

**РАЗДЕЛ 2  
ПРАКТИКА  
ОРГАНИЗАЦИИ РАБОТЫ  
СОВЕТОВ ДИРЕКТОРОВ**

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**SECTION 2  
BOARD  
PRACTICES**

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**BOARD PRACTICES: AN INTERNATIONAL REVIEW**

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**Abstract**

The paper considers board practices in the Ukraine and developed countries such as the USA, the UK, Germany and Japan. Investigation on the board practices in the Ukraine is the first ever has been conducted. As a result of investigation undertaken, major conclusions have been made. The most important of them is that the German model is getting spread in the Ukraine from year to year. Major evidences are small number of independent directors on the board, low frequency of meeting of the board, small number of committees on the board, the management board influences the supervisory board. The main reason of closing the board practices in the Ukraine to those in Germany is increase in concentration of ownership that is following with increase in corporate control, violation of the minority shareholders' rights, increase in number of conflicts of interests and decrease in transparency of the Ukrainian joint stock companies.

**Keywords:** board practices, independent directors, corporate control, committees

**Introduction**

Boards of directors are a crucial part of the corporate structure. They are link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers). The board's primary role is to monitor management on behalf of the shareholders. As Tricker says, in the common definition corporate governance "addresses the issues facing boards of directors". In this view, corporate governance in the task of the directors and therefore attention must be paid to their roles and responsibilities. In the broader view, boards of directors are the part of the governance system.

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The way how this part of the governance system influences corporate governance depends on the governance concept used - monistic, dualistic or pluralistic. At the same time, certain governance concept shapes the boards practices.

Fundamental governance concepts have been developed in industrial countries. Countries of the Eastern and Central Europe, so named "post-communist", are still looking for an optimal concept to put it into the basis of the best board practices.

One of the countries where there is not still a firmly defined and well-developed governance concept is the Ukraine. After a ten-year history of privatization of the state property there is a lack of research in the field of the board practices. Therefore, the primary objective of the paper is to improve transparency of the board practices in the Ukraine and explain the main trends at the market.

### **Methodology of research**

The procedure of research consists of four stages.

The first stage is to conduct research of those boards that operate under monistic concept of the corporate governance. These companies are from the USA and the UK.

The second stage is to undertake an investigation of the boards operating under dualistic concept. These are German companies.

The third stage is to explore the board practices in Japan where there is pluralistic concept of the corporate governance.

The last, the fourth step is to conduct research of the board practices in the Ukraine. The major conclusions must be issued and the main trends must be explained in details.

At this stage, a very detailed investigation of the most active Ukrainian joint stock companies has been undertaken. The following numbers have been researched: size of the boards; frequency of the board meetings; independence of directors; committees on the board; director nomination; director election; employee participation on the board; the chairman/CEO duality.

Total number of the companies under research is 50. They belong to the most developed industries - metallurgy, machine-building, energy generating and energy distributing. The period of investigation is from 1998 to 2003. The following data sources have been used to conduct investigation: annual reports of Ukrainian joint stock companies; annual reports of the State Securities and Exchanges Commission in Ukraine; annual reports of the First Stock Trade System in Ukraine; stock market reports, developed by famous Ukrainian investment companies.

### **Monistic concept - the USA and the UK board practices**

Boards of directors in the USA and UK are represented by 12 and 15 members respectively. Spencer Stuart's 13th annual survey on board practices in large US companies found that average board size had shrunk from 15 in 1988, to 13 in 1993, to 12 in 1998. Almost one-third of boards in the USA had eleven or fewer directors in 1998.

Multiply directorship is a feature of board practices in the USA. According to Bassiry and Denkmejian (1990) 72 percent of CEOs of the largest 50 the USA corporations serve on the board of other firms. In the UK 58 percent of directors assume non-executive directorship position in other companies and 81 percent of them hold two to four directorships (Nash, 1990).

CEO/chairman duality is very popular in the USA and UK. According to a survey by Richner and Dalton (1989) in the United States 75 percent of large manufacturing companies are run by CEO-chairman. CEO duality is also prevalent in the UK where in 60 percent of

large firms including financial corporations the chairman is also the CEO, according to Korn/Ferry international survey.

Spencer Stuart reported that "The trend toward director independence is firmly entrenched". They found that in 1998 about 78 percent of S&P 500 company directors were outsiders, an increase of five percentage points since 1993. In 1993 they found that the largest 100 companies had an average of three inside directors; and just 14 boards had only one inside director in the form of the CEO. Many British multinationals constitute boards so that the mix is about 60:40, perhaps seven outsiders and six executives, including the CEO. More often than the North Americans, the British use outside, non-executive chairman in the role distinct from the CEO. In this way there is an echo of the rationale behind the separation of the supervisory and the management boards in other countries.

According to Spencer Stuart, the average S&P 500 board met seven times in 1998, the same frequency as in 1992, and down slightly from an average of eight meetings in 1998. In 1993 only about one-quarter of the boards fell into category of '4-7' board meetings a year, while the number of companies in that category is now approaching one-half. The decline in the number of full board meetings is partially explained by the increased reliance on the board committees.

In 1998, 98 percent of S&P 500 boards had human resources/compensation committees; 82 percent had nominating/corporate governance committees; 71 percent had executive committees; 58 percent had finance committees; the least popular was an environmental/healthy and safety committee, found by Spencer Stuart in only 13 percent of companies.

### **Dualistic concept - the German boards practices**

Since 1976, German law has required that one-third (in smaller companies) to one-half (in companies with more than 2,000 employees) of the members of the supervisory board be elected by employees; the others are elected by shareholders. The German board is thus an institution geared towards binding together parties with potential conflicts of interests.

As usual part of the employees' posts are taken by senior managerial employees. The chairman is elected by the shareholders and has a casting vote.

The supervisory board includes professional advisors to the company, such as lawyers and accountants, as well as representatives from banks and other firms with which the corporation has a business relationship.

The maximum period of appointment of members of the supervisory board is four years plus the balance of the year in which the appointment is made. In comparison to the supervisory board, members of the management board are appointed for a period of five years.

The supervisory board in turn appoints the executive board. Once appointed, however, the executive board enjoys a high degree of managerial autonomy, although the most important decisions must be confirmed by either the supervisory board or the general meeting of shareholders.

In Germany the separation between the supervisory board and the management board is legally assured as no member of the one board is allowed to be a member of the other at the same time. There is strong dominance of banks on the German supervisory boards. Of Germany's 84 largest companies, 75 have bank representatives on the supervisory boards; in 31 cases, that representative is also the chairman of the supervisory board. In 18 of those 31, the chairman is from Deutsche Bank.

According to an empirical study by Gerum (1991) on 62 large firms the monitoring function performed by the supervisory board functions effectively only in firms whose supervisory board is dominated by one or more block vote holders. The study shows that in a majority of 64 percent of the sample firms the management board influences the supervisory

board. Only in 13 percent of firms does the supervisory board discharge its oversight functions over the management board. In the remaining 23 percent of firms, the supervisory board is strongly involved in the decision making of the management board, a power concentration similar to the Anglo-Saxon, French and Japanese practices.

Bleicher's study of directors (1987) shows that 36 percent of his sample assume directorship in more than three corporations. In Germany the maximum number of board memberships is set at 10 without counting directorships in subsidiary companies.

German supervisory boards meet four times a year, usually for an evening and the following morning. This is much smaller number than in Finland, where there is two-tier board system and supervisory board meets eleven times a year.

### **Pluralistic concept - the Japanese board practices**

Japanese boards are the largest compared to those in the USA, the UK and Germany. The average board size for the top three construction firms is about 52, for the top three trading companies is 50, for the three largest automobile and banking companies around 43.

A large size of boards in Japan is explained by the fact that board membership is often a reward for long and faithful service or major contributions to the company. The Japanese boards of directors have been transformed into a motivating and marketing tool.

According to results of research by Oxford Analytica, nearly all directors are senior managers of former company employees. Almost 80 percent of all Japanese companies have no outside board members and another 15 percent have no more than two outside board members.

The Japanese board chairmanship is usually an honorary, symbolic or advisory position, the last step on the ladder before retirement from the company after having been president for several years. The chairman rarely interferes with the day-to-day managerial activities of the president, though his advice may be occasionally sought on major strategic decisions or on the appointment of key managerial positions. He spends most of his time representing the firm at external functions and activities, such as meetings of trade and economics associations, government commission etc.

Formal authority is held by the company president and the board of directors, but meetings are infrequent and decisions are rubber stamped. Real authority is held by the company president and the operating committee, which meets often.

Selection of new board members and election of officers is handled by the president and the operating committee. Their decisions are finalized by the formality of board and shareholder votes - in the latter case often by a clapping of hands at the shareholders' meeting.

### **The Ukraine's board practices**

**Size.** Average number of members of supervisory boards at Ukrainian joint stock companies is about 8-10. By this feature the Ukraine's board practices are closer to Anglo-Saxon model than to German model of corporate governance.

There is strong dependence of the size of supervisory boards in the Ukraine on the degree of concentration of corporate ownership. Thus, the higher degree of concentration of ownership the fewer members are on the board. Companies, where controlling block of shares (50 percent + 1 share) belongs to one owner, have boards with 5-6 members who completely represent interests of the controlling shareholder.

Companies, where there is no one shareholder owing even 10 percent of shareholders equity have as a rule more than 12 members on the board. The same concerns those companies under control of employees. So named "trade-union democracy" is labeled with the fol-

lowing principle in the board practices: "The more the better". Number of members on the board reaches 15-16 persons.

Besides that, there is strong correlation between the size of the board and origin of the controlling shareholder. Thus, companies under control of Ukrainian financial-industrial groups are supervised by the board consisting of 4-6 persons. At the same time, companies controlled by foreign institutional investors or Ukrainian investment companies have about 7-9 members on the board.

The last factor influencing the size of the supervisory boards at Ukrainian joint stock companies is a number of committees on the board. Those boards where there are professional committees consist of the higher number of persons in comparison to those without committees.

**Frequency of meetings.** Members of the supervisory boards at Ukrainian joint stock companies meet as a rule quarterly. Regrettably, there is still no dependence of number of meetings on number of committees on the boards. This evidences that committees on the board are still working not effectively.

Boards at the companies where the ownership is strongly concentrated hold meetings less frequently than at those companies where the corporate ownership is spreaded. This is because of controllers have a chance to have both the supervisory and the management boards under their control, letting just their representatives be on the boards. So, the supervisory board has nothing to supervise.

**Table 1.** Ownership structure, size and frequency of meetings of the supervisory boards at Ukrainian joint stock companies

Board practices	Companies controlled by					
	Executives	Ukrainian FIGs	Ukrainian investment companies	Ukrainian banks	Employees	Foreign investors
Size, persons	12-15	4-6	8-11	8-12	12-15	7-9
Frequency of meetings a year, times	5-7	4-5	5-6	4-6	6-7	4-6

The highest number of meetings of the supervisory board is at the companies where the fight for control is still lasting. These are companies where there is the share of the state. The Supervisory board holds about 6-7 meetings a year.

Moreover, in some cases violation of rights of minority shareholders is the factor which makes the board hold more meetings. This concerns situations when these minority shareholders are not numerous or represented by institutional investors, whose degree of knowledge on corporate governance is quite high. This does not concern companies where minority shareholders are employees or individual outside shareholders.

**Independence of directors.** Generally, members of supervisory boards at Ukrainian joint stock companies are not independent. Some of them own huge share of equity of the companies. Next directors have strong relationships or even ownership at supplying or buying firms. Some directors are relatives of large shareholders. As a result, only 8 percent of directors in the Ukraine are independent.

It is worth of mentioning that about 42 percent of Ukrainian joint stock companies under research have no independent directors on their supervisory boards at all. About 31 percent of researched Ukrainian companies have not more than one independent director on the board.

The lowest number of independent directors is on the boards at companies controlled by Ukrainian financial-industrial groups and employees. Companies under control of FIGs have

on the boards the lowest number of independent directors because a controlling shareholder wants to have on the board those persons who would bring at the board contacts with suppliers, customers and the state authorities.

**Table 2.** Ownership structure and number of independent directors at Ukrainian joint stock companies

Years	Share of companies under control of _____ having at least one independent director, %					
	Executives	Ukrainian FIGs	Ukrainian investment companies	Ukrainian banks	Employees	Foreign investors
1999	12	29	42	49	6	65
2003	17	38	100	88	14	100

Companies, controlled by employees have on the boards the lowest number of independent directors because as a rule the boards are overfilled with their relatives or employees.

**Committees.** International board practices concerning establishing committees on the board are still not spread in the Ukraine. The state has obliged Ukrainian joint stock companies to establish audit commission. But the commission is not on the supervisory board. It is not an integral part of the board. Members of audit commission are prohibited to be members of the supervisory board at the same time. Although the audit commission reports to the supervisory board, objectives of the audit commission are narrowed only to controlling financial transactions executed by the management board.

Therefore, it is worth of establishing an audit committee on the supervisory board with a broader spectrum of functions and equipped with latest knowledge.

Compensation committees are established on the supervisory boards at 10 percent of researched Ukrainian joint stock companies. These are companies mainly under control of foreign institutional investors.

Finance committees are on the boards at only 3 percent of researched companies. Administration committees are not popular on the boards of Ukrainian companies too. About 4 percent of researched companies have on the boards an administration committee.

Shareholders committee is not popular at Ukrainian joint stock companies. It is quite surprisingly because of frequent cases of violation of the minority shareholders' rights by majority shareholders and executives. This situation can be explained by two reasons. The first is unwillingness of majority shareholders to take into account interests of minority shareholders. The second factor is the very low degree of knowledge of minority shareholders on the major mechanisms of protecting their rights. One of these mechanisms is establishing and participation on the board's shareholders committee.

Only 4 percent of researched Ukrainian joint stock companies have a shareholders committee on the board. It is interesting that all these companies do not experience agent conflicts and are very transparent.

A policy committee is the most popular committee on the boards at Ukrainian companies. Almost 25 percent of researched companies have a policy committee on the board. Policy committee is the most spread on the boards of the companies under control of foreign institutional investors, Ukrainian financial-industrial groups and Ukrainian investment companies and funds. The higher concentration of ownership structure the higher likelihood of establishing a policy committee on the supervisory board.

**Director nomination.** In the Ukraine there are no nominating committees on the boards in contrast to the USA board practices. That is way the procedure of nominating new directors is very simple and little chaotic at the same time. Every shareholder who owns above 2 percent of shareholders equity can propose his own candidate on the supervisory board.

Moreover, directors can be nominated by the supervisory and the management boards independently. The procedure of nomination requires a meeting of the board where candidates are proposed.

The companies with dispersed ownership structure have a practice of nominating directors by governing corporate bodies - the supervisory and the management boards, or the audit commission. It is really hard to accumulate 2 percent of shares at Ukrainian companies under conditions of weak activity of individual, minority shareholders.

All candidates on the board in any way must be shareholders and can not be simultaneously nominated on the management board or on the audit commission which is independent body of corporate governance.

All candidates must fill the standard application form. Required information is rather formal than describing ability of the candidate to execute his duties on the supervisory board effectively. This application form is delivered by the shareholders to the management board. The management board is responsible for preparing the shareholders meeting. Therefore, all application forms are collected by the management board to be considered at the shareholders meeting. At the shareholders meeting owners vote for candidates.

Supervisory board can not influence the process of nominating. Members of the supervisory board can not press on the members of the management board to control the process of nomination of directors.

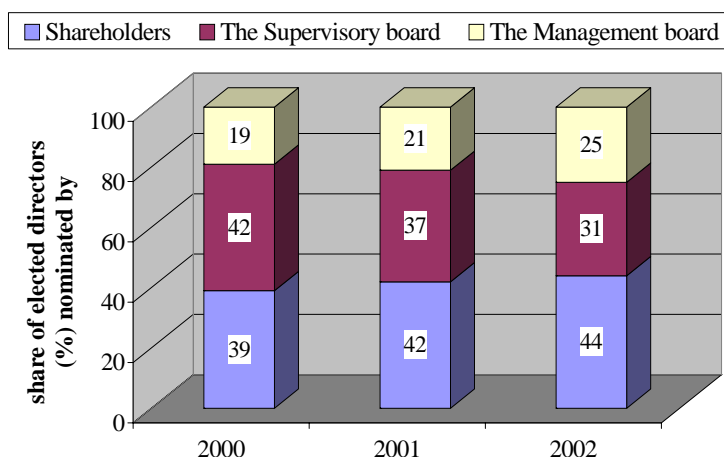


Fig. 1. Groups nominating directors and their efficiency

In 2002 the most successful in nominating directors were shareholders. About 44 percent of elected directors were nominated by shareholders.

Surprisingly, the management board is a step ahead of the supervisory board in successful nomination of directors. Thus, 31 percent of elected directors were nominated by the management board. Only 25 percent of directors were nominated by the supervisory board.

These trends could evidence the executives' wish to eliminate separation of ownership and control in the Ukraine. Moreover, decrease in successful nomination of directors by the supervisory board says that shareholders do not want to sit on the supervisory board themselves. They prefer to have there their representatives. This is very serious conclusion because such behavior of shareholders could be explained by their wishing to be controllers in indirect way, i.e. through electing directors and executives who would represent their interests. Even large shareholders meet each other only one time a year - at the shareholders meeting. Sitting on the board is too obligatory, time-consuming and even boring duty for them.

**Director election.** In the Ukraine directors are elected at the annual shareholders meeting. They can be elected only by owners. The chairman of the supervisory board can be elected either at the shareholders meeting or at the first meeting of the newly elected supervi-

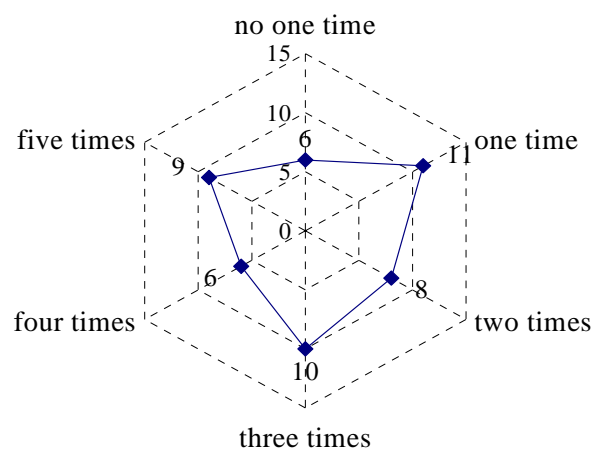
sory board. About 68 percent of researched Ukrainian joint stock companies have a practice of electing the chairman of the supervisory board at the meeting of the board. The rest prefer to elect the chairman at the shareholders meeting.

There is strong dependence between the degree of concentration of corporate ownership and the procedure of the chairman election. The higher level of concentration of ownership the higher likelihood of electing the chairman at the meeting of the supervisory board. It is because electing the chairman at the meeting of the board allows large shareholders keep the process of corporate governance not transparent to facilitate pursuing their own interests.

Directors are elected for the term of one year. This is quite wide-spread practice in the Ukraine. Only 19 percent of researched Ukrainian joint stock companies elect directors for other terms, usually longer than one year. Every annual shareholders meeting the members of the supervisory board report to the owners what work they have done for the last year and results achieved. In the case if shareholders are satisfied with the report provided, they, as a rule, prolong residence of the members on the board. If the owners are not satisfied with the results of work achieved by the supervisory board they elect new members on the board.

About 32 percent of researched Ukrainian joint stock companies keep on the supervisory boards members for the period more than five years. This is an evidence of the low mobility on the board. At the same time, there is quite high ratio of mobility of the chairmen on the supervisory boards. Thus, only 8 percent of companies have the same chairman on the supervisory board for the period more than five years. This is a result of strong fight on the market for corporate control and remarkable changes in the corporate ownership structure.

◆ Number of companies which substituted the chairman of the board\_\_\_for the period of five years



**Fig. 2.** Number of substitutions of the chairman of the supervisory board at researched Ukrainian joint stock companies for the period of five years

Among 50 researched Ukrainian joint stock companies, 9 companies substituted the chairman of the supervisory board 5 times for the period of five years, i.e. each year; 6 companies - 4 times for the same period of time; 10 companies - 3 times; 8 companies substituted the chairman of the board 2 times; and 11 companies - one time for the period of five years.

In the Ukraine there is still a practice of election (reelection) of all members of the supervisory boards. Practice of partial substitution (elections) of the directors is not developed at the Ukrainian joint stock companies. At the beginning of 2003 only 11 percent of researched companies practiced partial election of directors when up to a half the board is elected.



**Employee participation.** In contrast to Germany, in the Ukraine law does not require that a part of the supervisory board to be elected by employees. Therefore, employee participation is a very hard issue to implement into the life.

International practice of employee participation places an emphasis on availability of mechanisms to let employee representatives to be informed by supervisory board about important decisions. One of such mechanisms is collaboration of members, elected by shareholders, and those, elected by employees on the board.

In the Ukraine employee participation is available only at the companies where employees are majority shareholders. Taking into account that in the Ukraine employees shareholders activism is not popular, and cumulative representation on the board is not fixed by the law, it is not worth of supposing that minority shareholders employed at the company can participate in corporate governance on the supervisory board.

**The chairman of the supervisory board - the former chairman of the management board.** The practice that is popular in Japan is not spread in the Ukraine. In the future it is possible to wait for such kind of practice at those Ukrainian joint stock companies which are controlled by executives (members of management board). Retiring executives would aspire to control the company after they leave the management board.

Companies under control of Ukrainian financial-industrial groups, banks, investment companies and mutual funds will be rather common in misleading the above practice. It is because the above groups of shareholders are strongly motivated controllers and they will not share their power with somebody else.

Only 4 percent of researched Ukrainian joint stock companies have the chairman of the supervisory board who is the former chairman of the management board. As usual these are people who can not execute their duties and undertake responsibilities as the chairman of the management board because of their age.

## Conclusions

After the ten years of privatization, the supervisory board practices in the Ukraine adsorbed features of both well-known models - Anglo-Saxon and German. Features of Anglo-Saxon model, brought to the Ukraine are the following:

- small size of the supervisory board;
- absence of legally stated employee participation in the corporate governance.

Meanwhile, German model is getting spread in the Ukraine from year to year. At this time the board practices in the Ukraine are similar to those in Germany. These are:

- small number of independent directors on the board;
- low frequency of meeting of the board;
- small number of committees on the board;
- management board influences supervisory board.

The main reason on closing the board practices in the Ukraine to those in Germany is increase in concentration of ownership that is following with increase in corporate control, violation of the minority shareholders' rights, increase in number of conflicts of interests and decrease in transparency of the Ukrainian joint stock companies. All these are generally accepted corporate governance practices in Germany.

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