Corporate Governance in Transition Countries

Dr. Ylber Bezo¹  Prof. Asoc Dr. Dr. Fran Brahimi²  Rezart Dibra³
1. President of Professional Business Academy
2. Faculty of Economic and Agribusiness/Agricultural University of Tirana, Albania, Finance-Accounting Department Koder Kamez, 1029

* E-mail: ylberbezo@yahoo.com, franbrahimi@yahoo.com, rezartdibra@yahoo.com

Abstract
Corporate governance has come to the forefront of academic research due to the vital role it plays in the overall health of economic systems. The wave of U.S. corporate fraud in the 1990s was attributed to deficiencies in corporate governance. The recent 2008-2009 global financial crisis, triggered by the unprecedented failure of Lehman Brothers and the subprime mortgage problems, renewed interest in the role corporate governance plays in the financial sector. The development of a strong corporate governance framework is important to protect stakeholders, maintain investor confidence in the transition countries and attract foreign direct investment. This paper looks at the role of corporate governance in European transition countries in their transformation to a market economy. Corporate governance has come to the forefront of academic research due to the vital role it plays in the overall health of economic systems. The wave of U.S. corporate fraud in the 1990s was attributed to deficiencies in corporate governance. The recent 2008-2009 global financial crisis, triggered by the unprecedented failure of Lehman Brothers and the subprime mortgage problems, renewed interest in the role corporate governance plays in the financial sector. The development of a strong corporate governance framework is important to protect stakeholders, maintain investor confidence in the transition countries and attract foreign direct investment. The paper compares the different levels of corporate governance established among the transition countries.

Keywords: corporate governance, transition countries, emerging economies, corporate governance, responsible corporate governance etc.

1. Introduction
The transition economies in Central and Eastern Europe have privatized their economies at an unprecedented speed in the 1990s. The expectation was that under private ownership, formerly state-owned firms would act as dynamic, profit-oriented players driving economic restructuring and growth. Yet, the expectation has rarely been fulfilled, and lack of effective corporate governance is often seen as a culprit.

A strong corporate governance foundation is important for a growing market economy. It has to include the integrity and transparency of financial and corporate operations, checks and balances in compliance with applicable laws, the practices of sound financial and corporate operations and accounting practices that are in accordance with international standards. In the legal sector, laws that are enacted must be timely and consistently enforced. The laws must be clear and consistent: in areas of orderly entry and exit of firms, property and asset protection of investors and transparency of the legal system. Establishing effective corporate governance is of particular importance for transition countries because its success is crucial not only for the growth of a healthy corporate sector but also for sustaining a healthy market economy. Bekar et al (2001) find that the liberalization of financial markets in transition countries increases economic growth by about 2 percentage points per year. Some countries like Romania, Ukraine, and Georgia have very low effective corporate governance with high incidences of corruption and fraud in the political and economic systems. Other countries like Poland, Hungary and Latvia have established relatively effective corporate governance with greater achievements made toward market-based economies

"Corporate governance" comprises a country's private and public institutions, both formal and informal, which together govern the relationship between the people who manage corporations ("corporate insiders") and all others who invest resources in corporations in the country. These institutions notably include the country's corporate laws, securities laws, accounting rules, generally accepted business practices and prevailing business ethics.

2. The Sources of Corporate Governance
The process of identifying definitions for the concept of corporate governance facilitates the understanding of differences between views regarding the content of this concept. The first attempt to explain the concept of corporate governance belongs to Berle and Means (1932) who consider that corporate responsibility refers to the "equitable control" that managers must exert to meet the interests of shareholders. A widely used definition belongs to the Cadbury Committee (Mallin, 2007): "the system by which companies are directed and controlled".
Shleifer and Vishny (1997) approach corporate governance while having in mind the means by which "resource providers" and financial investors ensure the profitability of their investments. Corporate governance can mean: "leadership, organizational structures and processes that help ensure that an organization’s functions sustain and extend its strategies and objectives. Put more simply, it is the culture, policies, procedures and controls that help ensure a company will meet its business goals." (Lamm, 2010a), "a system of rules and norms, of either institutional or market nature, within which various categories of stakeholders, shareholders, management, public administration, staff, customers, suppliers, etc. arise or develop" (Bostan and Bostan, 2010), "a concept that encompasses a wide range of activities, rules, processes and procedures designed to ensure optimal use of resources and corporate strategies in order to meet its objectives" (Dobroțeau et al., 2011).

The development of the concept of corporate governance was made in connection with a number of theories. The agency theory (Jensen and Meckling, 1976) dominates other theoretical approaches of corporate governance and extends the basis theory on the separation of ownership from control, analysing the relationships between those who delegate authority (shareholders) and those who perform services to the benefit of the former (CEOs), as a consequence of information asymmetry. Recent research demonstrates the implications of transaction costs on resource allocation and on the structure of organizations (Iacobuță and Frunză, 2006). Transaction cost theory states that the transaction is the basic unit of analysis in economics; economic governance is essential to optimizing resource allocation and increasing economic efficiency (Williamson, 1975).

Stewardship theory shows that managers, as administrators of the business, are inclined to meet the interests of shareholders. This theory (Donaldson, 1990) eliminates the idea of personal interests, arguing that variations in performance obtained by managers are determined by their position.

Stakeholder theory (Donaldson and Preston, 1995) provides a legal framework for the inclusion of stakeholders in the managerial decision-making process (Crane and Ruebottom, 2011). The main goal of management should be to create value and satisfaction for all stakeholders (Aggarwal and Chandra, 1990; Kochan and Rubinstein, 2000). In this context, some research sought to analyse the topic of shareholder value versus stakeholder orientation based on empirical studies of managers from top U.S., UK and European companies (Stadler et al., 2006).

A series of corporate governance models have been individualised in scholarly literature. Albert (1993) distinguishes two models of corporate governance: shareholder value model (Anglo-Saxon model) and stakeholders model (Rhineland model). De Jong (1997) considers that there are three alternative models of corporate governance: American (Anglo-Saxon or market-oriented system), continental (Germanic or network-oriented system) and Latin (represented by companies from Italy, France, Spain, etc.). Yoshimori (1995) believes that we can identify three distinct concepts related to corporate governance: "monistic, dualistic and pluralistic". In another vision (Bostan and Bostan, 2010), the two models of corporate governance are: the "insider system" model and the "outsider system" model.

3. Corporate Governance in Transition Countries

The difference in the corporate governance problem in transition countries is one of controlling versus minority shareholders problem. The early privatization of the state-owned enterprises (SOEs) resulted in mostly concentrated ownership by dominant or block-shareholders, (institutional investors - Hungary, management buyout (MBOs) or management-employee buyouts (MEBOs) - Poland, employee-owners – Czech), giving these controlling shareholders considerable greater control over corporate assets than their stock ownership warranted. Of even greater concern than the concentrated ownership is the prevalence of complex ownership structures through cross-shareholdings, multiple-class shareholdings with different voting rights, pyramidal corporate ownerships. A landmark study by Bebchuk et al (1999) shows that “expropriation costs” are very large when such complex shareholdings are used to increase control rights beyond their cash-flows, even larger than concentrated ownerships. The role of corporate governance to undergirth weak competitive market mechanisms and democratic political institutions is the complementing factor necessary to sustain the long-term modernization of the transition countries. In other words, the “principal-agent” relationship that governs most capitalist societies that provides the incentives and environment in which investors (principals) can reap the profits of their investment through their corporations (agents) and the behavioral relationship are determined by a set of corporate governance standards. EBRD’s Legal Indicator Surveys reports that transition countries have an implementation gap between the enactment of laws and its enforcement. Unlike developed countries in the United States and United Kingdom with widely dispersed shareholders, the principal-agent corporate governance problems are primarily due to the agent (manager) perpetrating embezzlement and fraud. The corporate governance regime of the English legal origins (US-UK) emphasizes the protection of shareholders from being expropriated by the firm’s management. In contrast, the European legal origin countries (French-German) emphasize the protection of stakeholders (state, blockholders, employees) from expropriation. A relationship-based system and investor expropriation tends to prevail in emerging economies. In Russia, Bulgaria and
elsewhere mass privatization enriched the oligarchs and the politically well connected. The “cronyism” and relationship-based structure carried over from the communist era with most of the post-communist corporate owners part of the politically connected or political elite is difficult to root out. The lack of effective corporate governance, in particular, Russia, engenders a hostile business environment: corruption, organized crime, a bias judicial system and government interference. In the post-socialist European countries, the set of corporate governance standards adopted varies which may depend on past legal heritage. The group of Central and Eastern Europe and Baltic (CEEB) nations has a German legal heritage which includes the Czech Republic, Estonia, Croatia, Latvia, Lithuania, Poland, Hungary, the Slovak Republic and Slovenia. The group of South East European (SEE) nations has a French legal heritage which includes the Bulgaria, Yugoslavia, Romania, Bosnia and Albania. The last group consists of most of the Commonwealth of Independent States (CIS). Pistor (2000) finds that past legal heritage is not significant in explaining what predominant system of legal structure will be adopted by the transition countries. Rather, the adoption during the initial transformation period is driven more by the desire to converge with the EU legal system with an eye to attaining accession or the US system. Pistor also observes that differences in legal reforms among the transition countries are due primarily to policy makers responding to economic changes: greater privatization engenders better protection of creditor’s and stockholder’s rights or whether the dominant external advisors are from the US or EU. Mahoney (2001) similarly argues that a nation directly or indirectly adopts a set of legal structure in response to change rather than solely because of its past legal heritage. Poland and the Czech Republic are good examples of differences in privatization, corporate governance development and economic growth. An interesting study by Coffee (1999) compares the differences between Poland and the Czech Republic experience. Both countries adopted corporate law system based on the German civil law heritage. The important difference is that despite the German heritage, Poland’s securities regulations and practices follow the common law system of the Anglo-American more closely: greater private ownership protection, stringent disclosure standards and a strong enforcing securities commission agency. Coffee concludes (1) that better securities regulation to protect minority shareholders from expropriation is more effective than ineffective corporate laws, (2) that the Anglo-American common laws structure of corporate governance outperforms the German-French civil law structure despite their legal heritage. The result is the successful growth of equity financing for businesses in Poland with a growing healthy growing stock market. The Polish stock market is one of the largest among the transition countries with a market capitalization of US$175.85 billion in 2010; in contrast, the Czech Republic stock market capitalization is only US$68,831.

4. Stages of Market Transformation

Transition economies are former centrally planned economies undergoing unprecedented, comprehensive transformations to market-driven economies (World Bank, 2002). Planned and market economies are opposing economic systems adhering to different institutional frameworks (King, 2001; Martin, 2002; Peng, 2003; Williamson, 1995). An institutional framework is a set of formal constraints such as legal and regulative systems; and informal constraints such as social values, codes of conduct, norms of behavior, and conventions that regulate human behavior and economic activity (e.g., the use of norms of trade associations to regulate exchanges; social pressure to ensure that parties perform their duties) (North, 1990; Scott, 1995). The institutional framework associated with a centrally planned economy, which we label the bureaucratic control institutional framework, principally underlies public ownership, state coordination, redistribution, and control (Boisot & Child, 1988; Kornai, 1990). The institutional framework associated with a market economy (market institutional framework) principally underlies private ownership and market transactions (Kornai, 1990; Williamson, 1995).

Institutional theorists assert that the replacement of an institutional framework with a new one often occurs in three stages: dominance of the old framework, emergence of an interim framework with some elements of both frameworks, and finally prevalence of a new framework (Benson, 1977; Gerry, 2000; Lachmann, 1979; North, 1990). We suggest transformation from bureaucratic control to the market institutional framework is likely to go through an interim (intermediate) stage, during which the formal rules associated with the centrally planned system weaken rapidly. The new market rules evolve slowly, forcing various constituents to rely on informal constraints (Lachmann, 1979; McMillan & Woodruff, 2000; Peng, 2003; Peng & Heath, 1996). The intermediate period therefore can be defined as the relational stage dominated by a relational institutional framework (Peng, 2003). Although one institutional framework is dominant in a particular stage, the three institutional frameworks tend to coexist during the transition process, and together constitute a larger societal institutional environment (Benson, 1977; North, 1990).

Extant literature on transition economies documents the existence of three stages. The factors inherent in the bureaucratic control stage (i.e., state ownership, intervention, and redistribution) have been reported in various studies (e.g., Andreff, 1999; King, 2001; Kornai, 1990; McCarthy & Puffer, 2003; Stark, 1994; Suhomlinova, 1999). Andreff (1999) showed that in 1995, after six years of transition, the average state
ownership in former socialist economies in Central and Eastern Europe was 58 percent; among them the Czech Republic had the lowest level of state ownership (31%), and Tajikistan and Turkmenistan had the highest (85%). The existence of a relational stage is also well documented (e.g., King, 2001; McMillan & Woodruff, 2000; Peng, 2003; Peng & Heath, 1996). These studies have demonstrated that widespread, relationship-based exchange tends to emerge systematically in transition economies due to the absence of formal, market-based laws and regulations. Finally, some transition economies (e.g., those of the Czech Republic and Poland) have now progressed to the late stage of transition as they now have an advanced market institutional framework (Tihanyi & Roath, 2002).

We do not focus on the investigation of how transition economies progress. Instead, we assume transition economies are committed to transforming to a market economy and are likely to go through the three stages we specify. We believe that bracketing the transition process into different stages with fairly distinct institutional trajectories is useful in examining the impact of institutions and institutional changes on corporate governance in transition economies.

5. Towards responsible corporate governance.
According to traditional understanding, corporate governance practices may be involved in societal activity provided that they are fully voluntary and result in a positive contribution to profit. Only for this reason, directors are informed about environmental risks, liabilities and key environmental compliance issues the company may be facing (Kuhndt et al., 2004). Starting from this idea, the corporate boards are believed to be accountable only to their shareholders and to no other group in society. Hence, the board is answerable to shareholders and, in some systems, to employees and creditors. Recently, a new approach to corporate governance has been developed which relies on the assumption that man is free and responsible (Aras and Crowther, 2010). On this basis, corporations are viewed as communities of free and responsible persons engaged in a creative project, able to contribute to the common good. The terms “good corporate governance” or “responsible corporate governance” are used ever more often in scholarly literature. Bad governance is being increasingly regarded as one of the underlying causes of all evil in our societies (Shil, 2008). Good corporate governance is a must in ensuring the values required by different stakeholder groups. It enhances the performance of corporations, by creating an environment that motivates managers to maximize return on investment, enhances operational efficiency and ensures long-term productivity growth. Consequently, such corporations attract the best talent available on a global scale. It also ensures the alignment of corporations to the interests of investors and society, by creating fairness, transparency and accountability in business activities among employees, management and the board (Oman, 2001). Good corporate governance in a corporate set up leads to legal maximization of shareholders’ value, in an ethical and sustainable manner, while ensuring equity and transparency to every stakeholder – customers, employees, investors, vendor-partners, government, and community (Murthy, 2006). Another aspect of stakeholder empowered corporate governance is the development of “Leadership for Responsibility”. This refers to utilising the resources of corporations to bring about societal change. A leader in responsible corporate governance sees the whole policy approach as an opportunity rather than a challenge. Leadership requires the creation of a demand for sustainable action rather than answering demands for responsible action (Kuhndt et al., 2004). Some authors believe that corporate social responsibility is an important regulator of corporate governance. Responsible corporate governance “is a stakeholder-oriented policy that allocates responsibilities to societal actors and that will drive corporate accountability” (Kuhndt et al., 2004). Responsible corporate governance is a never-ending process, which progresses through conflicts, under the condition that conflicts are solved, as far as possible, through integration and not through domination and compromise. Therefore, responsible corporate governance lies in entrepreneurial democracy, which systematically questions the organization’s mission and its relation to the common good (Aras and Crowther, 2010). Good corporate governance therefore sets the balance between economic and social growth (Zinkin, 2010). Contemporary experts have identified the elements of responsible corporate governance: “stakeholder empowered corporate governance; management and performance evaluation systems; transparency enhancement; accountability verification” (Kuhndt et al., 2004). Businesses characterized by responsible corporate governance must abide by the following principles (Kuhndt et al., 2004): “assume societal leadership for responsibility; clearly and specifically identify their social, environmental and economic values in accordance with the demands of their stakeholders; define their social, environmental and economic priority areas of action; adopt specific management practices to integrate these values into their operations and take measurable action; disclose comprehensive data on their social, environmental and economic impacts; involve in comprehensive review of their activities; strive for continuous learning”. In our view, responsible corporate governance can be used with direct reference to governance that is based on three important principles: fairness, transparency and accountability. Responsible corporate governance practices are the foundation of the organization's overall vision, decision-making processes and structures that support long-term business sustainability. Adoption of responsible corporate governance practices is considered a voluntary act of
organizations (Anand et al., 2006), enabling them to generate economic, social and environmental results. According to this view, best practices in corporate governance require vision, processes and structures that ensure long-term sustainability.

6. Corporate Governance environment in Croatia

After privatisation process started in 1991, interest in corporate governance has been raising parallel to the growth in private sector. Improvement in corporate governance is seen through better access to capital, promoting efficient performance and development, transparency compared to European requirements and rules and accountability. In consideration to corporate governance there is also some important issues to be mentioned, primarily related to the history of social ownership and all aspects of adjustments in transition period. Privatisation process was undergone according to the model, which was severely criticized in public and because of that partly cased inefficient industry sector. The weak side of privatisation model was that some enterprises are privatised without inflow of new capital and ex managers begun new owners without investing their own money. A consequence was inadequate composition of boards and in many cases performance was unproductive and inefficient. In Croatia managing of enterprises is regulated by Company Act following German law, while the Securities Law are regulated mostly against Anglo-American securities market legislation. Now, Croatia is in the process of reviewing all legislatives according Directives of the European Union. Croatian system of boards is two-tier. Supervisory Board is responsible for monitoring enterprise leadership and thus could investigate all record keeping and documentation, cash etc. regarding business performance. Top Management (called Managerial Board or Board of Directors) are committed to inform Supervisory Board about business policies, profitability, income statement, liquidity etc. at least once a year. Guiding corporate strategy and corporate performance including interests of stakeholders is not the function of Supervisory Board. The emphasis is on monitoring performance through financial data and that is the main difference between Board of Directors and Supervisory Board. Supervisory Board members chosen by the owner have in many cases only formal role of monitoring and their influence on enterprise performance is disputable. In the case of mixed ownership or small shareholder ownership, members of Supervisory Board are chosen at the basis of skill and they are more accountable for efficiency performance of enterprise (Vitezi, 2003). In public enterprises Supervisory Board is selected upon party representation. Managerial Board main role is responsibility for running business affairs, i.e. business politics, profitable performance and others affairs. It consists of several members and one of them is chairman, usually owner. They are confirmed by Supervisory Board and could be hired or fired by them. But the role of Managerial Board is stronger especially in the cases where the Supervisory Board is only a formal body and has not much influence to the enterprises decision-making process (stated owned enterprises). Comparing to the recent literature on the subject (Nadler, 2004) there are different types of boards: passive, certifying, engaged, intervening and operating. Operating makes key decisions that other directors and managers then implements, and this kind of board is the most similar to the one exist in Croatia. They are responsible for business policies of the enterprise and in the case include the one main owner if he is the only one. The tendency should be on high performance board, which will be competent, coordinated, collegial and focused on an unambiguous goal. With changing from social to market oriented economy many believed that these changes would help enterprises to gain competitive advantages and therefore contribute in increasing national efficiency. Privatisation is based on the premise that it will improve enterprises performance and help countries grow. But the effects are different on aggregate or micro level and depend on industry structure. In a cross-country aggregate study, Sachs, Zinnes and Eilat (2000, Vol.III) state that privatisation does not by itself increase GDP growth, but they suggest that a positive effect is present when privatisation is accompanied by in-depth institutional reforms. Applicable to Croatian economy, inflation rate is low and decreasing from 6.2 per cent in 2000 to 2.1 in 2004, and GDP rate vary from 2.9 per cent in 2000. to 5.6 per cent in 2002, decreasing to 3.3 per cent in 2004. It is obvious that institutional reforms but also more important stabilization, industry restructuring, financial discipline and new investment are prerequisite for increasing of macroeconomic indicators. Additionally, privatisation force enterprises restructuring and therefore is accompanied with changes in management, corporate governance and organisation structure.

7. Corporate governance indicators

In this research corporate governance indicators are considered through some attributes of boards, particularly their structure, size, independence, internationalisation, diversity, frequency of meetings and others. Disclosure is investigated through existing information especially about board members, remuneration disclosure and adoption of ethics code. The results are as follows: Board structure. In Croatia companies have two-tier system (as in Germany, Austria, France, etc.–in fact, only 23 percent in Europe) comprising a Supervisory board of outside members close to the owners, and a separate Managerial Board of executive directors. The two boards meet separately with strictly defined accountability under the law. Concerning board internationalisation, in Europe boards are more domestic with only 16 per cent of non-national directors, than the companies
themselves. Contrary to the surveyed companies, the percentage of foreign members (one or few) in Supervisory or Managerial board is higher (20.8 per cent) in Croatia. Average ages of boards are in 68 per cent up to 45 year if the majority ownership is foreign, and in the rest of 31.8 per cent of enterprises are from 25 and 35 years. In domestic enterprises there are 82 per cent of them up to 45. Board member’s average age in Europe is 55 years. On average, directors have been 5.6 years on the same board what are little over than in Croatia (around 5 years). In the European board, the number of women increases from 6 to 7 per cent. In Croatia this percentage is much lower and is less than 1 per cent in Supervisory board. Only in Managerial board, women contribute with over 10 per cent.

**Board size.** The number of board size could not be considered as a factor, which determines efficient performance or has crucial impact to performance. There are a few reasons for explanation of this statement. First, board size is commonly determined by national law or listing requirements. Second, it is mostly based on the enterprise size and sector and therefore considered “appropriate”. Third, the knowledge of each member is very important for the efficiency of board decision-making. The emphasize is on effective board no matter of size, which means that board should be of sufficient size and the balance of skills and experience is up to the requirements of the business. In Croatia the average board (Supervisory) size is five and in accordance to the law minimum size is 3 and maximum 21 members depending on equity amount. Croatia average is still lower than the minimum size in Germany (8) and Austria (6) who has the same two-tier model. This could be explained by the size of enterprises and structure of owners. In Croatia 95 per cent of total enterprises are small, mostly with no obligations to have supervisory board. Middle sized and large enterprises contribute with rest five per cent and in majority have one or few owners. In some research made by Čengi (2001) it is confirmed that chair persons of boards (Supervisory and Management) with domestic owners are in the most cases long term employees or managers of these firms from the period before privatisation process started. Additionally, they have essential influence on processes relating to the structure of Supervisory or Managerial board.

Independence of board Croatian board name Supervisory board is not independent related to the law requirements and German model of two-tire board structure. Considering separation of chairman and CEO, two-tire board structure ensures the separation of roles. The member of the Supervisory board could not be at the same time a member of Managerial board. Audit committee Beginning of the 2001, after starting accounting scandals, the role of audit committee has come under close scrutiny. The audit committee responsibilities are to monitor and review the integrity of enterprise financial statements, its internal financial controls, the external auditor’s independence and objectivity and the effectiveness of the audit process as a whole. Hence, the independence of audit committee is very important for its effectiveness. The independence of the audit committee is 64.5 per cent and varies considerably from minimum 4 per cent of companies with a majority independent audit committee in Japan to over 95 per cent in UK, Netherlands, Canada, USA, Ireland and Luxembourg (Maier, 2005).

**Disclosure.** In addition to all information company should include in disclosure, the remuneration policy pay attention to shareholders and others, particularly because of the relation with enterprise remuneration. Remuneration also should motivate members of boards to run the company successfully, but remuneration level should be determinate with contribution to the efficiency growth. Croatian enterprises mostly (80 per cent of them) not disclose information on the remuneration of Supervisory or Managerial board members. This is regarded as good practice and from the survey of 24 countries in the world (Maier, 2005), the average of disclose is 84 per cent. Comparing the frequency of board meetings with remuneration, the average compensation per board meeting in Europe is 7,301 EURO per 2005. (Albert-Roulhac, and Breen, 2005). In Croatia Company Law defines frequency of board meetings. Supervisory board is committed to have quarterly meetings or at least semi-yearly. The average meetings as result from questionnaire are 6. (5.8 times). The average in Europe countries who has two-tier board are 6.7 meetings and is notable that unitary board has more frequent meetings (9.3) comparing with two-tire, but also is evident continues slight increase. (Albert-Roulhac, and Breen, 2005). When looking for good governance practice, the implementation of code of ethics is highly supported. In recent years a number governmental and private initiatives have focused on the need to reduce corruption, bribery, fraud etc. and urged a need to improve standards of corporate governance ethics, transparency and integrity. In Europe in average 73 per cent of companies have a meaningful code of ethics, and Croatian enterprises are not much below that (70 per cent). However, existing code of ethics if not strictly implement could not protect against all illegal doings.

**8. Main types of relationships between governing and management functions in companies in Central European transitional economies**

Two extreme views prevail today regarding the corporate governance system (Kuznetsov & Kuznetsov,256). The new neo-classical school considers shareholders as the only group that governs a company. The corporate social responsibility school requires looking beyond the classical concept of shareholders’ wealth by suggesting the stakeholders’ approach. Many authors prefer to deal with the so-called outsider (USA, UK) and insider (Germany, Japan, other parts of Continental Europe) systems of corporate governance (Gregorić et al., 186).
Dispersed ownership and liquid capital markets as well as strong investors’ legal protection are an important assumption of the outsider corporate governance system. The strong legal protection of creditors, a highly concentrated ownership and relatively illiquid capital markets, as well as favouring the stakeholders’ approach seem to be the basic assumption of the insider system. Legal regulations can allow or forbid the concentration of voting rights in different countries. It is not allowed everywhere that shareholders concentrate their voting rights without concentrating ownership. For example, Germany and the Netherlands allow it. Banks and other financial companies are not allowed to be shareholders in a number of countries. The Anglo-American system does not allow the legal institutionalisation of the employee right to share ownership or profit in companies (the right to economic democracy) (Zalar, 37). One can find an autonomous corporation surrounded by markets in an Anglo-American environment on one hand, and on the other hand, business groups as a typical constellation of corporations, mostly with the financial corporation in the centre, in Continental and Northern Europe (Collin & Ceslajs, 163). Taking into account all the stated differences, one can better understand the logic and distinctive features of the outsider and insider corporate governance systems that we frequently deal with as the Anglo-American and German governance models (Rozman, 103). These two models can also be seen as a one-tier and a two-tier model.

The Anglo-American corporate governance system is based on:
- The organisation of a large independent corporation
- A board of directors that is quite independent regarding its shareholders and stakeholders
- Corporations situated in environments characterised by strong financial markets and small government intervention
- A competitive culture
- A legal system that discourages ownership by banks and other financial organisations.

The model consists of two governance bodies: the shareholders’ assembly and the board of directors. Members of the board of directors are insiders and outsiders. The board has two main tasks: 1) controlling the business results and 2) controlling strategic decisions.

The German (Continental European) model is based on (Collin & Ceslajs, 167):
- Business group systems that dominate in the economy
- Weak financial markets
- A strong government intervention
- A rather co-operative or authoritarian culture
- Close connections between corporations and financial organisations.

The model incorporates three governing bodies: 1) the shareholders’ assembly, 2) the supervisory board, and 3) the board of directors. Representatives of employees are also members of the supervisory board. Members of the board of directors cannot be outsiders. The main tasks of the supervisory board are to hire and fire the board of directors and to supervise the company’s business performance. Mainly the law determines the role of the corporate governance function.

European transitional countries were able to choose between the stated two governance models. Central European countries chose mainly a variant of the German model. However, Russian reformers opted for the Anglo-American model of corporate governance (Kuznetsov & Kuznetsov, 250). E.g., the Republic of Macedonia’s Law on Trade Companies introduced a solution that allows both the one-tier and two-tier models (Drakulevski, 1132). The Commercial Code determined the corporate governance model in Poland. Its main characteristics are derived from the German model. The shareholders’ assembly, the supervisory board, and the board of directors are characteristic of the two-tier system. Slovenia and Croatia introduced similar systems. The German model applied and the still existing wide dispersion of ownership in Central European transitional countries enable top managers to behave rather independently and to hold major power in their hands. The described governance power distribution is quite typical for large domestically privatised companies nowadays.

In the pre-transition period, the governance power was with external owners (governments mostly). The privatisation of large, state-owned companies brought mainly dispersed ownership of large, domestically privatised enterprises, and thus the governance power has been transferred to executive managers (slightly more so in companies with a dominant share of internal owners than in those with a dominant share of external owners) (See Figure 1).
9. Conclusion

The role of corporate governance is manifested in: creating value for the corporation and supporting transparency (Lamm, 2010b); protecting shareholders’ rights and ensuring their equal treatment, acknowledging the interests of all entities that develop relationships with the company, assuming responsibility by the Board of Directors, integrity and ethical behaviour, transparency in implementing internal and external control systems to certify the validity of corporate financial reports (Dobrotă et al., 2011).

The corporate governance function provokes reconsideration everywhere today. We do not believe that a uniform corporate governance model will be appropriate for all countries, neither for all transitional countries. Historical, cultural, economic and political realities have strong influences on its suitability. In spite of this fact, different models will certainly have many common characteristics and they are worth being identified. The modest accumulated experiences with the governing practices in Central European transitional countries and their analysis can identify the main directions for the future development of corporate governance models in this part of Europe. The analysis shows that we need to further develop the stakeholders’ governance model that will not deny the central role of owners’ interests in corporate governance. On the other hand, the owners’ interests should not be the only ones that are incorporated in the corporate governance process. The corporate governance function must start to look beyond just the shareholders’ wealth creation. Knowledge-based industries demand highly knowledgeable employees that invest and risk much in providing their expert knowledge. Their remuneration is high enough that they are able to accept variable pay systems linked to corporate financial performance. They are, therefore, the most important group of stakeholders, beyond owners, entitled to participate in corporate governance. We do not see that on this base a workers’ self-management system of corporate governance has to be developed. The dominant power within corporate governance has to be balanced according to the level of risk that individual stakeholders take over. We believe that investors in companies will be those who will carry the biggest risk still for an extended period of time in transitional countries because domestic capital is still a very scarce resource in these environments.

References
The IISTE is a pioneer in the Open-Access hosting service and academic event management. The aim of the firm is Accelerating Global Knowledge Sharing.

More information about the firm can be found on the homepage: 
http://www.iiste.org

CALL FOR JOURNAL PAPERS

There are more than 30 peer-reviewed academic journals hosted under the hosting platform.

Prospective authors of journals can find the submission instruction on the following page: http://www.iiste.org/journals/ All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Paper version of the journals is also available upon request of readers and authors.

MORE RESOURCES

Book publication information: http://www.iiste.org/book/

Academic conference: http://www.iiste.org/conference/upcoming-conferences-call-for-paper/

IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich’s Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digital Library , NewJour, Google Scholar