

Governance of a Company in a Fast Changing Business and Technology Environment

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Abstract

This paper contributes to the current corporate governance debate by describing changes that have taken place in Nokia during the past decade. It can be seen that traditional ways of corporate governance and management do not apply for companies operating in a fast changing business and technology environment. The transformation of Nokia from a Nordic conglomerate to a global synergetic communications company is visible in a number of changes in the structure and principles of governance. From closed ownership, closed domestic markets and a board composition reflecting ownership, Nokia has moved to open capital markets, open global markets, and a board composition based on professional diversity and balanced dynamics of the board and the markets.

In global markets, companies can be seen as being owned by a collective called 'the market', which is impossible to identify. The market reacts as owner to events inside and around the company. For the company, it is necessary to be very sensitive to these reactions in any situation. Since markets focus on short-term developments, the role of the board in a company should be to have a long-term perspective.

The case of Nokia supports the hypotheses found in the corporate governance literature that governance systems are pushed by the market to become more efficient and different systems may generate satisfactory outcomes. However, the case study also shows that if markets are allowed to control alone, a short-term, "quarterly earnings"-thinking reigns. Therefore, the role of the board in a company should be to provide stability. Stability is built on gradually evolving platforms like values, competencies and processes as sources of product leadership and cost leadership and customer satisfaction.

Introduction

Corporate governance is associated with the way firms are managed and controlled. There are many differences in what the underlying principles and methods applied are. These differences can take several forms. Most pronounced is the difference between the Anglo Saxon corporate governance system of 'outsider control' and the European one of 'insider control'. In the Anglo Saxon system, managers are monitored by the external market and by the board of directors which is usually dominated by outsiders. In contrast, in most of the European and in the Japanese governance systems managers are allegedly

monitored by a combination of financial institutions, large shareholders and inter-corporate relationships that are maintained over long periods. In this 'insider control' system, an external market for corporate control is small, if not absent. Many claim that European and Japanese firms and their management are less concerned about short-term financial outcomes but rather prefer more investments with long-term shareholder values (Mayer, 1996).

The short- vs. long-term policy of corporate management in the various governance systems may affect corporate performance in different ways. In addition, substantially different managerial incentives, in particular in terms of stock option ownership, give the managers discretion to distribute efforts between corporate and personal rent seeking.

Some question that the difference between the corporate governance systems affects managerial behaviour, firm's objectives and corporate outcomes. Kaplan (1999) argues that "... as long as an economy is competitive or market-based, governance systems will be pushed by the market to become relatively efficient. Different systems, then, will generate satisfactory outcomes." (p. 10). This hypothesis is supported in an empirical study by Conyon and Schwalbach (2000) who compared corporate outcomes between the United Kingdom and Germany.

However, there is not enough empirical evidence to conclude that corporate governance systems in market-based economies do not matter. Although one observes persistent differences between different countries' patterns of corporate ownership structure, and even within countries, it appears that globalization and international competition lead national systems to converge toward the direction of the Anglo Saxon system. In the literature on corporate governance there is immense disagreement about these predictions of governance convergence. Gilson (2000) argues that "... national governance systems turned out to be more adaptive in function, and therefore more persistent in form, than the prophets of convergence expected." (p. 5). This suggests that one may see less formal convergence toward common legal rules and practice than functional convergence through a process of migration into stronger, foreign securities markets. Indeed, many European firms appear to be migrating in this fashion today.

In this paper we contribute to the current corporate governance debate from the perspective of Nokia as a transnational company operating in a fast-changing business and technology environment. We will show that Nokia's corporate development is highly path-dependent in the sense that its previous and current corporate structure governs future relationships between the corporation and its various stakeholders in a rapidly changing environment. It also will become clear that Nokia's development is closely tied to institutional complementarity in the Finnish corporate governance system.

Furthermore, we do not support the "one size fits all" view of corporate governance where all corporations converge toward a common system. Instead, we argue that corporate success is deeply rooted in the search for the best way to increase corporate and shareholder value. Fundamental to the governance system of Nokia are its corporate values of customer satisfaction, respect for the individual, achievement and continuous learning.

Developments in Nokia

The company called Nokia was originally founded in 1865 by the Finnish engineer Fredrik Idestam to produce paper. In 1966, three separate companies – Cable works, Rubber works, and Nokia – were merged to become the Nokia Corporation. The company grew and evolved steadily over the next twenty years, and had by 1988 developed into a conglomerate with activities ranging from aluminium and cables to floorings, paper, rubber – and telecommunications.

In the early 1990's, Nokia made the very fundamental and significant decision to focus on telecommunications. After this decision was made, a number of divestments followed throughout the 90's. Illustrating the dramatic effects of the focusing efforts, mobile telephones and telecommunications only stood for 10% of total net sales in 1988. In 1998, the proportions had already shifted significantly, and mobile phones represented 60% and telecommunications infrastructure equipment 33% of total net sales.

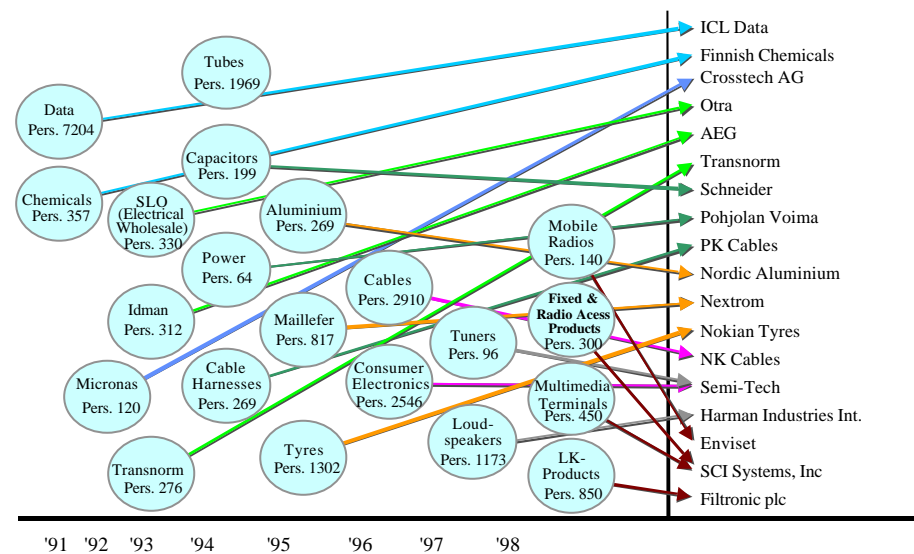


Figure 1: Major divestments during the 1990's

The period from 1992 to 2000 was one of continuing change. By 1997, the company had more or less finalized its focusing efforts and transformation from a conglomerate to a synergetic telecommunications company. After that, the company has again developed new businesses. Gradually, the scope has significantly broadened from pure telecommunications, and currently the company is more precisely described as a "Synergetic communications company".

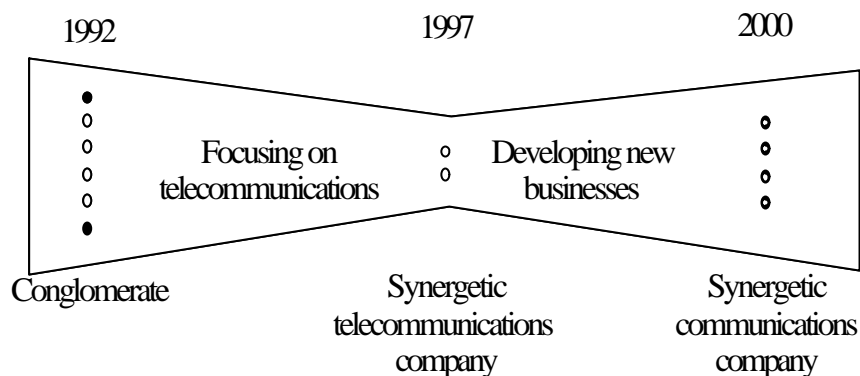


Figure 2: Nokia's change from a conglomerate to a synergetic communications company

In the transformation process Nokia has undergone a dramatic globalisation of its markets and operations, in parallel with a steady growth. During the latter half of the 1990's, net sales and profits grew steadily with up to 50% each year.

Nokia's markets have become global. Roughly split between major market regions, half of the revenue comes from Europe, while Americas and Asia-Pacific both represent a quarter.

In 2001, the record growth of the industry halted. The general economic slowdown, the burden of high 3G license costs for operators, and the ongoing technology transition to further generations were some of the reasons. As a result, the Nokia figures for 2001 showed only modest growth from the previous year. Net sales were 31,191 MEUR, the business group split being Nokia Networks 24%, Nokia Mobile Phones 74%, and Nokia Ventures Organization 2%. Operating profit was 5,237 MEUR. However, Nokia's full-year market share increased for the fourth consecutive year, reaching approximately 37% - almost double the level of 19% in 1997.

Rather naturally, the growth in business during the latter half of the 1990's has also been visible in terms of personnel. At the end of 1997, Nokia employed slightly less than 32.000 people, and at the end of 2001 slightly under 54,000 people. The employees were spread around the world in terms of R&D units, sales offices, and production sites.

Along with the business, Nokia's shareholding structure has changed fundamentally during the 1990s. A key trend has been the significant reduction of domestic ownership, following the removal of ownership restrictions for Finnish companies in 1993. From being around 80% in 1992, domestic ownership of Nokia has decreased to roughly 10%. At the end of 2001, foreign shareholders held 90,67% of all shares. Over 50% of Nokia's current owners are in the United States. A strong ownership resides also in Germany, as well as in Sweden and Finland. The diverse and broad global ownership structure, comprising institutional as well as private investors, is seen as a clear strength that supports Nokia's business in many ways.

Three phases can be identified in Nokia's development in terms of indicators to the governance system applied. During the time period ranging from the 1980's to 1991, Nokia was a Nordic conglomerate, with the clear majority of activities related to basic industries. Ownership was Finnish, and the corporate governance model applied was oriented towards banks and relationships to the surrounding society (see Tainio and Virtanen, 1996, for more on governance structures in Finland). The period from 1991 to 1994 can in turn be characterised as one of transition. Deconglomeration continued throughout the period. During these few years, the board was restructured, and a significant change occurred in the shareholder base.

During the period from 1994 to present, the company has steadily moved towards market orientation. During these years, Nokia has evolved into a global company with telecom focus. The shareholder base has become broad and international, with clear U.S. dominance. The listing of Nokia on the New York Stock Exchange was a significant milestone, which led to a new approach in investor relations management.

Increasing Market Orientation

In the process of becoming more and more market oriented, Nokia has changed a lot. The change is clearly visible in a number of changes in the structure and principles of governance. From closed ownership, closed domestic markets and a board composition reflecting ownership, Nokia has moved to open capital markets, open global markets, one series of shares, and a board composition based on professional diversity and balanced dynamics of the board and the markets.

Some key observations can be made that are valid even more generally than considering Nokia. The past decade has clearly been one of corporate restructuring and major changes in ownership. Current shareholder activism, which is similar to that in the U.S., is something not previously seen in Scandinavia. Major shifts have taken place in the shareholder profiles. Ownership has become international instead of domestic, and shareholders have moved from active voting to portfolios. Diversity among the owners has replaced the former setup, where the main owners were large domestic blocks influencing control on the company. Apart from ownership, significant changes have occurred in boardrooms as well. Previously, board compositions were reflecting ownership. This has given way to increased professional diversity.

At the same time, the formerly applied disclosure practices that were based on regulatory requirements have been replaced by active management of Investor Relations. Transparency has become a key. In order for the companies to have incentives guiding employees in the direction required by the new form of ownership, equity-based incentives have made their entry in listed companies also in Finland. A clear conclusion can be made that the market today exercises increasing control and takes some role of the board.

In the current business environment, companies can be seen as being owned by a collective called 'the market', which is impossible to identify. The market reacts as owner to events inside and around the company. For the company, it is

necessary to be very sensitive to these reactions in any situation. This emphasizes the increasing importance of excellent investor relations management.

On global markets, investors are distributed globally. In the case of Nokia, the clear majority of shareholders are outside Finland, and they are active on many stock exchanges. Nokia is currently quoted on six exchanges: Helsinki, Stockholm, London, Frankfurt, Paris, and New York. On the Helsinki Stock Exchange, Nokia is by far the most traded stock. The position is very strong also on other exchanges. On the New York Stock exchange Nokia is one of the most traded non-US company stocks. It is also clearly one of the stocks most monitored by technology investors world-wide, as well as by a large number of analysts. As a result, small deviations in the current development may lead to a volatile response.

A central requirement of the markets is an appropriate level of transparency. In this sense, Nokia has more than responded and has undertaken actions leading to significant changes when compared with the traditional governance model applied by Nordic companies. Since 1996, Nokia has reported quarterly. From previously reporting profits only on corporate level, Nokia has moved to releasing divisional profits since 1992. At first this was done only on a year-to-year level, but since 1999 divisional profits are released also quarterly. In addition to quarterly reporting, numerical guidance on next-quarter results is published. Increasingly, Nokia also publishes information on e.g. compensation of the company executives. Important moves towards increasing global transparency have also been the adaptation of IAS, and the reconciliation of US GAAP. Transparency is also exercised through proactive investor relations management to meet the requests of sophisticated institutional owners.

Nokia had previously two series of shares, the A- and K-series. The A shares were preferred in terms of dividend, they were entitled to a fixed dividend before the K shares. K shares in turn had a higher number of votes at the annual general meeting. To harmonize the ownership, conversion of K-shares to A-shares started in 1994, and in 1999, the share series were finally consolidated to one. As differences in the voting rights of share series is a phenomenon rarely occurring outside Scandinavia, this was an important move in developing the governance system to meet international expectations.

The role of the Board of Directors is emphasized in a company like Nokia, which has over 2 million shareholders and a major part of the ownership being in the hands of funds and other institutions. The board consists of a minimum of seven and a maximum of ten members. The complete set of board members is elected annually by the annual general meeting. This increases the supervisory role of the owners. In the Annual General Meeting in March 2002, the number of members was increased with one to nine. The Board of Directors has three subcommittees. The Personnel Committee monitors the personnel policy of the Group and oversees its implementation including the development of compensation policies. The tasks also include preparing policy matters and principles for remuneration for the Board of Directors. Since 1999, the roles of Chairman and CEO have been combined.

As mentioned previously, equity-based compensation has made its way also to Scandinavian countries during the 1990's. Nokia also has a number of Stock option plans running, and the number of employees participating in the plans has

increased constantly. In the end of 2001, roughly 25,000 employees were involved. Equity-based compensation is also practised in the form that part of the Board retainers are paid in the company's stock.

Dynamics and Stability

Markets quite naturally focus on short-term development. If markets are allowed to control alone, the result easily is that a short-term, "quarterly earnings" - thinking reigns. Therefore, the role of the board in a company should be to have a long-term perspective. Market decisions are very fast and often close-ranging, but strategic directions span over years.

When discussing differences between short- and long term perspectives, it is thus important to note that the dynamics of various aspects in the business environment are very different. 'Long' can have a very different meaning for different observers, depending on what viewpoint is taken, for example that of markets, business, knowledge or brand.

Market dynamics are fast. Decisions and actions can affect markets immediately. Typically, markets operate with a short, quarter-based perspective. Business dynamics already cover longer spans of time. Building a new business generally takes more time than a quarter or two. The sensible timeframe to observe in terms of business cycles ranges from one to a few years. Building up knowledge needed for generating business takes again significantly longer. It also vanishes slowly. If an actual business changes or even dies out completely, the knowledge behind it remains and can be applied to generate again new business. The sensible cycle for observing knowledge dynamics ranges from 5-10 years.

Still slower to change than knowledge is the brand. Building up a truly strong brand requires a very long time, a decade or two is no exception. A strong brand also has considerable inertia, which can carry it over even severe setbacks in the business. Brand dynamics can be said to have the cycle of 10-20 years.

Amid the varying cycles of different management aspects to consider in the fast-changing business and technology environment, the company needs stability from somewhere. Stability is built on gradually evolving platforms. These are based on values, knowledge and processes. Competencies are the foundation for and source of product leadership. Without a high level of competence, the company cannot exist. Processes in turn are the source for excellent operations throughout the organisation. They provide the platform on which cost leadership is built.

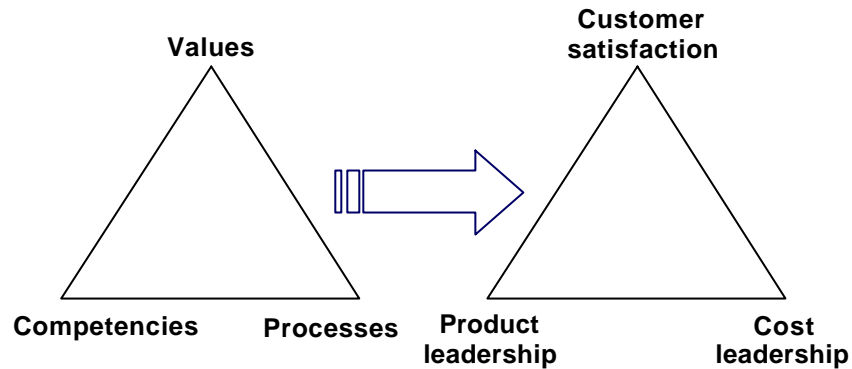


Figure 3. Competencies, processes and values provide a platform for product leadership, and customer satisfaction.

Together with competencies and processes, values become central for competitiveness. When properly shared throughout the company, they act as a source of stability for day-to-day operations, which are otherwise largely following market and business dynamics. Values provide a common mental framework for how the company operates to meet its targets. In a way, values constitute a tool for soft, inconspicuous governance. Nokia has formulated its values to be Customer satisfaction, Respect for the individual, Achievement, and Continuous learning.

Values and how they are shared within the company are closely related with how the company acts as a corporate citizen of the surrounding society. In order to succeed in the current environment and in the future, it is important for companies to contribute to society in general, and to promptly respond to internal and external expectations. Having a corporate image associated with a responsible and human company is very important. It guarantees visibility and a positive public opinion, thus complementing marketing efforts. Such an image cannot be built unless it is completely and transparently true (see Cordeiro and Schwalbach, 2000). A central way of building a company to this state is that the corporate values are real, visible in everyday operations and committable to. They need a continuous strengthening by the management through a 'walk the talk' –approach. When alive and relevant, corporate values can act as a very strong source of internal motivation and pride.

New Ways of Management Required

The market capitalization of Nokia has undergone a significant growth in a few years time. The market value of Nokia has become several times higher than the equity at book. The difference in market and book equity is typical for companies in knowledge-intensive industries. The most important assets consist of people, their brains, their knowledge, as well as the brand of the company. These key assets are not visible in the book equity. Many writers have during the recent years

touched upon this thinking, and proposals have also been presented on how to include these intangible but important assets in the balance sheets. As a summary of the overall discussion it can, somewhat aggravating, be stated that as the world now has more or less abandoned Marx' theories, they are gradually becoming applied after all. The key means of production – brains – are definitely owned by workers.

The increasing knowledge intensity places particular challenges on management, who in these industries face a completely new situation.

In traditional resource-based industries, business is mainly based on large investments. Behind these lie a few big decisions made by the top executives of the company. After the decision has been made, those who implement it need not know why the decision was made, or how it fits into the company's strategic objectives. In knowledge-based industries, business is in turn based on the knowledge of intelligent individuals. Infinitely many small decisions are made continuously. For an individual, it is often very difficult if not impossible to implement a decision if the thinking and reasons behind it are unfamiliar, and the objectives not known.

In an environment like this, the role of effective communication is emphasized. Strategies, objectives, timely information, everything must be shared effectively throughout the organisation. The importance and challenge of effective communication is underlined in a truly global company, where the brains are, literally, all over the world.

Management of traditional industries can well be compared with the operation of a symphony orchestra. Exact plans are followed, every participant has clear predefined roles. Common notes are followed, and all activities are well planned and aligned. Leadership is clear, every participant knows whom to follow.

In knowledge-based companies, the model is perhaps more that of playing jazz music in a small band. It is characterised by being innovative and adaptive. Intelligent individuals are in a way improvising on a common piece, and bringing their own special skills and knowledge into it according to the needs of the situation. There are no clear and determined notes specifying what everyone does, but the objectives are well shared. Certain rules exist, under which the participants act in a disciplined way according to their best understanding. Leadership is often inconspicuous; a clear leader is difficult to spot, especially for an outside observer.

Conclusions

The case of Nokia shows that traditional ways of corporate governance and management do not apply. Nokia evolved from a Nordic conglomerate into a global synergetic communications company. The transformation is visible in a number of changes in the structure and principles of governance. From closed ownership, closed domestic markets and a board composition reflecting ownership, Nokia has moved to open capital markets, open global markets, and a board composition based on professional diversity and balanced dynamics of the board and the markets.

In global markets, companies can be seen as being owned by a collective called 'the market', which is impossible to identify. The market reacts as owner to events inside and around the company. For the company, it is necessary to be very sensitive to these reactions in any situation. Since markets focus on short-term developments, the role of the board in a company should be to have a long-term perspective. This perspective should be based on values, competencies and processes as sources of stability in dynamic market environments.

The case of Nokia described in this paper supports the hypotheses found in the corporate governance literature that governance systems are pushed by the market to become more efficient and different systems may generate satisfactory outcomes. However, the case study also shows that if markets are allowed to control alone, a short-term, "quarterly earnings"-thinking reigns. Therefore, the role of the board in a company should be to provide stability. Stability is built on gradually evolving platforms like values, competencies and processes as sources of product leadership and cost leadership and customer satisfaction.

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