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The Role of Corporate Governance in Transition Countries.

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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. The paper compares the different levels of corporate governance established among the transition countries.
Keywords – corporate governance, transition countries, emerging economies, legal heritage and transitional reforms, market transition.

1. Introduction

The transition economies in Central and Eastern Europe have privatized their economies at an unprecendented speed in the 1990s. The expectation was that under private ownership, for merly 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. Transfer of ownership to private hands does not suffice to create powerful incentives for managers to engage in the market economies along the objectives of the new owners. This articles outlines the methods of privatization used in Central and Eastern Europe, and their consequences in terms of corporate governance. Many stakeholders acquired shares in ownership, which enhances their ability to influence management and creates complex challenges for managers to coordinate influential stakeholders. Central and East European economies may thus develop unique forms of capitalism, especially with respect to corporate governance systems. Corporate governance is often seen as a major obstacle to business in Central and Eastern Europe (CEE). Corporate governance refers to mechanisms that ensure that managers act inthe owners' best interest. In the transformation from central plan to market economy, privatization had a central place in policy agenda, yet the transfer of ownership alone does not suffice to create appropriate incentives for managers. The theory of property rights, primarily the principal-agent model, has been the ideological foundation of the privatization policy.However, many firms did not, as presumed by the model, end up in outside control but under the governance of a variety of stakeholders, including managers, employees, and the state.

Corporate governance generally refers to the set of rule-based processes of laws, policies, and accountability that governs the relationship between the investor (stockholder of a company) and the investee (management). Corporate governance attracted a great deal of attention in the aftermath of the Asian financial crisis of 1997-1998 and the early 2000s U.S. corporate scandals, like Enron and World Com. However, once the threat of global contagion financial crises passes, corporate governance was relegated to the back of academic research. The current global financial crises of 2008-2009 caused by the "excesses of capitalism" once again brought attention to the importance of effective corporate governance practices. With ever more closely integrated globalized financial markets, the newly emerging European transition economies particularly have been hit hard by the adverse impact of the current global financial crisis. Both the European Bank for Reconstruction and Development (EBRD)and the OECD promote the development of sound corporate governance for transitioning economies and developing economies through their initiatives, the Corporate Governance Sector Assessment Project (CGSAP begun in 2002) and Principles of Corporate Governance (1999, 2004, 2009), respectively. 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. Bekaert 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.

The problems facing transition countries are different from those facing other emerging countries by their nature of transforming from a centrally planned economy to an open market economy. For transition countries with no initial capitalistic framework in place, institutional frameworks in all sectors, both private and public, which support a capitalistic business environment, have to be created simultaneously: securities laws, corporate laws, accounting standards, sound business practices and ethics, and a judiciary and regulatory system.

2. Defining Corporate Governance

In the literature of corporate governance, there is a disagreement about the boundaries of the subject of corporate governance. Depending on their perspective, different authors define corporate governance in different ways. In its narrowest sense, corporate governance can be viewed as a set of arrangements internal to the corporation that define the relationship between the owners and managers of the corporation. An example is the definition by Monks and Minow (2001): corporate governance "...is the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management, and (3) the board of directors."

3. Literature Review

The Asian crisis brought the issue of corporate governance to the forefront of research. Most of the studies on the developing and emerging countries focus on the agency problem and weak, dispersed investors. Later studies focus on corporate governance in developed economies especially after the U.S. corporate fraud scandals. The topics range from internal and external governance, the role of the Board of Directors, incentives and compensations, ethics and transparency. Most are based on the Anglo-American (common law) models (Chew and Gillan, 2005). This model of widely dispersed shareholders where no single shareholder owns a majority stake is the basis of most corporate governance studies. Most authors argue that the protection of investors' interests can be effectively enforced through a strong corporate governance system (Shleifer and Vishny, 1997; Glaeser et al, 2001;Hanousek and Kocenda,2003). The Anglo-American corporate governance system differentiates the shareholders from the stakeholders with a well-developed external equity market system to monitor the manager. The additional protection and voice afforded a dispersed shareholders group in the Anglo-American model is the liquidity of the market to allow exit strategy in the event of weakening internal corporate governance. The well developed financial market in developed economies with rating agencies, market scrutiny and access to timely information is another layer of protection for the dispersed shareholders. Another body of studies tests the adoption of common laws (Anglo-American) versus civil laws (German-French) in the protection of investors (Coffee 1999, Pistor, 2000; Mahoney, 2001). Mahoney (2001) finds that nations that adopted the common laws (English) rather than the civil laws (French) system of corporate governance provided better protection for investors and have better developed financial markets. Mahoney concludes that, during the period under study from 1960-1992, common law countries experienced faster economic growth than civil law countries because common law is more supportive of private economic enterprises and property protection while civil law is more oriented toward government intervention and restrictions. Corporate governance studies naturally move to focus on the transition countries in their unprecedented mass privatization of state-owned enterprises (SOEs) and the structure wherein they operate to transform successfully to a market economy. Studies on corporate governance structures in transition countries debated various issues: the type of ownerships (concentrated versus dispersed), the mode of privatization, adequacy of shareholder protection and whether legal structures must precede privatization. Ownership structures in transition countries are still evolving. Widely held firms are not the norm due to the small and relatively illiquid underdeveloped capital markets. Corporate governance studies performed on developed countries therefore may not be applicable to transition countries with such different initial conditions. The corporate governance problems in transition countries are likely to be different from developed countries. Studies on corporate governance in transition countries may therefore have to take this into account. A body of studies looks at whether a transition country's past legal heritage (German, French) influences the adoption of the current legal structure and corporate governance or whether the Anglo-American system is more prevalent (Pistor, 2000; Martynova and Renneboog (2009). In Romania and Poland, the mass privatization and dispersed ownerships to employee owners and institutional intermediaries help to promote the development of the capital and securities markets (Gray and Hanson, 1993). Their main argument is that the German-Japanese model of active shareholding monitoring through intermediaries (banks, outsider, employee-owners) can develop closer ties to firm managers, better access to information, and deeper business knowledge than the Anglo-American model of dispersed shareholders.The German-Japanese model of more concentrated ownership with corporate governance assigned to intermediaries may therefore be more appropriate for transition countries. This argument is supported by other studies. Shleifer and Vishny (1997) and Rajan and Zingalies (1998) maintain that concentrated corporate ownership structures are a response to the agency problem and poor ownership protection for investors. Studies by La Porta et al (1997, 1999, and 1999) also support this hypothesis and that the degree of ownership rights and protection affects corporate behavior and, consequently, economic development. On the other hand, Miwa and Ramseyer (2000) argue against concentrated shareholders and creditor banks but rather dispersed shareholders are more effective in controlling managers in transition countries where the legal environment is ineffectual, a situation similar to late nineteenth-century Japan. This body of literature looks at the differing degree of legal protection with different corporate governance structures depending on whether concentrated or dispersed ownership is present. Privatization of state-owned enterprises goes beyond just transferring the assets to private ownership in transition countries. Privatization has to be evaluated in terms of three areas: the creation of a system of corporate governance to foster a healthy environment government ownership still1, moral hazard incentives, kwangsi (relationships), and agency problems outweighed emerging corporate governance practices. Lin (2001) finds that managers, while gaining greater autonomy from the “corporatization” of Chinese state- owned enterprises, manage the company badly and misuse it for self- dealings and embezzlements. Privatization of former state-owned assets to private ownership does not guarantee that the agent will act in the best interest of the principle in transition countries with no existing institutional foundation to support for businesses to flourish, the advancement in legal and enforcement infrastructure, and self-sustaining economic growth. There are a number of studies on the positive and negative effects of privatization in transition countries.Privatization of state-owned enterprises is seen to be the vehicle by which transition countries are transformed to a market economy and takes different forms. The expectation is that private ownership would spur profit-oriented managers toward market restructuring leading to economic growth under the presumption of the principal-agent model. In most transition countries this expectation has been unfulfilled due to the lack of effective corporate governance and a major obstacle to a friendly business environment (Meyer, 2003). In transition countries, the problem of corporate governance progress is exacerbated by the vested interest of the powerful and highly concentrated owners with ties to the political structure. This cronyism relationship breeds corruption that plagues the early transformation efforts of most of the transition countries. This is particularly prevalent in transition countries like China, Russia, and Bulgaria. In China when the state- owned enterprises were “corporatized” with majority government ownership still1, moral hazard incentives, kwangsi (relationships), and agency problems outweighed emerging corporate governance practices. Lin (2001) finds that managers, while gaining greater autonomy from the “corporatization” of Chinese state-owned enterprises, manage the company badly and misuse it for self-dealings and embezzlements. Privatization of former state-owned assets to private ownership does not guarantee that the agent will act in the best interest of the principle in transition countries with no existing institutional foundation to support private ownership. Questions of the role and rights of various stakeholders (manager-employee owners, government, outsiders, managers, investors, employees) of the privatized firms with differing interests have to be determined within a legal and regulatory structure. The Russian experience questions whether mass privatization is the answer in transforming from central- planning to a market economy. Russia’s mass privatization to concentrated manager ownership was the antithesis of privatization success: insider self- dealings, corruption, incompetent management, asset stripping and the destruction of minority shareholders’ value.

4. The Sources of Corporate Governance

Discussions of corporate governance demonstrate two basic approaches to assuring managerial dedication to the interests of the corporation and its shareholders: the regulatory approach and the non-regulatory approach. The regulatory approach relies upon formal rules and institutions backed by the coercive power of the state’s legal system. In the United States, which has a system of federal law, each of the fifty states has its own corporation code. In addition, judicial decisions by state courts have developed important legal doctrines governing corporate behavior, such as "the business judgment rule" and the duties of care and of loyalty of corporate officers and directors. American state corporation laws are very similar, but not identical. Indeed, the corporate laws of certain states may favor one interest group over another. Throughout the twentieth century, individual American states, seeking to maximize revenues from corporate franchise taxes, competed to become state of Delaware is the legal home to about 60 per cent of the Fortune 500 companies. The principal source of corporate governance in Europe is the legislation of the individual European country concerned. Although European Union legislation does have an impact on certain aspects of corporate governance, it has not unified corporate governance practice to the same extent as U.S. federal law and regulations, together with stock exchange rules, have tended to unify American practices. Thus, there is a greater divergence on corporate governance rules among publicly traded European corporations than there is among their American counterparts.

5. 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 shareholdings. 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- flow rights, even larger than concentrated ownerships. The role of corporate governance to under girth 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 U$175.85 billion in 2010; in contrast, the Czech Republic stock market capitalization is only U$68,831.

6. 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.

7. 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.

8. 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-tire 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 ap 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 performance.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.

9. Corporate Governance environment in Slovenia

Slovenia has made a rapid progression from a state controlled economy. After independence in 1991, Slovenia quickly sought to develop its capital markets and the legal, regulatory and institutional structures that underpin these markets. On gaining independence from the former Yugoslavia in 1991, a mass-privatisation programme began in 1992 that established the private ownership of capital. This was reinforced with the passage of the first framework Companies Act in 1993. Slovenia rapidly pursued political and economic integration with Europe, joining the European Union (EU) in May 2004 and the European Monetary Union in January 2007. Since joining the EU, the Government has also pursued a comprehensive strategy to amend its capital markets and corporations law architecture in order to ensure consistency with EU directives. While implementation of EU standards has provided Slovenia with a solid legal framework in the field of corporate governance, the accession review has focused on the implementation of the OECD Principles through the practices of the regulatory authorities and the dynamic capacity of the system to change in response to evolving market practice. Capital markets in Slovenia are limited in both depth and liquidity and have a narrow (and domestically focused) investor base. The current state of development of Slovenia's capital markets, and corporate governance framework, must be seen through the prism of its historical development. The Stock Exchange, which has itself been recently taken over by the Vienna Stock Exchange, is relatively small with total equity market capitalisation of EUR 8.5 billion which represented 25.2% of GDP (as at 31 December 2008). However, while the rate of progress has been impressive, two key corporate governance challenges remain. First, Slovenia has retained significant ownership of commercial enterprises. As shown by the experience of OECD Members, this can be a problematic area. When companies are owned by governments, they can be inefficient, uncompetitive, a drain on public finances and used to pursue political objectives. The OECD Guidelines on Corporate Gove rnance of State-Owned Enterprises stress that effective ownership by government requires coherent and transparent policy and the capacity to make objective and commercial decisions as a shareholder. The Slovenian Government recognises this challenge and introduced significant reforms in early 2010. Second, after less than twenty years, Slovenia's legal and regulatory architecture of governance and the cultural norms of operating private capital markets are not yet well developed. A key focus of the Committee in carrying out its review was on ensuring that not only were the legal and regulatory frameworks in place for effective corporate governance, but that regulators and policy makers are adequately resourced, and have the appropriate political support to ensure that the systems could promote and enforce appropriate market behaviour. In the course of the review, the Government commenced comprehensive reform to its corporate governance framework. In mid-2009 the Government formally adopted an Action Plan for Corporate Governance Reform in Slovenia. This Action Plan commits the Government to a range of actions that would improve corporate governance practices in Slovenia, including a review of the legislative provisions protecting minority shareholder rights; an increase in the capacity of the judicial and regulatory authorities to monitor and enforce compliance with corporate laws, and improvements in the way in which state owned enterprises are governed. To give effect to the Action Plan, the Government endorsed a Policy on Corporate Governance of State-Owned Enterprises, the centrepiece of which was a commitment to pass legislation to establish a separate central ownership agency to coordinate all government ownership actions. The Policy also proposed legislation to better define the relationship between the Government, KAD and SOD, and to structure these separate funds as portfolio investors at arms' length from the Government.The legislation establishing the central ownership agency (the Law on the Corporate Governance of State Capital Investments) was adopted by the National Assembly on 20 April 2010. Under the new law, the agency will control all the direct holdings of Government in companies established under the Corporations Law; exercise all of the ownership rights pertaining to all shareholdings (both direct and indirect) including board nominations; gather centralised information on government holdings; measure and report performance; and develop and enforce a code of corporate governance that will apply to SOEs. The agency will operate independently of existing ministries, and will have a Council and a management board whose members will be appointed by a qualified majority of Parliament on the recommendation of the Government. The law provides that the agency must be set up within three months of the adoption of the legislation. Once established, the agency has another three months within which to adopt a code of corporate governance for SOEs. It will also, as part of its mandate and within three months of its establishment, define and allocate financial assets by their groupings (marketable, non-marketable, strategic, public interest, etc.) and define the State's objectives for these asset groups. Under the draft legislation to define the relationship between the Government and the two state-controlled funds (KAD and SOD), KAD will be separated into two funds: one being a pension fund manager, and the other an insurance company. The central ownership agency will assume responsibility for exercising the shareholding rights (such as voting) attaching to the KAD and SOD shareholdings. Following public consultation, the legislation for the reform of KAD and SOD has been adopted by the Government and was planned to be submitted to parliament in the middle of 2010.

9.1 *Ensuring the enforcement of shareholder rights and equitable treatment***.**

The legal framework in Slovenia provides a relatively high degree of protection for shareholders, in particular minority shareholders. There is limited capacity for large shareholders to use capital structures to obtain disproportionate control and qualifying majorities are required to effect substantial changes to the constitution of the company or the capital structure.Minority shareholders powers of redress are predominantly exercised through the general meeting, and include rights to seek the appointment of independent auditors to verify a number of matters, including the financial accounts, alleged breaches of the articles of association or specific transactions. While the legal rights are strong, the capacity of shareholders to enforce their rights is partly constrained. At a practical level, minority shareholders are widely dispersed with limited economic interests in the companies in which they are shareholders. To exercise their rights via the general meeting, shareholders must have a threshold level of voting interest (either 5 or 10% depending on the circumstances), meaning that often only the larger shareholders have the practical means to seek some form of redress. The court system has in the past been slow and is having to adjust to a dynamic legal and commercial environment, which limits its effect iveness as a forum for settling corporate actions. Legislation passed in 2009 giving effect to the EU's Shareholders Rights Directive will make significant steps towards addressing these concerns. Furthermore, the Government is undertaking a study focused on further improving the enforcement of the provisions of the Companies Act dealing with minority shareholders rights. The study is due to be completed in 2012. Slovenia has also recognised the importance of efficient and competent courts, as evidenced by actions taken in order to enable specialisation, reduce court backlogs and improve their efficiency.

10. 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 (Gregorič 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.

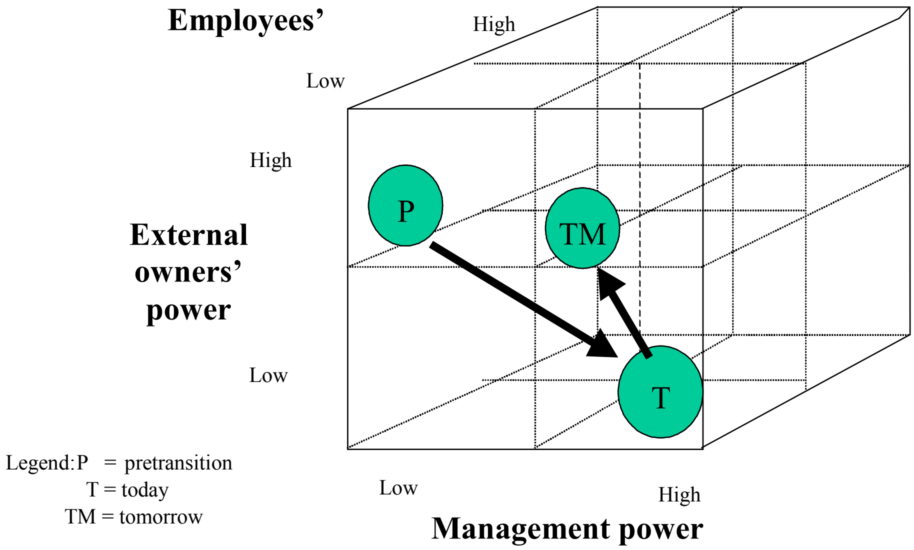
The German (Continental European) model is based on (Collin & Cesljas, 167):

- 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).

Figure 1. Changing patterns of the governance power distribution in domestically privatised large companies in Central European transition economies



11. Conclusion and Recommendations

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.

Slovenia should conduct a formal review of the provisions of the Companies Act within the anticipated time frame dealing with the treatment of minority shareholders to ensure that they provide adequate protection of shareholder rights in practice and give due consideration to any recommendations from that review.

Slovenia should consider further measures to support the financial and operational independence of the Securities Market Agency, including ensuring that the Agency has sufficient and independent financial capacity for its mission and its activities; ensuring that the Supervisory Board and management are appointed according to arrangements that ensure their independence; and consider the exemption of employees of the Agency from public sector employment arrangements.

Regulators and policy makers should remain vigilant in monitoring the potential for "share parking" activities, particularly in relation to takeovers, to ensure that current legislative and enforcement arrangements are adequate to prevent such practices.

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