# THE ROLE OF CORPORATE GOVERNANCE IN TRANSITION ECONOMIES: CONTRIBUTION AND DEVELOPMENT

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***Abstract***

*With more evident process of globalization of the world market, the concept of corporate governance gains importance. The global economic crisis highlighted the problems of corporate governance both in developed countries and developing economies. Analyzing the effects of the global economic crisis, including striking collapse of many companies, the huge increase in unemployment and the increased number of people living on the poverty line and below, it can be concluded that some of these problems are result of various weaknesses and failures of corporate governance. Even though the introduction of a number of rules, codes and practices of corporate governance have been made, the global economic crisis has shown that more effective application of the standards of corporate governance is necessary. Corporate governance issues are especially important in transition economies, since these countries do not have the long-established financial institution infrastructure to deal with corporate governance issues. Before 1989 there was no need to discuss corporate governance issues, because all enterprises were owned by the state and there were no shareholders. All that has changed. This paper discusses the importance of corporate governance, with special reference to transition economies. Directors, owners and corporate managers have started to realize that there are benefits that can accrue from having a good corporate governance structure. Good corporate governance helps to increase share price and makes it easier to obtain capital. International investors are hesitant to lend money or buy shares in a corporation that does not subscribe to good corporate governance principles. Transparency, independent directors and a separate audit committee are especially important.*

***Key words:*** *corporate, governance, transition, principles;*

***Clasification JEL****: D23, G32, G38, K1, N0.*

## 1. INTRODUCTION

Good corporate governance involves a set of relationships amongst the company's management, its board of directors, its shareholders, its auditors and other stakeholders. These relationships, which involve various rules and incentives, provide the structure through which the objectives of the company are set, and the means of attaining these objectives as well as monitoring performance are determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations; the accountability of managers and the boards to shareholders; and corporate responsibility towards stakeholders. Namely, good corporate governance contributes to sustainable economic development of each country in a way that:

- Improve business performance of companies and their operational efficiency;
- Promotes and facilitates access to capital markets;

- Reduces costs of companies on the acquisition of capital and increases the value of the property;
- Contributes to improve the reputation of companies.

Current processes such as globalization, the financial crisis and the transition process in many countries and in ours, conditioned complex economic reality and a higher level of uncertainty in the contemporary operating companies in which adequate and relevant business decisions should be based on comprehensive, reliable and comparable accounting information of financial and non-financial nature. The demands of stakeholders for information becomes more complex in terms of content, scope and quality of information presented in the financial statements, and quality financial reporting has become imperative for the survival and development of companies in the new business environment.

An appropriate accounting regulation and quality mechanisms of corporate governance (system of internal control, internal audit, external audit and audit committee) and their consistent adoption and implementation are the key prerequisites for ensuring the quality of financial reporting. Corporates scandals, which on daily basis shattered companies, clearly testify to the need for continuous review and improvement of regulations on the accounting and auditing profession, and the role of corporate oversight mechanisms in the financial reporting process.

Considering that many countries in transition, including the Republic of Macedonia in order for effective global trends, regulatory frameworks for corporate governance and financial reporting built on the basis of international solutions and practices, it is interesting to analyze how new solutions for modern corporate governance influence the process of financial reporting, and in particular, the results of the operation - the profitability of companies in the countries in transition.

Therefore, good corporate governance structure is one in which a successful system is set up, in terms of setting goals and making decisions, as well as in terms of proper monitoring of goals achievement and decisions implementation. In this way, through such organized a structure of relationships and processes, the company can successfully face the changes in the environment, and react consequently, in a fashion that does not compromise the interests of any of its stakeholders.

However, as already mentioned, the story of good corporate governance does not end by establishing solid internal structure. The company is an entity that both affects and is affected by the environment in which it operates, and therefore establishing harmonious relationships with its surroundings is critical as well.

**Table no. 1** - Calendar of corporate governance events [1]

| Year | CORPORATE EVENT |
|---|---|
| 1600s: | The East India Company introduces a Court of Directors, separating ownership and control (U.K., the Netherlands) |
| 1776: | Adam Smith in the «Wealth of Nations» warns of weak controls over and incentives for management (U.K.) |
| 1931: | Berle and Means publish their seminal work «The Modern Corporation and Private Property» (U.S.) |
| 1933/34: | The Securities Act of 1933 is the first act to regulate the securities markets, notably registration disclosure. The 1934 Act delegated responsibility for enforcement to the SEC (U.S.) |
| 1968: | The EU adopts the first company law directive (EU) |
| 1987: | The Treadway Commission reports on fraudulent financial reporting, confirming the role and status of audit committees, and develops a framework for internal control, or COSO, published in 1992 (U.S.). |
| Early 1990s: | Polly Peck (‡1.3bn. in losses), BCCI and Maxwell (‡480m) business empires collapse, calling for improved corporate governance practices to protect investors (U.K.) |
| 1992: | The Cadbury Committee publishes the first code on corporate governance; and in 1993, companies listed on U.K.'s Stock Exchanges are required to disclose governance on a «comply or explain» basis (U.K.) |
| 1994: | Publication of the King Report (S. Africa) |
| 1994, 1995: | Rutteman (on Internal Control and Financial Reporting), Greenbury (on Executive Remuneration), and Hampel (on Corporate Governance) reports are published (U.K.) |
| 1995: | The Russian Law on Joint Stock Companies is adopted (Russia)<br>Publication of the Vienot Report (France) |
| 1996: | Publication of the Peters Report (the Netherlands) |
| 1998: | Publication of the Combined Code (U.K.) |
| 2001: | Enron Corporation, then the seventh largest listed company in the U.S., declares bankruptcy (U.S.) |

| | |
|---|---|
| 2001: | The Lamfalussy report on the Regulation of European Securities Markets (EU) is published |
| 2002: | Publication of the German Corporate Governance Code (Germany) |
| 2002: | Publication of the FCSM Russian Code of Corporate Conduct (Russia) |
| 2002: | The Enron collapse and other corporate scandals lead to the Sarbanes-Oxley Act (U.S.); the Winter report on company law reform in Europe is published (EU) |
| 2003: | The Higgs report on non-executive directors is published (U.K.) |
| 2004: | The Parmalat scandal shakes Italy, with possible EU-wide repercussions (EU). Source |

## 2. DEFINING THE CORPORATE GOVERNANCE AND LEARNING CAPACITY

When we talk about corporate governance, there are many definitions of the term that depart before the level and scope of purely economic ("shareholder" approach) or wider ("stakeholder" approach) concept [2].

The Organization for Economic Cooperation and Development (OECD) defines corporate governance as: "a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Thus, in its narrower sense, observed from the perspective of companies, corporate governance can be defined as a set of rules governing the relations between the owners and management of the company. As defined by the OECD in 2001, "Corporate governance is a public and private institutional framework, including a legal infrastructure, legislative and business practice, created with the aim for editing an efficient relationship between managers from one side, and those who invest in the company, from the other side (owners). "

World Bank broadly defines the term corporate governance - as an institutional framework that allows more quality relationship between managers, owners and other stakeholders (employees, state, public, etc.).

Corporate governance is also defined as a system of distribution of rights and responsibilities among different participants who participate in the work of the company, primarily owners and managers, as well as suppliers, customers, finance and so on.

Most general definition, according to which corporate governance is a legal, economic and social phenomenon that is created primarily by private initiative, with the main objective of maximizing efficiency and reducing conflicts of interests between managers and owners of the firm, and lowering of agency costs that arise as a product of splitting, separating the management of the ownership function.

Furthermore, there are two basic dimensions of governance modes: insider and outsider governance modes. The insider governance mode is characterized by governance mechanisms imposed by dominant ownership management and employees and outsider governance mode is associated to dominance of ownership from investors outside of the company. The other two dimensions are low or high absorptive capacity that indicates the capability of the company to upgrade its competences due time and competitive pressures [3].

**Table no. 2 -** Corporate governance and learning capacity [4]

| | **INSIDER GOVERNANCE** | **OUTSIDER GOVERNANCE** |
|---|---|---|
| | **Quadrant 1: Stuck privatization** | **Quadrant 2: Privatization to domestic institutions** |
| Learning — low absorptive capacity | *Organizational characteristics:*<br>• Managerial incentives reduced in absence of purchase<br>• Low managerial turnover<br>• Resistance to outside board members<br>• Entrenchment of traditional networks<br>• Low learning and weak governance<br><br>*Strategic outcomes:*<br>• Likelihood of low corporate restructuring | *Organizational characteristics:*<br>• Managerial incentives but poor wealth diversification lead to low risk behavior<br>• Monitoring by outside investors<br>• Limited access to outside networks<br>• Important role of bank-led financial-industrial groups producing financial reallocation but also private appropriation<br>• Ambiguous efficiency of governance, may be traded off for low learning<br><br>*Strategic outcomes:*<br>• Likelihood of moderate corporate restructuring effectiveness |

| | | |
|---|---|---|
| | effectiveness<br><br>**Quadrant 3: Privatization buy-outs** | <br><br>**Quadrant 4: Privatization to foreign investors** |
| Learning — high absorptive capacity | *Organizational characteristics:*<br>• Managerial incentives<br>• Passive monitoring by financiers<br>• Limited access to outside networks<br>• High learning is traded off for weak governance<br><br>*Strategic outcomes:*<br>• Likelihood of moderate corporate restructuring<br>effectiveness | *Organizational characteristics:*<br>• Effective boards<br>• Managerial turnover<br>• Break-out from traditional networks<br>• High learning complements high efficiency Governance<br><br>*Strategic outcomes:*<br>• Likelihood of high corporate restructuring effectiveness |

## 3. MECHANISMS OF CORPORATE GOVERNANCE

One of the most important mechanisms of corporate governance that is characteristic of countries that do not have developed capital markets, a concentration of ownership. In this case the basic assumption is that the great ownership stake allows effective supervision of management by the owners, with lower agency costs. However, this mechanism often determines minority owners in the dependent position in relation to major owners and the expropriation of their rights [5].

The Board (corporate boards) of directors represents also one of the mechanisms through which shareholders and owners can effectively monitor management. Strong and organized board of directors is very important for creating an effective strategy, effective oversight of management and defining the identity of the company. In doing so very important is the structure of the board of directors (the relationship between executive and non-executive directors). Thus, the empirical literature is divided between those who suggest that non-executive directors provide effective and independent monitoring of operation management and those who advocate the thesis that non-executive directors do not have enough information about the company and are not interested in critical review of the company [6].

The compensation management, as well as bonuses constitute one of the most commonly used internal tools of corporate governance, which is considered to represent a quality influential device which should align the interests of owners (profit maximization), with the interests of management. Typically, the compensation of management does not refer only to the financial amounts that are determined based on job performance management, but also to the compensation in the form of stocks from the company, which will contribute to even better alignment of interests of managers with those of owners because through this arrangement and managers become owners. However, this mechanism can cause even more opportunist behavior of management, because through the manipulations with information in financial statements they can be affecting the stock price, in order to obtain more favorable and more compensation. From this spot, comes the danger of this mechanism, if not properly controlled.

External mechanisms of corporate governance relate primarily to the market of corporate control, which effectively monitor the management of companies, so that those companies that are not efficient enough, or whose management is not working efficiently, it can quickly be taken from more efficient companies. Also, one of the efficient mechanisms of corporate control represents the market manager, who forces them to operate effectively, because there is always the possibility of replacing them.

In summary, the business practice has demonstrated the need for institutionalization of corporate governance within companies, through whose full implementation enables effective problem solving related to the conflict of interests between owners and management, fully respecting the rights of all stakeholders, from suppliers through employees, to financial institutions.

### 3.1. The importance of corporate governance for the development of transition economies

Recent experiences from transition countries show that the assumption that an effective system of corporate governance will develop an automatically, as a result of ownership transformation, is quite unrealistic. Even in developed market economies, the differences in the ownership structure and the level of concentration or dispersion of owners, affect a lot on the selection and adaptation of corporate control mechanisms. In transition countries, the problem of setting good corporate governance becomes even more complex, as a result of underdeveloped institutional infrastructure. For this reason, we need a thoughtful and serious approach to corporate restructuring, in order to establish a strong private sector, through which be realized a successful economic transformation to a developed market economy [7].

The importance of developed and efficient corporate governance in transition economies can be explained simply through its impact on the following areas:

1. Creation of the key institution of private corporation, which drives the successful economic transformation to a market based economy;
2. Effective allocation of capital and development of financial markets;
3. Attracting foreign investment and
4. Making a contribution to the process of national development.

The development of corporate governance demands the establishment of certain market economy institutions necessary for economic growth. Without good corporate governance, corporations cannot fulfill their main mission – profit making and contributing to the social welfare, with maximum effectiveness. Companies cannot operate successfully without setting the adequate rules of governance and institutions that support them, without embracing a culture of corporate governance among managers, owners and other stakeholders.

For countries in transition, companies and associated institutions are the key factors in the process of economic transformation. Well laid out and developed corporate governance requires that all relevant actors in this process recognize and well understand their roles. Mass privatization created a lot of managers who are not active participants in ownership relations, because they simply do not understand their essential roles, rights and responsibilities. Most of them simply wait for the paying out of dividends, which are often worthless in their value. They also, often, cannot understand the role of agents they have in relation to owners, and they run the companies as they were their property, by satisfying their own interests, to the detriment of the owners and the company as a whole. Corporate governance requires coherent and strict national regulations, which is the basis for setting the mission and goals for the makers of economic policies of the country. Furthermore, indispensable are recruit, train and reward professional managers who can be held to high standards of competency, ethics and responsibility.

Corporate governance is directly related with financing and investments in the country. Making managers disciplined, by means of corporate governance mechanisms, results in an efficient allocation of resources. For countries in transition it is doubly important: the scarcity of domestic savings demands that capital be directed towards the most profitable companies, which is possible only by establishing a public, transparent and constantly monitored principles of corporate governance; additionally, due to the imperfection of market mechanisms (undeveloped markets of stocks and bonds markets and insufficiently efficient banking system), corporate governance presents an additional mechanism for discipline and effective management control in companies.

It can be concluded that good corporate governance is an important factor for the functioning of financial markets, contributing to an efficient allocation of financial resources and at the same time is the key to effective economic development.

International capital flows enable companies to tap sources of financing from a great number of investors. If countries want to take advantage of global capital markets and also to attract long-term capital, they must follow clear standards and principles of corporate governance at the international level. The degree to which the companies use basic principles for good corporate governance is a relevant factor for investment decisions as well. This is particularly important when it comes to direct investments, which are especially important and useful for countries in transition, because they do not mean only the influx of capital but also the transfer of new technologies, skills, know-how, etc. Direct investors, who practice a high degree of control, pay particular attention to corporate governance framework in the country, demanding respect and adapt to global standards (accountability, transparency, accounting and auditing, etc.).

Effective corporate governance cannot be considered in isolation. Regarding the financial sector of the country special attention should be given to measures to strengthen the banking system and financial institutions as a whole. In the real sector, as recommended by the OECD, special care should be dedicated to competition policy, as well as sector specific reforms. The problem with the OECD guidelines, in particular when applied to developing and transition economies, is that they cover a broad range of rules and principles without specifying clear priorities among them. Given that the guidelines assume many of the institutions that are lacking in these countries they also do not provide priorities across policy areas. Furthermore, even the watered-down language of these prescriptions is often too ambitious for policymakers. Nevertheless, we believe the OECD guidelines provide a useful start. We indicate, therefore, in the following paragraphs how we view the priorities for developing and transition countries [8].

1. Any international guidelines must recognize the international differences in governance systems.
2. The general accounting rules and transparency requirements of the OECD guidelines should be a benchmark.
3. Protection of external investors is more important in transition economies than in developing countries.
4. The development effect from any program that focuses solely on the plight of small shareholders is likely to be very small

5. Protection of creditors is more important than that of shareholders in developing and transition economies.
6. The short- and medium-term emphasis on investor protection should not be on creating liquid markets for shares and corporate bonds.
7. In the long term, liquid securities markets can be important for attracting foreign portfolio investment.
8. Reforms focusing on enforcement are more important, and more difficult, than are changes to the letter of the law.
9. Reforms must recognize the complementarity of different parts of the law and political institutions.
10. In many contexts the most immediate concern is to protect stakeholders other than shareholders
11. Implementation and enforcement of fundamental corporate governance reform will in many cases require external conditionality.
12. Effective corporate governance reform will often require a combination of threats and co-optation of the main actors.

**3.2. Necessity of development framework for corporate governance**

Specific corporate governance system can vary considerably; depending on the mechanisms which the owners use to influence the behavior and performance of managers [9]. Can be distinguish three different ways that owners maintain control over the work of managers:

1. The owners direct impact on definition of the company's strategy and the selection of management team;
2. The owners delegate their rights to the board of managers, but to ensure that the compensation and other bonuses are aligned with the rise of share price;
3. The owners rely on the market mechanisms of corporate control, such as a takeover, when due to a decreasing share price, new owners take over a company and change to management, in order to rehabilitate the company and increase its market value.

In other words, the corporate governance mechanism can be both internal and external (Table 3).
The internal mechanism of corporate governance includes:

1. Ownership concentration,
2. Board of directors,
3. Rewarding managers and
4. Introducing the multidivisional organizational structure of the company.

The external mechanism of corporate governance refers primarily to the market for corporate control, i.e., a group of potential owners attacking the undervalued companies in order to change the inefficient management team and improve the competitive position of the company.

Table 3: Mechanism of corporate governance

| **INTERNAL MECHANISMS:** | |
|---|---|
| 1. *Ownership concentration* | A relative amount of shares owned by individual owners or institutional investors |
| 2. *Boards of directors* | Individuals are responsible for representing the owners' interests, by means of controlling strategic decisions made by the top management |
| 3. *Rewarding managers* | Using earnings, bonuses and other long-term stimuli, in order to reconcile interests of managers and owners |
| 4. *Multidivisional organization structure* | Separation of the business of more divisions, in order to control the strategic decisions of management |
| **EXTERNAL MECHANISMS:** | |
| **1.** *Market for corporate control* | Take control of an underperforming company in order to improve the strategic competitiveness |

### 3.3. Corporate Governance in Macedonia: framework

For the purpose of the Assessment, the corporate governance framework and the practices were divided in five key sections [10]:

1. Structure and Functioning of the Board;
2. Transparency and Disclosure of company information;
3. Internal Control;
4. Rights of Shareholders; and
5. Stakeholders and Institutions.

The ratings are presented in this frameworkt through the colours detailed in the box below and the demonstrate the adequacy or need of reform in respect to each governance section and sub-section.

- *"Strong to very strong" (dark green)* **-** The corporate governance framework / related practices of companies are fit-for-purpose and consistent with best practice.
- *"Moderately strong" (light green*) **-** Most of the corporate governance framework / related practices of companies are fit-for-purpose but further reform is needed on some aspects.
- *"Fair*" *(yellow)* **-** The corporate governance framework / related practices of companies present some elements of good practice, but there are a few critical issues suggesting that overall the system should be assessed with a view of reform
- **"***Weak" (orange***) -** The corporate governance framework / related practices of companies may present some few elements of good practice, but overall the system is in need of reform.
- *"Very weak" (red)* - The corporate governance framework / related practices of companies present significant risks and the system is in need of significant reform.

Table 4: Corporate Governance in Macedonia: framework

| KEY AREAS | RATING |
|---|---|
| ***1. Structure and Functioning of the Board*** | Weak |
| 1.1. Board Composition | Fair |
| 1.2. Gender Diversity at the Board (15.87%) | Fair |
| 1.3. Independent Directors | Weak |
| 1.4. Board Effectiveness | Weak |
| 1.5. Responsibilities of the Board | Fair |
| ***2. Transparency and Disclosure*** | Fair |
| 2.1. Non-Financial Information Disclosure | Weak |
| 2.2. Financial Information Disclosure | Fair |
| 2.3. Reporting to the Market and to Shareholders | Fair |
| 2.4. Disclosure on the External Audit | Fair |
| ***3. Internal Control*** | Fair |
| 3.1. Quality of the Internal Control Framework | Fair |
| 3.2. Quality of Internal and External Audit | Moderately strong |
| 3.3. Functioning and Independence of the Audit Committee | Weak |
| 3.4. Control over Related Party Transactions and Conflict of Interest | Moderately strong |
| ***4. Rights of Shareholders*** | Moderately strong |
| 4.1. General Shareholders' Meeting (GSM) | Moderately strong |
| 4.2. Protection against Insider Trading and Self-dealing | Fair |
| 4.3. Minority Shareholders Protection and Shareholders' Access to Information | Moderately strong |
| 4.4. Registration of Shareholdings | Moderately strong |
| ***5. Stakeholders and Institutions*** | Fair |
| 5.1. Corporate Governance Structure and Institutions | Fair |
| 5.2. Institutional Environment | Fair |
| 5.3. Corporate Governance Code | Weak |

## 4. CONCLUSION

The countries in transition are facing the problems of corporate governance in a specific way. The business environment in these countries lacks certain elements necessary for installation and maintenance of competitive relationships that are advantageous primarily, to older, large and dominant companies, which discourages entrepreneurship and the appearance of new companies. Unstable macroeconomic conditions create a surrounding of great uncertainty, with unpredictable economic conditions, in which managers see their positions as temporary and unreliable, which leads to maximizing their own profits, rather than the profits of the company in general. In such conditions, the state's role is twofold: on the one hand its role should be limited; on the other hand, strong state power is needed, which through political program will successfully implement the economic transformation. Nurturing good business relations between companies and banks is also significant, in terms of providing the necessary capital and credit, and they remain heavily influenced by personal and institutional relationships and connections. In terms of unavailability of financing through loans, developing business relationships and trust between companies provide an alternative method of financing.

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