flows of capital, we believe that convergence is a more powerful force than divergence. This is as true for corporate governance as it is for the general business culture.

However, it is important to understand some of the differences, before considering how convergence is taking effect.

### ***On the one hand, there is the Anglo-American model...***

The chief characteristics of this model are as follows:

- Large and liquid capital markets. According to figures compiled by the Centre for European Policy Studies, there are around 2,000 quoted companies in Britain which collectively have a market capitalisation of more than 130% of the country's Gross Domestic Product. This compares to an EU average of around 44% of GDP and about 85% in the USA. Germany, Europe's largest economy, has around 670 quoted companies, whose market capitalisation amounts to a quarter of GDP.
- A growing concentration of shareholder power within institutional investors, typically pension funds and other professional fund investors such as insurance companies or unit trusts. The influence of other parties such as government, unions, management or banks is more limited. In the UK, institutional investors' share of stock market investment rose from 19% in 1963 to 59% thirty years later.

– An active “market for corporate control”, where outside shareholders can dislodge poorly performing management by way of takeover bids. Statistics show that the UK dominates Europe in terms of the volume and value of takeover bids. According to figures published by Corporate Finance magazine, the UK accounted for over 40% by value of such transactions in Europe in the first eight months of 1996.

### ***...and on the other hand***

The equity markets of countries which conform to the contrasting Rhenish model – often described as the “Germanic” or “continental European” model – are less liquid than in the UK or USA. There has traditionally been a greater concentration of economic power with families, banks or government.

In Italy, for example, the economic landscape is shaped by the influence of a relatively small number of powerful industrial families. OECD statistics show that single majority stakes account for about 60% of total stock market capitalisation, compared to just 5% in Britain, the USA or Japan. The largest five shareholders in each Italian listed company typically hold nearly 90% of the shares between them, compared to 41% in Germany and 21% in Britain.

Senior executives, often family members, are able to control the equity capital of some large Italian enterprises through a cascade of holding companies, even though their direct stakes in any particular enterprise may be as little as 10%.

### ***Banks play a crucial role in the German economy...***

In Germany, corporate shareholders own about 40% of the shares of companies listed on the stock exchange. Banks and insurance companies are also large shareholders, owning over 20% of the market between them. The result is a relatively small “free float” of shares only partly owned by institutional investors.

The historic ties between German banks and industrial companies are especially important. Deutsche Bank was, for example, founded over a century ago by a member of the von Siemens family which had established the well known electrical engineering group. Other relationships are similarly deep-rooted; Deutsche Bank’s 25% holding in Daimler-Benz, Germany’s biggest industrial company, dates back to the 1920s.

Until the recent privatisation of Deutsche Telekom, the general public in Germany had tended to avoid equity investment, preferring the comparative security of government bonds. Prior to the Telekom flotation less than 6% of the population owned shares directly, compared to 16% in Britain and more than 20% in the USA.

The role that banks play in the financing of German industry is sometimes exaggerated; retained profits in fact are the biggest source of finance for companies. But bank borrowings are considerably more important than equity capital as a source of external finance. This is reflected in the country's two-tier board system. In simple terms, there is a clear division between the Aufsichtsrat (supervisory board), which is responsible for overseeing the company, and the Vorstand (management board), responsible for day-to-day management.

Bankers play a key role on supervisory boards, often occupying the chairmanship. This position gives them considerable influence over companies' strategy and over the appointment of executive directors.

***...and across Europe other interest groups are often accorded equal priority to shareholders...***

The interests of employees, for example, are often enshrined in law. In both the Netherlands and Germany, statutory provisions ensure that employees play an important role in corporate governance through their seats on works councils and supervisory boards. Most importantly, employee representatives on such bodies must give their consent to management decisions which affect the terms and conditions of employment.

In France, the government is an important "stakeholder". This is partly the result of the state's direct shareholdings in French industry, somewhat diminished due to the wave of recent privatisations. It also reflects the constant circulation of senior executives between the civil service and industry boardrooms. Management and government officials share a common outlook, instilled by the country's education system which has tended to produce an "administrative elite".

***... with the result that there are so-called "insider" and "outsider" business cultures***

The importance of non-shareholder interest groups helps to promote an "insider" business culture, as opposed to the "outsider" culture prevalent in Britain or the USA, where providers of external equity finance play a dominant role in business and economic life.

Although changes are beginning to take place, there is still underlying much continental European business culture a widespread belief that a company has its own personality, character and aspirations; that the development of the company's role in society is a more important matter than generating ever greater financial returns for shareholders. This is distinct from the predominant Anglo-American view that a company is managed by directors as agents of the shareholders, and that the highest priority of directors is to create value for shareholders.

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If the Anglo-American model promotes “financial” thinking, the continental version arguably encourages greater attention to the long-term development of industry. This is at the heart of the well rehearsed “long-termism” versus “short-termism” debate.

Yet in reality, there is no single model which applies consistently across the whole of continental Europe. Nor are the demarcations between “Rhenish” and “Anglo-Saxon” style capitalism as rigid today as they may once have seemed. For example, there are signs that much corporate activity in Germany in recent years has been directed towards increasing shareholder value, whilst in the UK the top-tier companies are engaged in building long-term relationships with their stakeholders.

The different business cultures are undergoing a gradual process of convergence.

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### ***The governance debate originates in the USA...***

It is often said that financial innovation originates in the USA and crosses the Atlantic to the City of London, before making a slower journey to the less liquid financial markets of continental Europe.

If this is valid for the development of financial products and services, it is equally true of the debate on corporate governance. Governance has been on the agenda in the USA for at least two decades, during which time the large institutions which dominate the US stock market have actively and publicly wrestled with the problems of exerting control over the companies which they own.

### ***...has crossed the Atlantic...***

In Britain, the corporate governance debate was ignited by a series of prominent corporate failures at the end of the late 1980s. The collapse of companies such as Blue Arrow, Coloroll and Polly Peck prompted company directors, institutional investors, auditors and financial advisors, supported by government, to engage in collective soul-searching to find ways of ensuring that such failures could not happen again. In the mid-1990s, perceived high levels of executive pay, particularly in the privatised utilities, gave a new lease of life to the governance debate.

The result was a series of Committees and Codes which have made a major impact on British corporate life. The most prominent of these was the 1992 Cadbury Committee on the Financial Aspects of Corporate Governance.

### ***...and has now become an issue in Continental Europe***

Corporate governance is a relative newcomer to the agenda in many continental European countries. "The correct system of corporate governance can be graphically compared with the relationship of a patient with his doctor", said a leading German finance director in 1994. "As long as there are no acute pains there is no reason to see the doctor. At best one might think about talking over preventative measures."

For as long as industry delivered above average economic growth, there was little reason to criticise the status quo. However, in the 1990s many Western European economies have stagnated; observers have suggested that governance structures have impeded industrial restructuring and thus hindered economic revival.

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***Some notable corporate collapses stimulated the debate...***

As in the UK, a series of spectacular and well publicised corporate collapses or near collapses provided a catalyst to debate. Examples in Germany include Metallgesellschaft and the Schneider property group, and in France, the bank Crédit Lyonnais. In some cases, critics alleged that the collapses occurred despite the close involvement of the banks or of government-appointed directors on the board.

These failures prompted an unprecedented public discussion about the shortcomings of existing models of corporate accountability, some possible remedies, and some tangible changes. Banks agreed to review the number of supervisory board mandates they would take on, and a number of leading companies established audit committees as a way of enhancing internal controls.

***...but other factors also triggered discussion***

In other major continental European countries different factors have brought about a re-examination of existing governance structures. In France, the government's privatisation programme has led to a debate over the dominant role of the top cadre of executives – Présidents Directeurs Généraux. The French tradition of financing major companies through a complex series of cross-shareholdings, with a relatively small group of these executives sitting on the boards of many large companies, has also come under scrutiny.

Privatisation programmes have also encouraged discussion of the role of directors in corporate structure in Spain, where the Instituto de Contabilidad y Auditoria de Cuentas (the national accounting and auditing institute) has shown much interest in the UK's Cadbury reforms.

In Italy, a succession of financial and political scandals, such as the well-publicised problems at Olivetti, have stimulated the debate. In Switzerland, unfamiliar economic problems have increased shareholders' demands of management.

The impetus for change varies from country to country, just as the precise governance structures vary. But a number of broad themes apply. Traditional socio-economic structures, such as the balance of power between labour and capital, are coming under strain as countries struggle to meet the stringent criteria set out in the Maastricht Treaty as the precondition for European Economic and Monetary Union.

The globalisation of capital markets adds to the pressures. In currency markets, the impact of international investors and speculators has diminished the freedom of manoeuvre traditionally enjoyed by elected governments in the management of economic policy. Likewise, the growing role of institutional investors in large European companies has imposed unfamiliar constraints on management's freedom to manage.

The trend towards privatisation in Europe has increased the influence of foreign institutional investors. As continental Europe countries have imported foreign capital, they have found themselves facing new and unfamiliar demands – for transparent financial information and for more hard-headed management of assets in the name of shareholder value. Growing international competition for capital means that companies cannot evade the standards for corporate governance imposed by investors, unless they consciously or unconsciously accept disadvantages when it comes to raising finance.

In the following sections some of these pressures for changes in corporate governance are examined in more detail.

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***Many continental European countries have underfunded pensions systems. The development of funded systems is likely to lead to increased levels of equity ownership, with long term consequences for the way in which companies are managed***

Fewer than one in four citizens of working age in the European Union is currently covered by a funded pension scheme. Funded, as opposed to state, schemes account for just 7% of the total pension pay out. Meanwhile unfunded pension liabilities account for an average 145% of European countries' GDP.

The need to shift the burden of pension liabilities away from the state into the private sector is urgent. Demographic changes mean fewer workers will have to support greater numbers of pensioners, but governments are also mindful of the cap on their deficits set by the Maastricht convergence criteria. One way or another, this is likely to lead to a greater concentration of private pension schemes in Europe and the emergence of a new type of institutional investor.

Pension funds in Germany and the Netherlands maintain respectively about 10% and 30% of their assets in equities, compared to more than 80% in Britain. It may be assumed that a significant shift towards private pension provision will channel more funds into equity investments and so increase pressure on European companies to deliver acceptable returns to shareholders. The European Commission's estimate is that the pension fund asset base could expand from a current value of around 1,100 billion ecus to 10,200 billion ecus in today's prices by the year 2020.

### ***The changes are slow but inevitable***

In most countries the establishment of private pension funds requires significant changes to tax legislation and a liberalisation of the investment regulations which govern pension funds and insurance companies to allow a free choice in asset allocation.

Private pension funds are still not sanctioned by law in some countries and provision is instead made through state sponsored pay-as-you-go schemes. This has been the case in France, where virtually all employees are members of compulsory "répartition" schemes, funded by employer and employee contributions, designed to complement the basic state pension.

The absence of privately funded schemes in France led to growth in the mid-1990s in individual life assurance contracts. Only in November 1996 was new draft legislation introduced, proposing that companies should be permitted to set up voluntary private funds to supplement these state schemes.

Private pension funds will be required throughout continental Europe not just to absorb retirement liabilities but to underpin privatisation programmes in much the same way that Conservative governments in the UK used the concept of wider share ownership as the key to unlock sales of state assets.

The likelihood is that the growth of private pension provision will increase the funds flowing into equity markets as funds seek the best possible return on assets. The precedent for this is the UK, which has created a strong and long term institutional investor base, increasingly seen as the focus for efforts to promote shareholder value. It seems inevitable that the pension revolution will have widespread repercussions for corporate governance in Europe.

“the growth of private pension provision will increase the funds flowing into equity markets as funds seek the best possible return on assets”

***Traditional governance structures in Europe are also under pressure from cross-border investment***

In the autumn of 1993, the normally well-disciplined Annual General Meeting of one of Germany's largest companies was disturbed by an unprecedented denunciation of the country's corporate practices. The criticism came from a proxy agent speaking on behalf of CalPERS, the Californian state public employees' pension fund which is one of the USA's leading institutional investors.

The speaker condemned the dual voting structures in place at RWE, a utility, which gave effective control of the company to local communities even though they collectively owned only a minority of the group's equity capital. He said that RWE's management, in common with that of other leading German companies, was simply not paying attention to the requirements of foreign institutional investors.

The intervention was widely reported in the business press, as the first sign of an expected wave of intervention on behalf of foreign investors in the governance of continental European companies.

***Foreign investors are the key source of capital for European companies at the margin***

The importance of international investors as a catalyst for change in corporate governance cannot be underestimated. Institutional investors own up to 40% of the "free float" in German shares, a third or so of the French stock market, and significant stakes in leading companies in many European countries. Given the considerable competition for equity on a global basis, it is inevitable that those companies which need international equity capital have had to make substantial adjustments to the requirements of equity investors.

The prime requirement of equity investors is for a high degree of profitability, as measured in terms of return on capital, earnings per share growth and dividend payouts. This goes hand in hand with greater transparency of financial information, "one share one vote" shareholder structures which do not discriminate against minority investors, and greater accountability of management.

***Privatisation is also bolstering the role of foreign shareholders***

The ranks of those corporations which are obliged to take account of institutional investors' interests are being swelled by privatisation. The value of European privatisations in 1994 and 1995 amounted to a total of more than \$50 billion. Morgan Stanley, the investment bank, estimates assets worth \$250 billion – 300 billion might be sold between 1997 and the end of the century.

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The importance of foreign investors in these countries' privatisation programmes cannot be exaggerated; international investors bought 63% of all privatisation issues in 1995.

Italy's privatisation programme has attempted to diversify the focus of Italian capital markets away from bonds and into equity issues. In order to fulfil its privatisation targets, the state has sought to entice both the retail investor and foreign institutional investors, the latter group being more demanding of corporate behaviour.

Experience has shown that if companies do not take appropriate steps towards openness and accountability ahead of privatisation, the price at which they can be sold is affected, with adverse consequences for government sellers. After privatisation, it is imperative to provide regular and transparent information to institutions and to demonstrate commitment to shareholder value.

Reflecting these pressures, companies are gradually moving to more open accounting disclosure, and they are intensifying their investor relations efforts.

### ***From across the Atlantic...***

The Americans are coming; in fact, they are already here. US funds have embarked on a long term policy of increasing the international weighting of their equity portfolios. Analysts suggest that US fund managers must double the percentage of their assets held abroad, from 8% now to nearer 20%, in order to achieve the optimal relationship between risk and reward. American-backed institutional investment service bureaux such as IRRC and ISS, which offer advice on proxy voting matters, are also making their presence felt in Europe.

To date, large British and US institutions have tended to intervene directly in continental European companies' affairs on an extremely selective basis, or to make their views known to management privately.

The reasons for this are partly a natural tendency to focus most fund managers' scarce human resources on the core domestic market. However, they have also to do with a lack of familiarity with the local "territory" and the cost and effort involved in obtaining information about foreign companies; indeed some US investors have complained that they face difficulties in seeing the relevant papers and motions for shareholder assemblies in certain countries. In the domestic market, however, their policies are very different.

In the USA, CalPERS has taken an interventionist “passive manager – active owner” stance in corporate affairs. Where it sees company management underperforming it will first ask for meetings with the directors and seek key changes in their governance practices. US executives and, more importantly, Wall Street have grown accustomed to this “hands on” approach – an intervention by CalPERS is usually a sign that the company's results will improve. (A study suggested that companies targeted by CalPERS significantly under-performed the S&P 500 index in the five prior years and out-performed the index for up to five years afterwards.)

If private meetings are refused, CalPERS has not been afraid to go public with its concerns. It puts pressure on US managements by publishing an annual list of companies which it deems to be poorly performing, benchmarking their performance with others. It has also led some very public shareholder revolts against incumbent management.

We can certainly expect to see the focus shift to Europe in due course. As William Crist, president of the Board of Trustees of CalPERS recently stated in an address to European businessmen, “outside the US, the traditions, laws, habits, practices and markets are quite different and changing rapidly. We're speaking to directors to seek companies with good internal structures to ask them how they work”.

### ***...and from the Pacific Rim***

De-regulation of Japan's enormous pension fund system means that investment managers are likely to increase the currently low weightings of foreign equities in Japanese funds. Traditionally, corporate pension funds have been obliged to direct resources into the accounts of the giant life companies and trust banks which are run on very conservative lines. Now the rules on how much may be directed towards domestic and foreign equity securities have been relaxed. The performance of European companies may thus come under scrutiny from the East, though the source of that scrutiny may in fact be from the Americans and British, who run some of the most active fund management organisations in Japan's foreign equity markets.

“an intervention by CalPERS is usually a sign that the company's results will improve”

***Institutional shareholder dissatisfaction with incumbent management may currently be expressed in private meetings, but what of the aggrieved minority shareholder***

The recent demonstrations by French investors in Eurotunnel show that groups of small shareholders are prepared to make their voice heard. The same shareholders later continued their efforts by submitting a list of questions on corporate governance issues to the board at the annual meeting.

Such a degree of organisation has historically been rare in continental Europe but has started to grow as activists model themselves increasingly on their US counterparts. Shareholder action groups and corporate governance consultancies have formed in several countries, often to champion specific issues or to handle proxy voting matters. Examples include the Association des Actionnaires Minoritaires (ADAM) and Proxinvest in France, and Deminor in Belgium. If not properly handled by the company, small shareholder groups can generate unwelcome publicity for the business.

Shareholder activism can take different forms. Individual campaigners, such as Ekkehard Wenger, the Würzburg economics professor, have made a contribution to the governance debate. In Switzerland, the most visible example of shareholder activism has been the confrontation between Martin Ebner, a Zurich fund manager, and Union Bank of Switzerland (UBS). Mr Ebner built up a sizeable stake in UBS shares and since 1993 has used his shareholding to demand boardroom changes and a change in the bank's strategy to improve its return on equity.

In Italy and Spain, there have been isolated incidents of shareholder dissatisfaction; for example, small shareholders helped to overturn a proposed merger in 1995 between Ferruzzi and Gemina, two of Italy's largest companies. They claimed they had not been consulted on a deal which they believed was largely to the benefit of large shareholders.

***But negotiation, rather than confrontation, is the way forward***

PIRC, a consultancy which advises British public sector pension funds on proxy voting issues, achieved much publicity in its early days, but its uncompromising stance perhaps served to alienate company directors. However PIRC and other interventionist groups operating in Britain have recently adopted a more conciliatory tone, taking time to address conferences of business leaders and put across their case.

The current trend, apparent also in the mood of both French and Swiss activists, is to seek consensus rather than confrontation with management, having surmounted the initial hurdle of getting themselves noticed. There is a feeling among some of the leading activist groups that damage is done to their cause by headline grabbing rows.

The lessons for companies are clear. Managements must be aware of their shareholder constituencies: who is on the share register; if the shares are held through nominees, who the beneficial owners are; and who advises them on proxy voting matters. Through skilful management of investor relations, and maintaining awareness of latest thinking on governance issues, companies have a better chance of limiting the opportunities for shareholder dissatisfaction and unwelcome publicity.

“the lessons for companies are clear. Managements must be aware of their shareholder constituencies”

***Stock exchanges have played a pivotal role in raising standards of corporate governance, but this may be tempered by intensifying competition between world financial centres***

Stock exchanges in those parts of the world which have more established equity markets have played a key role in ensuring that investors have access to transparent financial information about companies, and in promoting common standards of corporate governance.

In the USA the Securities & Exchange Commission (SEC) acts as the independent regulator which determines the content of financial reports which publicly traded companies must file. In the UK the London Stock Exchange plays a lesser role in relation to accounting requirements, but has mandated that listed companies should give statements of compliance in their annual reports, explaining the extent to which they have complied with the Cadbury (corporate governance) and Greenbury (executive remuneration) Codes of Best Practice.

Other exchanges in Europe are beginning to impose certain minimum standards of corporate governance as part of the conditions for admission to listing, or as part of the continuing obligations. For example the new EASDAQ market, launched in Brussels in 1996, specifies minimum governance standards as a condition of admission.

Generally, governments and industry recognise the need to enhance the efficiency of financial markets as a way to lower the cost of companies' capital and finance government deficits more efficiently. And efficient capital markets enhance the price at which governments can raise funds by way of privatisation.

Germany, France and the Netherlands have taken steps to improve the attractiveness of their markets for domestic and international investors. In Italy, CONSOB (the Italian Stock Exchange Commission) highlighted in its 1995 annual report the need for new standards in the corporate governance of companies.

***There is new legislation in Germany***

There has been a burst of new legislation designed to enhance the attractions of "Finanzplatz Deutschland" – Germany as a financial centre. This includes two Financial Markets Promotions laws and changes in takeover regulation.

Germany's voluntary takeover rules oblige company management to treat minority shareholders more fairly than in the past. The acquirer is not required to launch a bid until it has bought 50% of the shares in its target, and thereafter has eighteen months before it is obliged to launch a bid for the outstanding shares.

“some countries have taken steps to improve the attractiveness of their markets for investors”

This is by no means as stringent as the UK's Takeover Code, but it is a step towards policy harmonisation. It is unlikely to unleash a wave of hostile takeovers in Germany, but does increase pressure on company management to react to the views of shareholders.

The German government is also considering measures which would facilitate share buy-backs. The draft legislation will give more rights to ordinary shareholders by banning multiple voting of shares and other devices which limit voting rights. Banks will be unable to use open-ended proxies granted by clients at the same time as voting shares held in their own portfolios. The proposals will be welcomed by cash-rich businesses which would be able to return value to shareholders.

### ***But exchanges cannot afford to make their rules too prescriptive***

Governments and regulators are equally conscious of increasing global competition among securities markets to attract companies looking for a secondary or tertiary listing. On a European level much trade in European debt and equity securities and their derivatives is currently handled in London, but the continental bourses would like to win it back. In the US, it is speculated that the New York Stock Exchange has refrained from introducing more rigorous requirements for overseas companies, for fear that they may list on a more benign market.

Governance is thus a two edged sword. Good standards of governance inspire confidence in investors and enhance the integrity and efficiency of the markets. Make the rules too tough, however, and companies will seek a listing elsewhere.

“good standards of governance enhance the integrity of the markets. Make the rules too tough, however, and companies will list elsewhere”

***Although focus on shareholder value is increasing, the influence of other interest groups should not be underestimated***

Whilst this survey focuses on the impact of shareholders, particularly institutional investors, on the European corporate landscape, the importance of other “stakeholders” – especially employees – should not be ignored. For some companies, employees have a greater influence on management decisions than capital investors.

The interests of employees are often enshrined in law. Under the German Co-Determination Law, half of the members of the supervisory board are elected by employees, the other half by stockholders at annual general meetings. Although the chairman is normally a representative of shareholders and holds a casting vote, the influence of the workforce representatives is undeniable.

Commentators have suggested that these arrangements have resulted in supervisory board meetings being dominated by discussion of pay awards, whilst issues of wider business and financial performance have been neglected.

At Volkswagen, one of Europe's largest players in the highly competitive automotive sector, ways have been found of keeping workers on the payroll despite the overcapacity in the industry. Some observers ascribe this action to the combined influence of the local Government of Lower Saxony, which owns a large stake in Volkswagen, and employee representatives on the supervisory board. Both groups seem to attach a greater priority to preserving jobs than to maximising financial returns.

In the Netherlands, the Works Council Act ensures that employees occupy a powerful position in corporate governance. This elected body must be consulted by management on a number of issues, including major strategic decisions, and it must give its consent to management decisions to change the terms and conditions of employment.

In both countries the pace of corporate restructuring is governed by the need to maintain consensus, reflecting the representation of workers on supervisory boards and the role of works councils. Restructuring is invariably gentler than in the Anglo-Saxon environment.

***Works Councils are seen as a vehicle for employee involvement***

The importance of employee stakeholder groups has also been recognised by the European Commission. The European Works Council Directive of 1994 required all companies which employ more than 1,000 workers across the European Union and at least 150 workers in each of two member states to set up an employee consultation and information committee (although the UK government opted-out of adopting this legislation).

In practice, works councils may meet only once or twice a year and have little formal power in collective wage bargaining or management decisions. However, they are a potentially powerful forum for giving employees a collective voice if controversial corporate decisions have to be taken.

The UK has to date not seen tangible evidence of employee influence. In part this may be the result of decades of individual share ownership, including a deliberate policy for widespread shareholding encouraged by fiscal incentive for shares to be issued to employees. A greater proportion of the workforce therefore reacts as “shareholder” rather than employee.

Convergence of cultures, however, works in two directions. The UK must therefore expect to see a greater emphasis on employees as a major force in corporate decisions. The political phrase “stakeholder society” is perhaps the most obvious indicator of this new focus of attention for British management in the future. There are already signs of change; around 50 companies have ignored Britain’s opt-out of the Directive and have set up or are negotiating the establishment of works councils.

“the UK must expect to see a greater emphasis on employees as a major force in corporate decisions”

***In the face of these pressures for change, French business is increasingly examining its own structures for accountability...***

In France, the government has stopped short of introducing legislation to reform governance structures. However, the Viénot report, a major contribution to the governance debate when published in the summer of 1995, was conceived as a deliberate, private sector attempt to address some of the concerns of foreign investors. The report was commissioned by two employers' federations which asked a leading banker, supported by a group of eminent private sector companies, to examine the role of boards of directors in French listed companies.

The committee of 14 company chairmen, under Marc Viénot, president of the Société Générale bank, made a number of recommendations, including the following:

- boards should be required to review their composition and structure regularly;
- boards of public companies should include at least two "independent" directors;
- care should be taken to ensure the board does not contain an excessive number of reciprocal mandates;
- limits should be placed on the number of outside directorships which directors may hold; and
- committees should be established to deal with board appointments, audit and directors' remuneration.

The report was not intended to be the French equivalent of the UK Cadbury Report, whose recommendations were subsequently incorporated into the rules of the London Stock Exchange. The Viénot report comprises a series of recommendations which companies can follow if they see fit. In particular it did not tackle some of the more sensitive issues in French corporate governance.

For example, it did not criticise the cross-shareholdings which are common in industry and which have the effect of protecting incumbent management from takeover and insulating them from the adverse consequences of poor performance. Although "noyaux durs" or official cross-shareholding structures are in retreat following recent privatisations, it is not uncommon to see a cascade of indirect stakes which give "backdoor" control to one or two shareholders.

"the Viénot  
Committee  
recommendations  
have sparked off  
a governance  
debate in France"

Nor did the Viénot report address popular perceptions about management traditions among big French companies – that a small cadre of senior directors moves constantly between posts in government and industry, reinforcing state influence over business. The growth of companies outside this establishment circle may help to weaken the influence of this traditional elite, as may the emergence of markets such as the Nouveau Marché which will encourage private capital to back new entrepreneurs.

Though the reforms are less far reaching than those of the Cadbury Committee in Britain, the Viénot committee recommendations have at least sparked off a governance debate in France and asked management to think in a more focused way about the priorities of other shareholders. Viénot suggested that progress be monitored in three years time, in 1998. The French government appears to be in favour of an earlier reassessment and has not ruled out legislative action.

### ***...and in the Netherlands***

The “Peters Report”, commissioned by the Amsterdam Stock Exchange and the VEIO (Association of Securities Issuing Companies) takes a comprehensive look at governance practices in the Netherlands. The committee members were drawn from business, the securities industry and the professions.

The report contains no fewer than 40 recommendations for better governance practice, ranging from the suggestion that no more than one former Executive Board member should sit on a company's Supervisory Board to the proposal that both the Executive and Supervisory Boards should report to and be accountable to the general meeting of shareholders for their performance. It also suggests that acquirers should launch a full bid for a company once a shareholding reaches 50%.

The recommendations are designed to enhance the influence of shareholders in an environment where strict anti-takeover laws make it difficult for the owners of companies to dislodge management whose performance is deemed unsatisfactory. They are entirely voluntary. The Report urges that all Dutch listed companies should closely monitor compliance with the recommendations and publish a report on progress for their 1998 annual general meetings.

Mr Paul Arlam, secretary and member of the Peters Committee, defended the decision to make the implementation of the proposals voluntary rather than statutory. Speaking on a recent visit to London, he said: “by far the most important mechanism is to put companies to shame. For some companies there is nothing new, for others there is a lot new. Our expectation is that, as the Committee had such a wide composition, it will be difficult for companies to ignore.”

The implication is that if Dutch companies do not themselves show evidence of change in the next year or two, the Government will feel compelled to legislate. "We need flexibility – the diversity of Dutch companies means that formal rules are almost impossible," commented a senior official of the Amsterdam Stock Exchange, "but if industry fails to come up with the goods, legislation is there."

These initiatives show that the business community, particularly if prompted by local stock exchanges, is able to find governance solutions which respect national, cultural and historical differences. That is perhaps an argument for resisting, at European level, the imposition of any supra-national "standard" on corporate governance.

Where the UK Cadbury Committee, and now France and the Netherlands have led in setting the governance agenda in their own national contexts, will the business leaders in other European countries follow?

"the Peters Report takes a comprehensive look at governance practices in the Netherlands"

***Involvement of quality independent directors can improve business performance, as well as strengthening governance structures***

There has been much discussion in some countries, notably the UK, about the relative merits of unitary and two-tier structures for boards of directors. In our view this debate serves to illustrate the difficulties of trying to “export” governance solutions from one territory to another. Two-tier boards suit the business culture in Germany, but should not be expected to work so well in a different environment.

What is important is that, regardless of what formal board structure is in place, there should be adequate representation of “independent” directors. These may be labelled “non-executive” directors as in Britain, but the key requirement is that they should be truly independent of the day-to-day operations of the enterprise.

Independent directors should not be regarded as policemen who check and ratify every decision of operational management, but they can usefully act as guardians of the interests of shareholders and other stakeholders in the enterprise. They should have sufficient access to financial and other business information in order to bring their experience and expertise to bear, and thus “add value” to the company’s strategic decision-making.

***The number of independent directors is not in itself important***

In relation to appointments of independent directors, it is quality, rather than quantity, which counts. Informal surveys of institutional investors’ opinions in the UK supports this view. They see the involvement of non-executive directors as a positive element in the governance framework only if those directors possess experience and skills relevant to the business sector concerned; the appointment of large numbers of “token” independent directors is seen as unhelpful.

These views are beginning to take hold elsewhere in the world; US corporations are gradually reducing the size of their boards in order to facilitate more focused discussion.

More radically, some observers have gone so far as to suggest that non-executives can reinforce long-term partnerships between institutional investors and companies. Neville Bain in his recent book “Winning Ways Through Corporate Governance” suggests that financial institutions should be persuaded to retain stakes of 10% or more in companies, entitling them to nominate non-executive directors to those companies’ boards. Whilst an approach which saw directors appointed in respect of specific shareholder interests would be viewed as revolutionary in the UK, it is not so far removed from the system in Germany where representatives of banks and employees sit on the supervisory board.

“two-tier boards suit the business culture in Germany, but should not be expected to work so well in a different environment”

***Board committees are assuming increasing importance***

One trend that has established itself in recent years is that audit committees have become an increasingly common feature of European companies. These committees are typically composed wholly of independent directors. Separate audit committees may not, however, be necessary if matters relating to the presentation of the financial statements, internal controls, and arrangements for internal and external audit receive adequate attention at supervisory board level.

In its recent Green Paper “The Role, Position and Liability of the Statutory Auditor in the European Union” the European Commission shows that it views audit committees as a potentially powerful tool which can reinforce the independence of external auditors and strengthen the auditor’s hand when dealing with operational management. In the Commission’s own words “experience has shown that, even where audit committees have been set up mainly to meet listing requirements, they have proved their worth and developed into essential committees of boards of directors.”

“experience  
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directors”

***Even if there is no easy way to translate the phrase into other languages, "shareholder value" has become a buzz word in many European boardrooms. Management has become more responsive to the demands of investors***

As with corporate governance, so for shareholder value: the USA is probably furthest ahead in terms of awareness of the concept, followed by Britain. Elsewhere in Europe, Germany is leading the pack, with some countries only beginning to wake up to the pressures to create value. This patchy picture is best illustrated by Barry Riley, writing recently in the Financial Times.

"The focus is on Germany and Scandinavia, plus, to some extent, Switzerland and Spain. France, on the other hand, is a dirigiste paradise, while on a shareholder value scale of one to 10, Italy, .... rates about minus three."

The streamlining of Daimler-Benz is a prime example of the process at work in Germany. Management here recognises that strategic focus and an emphasis on shareholder value creation are complementary to the overarching need to become more competitive in product markets. Under new chairman of the Vorstand Jürgen Schrempp, the group has cut thousands of jobs and has retreated from its strategy of being a "technology group", disposing of non-core businesses.

At Veba, Ulrich Hartmann has made the enhancement of shareholder value the keynote of his chairmanship of the utility, chemicals and telecommunications group. The group divested non-core activities and introduced value-based reporting systems throughout its many divisions as a way of focusing management's attentions on the creation of shareholder value. The group has since witnessed a strong rise in earnings and a share price performance well above the German market as a whole. Moreover over 40% of the group's share capital is now owned by foreign investors.

Hoechst has also taken steps to enhance shareholder value. Last autumn, it announced plans to turn itself into a holding company with six independent business units, some of which would obtain separate stock market quotations.

The drive to restructuring by these and other companies is deemed by analysts to be a significant factor behind the strong performance of the German equity market in 1996. This seems to be confirmed by the findings of a newly published survey (by Price Waterhouse and Dietmar Hannebohn Consult) of the stock market performance of Germany's 30 largest industrial groups. It concludes that companies which steer a strategic course along shareholder value lines achieve a significantly higher than average share yield.

The pressure to generate shareholder value is also taking hold at a number of other large European financial and industrial groups. It is at least a partial motivation for the restructuring of the Swiss banking sector and a factor in the decisions of both Union Bank of Switzerland and CS Holding to dispose of their non-core interests in electricity generation, held through their stakes in Motor-Colombus and Electrowatt respectively. In France, it underscores the restructuring of Total, the oil group, and is the keynote for the rationalisation that Serge Tchuruk, former Total chairman, is putting into place at Alcatel Alsthom.

***But if change is introduced too quickly, it may not be accepted***

Despite the adoption of the new concepts there still appears some reluctance (for example by French and German companies) to commit themselves wholeheartedly to the enhancement of shareholder value: this objective remains but one among many goals of a corporation. This reluctance is perhaps most keenly felt by the German "Mittelstand" companies, started in the mid-twentieth century as family concerns but which have grown into major industrial groups. They retain a paternalistic culture which encourages consensus between management and employees, but which may view "shareholder value" as a new fad which pays undue attention to one interest group – equity investors.

Indeed, the sensitivity over too great a concentration on shareholders' interests has, according to the Financial Times, led Daimler-Benz and Veba to drop the English phrase "shareholder value" – when discussing their strategic priorities in Germany – in favour of the less contentious word Unternehmenswertsteigerung (the growth in value of the enterprise).

"companies  
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yield"

***Good investor relations is seen as an essential part of value creation***

The trend towards shareholder value creation has been matched by an increased emphasis on investor relations. Progressive continental European companies, like their US and British counterparts, recognise that they must be proactive in taking their message to international institutions if their shares are to be appropriately valued.

This is a comparatively recent phenomenon. Dr Hans-Georg Bruns, head of investor relations at Daimler-Benz, told Investor Relations magazine that the group only started to take investor relations seriously after it became the first German company to obtain a listing on the New York Stock Exchange in 1994.

Prior to the listing, the group took little initiative in communicating with shareholders and did not see that investor relations could give it a competitive advantage vis-a-vis its peers, in terms of raising its profile with investors and reducing the cost of equity capital. The group revolutionised its attitude after encountering the US analysts' community during the course of the share placing. Daimler now holds an annual roadshow, visiting twelve cities in the US, as well as Frankfurt, Paris, Zurich, London, Edinburgh, Tokyo and Singapore. As part of this exercise, senior executives give presentations and hold one-on-one briefings with leading investors.

For the leading analysts and institutional investors, regular access to the very highest levels of management is seen as essential. A survey by the Investor Relations Society found that more than 60% of chief financial officers and 45% of chief executives spend a "significant" proportion of their time on investor relations. This effort can only be expected to increase. Companies must ensure they commit sufficient resources to developing the presentation and communication skills of their top managers.

"In Germany and elsewhere in Europe, there is a new generation of managers who know exactly what the international capital markets expect of them," comments Bill Stokoe, investor relations specialist at Brunswick. "They are embracing all the established investor relations techniques – from roadshows to teleconferencing and market research – and are receptive to new ideas."

"there is a new generation of managers who know exactly what the international capital markets expect of them"

### ***Changes in accounting disclosure reflect the trend towards improved communication as well***

Accounting, it is often said, is the language of business – but it is a language for which there is no common grammar. Hence the anomaly that in a global economy, there is no globally consistent accounting language.

This may change within a few years, as the International Accounting Standards Committee (IASC) and the organisation of the world's stock market regulators (IOSCO) have reached agreement to develop a core of internationally acceptable accounting rules. The plan is for these to be ready in 1998. At that point, if the US Securities & Exchange Commission approves of the new rules, and if the European Commission's 1995 "New Accounting Strategy" is adopted in the member states, it may become possible for European companies to use one set of accounts to communicate with all the world's stock exchanges.

Currently, the picture is rather different. National requirements mean that if companies want to list their shares outside the domestic market, they must prepare several different sets of accounts, at some expense and inconvenience.

### ***Contrasting styles of reporting***

These historic accounting rules reflect the distinction between "insider" and "open" stock market based economic systems, as well as technical factors. Under the latter system, accounting has evolved to the point where it serves the needs of external equity investors. It gives abundant detail about the financial performance of the company so that fund managers can regularly make informed judgements about their investments.

By contrast, in "insider" systems, the accounts have historically presented a less comprehensive picture of the group's financial performance. Key information is distributed among the select group of insiders – management and supervisory boards and bank creditors. The accounting frameworks in these territories have also tended to be tax-driven.

At a time when global competition for capital flows is intensifying, a rigid adherence to rules which are unfriendly to shareholders is a disadvantage, at least for those companies that need to raise equity capital from international investors.

Hence continental European companies have started to give more information to the outside world. Daimler-Benz was the first German company to publish its accounts under US Generally Accepted Accounting Principles (US GAAP) followed by Deutsche Telekom and Veba. Dozens of other large European companies have taken the decision that the advantages of converting to US GAAP outweigh the costs.

Many more companies and financial institutions have moved to embrace International Accounting Standards (IAS). In Europe, these include Deutsche Bank, Bayer, Merck, Roche, Nestlé and ABB. IAS, in contrast to US GAAP, offers more of a synthesis of different accounting cultures while ensuring that investors obtain more of the information they require to assess a company's performance. It therefore seems to be a framework more sympathetic to European tastes.

### ***An emphasis on disclosure***

Whatever the basic accounting rules, the trend is clearly towards greater disclosure. This reflects the pressures exerted by institutional investors on management, and subtly alters the balance of power between management and equity owners. The more information companies disclose, the easier it is for analysts and investors to make comparisons between companies in the same sector.

"There is clearly pressure for common standards," observes Karel Lannoo, research fellow at the Brussels based Centre for European Policy Studies, "with the dominant capital market setting the principles for the rest of the world".

This demand for common standards and greater disclosure is real – a recent survey of the opinions of 68 leading German institutional investors found that 75% were dissatisfied with the information published by companies, particularly the lack of meaningful data on business segments.

"IAS seems to be an accounting framework more sympathetic to European tastes"

***Good communication doesn't stop where the pages of the financial statements finish***

The trend towards increased financial disclosure is replicated by the growing number of pages in annual reports devoted to different forms of narrative reporting. Some forms of narrative reporting are already compulsory in most countries. But the demand from shareholders, potential investors and analysts for more comprehensive, voluntary discussion by management of the performance of the business has resulted in more pages of commentary to accompany the figures.

In the UK, most listed companies include in their annual reports an Operational and Financial Review ('OFR') – this is modelled on the Management Discussion and Analysis required by the SEC in accounts of companies listed on US exchanges. Rather than being seen as burdensome, or a dangerous giving away of intelligence to competitors, the preparation of a commentary such as the OFR should be viewed as an opportunity – to communicate to the market messages about business strategy; and to show how management deals with the operational and financial risks facing the company.

If the financial risk management strategy is spelled out, shareholders and others will be in a better position to assess the risk they themselves are exposed to in investing in a particular company. For example the policies adopted with respect to exchange rate, interest rate and derivatives risks could be disclosed, together with an explanation of the high level controls relating to treasury operations.

***There is growing interest in environmental issues...***

Other countries lead the way on narrative reporting of other important areas of risk. Environmental reporting is compulsory in Denmark, but voluntary disclosures on environmental matters also tend to be more comprehensive in other Northern European countries. A 1995 study by FEE, the representative body for the accountancy profession in Europe, noted that, of those EU countries examined, levels of disclosure were highest in Austria and Germany.

There has been much public interest in the "eco-balance sheet" or "Ökobilanz" being provided by a growing number of Austrian and German companies. This usually takes the form of an input-output analysis – materials and energy used on the one hand versus production and output to the environment (for example, water discharges and emissions into the atmosphere) on the other.

Elsewhere this quantitative route to providing environmental information has not been taken, at least as far as public reporting is concerned. In Denmark and in the UK there tends to be more discussion of policy and commitments, and description of the high level environmental control systems, rather than quantitative evaluation of the impact on the environment of company activities.

"the preparation of a commentary to accompany the figures should be viewed as an opportunity to communicate to the market"

Observers suggest that such policy statements and commitments may merely be a means of securing competitive advantage, and of paying lip-service to the demands of other stakeholder groups, but there is compelling evidence that the better companies are taking their responsibilities to the community more seriously. For example the Shell oil company, in its 1995 annual report, openly admits that episodes such as the disposal of the Brent Spar platform, if not handled well by a company, can damage its reputation and its "licence to operate." As the Shell report states, "we learned that we need to have greater external focus if we are to create a better acceptance of the group's business among varied audiences."

### *...and in business ethics*

Around the world, there is evidence that top-tier companies are recognising the scale of the impact their activities have, not just on national economies but on the communities in which they operate, and of the greater external scrutiny of their affairs which this brings.

Business ethics is a subject beginning to receive more attention in annual reports. A survey of the 1995/96 reports of 50 top British companies from the FTSE100 index showed that around a quarter discussed ethics and standards of business behaviour. A few companies have gone further and published their internal codes of conduct. These trends can only be expected to continue.

"there is compelling evidence that the better companies are taking their responsibilities to the community more seriously"

***Privatisation in western Europe and other parts of the world is helping to change corporate governance behaviour. In central and eastern Europe, it is shaping the future of these fledgling capitalist economies***

Privatisation programmes have driven the economic liberalisation of eastern Europe. However, the experiences of outside shareholders in former state-owned enterprises vary enormously, and show that these countries have much ground to make up in replicating western style governance practices.

Some privatisation programmes in the former Communist bloc have been designed specifically to give institutional shareholders – including foreign investors – a significant role in how companies should be restructured and managed in a market economy. Poland and the Czech Republic have adopted mass privatisation programmes, designed to distribute shares at a low price in order to create a wide shareholder base for the first time.

***Experience in Poland...***

In Poland privatisation has taken a variety of forms; flotations of large enterprises on the stock market; direct sales to foreign or domestic investors; and through National Investment Funds (“NIFs”). These funds, which invest in a diverse portfolio of large, medium and small enterprises, are managed by partnerships of local and foreign investment companies. The management companies are awarded 10 year contracts and are answerable to a supervisory board. Polish citizens pay a nominal registration fee for vouchers which will convert into one share in each of 15 investment funds, the aim of each of which is to maximise the financial returns to its shareholders by increasing the value of the assets in its portfolio.

There has been almost as much upheaval within the funds as in the underlying companies whose shares the NIFs have bought. Some foreign fund managers have been sacked by supervisory boards. Although the method is rough and ready, the privatisation programme has ensured that shareholder value creation is a management priority.

***...and in the Czech Republic***

In the Czech Republic ownership of the vast majority of former state enterprises was transferred to investment funds during the large scale privatisation process. Many of the larger funds are affiliated to the leading Czech banks which are themselves still partially state-owned.

“these countries have much ground to make up in replicating western style governance practices”

However the recent turmoil in the Czech banking sector, where some banks have suffered liquidity crises, and the aggressive tactics reportedly employed by some investment companies have led to problems in public confidence in these organisations. These factors, together with the need for enhanced corporate and capital market transparency, point to a need for minority shareholder protection and the establishment of western corporate governance practices.

### ***A different story in Russia***

The practical hurdles faced by investors in Russian securities are so extensive, ranging from difficulties in getting shares registered to liquidity problems, that corporate governance issues are far from paramount. However, there is an awareness of the need to establish order in a chaotic market and the authorities have been making efforts to tighten the legislation governing corporate behaviour.

The new law on Joint-Stock Companies, passed in 1996, provides for increased protection of shareholder rights, but the enforcement mechanism is as yet unclear. Recent press reports also indicate that the government has woken up to the need to promote more western styles of financial reporting and provision of information to investors; it may be considering moves to require companies to adopt internationally accepted accounting practices.

Converging Cultures is designed for the information of readers. While every effort has been made to ensure accuracy, the material is intended only to provide an overview of current trends and should not be viewed as comprehensive.

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