

Corporate governance and management control in cooperatives

Pellervo
Confederation of Finnish Cooperatives

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Foreword

In recent years corporate governance has developed rapidly throughout Europe and particularly in Finland. The control of listed company managements has progressively taken place via the capital markets and away from the banks and other financial institutions. At the same time, a manager-based culture has become an owner-based one.

A Finnish consultant, Dr. Jyrki Veranen wrote in 1966 that: "The problem of a 'traditional' manager-based culture is that the return on capital invested in the company by the owners is often unnecessarily low and so the rise in the company's value and its ability to pay dividends is also low." The demands of owners on management have become more vocal and clearer once the goal of producing added value has been set.

The important question, however, is how to organise a company's operating framework and governance so that management works in the best interests of the owners. *What is the mechanism by which owners in the widest meaning can effectively supervise the activities of a company and also obtain the largest possible benefit?* This is core element in corporate governance.

The proliferation of share ownership and the development of the capital markets have led to the effective supervision of management by the capital markets. The decisions of major corporations are assessed daily by the owners, as well as by the hundreds if not thousands of analysts and investors.

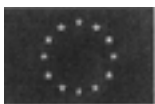
Ownership in a cooperative is different from that in a listed company because cooperative shares are not normally freely transferable and so there is no market for them. In practice, the benefit and added value produced by a cooperative accrues to the owners, that is the members of the society, via the business relations between them and the cooperative.

Many cooperatives have grown into major enterprises. *The major cooperatives - whether incorporated as joint stock companies or not - are exposed to comparison with listed companies.* They compete for the best managers and their information is compared to their competitors. Today's major cooperatives demand from their directors, as well as from their owners, at least as good professional skills as listed companies. The role of cooperative member-owners and their responsibility for the success of the enterprise is in actual fact greater than in publicly quoted companies as the market continuously monitors the company and distributes information via the media.

The management of cooperatives, both professional and lay, has certainly improved during the last decade. Likewise transparency has increased. The requirements, however, are growing continuously and *cooperatives are subject to the same pressures for greater efficiency and change in corporate governance as other enterprises.* For this reason, it is important for cooperatives to consider corporate governance within the framework of their cooperative origins. It is useful to think about building up an effective system of internal control simply because even the largest cooperatives lack the kind of control that comes from the stock market. The general discussion concerning joint stock companies will provide many suggestions, but the cooperatives themselves must find solutions suitable to their form of enterprise, field of operation and operating environment. This discussion should

concern itself with good governance practice, that is how internal control is organised, as well as such broader issues as how to run cooperatives so that their resources produce the best possible benefits to their members. In spring 1999, the Board of Directors of the Pellervo Confederation of Finnish Cooperatives decided to organise a Working Group to consider these topics. The members of the working group were top managers and non-executive directors from cooperatives. The working group was chaired by Mr Samuli Skurnik, CEO of the Pellervo Confederation of Finnish Cooperatives and the secretary was Dr Raija Volk, Research Director of the Pellervo Economic Research Institute. The report is based on discussions held within the group and presentation given by outside experts. The report aims at stimulating discussion of this vital subject within the cooperative movement rather than offering readymade models.

The European Commission D.G. Agriculture generously contributed towards the cost of translating the report into English. The translation was made by Michael Wynne-Ellis. This paper has been provided also for the Corporate Governance seminar organised by the General Committee of Agricultural Cooperatives in the EU (COGECA) in Brussels in November, 2000



What is corporate governance?

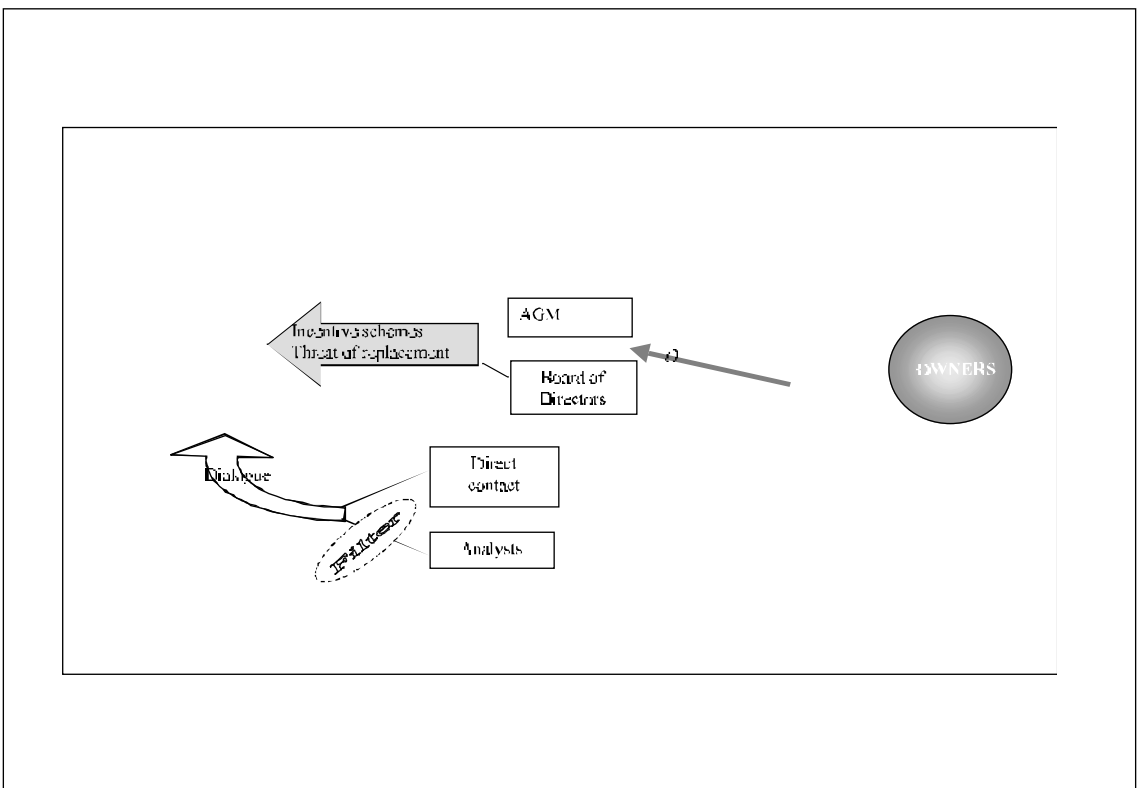
Basically, corporate governance concerns *all the steps taken by the owners of a company to ensure that it produces for them the best possible benefit*. One detailed definition of the concept is that used by the OECD, which is available on their website.

The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure

through which the company objectives are set, and means of attaining those objectives and monitoring performance.

Put simply, therefore, corporate governance concerns all the institutional structures that help to maximise efficiency, ie, legislation, company organisations, agreements, etc. A division is often made between internal and external control, as, for example, between legislative and capital market control. The organisation of corporate governance is more widely concerned with ownership structures as a company's success is affected by the type of ownership structure and owners it has.

Owners' channels of influence



Dispersed ownership necessitates corporate governance mechanisms

Corporate governance has been a major economic and managerial question ever since *ownership and management in a company were separated*. The theoretical and juridical roots of the debate stretch back to the 1930s.

The continuous growth in company size has created a need to find newer sources of financing, such as the stock exchange, which has further dispersed ownership. Cooperatives, too, have a wide group of owners and limited liability, but here the motivation of membership comes from the services produced rather than a return on capital invested.

Dispersed ownership and the growth in company size pose a challenge to corporate decision-making, because they suppose the separation of ownership and control. Separation is a strength because it allows a division of responsibilities based on specialisation: the owners entrust decisions concerning the company's production to a professional and skilled management. On the other hand, separation is a weakness because management can use its decision-making authority contrary to the interests of the owners. For instance, management may be tempted to overinvest or overemphasise growth or market shares. It could also pursue private objectives that are contrary to the owners' interests. In corporate governance, *the aim is to give management sufficient latitude to use its expertise whilst ensuring it recognises its responsibility to the owners*.

Efficient capital markets have increased external control

Company control occurs via numerous channels both from within and from outside like the capital and commodity markets. Internal governance is the essential part of owner control. During the 1990s, external control via the capital markets became increasingly stronger due to deregulation and the revolution in information technology. This has led to the *rapid globalisation of financial markets*, accelerated in turn by the growing role of institutional investors like pension and investment funds. According to one estimate, the world's pension funds amount to something in the region of USD 11 000 billion.

With the proliferation in shareholding, investors

are constantly on the lookout for new opportunities. Simultaneously, *the importance of stock market information in corporate governance has increased*. Owners are more active and increasingly "vote with their feet" by selling when dissatisfied with share developments. *Strengthening market control has forced management to pay increasing attention to the development of shareholder value*. One outcome of rising investor activity has been that companies devote more time to investor relations. Companies are also increasingly returning money to their owners in the form of dividends and share redemptions for two reasons: firstly, they operate more efficiently if no "loose" money is available; and secondly, owners are more efficient at reinvesting assets than companies.

Emphasising shareholder value is generally considered to be a typically American phenomenon. However, one of the experts called by the Working Group, Professor Bengt Holmström (MIT) has shown that the concept of shareholder value is also quite novel in the United States. Its origins lie in the takeover boom of the 1980s, but it was not until the mid-1990s with resistance to the traditionally, high-handed behaviour of American corporate managers that shareholder value was emphasised. *Takeovers were in the 1980s a significant mechanism for the control of management*. They resulted in the downsizing of multi-sector conglomerates. At the same time discussion focussed on issues as minority shareholder protection. Therefore, existing legislation in the United States has made takeovers very difficult and increasing shareholder value is supported through management incentive systems like stock options.

The emphasis on shareholder value is largely a question of those *market mechanisms by which owners try to ensure that management works to their advantage*. In other words, that they receive the best possible return on their investment in the case of a joint stock company or the most efficiently produced services in the case of a cooperative. The strengthening of external, capital market control is reflected in company objectives. In a listed company, increasing share value has become a primary objective.

We can summarise the owners' channels of influence through the capital markets as follows:

Owners´ channels of influence the capital markets

- Daily stock exchange evaluation of company’s and management’s achievements
-> facilitates control
- Stock exchange helps to guide operations
-> facilitates decision making
-> analysts and investors function as management’s ”sparring partners”
- Investment bank studies of listed companies elicit ideas and can help in decision making and evaluation
- Stock exchange exerts a positive influence on management to operate in the interests of the owners
-> share undervaluation weakens compensation and increases take-over threat

Mika Ihamuotila, Mandatum Asset Management

The difference between European and American systems

The pressure for uniformity in corporate governance systems caused by globalisation has given rise to a lively dialogue throughout Europe. The greatest difference between existing systems of

corporate governance has been in the field of external control. European systems are typically bank-based and owner-concentrated, whereas American ones rely on the stock market and dispersed ownership. The differences are due to legislation (banks in America are forbidden to have significant holdings in companies), the nature of

Different financing systems, different corporate governance mechanisms

	Bank-based Japan Germany Finland	Market-based UK USA
Ownership structure	Concentrated Much cross-shareholding	Dispersed
Largest owners of industrial companies	Banks	Institutional investors Investment funds
Share structure	Vote-carrying ordinary shares	One-share-one-vote
Minority protection	Poor	High
Take-overs	Never	Normal phenomenon
Board of Directors	Insiders Controlling Meaningless	Outsiders Guiding Very important
Operative management incentive schemes	Insignificant	Considerable Tied to exchange quotation

Source: Mika Ihamuotila, Mandatum Asset Management considerations in European corporate activities.

financing (European companies have depended on debt financing as the capital market opened and developed much later) and also partly to social attitudes (American society, with its emphasis on personal freedom, favours the quick repatriation of profits, whereas Europe's more socially-conscious culture sets other objectives for businesses). In Europe, management thinking has traditionally been more socially oriented and considerate of wider stakeholder interests than in America. Continuity and employment are primary considerations in European corporate activities.

Stakeholder versus shareholder value approach

European thinking stresses *that not only owners are affected by company decision making, but also other stakeholders*, such as employees, customers, suppliers and the local community. When

setting its objectives a company should also consider the well being of these groups. In Germany the right to codetermination¹ is believed to have increased the productivity of workers because it has encouraged them to invest in the skills required by the company.

The shareholder value and stakeholder views are most clearly differentiated when considering in whose interest corporate governance functions. The shareholder value view emphasises owner-orientation and the realisable benefit of share value, in the case of joint-stock companies, whereas the stakeholder view is that others than the owners have legitimate demands and expectations on management.

This antithesis has occasionally led to the belief that shareholder value thinking has completely displaced and disregarded all other stakeholders. Its defenders, however, deny this, stressing that the maximisation of profit not only enables a compa-

The effect of different financing systems on corporate operations

	Bank-based	Market-based
	Japan Germany Finland	UK USA
Business objectives	Stakeholders	Shareholder value
Restructuring of operations	Via internal pressure	Market for corporate control Takeovers and their threat
Crisis restructuring	Bank to the rescue	Bankruptcy and Chapter 11
Business openness	Closed	Transparent
Business time span*	Long-term	Short-sighted interim report fixation
Business risk*	Low Bank safeguard own receivables	High Maximisation of share capital value
Company structure	Multi-sector	Concentration on core business MBO's
Profitability of business operations	Nobody knows if there is a difference between the systems in the long run	

* Considerable differences of opinion
Source: Mika Ihamuotila, Mandatum Asset Management

8 ¹ Codetermination means that all companies in Germany with more than 2000 employees are required to have an equal number of employee and shareholder representatives on the supervisory board.

ny to pay wages, but also to consider other groups.

The advantage of emphasising increasing profits and shareholder value is that it sets clear and effective decision-making criteria for management. *The problem of stakeholderism is how it should be implemented* (either as wide-based objectives for management that balance the various stakeholder interests or by involving the different groups in the decision-making process as in the German model) *and how to measure the achievement of the objectives*. The dangers are that matters become more open to interpretation, responsibility is blurred and decision-making is slowed down.

The fear in *shareholder value thinking* is that it may lead to shortsighted operations and a "fix-ation with interim reports". To retain its competitiveness, a company must invest in long-term product development and innovation, so the question has been how can producing sufficient profits for the owners and securing long-term innovativeness be adjusted to each other.

Even though stakeholder considerations and bank-based financing are more common in Continental Europe than in Anglo-American countries, there are also major national differences between European countries. The structure of the capital market, legislation and operating environment factors have produced that system of ownership and corporate management best suited to each country at each time. The integration of the capital market has changed the European owner governance mechanism, but not necessarily in the same way in each country. Neither was there any need to do so because *economic research has not yet proved a connection between an corporate governance mechanism and economic success*.

Ownership policies also concern cooperatives

Owner-based policies and emphasis on shareholder value originate in listed companies. In respect to cooperatives, emphasising shareholder value is sometimes thought misleading and a more natural approach would be to think in terms of stakeholders. In examining the cooperative movement as a whole, it is more natural to stress stakeholders, because cooperatives often try to offer services that the market fails to produce effectively. However, a member in a cooperative society normally has the full rights and duties of ownership.

Furthermore, the goal of a cooperative is to produce the goods and services required by its member-owners. *Thus owner-based thinking is highly suitable when considering corporate governance in cooperatives. Owner value, however, is defined differently in a cooperative from a listed company*.

In the listed companies it is natural to measure owner value in terms of share value. For cooperatives, however, there is no equally clear way of measuring it and neither does the same method apply to all types of cooperatives. For instance, owner value in an agricultural cooperative is formed by the difference between the market price and that paid to the members, the monetary value of the services produced and the assets retained by the cooperative. What is essential is that owner value is expressed as a monetary quantity that can be monitored and measured. *Future profit expectations cannot be taken into consideration in the value of a cooperative because the shares are not transferable*. Therefore, it is never possible to compare the owner values of listed companies and cooperatives.

The challenge to the members and managers of a cooperative enterprise is to recognise how it differs from a publicly quoted company and how good board practice can best be implemented. An excellent example of the topical importance of this debate is the conference organised in the United States in November 1999 in which 135 cooperative leaders in agriculture met to discuss and devise ways of organising cooperative governance (see <http://www.wisc.edu/uwcc/events/2000-99tc.html>).

The topics discussed at the conference included the use of outside directors and advisory boards, board size and qualification of board members, selection and development of board members, governance in special cases such as joint ventures and alliances, and governance issues related to using outside capital. These subjects all reflect the changes in operating environments that have forced cooperatives, worldwide, to improve governance and adopt new organisational methods to counteract increasing competition.

Basically, corporate governance is the same in cooperatives as in publicly quoted companies. *In order to be competitive, a cooperative must have owner governance organisations (boards) that support the success of the enterprise, as well as incentive mechanisms that operate in the inter-*

ests of the owners.

Even though the question of controlling managers is basically the same in both cooperatives and other types of companies, the cooperative has many special features that make governance different and challenging. *Cooperatives differ from traditional investor-owned companies in respect to their ownership character, goal setting, methods of financing and profit distribution, and decision making.* These differences not only bind members more effectively to the activities and running of the cooperative, but also blur the ownership role and bring to the owners many other interests in addition to the success of the enterprise.

- The dispersion of ownership, as well as the separation of ownership and management, is equally present in cooperatives and in joint-stock companies. The characteristically dispersed ownership of cooperatives means that the divorce of decision-making from financing, as well as the one member and one vote principle, make it impossible for any single owner to predominate in decision-making, and likewise guarantees an equal voice for all members.

- Goal setting appears to be the first thing that differentiates cooperatives from joint-stock companies. The goals of a cooperative might be very diverse whereas in a publicly quoted company efficiency and economic added value accrues to the owners in the price of their shares. From the owner's point of view, a cooperative is more than an investment. The core activity of a cooperative is determined by the services the members require and not by the return on investment.

At the same time *cooperative lacks the essential channel of information and control of the listed company: the share.* The stock markets have proved to be highly effective in real-locating capital between widely divergent sectors of the economy and thus functioning as the engine of structural change. In cooperatives the pressure to redirect capital and its efficient usage is not always so great as in a listed company. Cooperatives are forced to ask whether, *under prevailing conditions where business is faced by strong pressures to change, they can find a signal similar to stock market information.*

- A further difference is that, as cooperatives traditionally stress customer and business rela-

tions, and ownership in the sense of capital input is normally considered subordinate, capital investment and profit distribution is normally in proportion to the services used. Due to this business relationship, cooperatives are also able to distribute the profits or surplus continuously as part of buying or selling transactions, and not only after the closing of the accounts. For this reason, performance ratios based on cost accounting, originally developed for joint-stock companies but also used extensively in cooperatives, give an inadequate picture of a cooperative's condition. This means that a cooperative must think more deeply about how sets its objectives and measures their achievement.

It is important for cooperative members to be conscious of their dual roles as customers and owners. This dual role can lead, at one extreme, to total "managerialism", i.e., to an over-emphasis on managerial objectives. And at the other extreme, stressing customer relations in the division of the surplus can lead to pressure for the rapid repatriation of the cooperative's profits, especially when the funds allocated for its development cannot normally be realised by the individual member.

Cooperative governance is also complicated by the pressures on their operating environment, which have forced them to adopt new organisational modes. Examples of this are the partial or total incorporation of the operations of cooperatives and the fundamental re-evaluation of cooperative principles initiated by the new generation cooperatives in the United States. There has been also widespread discussion on how to expand the capital input of member-owners. All these trends have added new ideas for cooperative models and are proof of the way in which member-owners are searching for more efficient ways of producing added value.

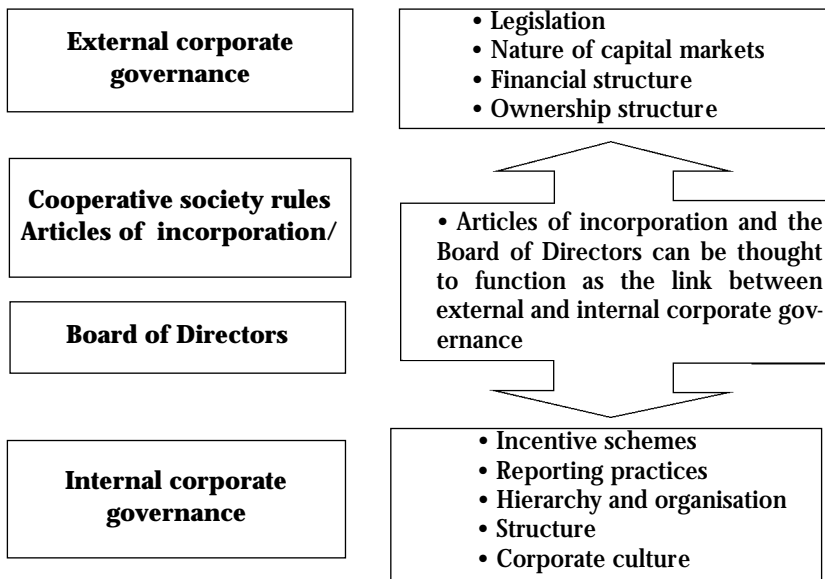
To enable cooperatives to understand their position and the key issues in the corporate governance debate, the following chapter discusses the main mechanisms in relation to the special character of cooperatives. Because they are becoming ever more complex in structure, the discussion also touches on the joint-stock and family company, of which the latter resembles a cooperative in its goal setting and financing structures.

2

Corporate governance mechanisms

2.1 External corporate governance and its meaning in cooperatives

Corporate governance mechanisms can be divided into external and internal, as well as those that combine both levels:²



Legislation (Cooperative Societies Act, Companies Act, Securities Market Act, Auditing Act, competition legislation, etc.) determines the general framework and rules on how business is carried out. Because legislation contains the general rules governing the running of a company (what boards it should have and how are their members elected, what to disclose concerning the company's operations, etc.) it plays a central role in the control of the company. How advanced legislation is in respect to some form of enterprise may decisively influence the form business assumes in a particular country. In respect to boards, for instance, Finnish cooperative and company legislation is very similar.

Capital markets

The nature of capital markets radically influences the form which corporate governance takes. In the United States, financing is traditionally based on the securities market and equity plays a major part in corporate financing. Similarly, securities market information and control are emphasised. In Europe and Finland, the role of banks as major lenders of capital and as shareholders, is very important and in this way they have exerted significant control over companies. The greater weight accorded to banks and debt financing is partly explained by differences in legislation. The capital markets and related legislation (Securities Market Act) in Finland, for instance, developed much later than in

² The diagram is based on the one presented by Dr. Mika Ihamuotila of Mandatum Bank in his paper to the Working Group.

the United States. In some countries, cooperative lending institutions can be important sources of capital for cooperatives operating in other sectors, in which case control takes place via them. Cooperative banks in Finland do not, however, have this role.

Financial structure is closely connected to the nature of the capital markets and also to the legal form of company the business takes.³ The equity or share capital of a cooperative differs from that of a joint-stock company in that:

- Share capital varies in size (it is not fixed in the same way as the capital of a joint-stock company)
- Share capital is accumulated either in proportion to member purchases or investments of the same sum (members do not invest according on the basis of risk as in joint-stock companies)
- An investment in share capital is not freely transferable (sellable) to another person as is a normal share - although in Finland share capital is in a limited sense "sellable", because the cooperatives return a member's share upon his resignation.
- Unlike equity shares, the value of an investment in share capital is not determined by the market (repayment of shares is at par value), neither does it reflect any appreciation arising from expected future earnings. In other words, any added value in a cooperative enterprise cannot be realised by the sale of shares but only by winding up the society.

There have, however, been changes in recent years in regard to the share capital element in the financial structure of cooperatives. The new generation cooperatives in the United States have tried to solve the problem of collective ownership⁴ associated with share capital in traditional cooperatives by taking into use transferable and appreciable investment shares in addition to closed membership. In addition, certain cooperatives have incorporated all or some of their operations.

Because traditional cooperatives do not have publicly quoted shares, they naturally lack the related corporate control mechanisms. One of these is the *takeover*, which played such an important role in the United States in the 1980s. As hos-

tile takeovers in particular lead to a change in management, one could also talk about the market for managers. A cooperative cannot be taken over by acquiring a majority share holding on the stock market and then replacing the management. The importance of this mechanism for listed companies has been reduced by the introduction of legislation making takeovers extremely difficult. *The absence of the threat of a takeover in a cooperative is actually considered as a positive feature, as it protects the original purpose of serving the members.*

It is unlikely that the takeover mechanism would work in regard to cooperatively owned incorporated and listed companies, because the cooperative society usually retains the majority of the shares (and votes). In this respect, cooperatives and their incorporated subsidiaries closely resemble familial companies.

In addition to equity and retained profit reserves, cooperatives and joint-stock companies can finance their operations by borrowing. In recent times, *the importance of debt financing as a management control mechanism has been emphasised* as the burden of debt ties managers' hands and forces them to work efficiently in order to service the debt at regular intervals. There is also less cash flow available at their disposal. The controlling effect of debt is firstly that, as it is normally granted for a relatively short period, management must make a real effort to find productive ways of operating in order to amortise the loan, and secondly, if the company is unable to meet its debts, the creditors have the right to apply for bankruptcy and realise the loan guarantees.

With their narrower ownership basis, cooperatives (and familial companies) have limited opportunities for accumulating capital, because this has to be collected from the members (or the family) rather than via the securities market. This tends to increase the importance of debt financing in cooperatives. Debt, however, also means the risk of bankruptcy, which is, perhaps, the reason why cooperatives in sectors susceptible to cyclical fluctuations and requiring heavy investments, like the forest industry, seek to spread risk through restructuring (joint-stock subsidiaries and becoming list-

³ Other factors, such as the tax treatment of various financing instruments, are also important.

⁴ The problem of collective ownership means here that a member who resigns cannot realise the society's assets arising from retained earnings or any appreciation in the value of the enterprise in general. Therefore a member no longer feels that it is his or her enterprise and may, under certain conditions, try to benefit from the enterprise at the expense of other members.

ed) rather than debt financing. When considering the role of debt financing, it is necessary to balance the incentives debt provides against the risk of decision-making power passing to the creditors when the company is unable to repay its debt. There is, however, no single answer to the optimal ratio between share capital and loan capital.

Many cooperatives have grown into major corporations that increasingly face the problem of where to obtain the necessary growth capital. The normal method of growth is through takeovers and company shares play a central role in financing them. Moreover, in growth sectors share-based incentives function as a way to recruit management as well as a governance mechanism. Each cooperative enterprise must consider when setting its goals - striking a balance between the efficient use of capital, and continuity and security⁵ - whether the efficient use of capital be secured by other means than capital markets pressures.

The nature of ownership

Ownership structure refers to the people who own a company and how dispersed ownership is. Ownership structure varies between countries and company type. In the United States, listed companies have extremely dispersed ownership, whereas in Europe (and also Japan) ownership is traditionally more concentrated, with blockholdings of shares in the hands of banks and families. Cross-shareholding between companies is also more common in Europe. Part of the reason for these national differences is legislative, as in America there are legal restrictions on corporate shareholding by the banks and insurance companies.

The ownership structure of cooperatives resembles that of dispersed-owned joint-stock companies, because the democratic decision-making process of the former prevents any concentration of ownership. This has two consequences. On the one hand, a cooperative has none of the tension between majority and minority shareholders that arises from the concentration of decision-making. This means that the member-owners of a cooperative are in a better position to ensure that

the enterprise is managed in the general interest of all the owners and not just the largest one. On the other hand, dispersed ownership can weaken the individual member-owner's desire to control the activities of management, because the benefits arising are divided equally among all of the owners.

Cooperatives, therefore, lack the control over management exercised by large (share) owners. This does not mean that member control in a cooperative is nonexistent. Many cooperatives are direct extensions of the occupations or businesses of their members, which means that they are prepared and motivated to take an active interest in the operations. Another factor that makes member control effective is the local character of many cooperatives.

Moreover, ownership in a cooperative has a "face", because of its close connection to membership and the use of services. The exit and voice control rights associated with shares in a listed company are used anonymously via the market. In a cooperative, the equivalent exit and voice controls (resignation from the society⁶) are both in the hands of the members. As the individual member's voice is mostly limited to one vote, and membership is otherwise dispersed, the face factor is not necessarily of any practical importance in controlling management.

The simultaneous linking of the customer and business relationship to ownership can also function as a management control mechanism in a cooperative. Member-owners are in constant, often daily contact with the cooperative enterprise. *Ownership in a cooperative is also long-term, often lifelong.* Both these factors involve members in the long-range development of the cooperative. However, by detaching decision-making (voice) from financing and tying financing and profit distribution to the use of services, the customer relationship is emphasised but the role of ownership is blurred. The management of a cooperative does not have the same clearly defined purpose as a listed company of maximising the return on owners' investment and this complicates the control of management.

⁵ What is decision is the degree to which these two objectives (efficient capital – continuity) cancel each other out. That is, to what extent stressing one of them will prevent the other's achievement.

⁶ How effective resignation or the withdrawal of custom is as a control mechanism largely depends on the other options available on the market: other food stores or purchasers of raw materials. Another limitation on their effectivity may be the obstacles and restrictions on resignation contained in the rules.

The situation is somewhat different *if a cooperative has transferred its operations to a joint-stock company in which there are also outside investors*. Just as in a family firm, such companies are forced to *strike a balance between the different groups of owners*. The very existence of one large majority owner may arouse concern about corporate goals among the minority owners. This is particularly true when the majority owner (or its members) is also the raw material supplier, for then an incorporated and listed company must place special emphasis on the transparency of its operations and also disclose how it tries to benefit the different groups of owners so as to avoid any negative reflection on share prices. Thus the distribution of the profits must be in the form of a return on investment and not in the price paid for raw material deliveries.

Ownership structures and cooperative strategies

Globalisation has also led to the standardisation of corporate governance mechanisms. Even so, depending on the circumstances and sector, there may be variations between ownership structures and methods of owner governance. For a company to succeed it requires the correct type of owners and ownership structures. The ownership structures and the company's sector and strategies must be in harmony. Although it has become customary to talk of a company having the wrong kind of owners, it is more natural, when considering ownership structure, to say that it is in the wrong field. One Finnish example of this was the agricultural supply cooperative Hankkija (later Novera), which quite clearly expanded its operations into the wrong field when it moved into the construction sector under the influence of its strong-willed and growth-oriented CEO. The owners' opportunities and resources were not in tune with the company's strategies and owner governance was too weak to effect any change.

As the years pass by, the competitive strategies developed within a cooperative may no longer be in harmony with its ownership structures. Member-owners are often rather slow in shedding

operations. On the other hand, the objectives of management in changing ownership structures may well be contradictory to the member-owners' opinions and interests⁷. *Particularly in cooperative enterprises, in which the ownership basis is very solid, it is essential to ensure the compatibility of strategies and ownership structures*. A cooperative's board should evaluate which activities are most important from the point of view of custom-based membership. Retaining control over the most essential parts of the business may be particularly important, but with regard to the less essential ones the aim should be either elimination or reorganisation. One topical problem concerning ownership structures is globalisation, because many cooperatives have expanded abroad through takeovers. As globalisation increases the risks, so member-owners should clearly see the comparable added benefit accruing to them and decide how to reduce the risks.

Occasionally, long-term changes in the dynamics of a sector may necessitate new ownership structures. This is often a question of the sector demanding a certain company size or growth rate or resources or even the development of a brand which is beyond the capabilities of a cooperative-based enterprise due to its limited capital. Here it could be in the long-term interest of the owners to relinquish the great part of its interest, that is also their corporate governance powers, particularly if the market in this sector functions so that the members do not need their own enterprise in order to access the market.

2.2 Internal governance

Composition of the boards

Large Finnish cooperatives *normally have a two-tier governance structure consisting of a supervisory board⁸ and a board of directors, or a three-tier one* in which the annual cooperative meeting is replaced by a *council of representatives* e mi2 0en TD (vfit g fxpnge rt inhe owp) .

The position of the *supervisory board* has been much discussed in recent times. Some non-cooperative Finnish corporations have abandoned them and introduced the Anglo-American model with its single board of directors. This model stresses the responsibility of board members and their familiarity with the company's sector and operations, and has led to an increase in both the amount of the time worked and levels of remuneration.

At the same time, *boards on which solely company managers* sit have become more rare. The trend is to relinquish boards occupied by operative management and where corporate governance is transferred to supervisory boards.

The problem of such boards arises from the powerful position of the executive directors and particularly the chief executive. As the other board directors are answerable to the chief executive, they feel themselves in a subservient position and this can easily lead to conflicts of interest within the board. The situation in which operative management is responsible to a body composed of its subordinates is hardly conducive to being critical. For this reason, it is recommended that a chief executive does not have the dual role of being the (supervised) chief executive and the (supervising) chairperson of the board.⁹

When there are such boards, controlling power is nominally the responsibility of the supervisory board. At its infrequent meetings, the latter is dependent upon information supplied by operative management, and few of its members have the ability or time to study the issues in depth. One solution here has been to use small working groups, but as they confuse the issue of responsibility, they are no longer recommended. Thus the model in which there is a supervisory board and a board of directors composed of the operative managers is considered problematic and no longer normally recommended.

In addition to the above, there are also *mixed boards* with inside executive and outside non-executive directors, normally representatives of the members. The operative management member is often the chief executive, but in some cooperatives¹⁰ also the chairperson of the board. In this kind of mixed boards inside and outside members

easily form "odd pairs" with the latter being overshadowed by the former, particular if one of them is the chief executive. In practice, the chief executive always attends board meetings even if not a member, so membership is not necessary to ensure the flow of information.

Many cooperatives use a model in which there is *both a supervisory board and a board of directors formed* by the member-owners. The owners are thus represented at two levels. This kind of multi-tier structure could be justified when the owners are very different and require a forum to express their joint intent concerning core strategies. Cooperatives often have a situation like this in which the supervisory board represents the whole membership and its voice. The supervisory board can be considered as a joint body of the member-owners, taking a stand and deciding on all long-range issues and committing itself to the owners' decisions. The democratic nature of cooperatives presupposes member communication. Member commitment and the related information and discussion are the necessary requirements for quick decision taking, which is often problematic in cooperatives. To do this a cooperative needs a network and formal bodies like supervisory boards are part of this network.

In practice, the question concerns the degree to which a narrower but more competent board can fulfil the same task of bonding the members as a broader supervisory board with a shallower knowledge of the company's sector and situation, as well as the reasons and circumstances for its decisions. In large cooperatives, member communication can be very expensive, so it is useful to consider the cost benefit of alternative systems.

It is important to understand *the pitfalls of a multi-tier structure*. One essential matter is the division of responsibility between the various bodies, firstly between the board of directors and operative management, and secondly between the board of directors and the supervisory board. Each body must make a positive contribution to the development of the company. Furthermore, the members of each body must have a clear understanding of their own role. A board of directors must act in the overall interest of the owners and

⁹ A board of directors should be able to dismiss, when necessary, the chief executive – how can this succeed if he is also the chairperson of the board?

¹⁰ At least in those Finnish retail cooperatives where the rules state that the chief executive is also the chairperson of the board of directors.

not in that of the different groups behind the members.

The necessity for supervisory boards in cooperatives has seldom been questioned. In producer cooperatives they could be thought to represent the owners, at least in that sense that the members are the users of the society. In consumer cooperatives, however, the question of who should sit on the supervisory boards and whom do they represent is not quite so obvious as in a producer cooperative. There are cooperatives in which the seats on the supervisory board are divided on a party political basis. Whereas this does not make the members any less competent or biased in representing the owners' interests, it easily leads to the problem of outside interests conflicting with those of the owners.

Finally, it is useful to remember that *no organisational structure automatically guarantees good corporate governance.* Neither does the cooperative form of enterprise make all cooperatives so similar that they would be justified in having the same system. There are considerable variations in the operating environments and also in the nature of member relations. Due to the continuity of business, relations are very close in producer cooperatives, whereas in consumer cooperatives they may be loose or random.

The basic question in running a cooperative is *how to effectively organise the boards, particularly the board of directors, and what kind of added value they should produce for the cooperative?* In addition to those matters that apply to all types of enterprises, cooperatives have the following special questions.

- *Non-executive directors are often highly committed to their cooperative:* they frequently have a business relationship and possibly also various personal goals vis-à-vis the society. A cooperative may well be an important employer in the area. Non-executive directors are not neutral outsiders. In an ideal situation, the interests of the all the society's members converge, which diminishes the significance of the personal aspirations of non-executive directors.¹¹
- Cooperatives have certain *"unwritten" rules concerning the grounds on which non-executive directors are elected (typically regional)* or arrangements aimed at guaranteeing that differ-

ent interests are represented on the boards. Non-executive directors, especially those taking part in board decision making, are always faced with the question of *whose view to keep in the foreground and how to strike a balance between contending interests.* To what extent they should concentrate on the long-term continuity of the enterprise, and to what extent on other factors, such as the momentary interests of different groups of members?

Non-executive directors may have the tendency to strictly control its background interests. It is important to recognise this characteristic feature of cooperatives, because *the board of directors may well be the guardian of specific interests rather than the body concerned with the development and running of the enterprise.* The worst scenario here is that the board could fail to take the decisions essential to the company's success. This problem does not arise as easily in purely investor-owned, joint-stock companies because all members of the board have one and the same aim, to increase shareholder value. Similarly, board members represent other owners who have the same aim.

- Under normal circumstances, non-executive directors in a cooperative cannot, unlike investor owners in a listed company, define their task simple as the control of shareholder value, profits and liquidity. However, cooperative non-executive directors must set equivalent objectives and evaluate the results accordingly. To make monitoring possible, the goals must be measurable, with clear and objective criteria established in advance.

Should board members occupy many positions?

In many countries, large corporations have moved in the direction of making board membership, or at least the chair, a fulltime occupation. The discussion on efficient board practice has brought forth recommendations concerning the maximum number of different company boards on which one and the same person can sit in order to be time-effective. Attention has also been called to cross-board membership: to the interdependences that occur when the representatives of the senior

¹¹ Professor Henry Hansmann (Yale Law School) shows that this is why cooperatives in practice often operate in a narrow field of business.

managements of two companies sit on each other's boards and, in the worst case, decide each other's emoluments. To ensure the independence of boards this kind of cross-membership should be eliminated. *Members should not have conflicts of interest and thus should not sit on the boards of competitor or client companies.*

The process of electing board members has also come in for criticism. Concern has been expressed over how to ensure that the owners' interests are specifically represented vis-à-vis the management if the chief executive has, in practice, a major say in the appointment of board members but the owners only a minimal voice. For this reason, a special appointments committee composed of non-executive directors is recommended.

Board members from outside the membership

Numerous reports published in the 1990s dealing with good board practice stressed the need to increase the number of non-executive board members, not employed by the company. Even though a company's operative management is usually the best informed concerning the business, it has been emphasised that the board should consist mainly of independent members in order to guarantee managerial responsibility.

In recent times, cooperatives have also discussed the idea of appointing members to the board from outside the membership, and this has occurred in a few cooperative-based enterprises.¹² Large cooperatives operating in highly competitive sectors have adopted organisational structures (incorporated operations), which have loosened the restrictions on the use of outside experts in traditional cooperatives. In cooperatives with non-executive directors, their number has been normally limited to 1 to 3 persons.

Even though the practice has become more widespread and more emphasis is being placed on the importance of the professional skills and inde-

pendence of board members, there is no common stand on the issue of non-executive directors from outside the membership. Extreme caution has been shown throughout the cooperative world in appointing people from outside the membership. A successful choice means *that the know-how of non-executive directors from outside the membership can supplement that of the board.* They can give the board the benefit of their special skills or independent judgement. Typically, non-executive directors from outside the membership are those with considerable experience in corporate leadership and international business.

Appointing outside non-executive directors, however, is not without its problems. Who will instruct them in their tasks? Can they fully appreciate the owners' interests?¹³

It is still typical for cooperatives to have a strong member representation on their boards. This could be though to give the members of the board of directors (or advisory board) a powerful motive to supervise management, because they themselves are member-owners. Ownership in cooperatives is, however, confused by being linked to the business relationship and also that profits are distributed in proportion to the use of services. This tends to emphasise the customer viewpoint. Accordingly, goal setting and owner interest is a more complicated process in a cooperative than a listed company.

A system of corporate governance that rests on member representation works best when the cooperative is local and its operations an extension of its members' businesses. The members' interests are then convergent and there is a genuine enthusiasm for developing the enterprise.

Who should be chairperson?

In deciding upon the composition of the board, *the members of a cooperative should pay particular attention as to who is appointed chairperson.* The qualities of a good chairperson should-

¹² In Finland, HK Ruokatalo Oyj, a limited meat processing company owned by a holding cooperative, has an outside director on its board. The owners have a majority on the board of the forest owners' Metsäliitto (parent cooperative) (6 owner representatives, the CEO and one outside director under an alliance agreement), but its subsidiary, Metsä-Serla Oyj, has both owner and outside representatives. Dutch cooperatives may have 2-3 outside non-executive directors, and in the USA some of the largest cooperatives have them.

¹³ The question has been much discussed in respect to joint-stock companies. It has been noticed in the United States that the vast majority of outside directors have but a nominal stake in their companies. Perhaps this is why certain companies in Finland (e.g. Nokia) have decided to pay part of the annual remuneration of board members in shares. In Nokia this amounts to 40 per cent. Setting the limit at 40 % is motivated by taxation considerations.

include enjoying the widespread confidence of the owners and the necessary respect both within and outside the board. The board, and particularly its chairperson, should have the know-how and experience that gives authority vis-à-vis the chief executive. Although members of the board are expected to have a reasonable ability to interpret statistical information relating to the company, they are not expected to be concerned with its day-to-day operations. On the other hand, the board should have the resources to use outside experts when necessary.

The attributes of board members can be listed as follows:

- 1) Foresight and extensive knowledge
- 2) Criticality, independent judgement and autonomy
- 3) Cooperative
- 4) Diligence and time-effective
- 5) Specialised know-how in some part area.

Thus, in addition to a sound professionalism, board members, and particular the chairperson, are required to possess a number of other personal qualities.

Efficient board practice

The board of directors is the body elected by the owners to carry out the tasks of controlling and supervising management on their behalf. One of its most demanding tasks is to attempt a balance of power (responsibilities, freedom of movement) between the owners and the professional managers.

The effectiveness of a board in supervising management depends largely on whether the shareholders really use their voting rights and threat of replacement. *Even in publicly quoted companies, the concept of efficient board practice is by no means clear.* Many institutional and portfolio investors in publicly quoted companies have been unwilling to use their voice or concern themselves with board practice. Institutional investors wish to retain their opportunity to quickly change the composition of their portfolios¹⁴ and so place more faith in the securities market and selling (“voting with their feet”) as manage-

ment control mechanisms.

In publicly quoted companies the capital markets comes to the aid of the board. In respect to cooperatives, the effectiveness of the market as a management control mechanism is diminished by the fact that share capital cannot be traded and the rules often place obstacles in the way of resignation.

Cooperatives lack the market signals that show how outside investors and their representatives evaluate the company’s plans and decisions. This has made *board working in large cooperatives more demanding than in other large corporations, so particular attention should be paid to board practices.*

A board should not run the everyday affairs of the company, *but it must have a good knowledge of the sector, of the company’s strategic position and competitive edge,* in order to appraise its operations and decisions. Although the board should question and control the managers, it should also support them in fulfilling their tasks. A competent, informed board supports the chief executive in defining the strategic direction.

A clear division of responsibilities between the different parties is essential. It is necessary to establish clear rules stating which matters concern the board (the owners’ representatives) and which ones the professional managers. A good line to take is that the board deals specifically with major issues.

However, drawing the border between the board and management territories is by no means straightforward. Although the board should ensure that the company is run efficiently, it should not interfere too much in the detail of its day-to-day management. Thus efficient boarding working requires the availability of sufficient, timely information and careful preparation. *As in practice even many strategic decisions have to be taken very quickly, there must be continuous interaction between the board and management.*

In addition to the above, effective control by the board also requires solving a number of other practical problems. The decisive ones concern the size of the board, the frequency of its meetings and

¹⁴ Some institutional investors maintain a stock exchange index of all the shares in their portfolio. This restricts their freedom to sell the shares, so the only way they can express dissatisfaction with a company’s management is by voting. Whether an institutional investor has a holding large enough to exert a real influence on the company is another matter.

the term of office of its members.

Efficient board working starts with the definition of its tasks. A certain number of formal tasks are set down in legislation. But the new owner-based culture involves much more than a decision on hiring or firing the chief executive. In today's management culture, the board has a much clearer responsibility for the success of the enterprise than hitherto.

The general tasks of the board are:

- 1 Ensure that the company produces the added value required to appreciate its value and economic benefits to its member-owners.
- 2 To ensure that the company does not take on too great or dangerous risks.
- 3 Ensure that the owner governance and management control and remuneration systems operate in the interests of the owners.

Thus the primary task of a board of directors is *to produce sufficient added value for the owners without taking on excessive risks.* Economic added value here means that the restricted capital of a company produces more than it costs. Points

1 and 2 above also concern the pertinent issue of deciding on strategies. This requires a familiarity with the operating environment, a knowledge of the company's competitive edge and an ability to make careful judgements, particularly nowadays when the larger cooperatives are becoming globalised. A board must, for example, be able to correctly evaluate the company's know-how and resources in relation to the risks of takeovers and globalisation. A board's task is to assess and measure the risks arising from its decisions.

Cooperatives should take the *evaluation and development of board practice* onto their work programmes. This starts with the setting of the objectives and working principles for the work and the critical evaluation of board working. The means available are the usual ones for developing management group working, such as post-appointment orientation, task training, feedback management, team working and so on. The initiative for evaluating board working rests primarily with the chairperson, and numerous guides exist as to how this can be improved.

3

The governance of cooperative groups

Federal organisations

Federal, multi-tier structures play a special role in the supervision of cooperatives. In a federal organisation, unlike a concern, the central cooperative has not the ownership power of a primary cooperative. On the contrary, it is the primary cooperatives that own their central cooperative (or joint-stock company). A cooperative group may easily have many of the features of a concern, alliance, cross-shareholding group or advanced strategic partnership. In groupings like this there are many common objectives, operations and also strategies, and although these offer the benefits of synergy there are also potential contradictions.

A central cooperative is often given the power to monitor and even directly intervene in the affairs of the cooperatives that own it. In Finland, for example, the Cooperative Banks Act obliges the central organisation to instruct and control the member credit institutions to secure the liquidity, solvency and risk management of the whole group. This is the case when the central organisation and the member bank are responsible for each other's debts and commitments.

The most frequently discussed aspect of cooperative group governance is *should the member-owners or the management of the primary cooperatives be represented in the board of the central organisation*. The traditional model based on member-owners is probably considered an extension of cooperative democracy. In Finland, consumer cooperatives have a federative structure, whereas the agricultural cooperatives have abolished it. Cooperative retail societies and banks have a two-tier structure (a board of directors and a supervisory board) in both their primary and central societies. In Finnish practice, regional and/or local society managements are represented alongside the member representatives in the supervisory boards of the central organisations.

There appears to be no simple way of determining what is an effective governance mechanism or who "genuinely" represents the owners at which level, particularly so if, as in fields like bank-

ing, legislation plays such a determining role. Furthermore, the role of a central organisation can, strategically and operationally, vary considerably.

It is clear, therefore, that the construction of an effective governance model for such groups is a demanding task, but it is advisable to observe a few basic principles.

- *The most important of these is not to create organisations that supervise and control themselves, that is, that the same party or persons both set the objectives, carry them out and supervise their implementation.* The conflict of interests that normally arises in these circumstances prevents effective governance. In principle, the use of members from a primary society in running central organisations creates the correct supervising/supervisor relationship. Whether they have the skills and interest to create an effective and genuine corporate governance mechanism is another matter.
- *An effective corporate governance mechanism is based on a clearly defined "marching order".* As a group formed by a central society and its members has a complex hierarchy of responsibilities, it is essential that all the parties agree on the "marching order".
- The local conditions of member societies belonging to a corporate network may often vary considerably. A system in which the regional societies' managing directors have a majority in the central society could threaten the setting of common objectives for the group and hamper decision-making. Due to the differences in regional interests, the creation of a clear owner viewpoint may be difficult. This is especially so if company management supervises itself, for then there could be excessive leeway in interpreting any differences of opinion. A particularly awkward situation may arise when faced with economic difficulties, as changing circumstances generally inflame hitherto concealed tensions. Such a group requires an operational group management in which the managing directors naturally participate.

The governance of hybrid organisations

Alongside traditional cooperative societies, new types of cooperative organisations have been created, so the same group can contain a hybrid of different types of companies. These range from operations that have been partly incorporated into listed companies, something that is quite common in Finland. *Typically, in the case where a cooperative owns a listed company the cooperative society and/or its members are in a majority and so, collectively, fulfil the role of the main owner.* Another kind of hybrid organisation is that of the American new generation cooperatives where the cooperative-corporative border has been blurred by making the membership closed and by permitting transferable shares.

As in the case of a federal organisation, so there are several ways of arranging group corporate governance in the hybrid type of enterprise. *In its basic interests, a hybrid group represents a variety of owners from member-owners to investors.*¹⁵ This makes for an exceptional system of internal and external, market control. In order that the objectives of the different groups of owners can be contained, a clear view of corporate goals is required.

In an enterprise with one major owner, external corporate governance via the market is more intensive than in an ordinary cooperative society, but its point is blunted. In an enterprise where the main owner is clearly cooperative, the threat of a takeover, replacing the board, downsizing and corporate restructuring are less than in a listed company with a dispersed ownership, so the pressure to produce profits may be lower.

On the other hand, the market supervises the company on behalf of the minority investors and continuously questions its decisions, something missing from a cooperative society. Passive control via the market thus increases. It is passive in the sense that it does not seek to change the compa-

ny's structures, but only to monitor and question its performance from the point of view of the investors. In practice, a cooperative-owned joint-stock company will have a lower share quotation in relation to its performance than a completely investor-owned one (see the attached figure). This has its own effect on the takeover situation (financed with company shares) and building up incentive schemes. If partly cooperative-owned subsidiaries wish to expand rapidly and finance takeovers with their own shares, the division of shares between the society and the investors has, due to valuation of shares, an effect on financial costs.

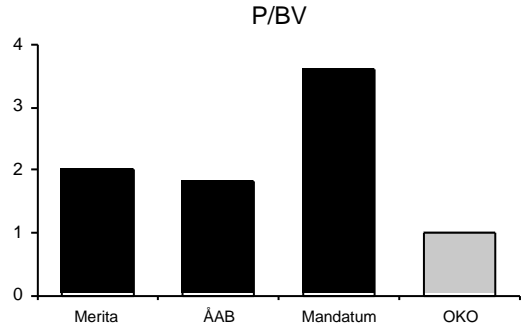
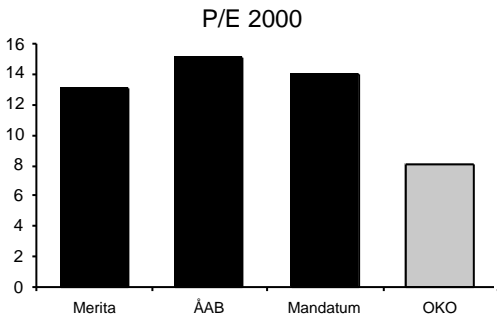
There are certain special issues related to the management of subsidiaries set up by a cooperative. Quite often the cooperative is a holding company and the subsidiary is responsible for the business operations or the cooperative is responsible just for those fields of business most closely related to the activities of the members. Therefore, the governance of the holding cooperative and its subsidiary must act together in monitoring and controlling the whole group. Through growth or globalisation, a subsidiary can distance itself from the society. There is, therefore, a danger that the members' representatives in the governance system can no longer evaluate the risks taken on by its subsidiary. Especially in the case of a cooperative or its subsidiary going international, high demands are set on the expertise of the member's representatives.

Finnish cooperatives incorporated as joint-stock companies, where the main owner is a cooperative society, are consolidated. This means that owner supervision and control can be organised in several ways. The basic question, however, is whether this is done by appointing owner representatives to the boards of the subsidiaries or via a group board. The system that has been found to work best in Finland is where the same member-owner representatives sit on the boards of both the cooperative society and the major subsidiary.

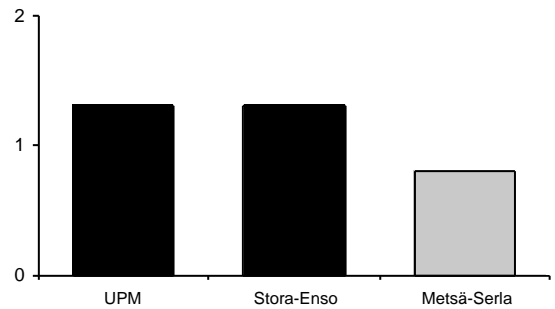
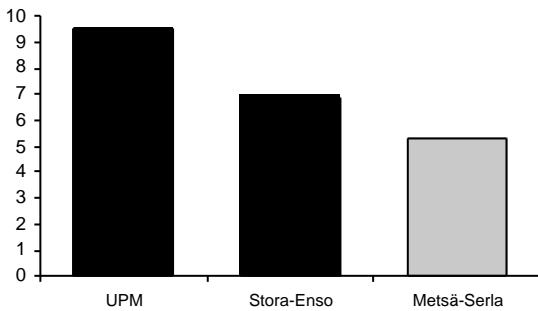
¹⁵ Such public limited companies in Finland include Atria Oyj, HK Ruokatalo Oyj and Metsä-Serla Oyj.

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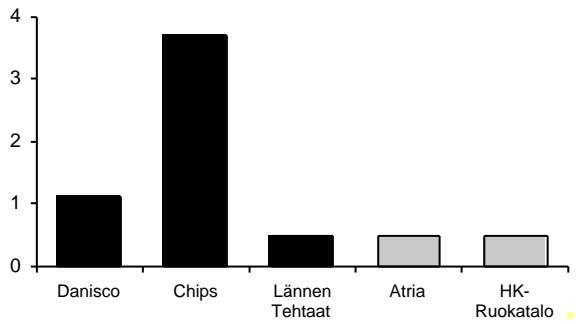
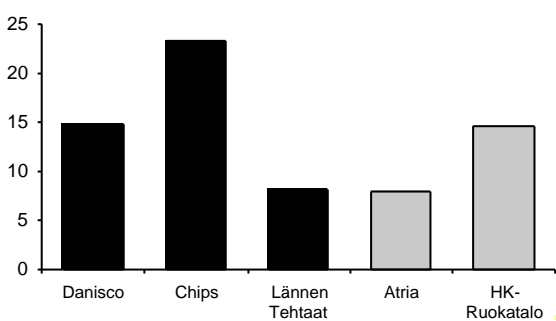
Banking sector



Forest industry



Food industry



P / E 2000 = Value of company's capital divided by anticipated net profit for 2000

"High P/E reflects belief in long-term ability of company to improve its result"

P / B = Value of company's capital divided by book net assets

"High P/BV reflects company's efficient use of assets."

Grey column = a cooperatively owned company

Mandatum Asset Management

4

Cooperative incentive schemes

The remuneration of managers

Management (and staff) remuneration schemes have become an important instrument of corporate governance. *Their proliferation is clearly related to an owner-based management culture.* This is not just a desire to motivate managers to work harder or guarantee them a competitive salary (thereby obtaining the best people), but a way of getting them to work in the interests of the owners.

Owners and managers should have parallel objectives and these should be reflected in the governance and remuneration mechanisms. The remuneration scheme is the signal of owner expectations from management. In order to construct an incentive scheme, the owners have to decide what they want from some measurable objective. The agreements then drawn up must be tied to the achievement of these goals. *It is best that incentive schemes are for short-, medium- and long-term periods.*

A remuneration scheme is based on the

- Corporate goals and their correct measurement
- Definition of the required level of performance (criteria levels) and rules concerning how “bonus points” accumulate
- Definition of the monetary equivalent of the criteria; “how bonus points are converted into money”

In order to be supportive and directive, those within a remuneration scheme – whether senior or middle managers or staff – must be able to identify those of their actions that will affect goal achievement. There is no point, for instance, for a staff incentive scheme to be tied to capital yield or operating profit.

Incentive and commitment salaries can be divided between

- Cash-based ones (= tied to operational performance) and

- Share ownership and share value based ones (=no drain on company cash flow).

The first includes performance- (or payment by results) and profit-related pay schemes. Performance-related pay is a bonus paid above the basic salary in accordance with a set of agreed criteria, such as exceptional work performance. Performance- or results-related pay schemes can be individual or based on a unit or enterprise. They are short-term incentives. The profit-related pay scheme is based on company profitability as measured, for instance, by return on capital. Personnel funds, tied to the company’s net profit, may also be considered a cash-based system.

Among the share-based systems, the most common are stock options. There are more than a hundred stock option schemes operating in Finland for management and staff. Recently it has become more usual to pay board members with shares. Stock options are long-term incentives, normally supplementing short-term schemes like performance-related pay. Economic value added (EVA) schemes may be used in the medium term.

The linking of management remuneration to the stock exchange value of the company is considered the best method of bonding managerial and owner interests. As Bengt Holmström (MIT) observes:

“Stock options have completely transformed managers’ thinking because they now have a significant amount of their own money at stake.”¹⁶

Short- and medium-term incentive pay schemes are available in cooperatives, but they do not have the long-term ones based on shares.

In the absence of market signals, cooperatives have to think very carefully in setting their objectives, as well as the criteria and means for their achievement. Actually they have been very hesitant in applying performance-related schemes, although no comprehensive survey has been carried out.

Furthermore, a cooperative society as the main

¹⁶ Helsingin Sanomat, 21.2.2000, p.C7.

owner of its incorporated parts, may find it difficult to build up an option-based incentive scheme. In a mature sector, the share price is usually so steady that a stock option scheme is not so attractive as in a growth sector. In addition, the market price of shares in a company with concentrated ownership tends to be lower than in one with a dispersed ownership.

Cooperative societies, and often also joint-stock companies largely owned by cooperatives, are thus forced to develop other incentive schemes. *Those based on economic value added suit cooperatives.*¹⁷ Future profit expectations are not included in the EVA but the ex post facto long-term share price has a high correlation to the index of economic value added. The idea of EVA is very simple: A company's management has at its disposal both share and loan capital. What remains

from the company's profits, after deduction of the required return on invested (share) capital and other capital, is the economic value added created by the company. The advantage of EVA, compared with many other performance indicators, is that it measures the efficient use of capital.

The remuneration of non-executive directors

The demands on the skills and time of non-executive directors in large cooperatives are increasing. A board chairperson is often required to work for several months of the year and this must be paid for. Finnish salaries have hitherto been rather modest. But if the work of non-executive directors makes heavy demands on time then this could be paid for in proportion to the salary of the chief executive.

¹⁷ In Kone Oyj, a part of management remuneration is determined on the basis of a three-year cumulative EVA (Talouselämä, 19.5.2000 p.35). Nokia also used EVA-based schemes in the 1980s.

5

Conclusion

There has been a clear increase in recent years in the level of competence required of non-executive directors. The operating environment of cooperatives has become more complex and global. In order to comprehend a company's strategies, non-executive directors must be able to identify the success factors in their sector and company. These in turn provide the bases for discovering the correct relationship to the company's operating environment and its institutional solutions, competitive corporate structures, as well as setting measurable objectives for management and supervising their implementation. To achieve these objectives, it is necessary to create within a cooperative environment, incentive schemes that are technically feasible and culturally acceptable.

An unofficial enquiry made among the participating board members at the American Farmer Cooperatives Conference in November 1999¹⁸ revealed particular concern with the following three questions:

1) How to involve professionally competent people in the work of the board in view of the competing demands on their time?

2) How to draw the line between board and management tasks?

3) How best to train board members in their tasks following their appointment?

The answers to these questions are indubitably relevant to Finland once a system of owner governance is carried out in practice.

Whether a cooperative is large or small, the following recommendations for a system of good corporate governance practice are equally applicable:

- An increase in annual report and similar disclosure, especially in respect to profit and its distribution
- More information concerning the tasks of board members and promoting the efficient working of both the board of directors and the supervisory board through training and developing self-evaluation
- Development and presentation of management control systems (control concerns both financial performance and goal monitoring)
- Development and evaluation of remuneration schemes.

¹⁸ For more information about the conference see <http://www.wisc.edu/uwcc/events/2000-99tc.html>