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CORPORATE GOVERNANCE: A CHALLENGE FOR SLOVAKIA*

Anton Marcinčin**

To many observers, the Slovak economy was a puzzle for several years, as its growth backed by low inflation and stable exchange rate was accompanied by weak interest of foreign investors and persistently high unemployment rate. The Slovak growth was not sustainable, however, for permanent postponement of essential structural changes. The country has not been able to secure adequately protection of the private ownership, execution of ownership rights by means of corporate governance regulation, and hard budget constrains. These were the main reasons why enterprise restructuring was delayed and the new owners often robbed enterprises and searched for rents. As a result, a major part of enterprising agents now produce losses, do not render their liabilities vis-a-vis banks, trade partners, state and employees, and represent social risk intensified by current high unemployment rate.

The current program of revitalization of the Slovak economy assumes the unlocking of financial flows and the extensive reform of the enterprising environment. By releasing financial flows, current unfavorable situation will be improved, while by reforming enterprising environment, return of current problems will be avoided.

In this study we address important part of enterprising environment design, corporate governance of enterprises. Slovakia urgently needs to strengthen rights of investors and creditors.

1. INTRODUCTION

The Slovak economy may serve as a textbook example of how a high preference of immediate economic growth and postponement of necessary structural changes lead to economic recession. The country focused on GDP growth with low inflation and stable exchange rate under almost exponential rise of indebtedness. The delay in microeconomic reforms at the same time was reflected in inadequate investment influx. Resources available to the country were used inefficiently thanks to the existing legislation. A *tunneling* became a rational behavior of owners and managers, and is only nicer term for robbery and fraud of vested property.

The Slovak growth as not sustainable for lack of new resources and bad employment of existing resources. The reason lies in design of legal and institutional framework of enterprising, which motivates economic agents to seek rents rather than combine efficiently production factors in order to create profit. Still problematic is security of private ownership and creditor rights protection, execution of ownership rights by means of corporate governance[1] , and enforcement of hard budget constraints. Schematically, regulation of the following areas is considered:

• *Company - suppliers of inputs.* Bad payment discipline is liquidating especially small suppliers. The companies often took commodities and services, converted them into cash and by self-liquidation avoided reimbursement of their liabilities towards suppliers. There were some speculations that some suppliers knew it well in advance that receivers would not pay them for their commodities and services, but used this way as a certain form of pressure against the government. They wanted to show their ability to produce and sell, while it was only the purchaser who temporarily and innocently became unable to cover its liabilities. This implied good backing for requirement that the government should help such a company to bridge existing temporary problems. If managers of the supplier firm were financially involved in the transaction, they intentionally contributed to the bad payment discipline in order to enrich themselves. At the same time, the purchaser who converted inputs into cash had intention not to pay. It has been very difficult to prove particular persons within the company a bad intention and therefore they were not prosecuted. This area is solved by an Execution law no.233/1995 and amended Bankruptcy Act by its 30-days limit: para.1 (2) *"A debtor shall be declared bankrupted if it has more creditors and is unable to cover its liabilities for more than 30 days after agreed maturity day."*[2] According to the Reasoning report of the amendment, the measure *"…pursues an improvement in payment discipline and prevention of chain payment inability because of defaulted mature liabilities."* It is also necessary to regulate personal responsibility of managers towards owners and other stakeholders of a company in cases, when managers acted in ways harmful to the latter.

• *Company - banks*. In this relationship, a problem in the regulation was on both sides. The Bank supervision was a weak point, since it allowed both large and small banks to systematically issue credits disadvantageous from the very beginning to minority shareholders and creditors of banks.[3] In essence, it neglected and therefore allowed *tunneling* of banks. It is probable, that bank supervision was all the time exposed to pressure from bank owners, especially state owned companies, and government policy in regional unemployment, but this cannot excuse its inactivity. Bank supervision has other goals defined than to look after unemployment and interest of state owned companies.[4] On the side of banks, there was no effective assurance of rights of commercial banks as creditors, so that commercial banks had no disposal of tools for recovery of unpaid credits. At the same time, valid tax legislation forced banks to replace bad credits by new credits in order to decrease their tax base by fictitious income from principle, interest and penalties. In that way, banks certainly reported better but misleading results on their portfolio quality. One of the results of weak regulation of relationship company - bank and insufficient activity of bank supervision is for example 100 billion debt in recovery organization Slovak consolidation,[5] complication in privatization of Slovak Telecom for the state help to the Post Bank and bailing out of several smaller banks indirectly by the government. The other result, that concerns enterprise sector very directly, is a credit crunch. It is rational reaction of banks to the situation, in which they do not have secured their rights in any legal way. Therefore, on the one side are banks that exist only to accumulate free finances and give credits, on the other side are enterprises, which urgently need finances, but there is no mechanism on the market that would allow banks to issue credits. In this area, it is necessary to improve efficiency of bank supervision, currently in responsibility of the National Bank, introduce criminal recourse to managers of banks and enterprises, and increase interest of savers in bank prosperity by reduction of credit insurance to level lower than current 100%. If mechanism regulating relationships bank supervision - bank and bank - company will not be improved, bank privatization may lead to disappointment and renewal of current situation.

• *Company - state.* If enterprise stopped to pay taxes and fees for its employees to the Social insurance, health insurance funds and National labour office, these institutions had very little possibilities to recover their claims. According to the estimations of Ministry of Finance, indebtedness of enterprises towards the state and public institution reached about 130 billion SK. This is almost 40 billion SK more that one year ago. The true uncovered loss on the side of private sector can be much lower, because state institutions themselves often are the source of insolvency. The aim of Ministry of Finance is to improve and unite current legislation so that above mentioned institutions could restructure their claims (by sale to the third person, asset swap and following sale and mandating the third person to recover existing claim), forgive penalty fees and part of principle if claim cannot be recovered. In this area it is necessary that government uses reform momentum to gain unambiguous reputation with enterprises that they cannot delay payments to the state without good reasons. The other problem of claims of the state and public institutions towards enterprises was that by law they had priority over claims of other persons in case of bankruptcy declaration, but the state did not have enough resources to administrate bankruptcies and other creditors had no incentives to bear costs of such administration for small residual value which would have to cover their claims. This, together with slowness and corruption of courts[6] prevented fast declaration of bankruptcies and sale of enterprises as on going concern or by parts. Nor claims of the state, neither of other creditors were satisfied. Enterprises were *tunneled* and led to liquidation and labor force at first stayed artificially bounded and then uselessly dismissed. Amendment of Bankruptcy act solves also co-ordination of the state and public funds with other creditors (see especially changes in para.54).

• *Company - investors.* Apart from partners' investment, bank credits and share capital, an enterprise may receive finances also by bond issue according to the law no.530/1990. Bond gives its holder no ownership rights towards the enterprise. Other investors are investment funds, that do not have real interest in execution of their ownership rights in enterprises, because their goal is to maximize portfolio value by purchase and sale of shares.

• *Managers - owners.* Shareholders are owners of join stock company, while partners are owners of limited liability company. Enterprises with lower amount of capital are usually owned by a single person, who is able to perform monitoring and management. Enterprises that for their optimal operation need bigger amount of capital use as the source of financing issue of shares which bear certain rights to their holders. This is because of diversification of risk connected to the deposition of capital in company on the side of investors. If rights of shareholders are in reality not enforced, enterprise cannot use this source of financing. This model requires delegation of part of rights of owners to managers, creates complications in monitoring and control of managers and a need of complex system of legislative norms and institutions regulating the relationship. Its advantage is, however, possibility to accumulate “any” amount of capital. Relationship between owners and managers is a subject of corporate governance in its narrow understanding. This area is covered by many laws, but especially by Commercial Code, Bank Act, Bankruptcy Act, Stock Exchange Act, Securities Act, Bonds Act, Act on Collective Investment and Act on Competition. Stock exchange, together with the Office of state supervision of capital market and Department of capital market within Division of financial market of Ministry of Finance supervise duties of publicly traded companies. Central register of securities registers transfers of ownership of shares. In Slovak environment, understanding of position of manager and owner is usually distorted because of privatization method - majority owner often takes over managerial function. One can often see also misunderstanding of importance of minority shareholders and necessity to establish their special standing within the company. At the same time, overestimation of majority owners necessarily diminishes volume of disposal capital and insolvency of enterprises. We analyze relationship between managers and owners in more detail in the fourth section of this study.

• *Managers - employees.* Special attention should be paid to the relationship between a company, represented by managers, and employees. Investment of employees into specific human capital (collection of knowledge and abilities, which in combination with particular capital produce output of the enterprise) should be considered sunk.[7] This is a source of interest of employees in good operation of enterprise and herewith employees became together with owners and other interested parties those, who have stake in the company.

• *Managers - other stakeholders.* Other stakeholders are municipalities, suppliers of inputs and other parties, whether persons or institutions, that share the interest in good operation of the company, even if this interest is not linked with ownership or employment in the company. It is generally accepted, that the company and its management must act responsibly also towards these stakeholders.

Apart of mentioned laws, whole area is touched by legislative regulation of income tax, prescribed chart of accounts, differences between the Slovak and international accounting standards, quality of work of auditors and ability of their punishment, differences in understanding of scope and frequency of publication of enterprise and bank information, and in understanding of content requirement of reports, that currently are more seen as information for tax purposes rather than about financial situation in enterprise.[8]

In this study we address especially relationship between managers and owners, i.e. the question of corporate governance (in its narrow understanding). This is defined by Shleifer and Vishny (1997, p.737) as a subject that *“…deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”* The OECD (1999a) defines corporate governance more broadly as *“a set of relationships between a company’s management, its board, its shareholders and other stakeholders.”* According to Zingales’s definition (1997), corporate governance system *“[is] the complex set of constraints that shape ex-post bargaining over the quasi-rents generated in the course of a relationship.”*

It is obvious that relationship between manager and owners cannot be studied separately from relationships between the company and bank, and the company and investors. At the same time, these relationships cannot be considered as a matter of companies alone, because corporate governance mechanisms, that try to overcome the problem of separation of ownership and control, are economic and legal institutions that can be altered through the political process.[9]

The structure of this study is: In the second section we explain briefly development of currently prevailing ownership type in Slovakia, because proper model of corporate governance depends on ownership type.

In the third section we demonstrate consequences of applied corporate governance. The fourth section analyze in more detail regulation of relationship of company in both directions, outside and inside it (broader and narrow understanding of corporate governance), and necessary changes in legislation.

The fifth section contains a summary of main conclusions: a concentrated ownership in Slovakia has in majority of cases rational justification and also in future these companies will not enter a public market. Other, larger companies will look for part of resources on public markets at home and abroad, and therefore will have to adjust to international standards. Original owners (privatizers) will sale their percentages to foreign investors either voluntarily, or involuntarily in case of bankruptcy. Model of corporate governance that has been applied led to great economic damage, with which Slovakia will have to cope several decades. In order to allow enterprises operate properly, many laws and conduct of many institutions must be changed. This will mainly influence commercial code, definition of personal criminal responsibility of individual managers, improvement in quality of work of auditors, change in reporting on financial data of enterprises (transparency) and availability and integrity of commercial register.

2. TYPES OF OWNERSHIP

Current ownership structure is a result of two waves of privatization and consequent development, given by the existing legislative and institutional framework of corporate governance. Here we recognize the following ownership types, relevant to our subject:

- Solo owner.
- Majority shareholder with at least 67% of shares and residual owners. Majority owner usually is (i) a private person or a company (strategic owner), (ii) a group of private companies and (iii) a group of state owned companies, banks and insurance companies. It could also be (iv) a group of hardy defined shell companies. Here we count also what remained from former investment privatization funds.
- Dispersed owner.

These main types of ownership intersect. Importance of particular types can be estimated from development of privatization.

2.1. Development of ownership structures

Ideally, there would be three main forms of prevailing ownership structure in Slovakia: Solo owner, majority strategic owner and dispersed owner. The solo owner developed either from establishment of de-novo smaller size firms (from point of view of required volume of capital), or by direct sale privatization of property and almost 100% shares of join stock companies especially in the second wave of privatization. The strategic owner[10] is typical for privatization of public utilities, banks and generally all enterprises that require fast influx of know-how and finances. The dispersed owner originated in voucher privatization. It was assumed, that small investors together with investment funds will be able to monitor existing management and undertake corporate control. Investment funds were expected to become an important source of capital for enterprises and an engine of trading on capital markets.

The true situation has diverted from this ideal conception for the following reasons:

- Non-existing protection of minority owners. The situation went that far that smaller than 67% shareholder could in fact be considered as a minority shareholder.
- Corrupted courts. They are, next to political instability, perhaps the second largest obstruction to economic development in Slovakia.[11] Corruption at courts may explain the best why influx of foreign direct investment to Slovakia stayed so low.
- Non-existing market tools for forced exit of companies from market, for example by bankruptcy. This area is linked to rate of corruption at courts and state interference to business sphere.
- Reluctance to disclose information, unavailability of records from commercial register, design of financial reports that serves more for taxing purposes than for analyses of financial condition of companies, reluctance of institutions to demand information from companies and make them public.
- The state support of rent seeking and different forms of the state assistance like toleration of tax and prescribed funds arrears, state guarantees, loans from state-owned banks under special conditions, public orders and toleration of *tunneling* of state-owned companies and banks.

The development of ownership structure happened in two phases - privatization and post-privatization. During the privatization phase, nomenclature *insiders* struggled at securing the best position in the process. So for instance they achieved to cancel the second wave of voucher privatization and to replace it by direct sales at symbolic prices. In post-privatization phase, new owners maximized their income in different ways - from resale of a company to drafting of legislation (like a Revitalization law).

The privatization phase started soon after November 1989. Till the end of 1998, National property fund (FNM) received property in total book value 349.4bn. SK.[12] From total privatized property (see table 1 in appendix), 74% was privatized like join stock companies and 21% by sale of assets. The largest share of total property (26%) keeps privatization by vouchers. The same percentage stayed as shares in administration by FNM. Standard methods, especially direct sale, were employed for sale of 13% of property.

The share of foreign investors was minimal. They privatized property in book value of 4.7bn. SK (1,5% of total privatized property) in twenty-seven cases.[13]

The voucher privatization involved 503 join stock companies. About 2.6 million of Slovak citizens took part in the scheme. Simplifying, one can say that a problem of voucher privatization was in creation of too dispersed ownership, that had negative impact on capital cost and performance of companies.[14] In 93% of companies privatized by vouchers, small investors (voucher booklet holders) and investment privatization funds acquired majority stake (see table 2 in appendix). Small investors had majority in 49% of companies privatized by vouchers, which is about 10% of all privatized companies and 31% of all join stock companies privatized. Investment companies enjoyed majority in 7% of all companies and in 22% of all join stock companies privatized.

Because no regulation that would allow minority shareholders to defend their rights was in place, their influence on governance of companies or investment funds was equal to zero. Their exit by sale of shares was possible only till the moment until ownership relations were settled - typically until majority shareholder acquired 67% of shares. But also other, much larger shareholders had problems to exercise their ownership rights. Thanks to corrupted courts, that were willing to recognize dubious results of general meetings, even 51% owner could not be certain about his position. It was enough if minority shareholders called a general meeting such that majority owner could not participate at, they nominated only their representatives to the executive and supervisory boards, adjusted articles of the company so that two thirds of votes would be required to recall by them elected representatives, and achieved fast registration in the commercial register.

Investment privatization funds (IPF) were expected that within management of their portfolio they would either actively restructure companies, or sale their shares to direct investors. However, there were two problems of governance on the side of IPF: On the one hand, owners of funds had no real chance to influence closed-end funds and usually had no chance of exit, so that the true owners of funds were their managers with small percentage holdings. On the other hand, funds themselves appeared in a bad position of minority shareholder in companies. We shall claim that managers of funds, given the existing economic environment, took rational decision to fraud entrusted means and maximize their private income. First, they were selling shares of portfolio to decrease its value. Later, funds and investment companies transformed themselves into join stock companies with a different subject of enterprising in order to escape state supervision over the financial sector.

According to our estimations (see table 3 in appendix), originally about 1.3 million people owned now transformed funds, while nominal value of their portfolio was 43bn. SK. It is very likely that current value of their portfolio is minimal. Only twenty funds with original book asset value of 5.1bn. SK and number of shareholders 108,000 operates under our estimations within the sector.[15] We can assume that companies originally privatized by voucher method are currently owned typically by majority shareholder.

A comparison of post-privatization development in companies originally privatized by different methods (table 1 in appendix) leads to the estimation that almost all companies are, or soon will be (after privatizing public utilities) owned by majority or solo owner. This estimation is based on assumption that originally dispersed ownership from voucher privatization meanwhile became concentrated, and there will be concentration in companies with important stake by FNM (natural monopolies that were already mentioned). Residual minority shares are not important, because allocation into restitution investment fund usually was only 3% high and reserve and other funds were insignificant as percentage on company equity.

Apart from expected sales of FNM and the state holdings to strategic investors, the current ownership rights will be clarified by the recent amendment of Bankruptcy act and bail out of bad loans in volume of 100bn. SK to the Slovak consolidation agency. The amendment of bankruptcy act will allow dying companies to find new investors. Because usually smaller size companies are involved, we can assume that they will be taken over by either firms specialized at restructuring and resale of vital parts to the new solo owner, or by foreign direct investors. The amendment will at the same time allow rather fast change in ownership in companies that their main problem is represented by their bad owners. As far as assets in Slovak consolidation agency are considered, they should be understood as a sum of contracts in total value of 100bn. SK, rather than true cash value. It will be very essential part of the consolidation agency to clarify and legally finalized several thousands of cases of dying but also of vital companies, whether by sale of assets in parts or whole companies to direct investors.

Another question, that should be asked in connection with a development of ownership structures, is position of companies on capital market. A majority of the Slovak companies were forced to enter bourse because or voucher privatization and they do not consider (especially Slovak) bourse as a source of capital, but rather only as a source of displeasure, as capital market statistics indicate (table 7 in appendix). Number of listed shares decreased to eleven, while this number also contains some duplicity of shares of the same companies. Since 1997, other shares are split between two markets - market of registered securities and free market. At the free market, *„all publicly tradable securities issued in accordance with valid legislation are admitted… The stock exchange informs the State supervision department for the capital market about the non-fulfillment of the issuer's obligations.“*[16] It is the market where the worst shares are deposited, and bourse in fact does not posses tools to exclude such shares from the market. In 1999, majority of shares belonged in this category: 786 from a total number of shares 830. The frequency and volume of trades at bourse is minimal. Volume of trades with shares reached maximum in 1996, almost 19% of GDP, but in 1998 it was only 6% and in 1999 3% (see table 5 in appendix). There are several reasons for that:

• Many companies are in fact closely held and do not have interest to be publicly traded. They should leave the bourse, but there is a requirement that 100% of shareholders must agree to cancel public trading of shares. It is certainly very difficult to meet this requirement. It is necessary to regulate better exit of join stock company from the public market - decrease limit for approval to and find a key for compensation of minority shareholders.

• Loss of confidence in collective investment - directly and through investment companies. It is a result of non-existing protection of investors. Paradoxically, although voucher privatization was intended to promote collective investment, it became a reason of its decay. The regulation is such, that Join evaluation of midterm priorities of Slovak economic policy by the Slovak government and European commission (2000, p.28) states: *„manipulation with prices of shares and abuse of confidential information in trading with securities have become a norm.“*

• Small and poor domestic market. Does country of five million people really needs its own stock exchange? The bourse may represent certain national sentiment and pride, but in reality it is rather costly institution which may become an obstruction to the economic development. The cost of national bourse is not only its operation expenditure, but also a complex of necessary legislation. Especially small transition countries, where a need of new legislation is great but resources too limited, should consider whether existence of national bourse has any rational ground. If the government preferred that enterprises place their issue of shares at foreign stock exchanges, these enterprises would necessary adjust to relevant legislation and international standards. A domestic bourse may become an obstruction, if the very fact of its existence is the reason to limit activities of companies and investment funds. For example, funds that offer supplementary pension insurance may according to the law no.123/1996 buy only shares registered at Bratislava stock exchange, what in practice is almost impossible, if one considers small liquidity of that market, and at the same time it would increase risk of their portfolio. If Slovakia should reform its pension insurance system, domestic bourse may become true obstacle to operation of funds.

As we maintain hat majority of companies in Slovakia will be owned by solo or majority investor, that will not have interest to enter public market, we shall also ask a question about a significance of corporate governance reform. As we will show, corporate governance regulation is connected with development of existing companies and establishment of new companies. Therefore, from the current point of view, the reform is necessary for correction of ownership structures (usually concentration and exit of small shareholders) and restoration of trust in collective investment. From the close future perspective, the reform is necessary for development of innovative enterprises.

3. RESTRUCTURING OF ENTERPRISES

Several studies analyzed level of restructuring of Slovak enterprises.[17] In this section we analyze restructuring only from the two aspects, the ability to produce profit and development of volume of past-due liabilities and claims. We analyze trends in development, whether the economy, and manufacturing within it, produces still higher volume of profits and lower volume of losses, whether number of profit making companies grows and number of loss makers declines, and whether volume of past-due claims and liabilities continues to decline or whether it already reached certain equilibrium level. We shall assume that if adequate restructuring of enterprises was happening in Slovakia, it would be possible to observe improvements in all analyzed trends already now. Data of Infostat, that we use, are not as accurate, as data of DataCentrum,[18] but according to our observations from 1996-199, they follow the same trend. A selection of period 1996-1999 is given only by availability of data.

On graph 1(in appendix) we can observe maximum profit of whole economy in 1997 and then decline even bellow the 1996 level (columns in the graph denote annual values, while lines quarterly values). We have to emphases that data are in current not constant prices, so that the picture is even worse. Positive turn happened in a volume of produced loss, when in 1999 its increase stopped and losses declined bellow the 1996 level. Sectors of manufacturing produced profits almost equal to losses in 1996 and 1997. The situation worsened in 1998 when loss was higher than profit by 29%, while the switch happened again in 1999 when profit was at 19% higher than loss. Differences between profit and loss for all categories are depicted on graph 2 (in appendix). Although whole economy generated all fours years positive profit, manufacturing generated except of 1999 losses. While an improvement in development of profit and losses was registered in 1999, a small volume of profit indicates that in the best case it could be considered as end of recession but still not as the beginning of recovery.

Number of profitable companies was in 1996 and 1997 in economy and manufacturing lower than number of loss companies (graph 3 in appendix). A switch, according to the Infostat, happened already in 1998, however, both number of profit and loss makers continued to grow.

From the point of view of past due claims in whole economy there is an improvement, since the 18% growth between 1998 and 1997 was followed by only 3% increase between 1999 and 1998 (graph 4 in appendix). A similar development happened also with past due liabilities. In manufacturing, volume of past due claims even decline to its minimum level in studied period, and volume of past due liabilities to the level of 1997, which is an annual decline at 13%. An improvement in this area is most likely given by a new attitude of companies that require cash advance payments (with all negative consequences for business conduct) rather than by improvement in contract discipline which would be associated with higher amount of finances in circulation.

In 1999, certain improvement was registered in restructuring of enterprises, but still most likely it was a year of the end of recession (which went through observed period) rather than a beginning of recovery. Total loss declined significantly, but at the same time also profits declined, too. Number of profit making companies exceeded number of loss makers, but at the same time, also number of loss makers increased. A payment (or contract) discipline improved, but most likely because companies switched to cash payments which is good emergency solution, but is not enough to make economy to recover.

4. CORPORATE GOVERNANCE

Corporate governance mechanisms are economic and legal institutions that can be altered through the political process.[19] These mechanisms try to overcome the problem of separation of ownership and control.

Incentive contracts (management share ownership, stock options, or a threat of dismissal) require that performance measures that are well-defined and verifiable by court are correlated with managerial effort. This is difficult. In addition, incentive contracts create opportunities for managers' self-dealing.

The most significant *legal rights of shareholders* include the right to vote on important corporate matters and on the election of supervisory board (that, however, do not necessarily represent shareholders' interests). The voting at general meetings is expensive to exercise and enforce, and its efficiency depends on legislation and court protection of shareholder voting rights. In many countries, shareholders' voting rights are supplemented by managers' duty of loyalty to shareholders. Courts in OECD countries generally accept this approach.

Large shareholders concentrate shares. They have an incentive to collect information and monitor management, thus avoiding free rider problem typical for spread ownership, where monitoring costs are private but acquired information is a public good. Large shareholders have interest in profit maximization and enough control over the assets, but their real power depends on the legal protection of their votes. The problem with this mechanism is that large shareholders have an incentive to expropriate the wealth of other, minority shareholders.[20] If minority shareholders are not sufficiently protected by law, they will not invest in shares.

Large creditors, usually banks, retain control similar to large shareholders. This control comes from short-term lending (forcing firms to come back) and creditors' rights when firms default or violate debt covenants. Large creditors are significantly involved in the governance of firms in Germany and Japan, where they have well-secured legal rights. The problem of this mechanism is that bank ownership is associated with conflict of interests, which result in higher interest rates paid by affiliated firms. Alternatively, banks do not terminate unprofitable projects in which they invested when continuation is preferred to liquidation. Debt finance is typical for firms with tangible assets, as new firms usually have nothing to offer creditors as collateral.

Take-overs. Typical for Britain and United States, take-overs imply that a bidder makes a tender offer to the dispersed shareholders to acquire control over the management of a target firm. This is a very expensive mechanism that appears when major failures occur in companies.[21]

Leverage buyouts imply that shareholders of publicly traded company are bought out by a new group of investors, which usually consists of old managers, a specialized buyout firm, banks and public debt-holders.

Which type of corporate governance prevails depends on legal protections of investors. Since legal protection is weaker in Continental Europe and Japan, corporate governance in these countries depends more on large investors (sometimes families) and banks with longer-term stable relationships to the firm. This is sometimes called the *insider* model.[22] The *outsider* system of corporate governance is typical for the United States and United Kingdom. Its features are: dispersed equity ownership, large institutional holdings, recognition of primacy of shareholder interests in company law, protection of minority investors in securities law and a strong requirement for disclosure.[23] Generally, the efficiency of corporate governance depends on transparency of information generation and use, the protection of legal and contractual rights, and the accountability of management.

According to La Porta et al. (1999), the difference in ownership structures of publicly traded companies, size of capital markets, dividend policy and access of companies to outside financing in different countries is given by a design of legislation protection of investors (owners and shareholders) against expropriation by managers and large shareholders. They consider managers and large shareholders as *insiders*. An expropriation takes form either of a simple robbery of profit or a sale of output or assets to other company for lower than market price.[24] Even if this activities usually are perfectly legal, their effect is the same as a theft.

Rights of outsiders are in general protected by the enforcement of regulation and laws. Regulation by government agencies and stock exchange contain some critical requirements on companies like disclosure and accounting rules, which are providing investors with necessary information for executions of their ownership rights. Among other rights of shareholders, possibility to sue directors or the majority for suspected expropriation is essential. In most countries, laws and regulations are enforced in part by market regulators, in part by courts and in part by market participants themselves. Emphasis put on laws and regulations differs from traditional approach to financial contracts, which does not consider regulation as necessary, because contracts are made by sophisticated issuers of shares and investors.[25] But the problem is to enforce contracts - courts are often unwilling or unable to resolve complicated disputes, are slow, subject to political pressures and even corrupt.

La Porta et al. (1998) provides a list of regulations of investors rights, a percentage of countries that in their legal system posses indicated rule and average value of anti-director rights index and creditors rights (see table 8 in appendix). Countries with a common law have the strongest and countries with French civil law the weakest protection of outsiders (shareholders and creditors). Countries with German civil law are in the middle with an accent on protection of creditors' rights. La Porta et al. (1999) deduce from the table an important conclusion, that differences between legal systems are best described as better or worse protection of outsiders a not as either protection of shareholders or protection of creditors.

There are two explanations, why common law protects investors better than civil law, 'judicial' and 'political'. In a system of common law, judges usually make legal rules, based on precedents and inspired by general principles, like fiduciary duties.[26] Judges apply general principles even if specific conduct was not described or prohibited by law. As far as expropriation of investors is considered, judges investigate whether insiders did not violate their fiduciary duties even in yet unprecedented way. On contrary, legal rules in civil law are made by legislatures and judges cannot go beyond the exact letter of the law. As a consequence, insider that finds a way of expropriation of outsiders that does not violate explicit wording of the law can proceed without being afraid of prosecution. Political explanation maintain that judge in common law system protect outsiders and not insiders. A common law developed to protect private ownership against the crown. In contrast, civil law was to allow the state to regulate better economic activities of private persons. As the law evolved, the dominance of the state transformed into the political conception of corporations and the limited rights of the investors against politically linked families that control companies. Judges were more dependent on the government and therefore were less likely to take the side of investors in dealing with government or companies close to the government.

There are three reasons of protection of the investors:

• Ownership model of enterprises. In countries, where protection of outsiders from expropriation is weak, control concentrates in hands of the entrepreneur.[27]
• Development of financial markets and dividend policy. Legal protection of investors' rights helps to develop financial markets. Investors protected from expropriation pay higher prices for securities, which in turn are more attractive to issuers. This is true also for creditors and development of crediting enterprises.
• Allocation of real resources. A development of financial markets can accelerate economic growth, because it increases savings, directs them into the real investments and therefore supports accumulation of capital, and improves efficiency of allocation of resources as capital flows to more productive uses.

An important conclusion of La Porta et al. (1999) is that corporate governance reform should be directed towards protection of rights of outsiders, i.e. both shareholders and creditors, rather than only one of the two groups.

The opposition against corporate governance reform is formed at governments and families (groups) who are in control of large companies. Should necessary legislation be adopted, they would surrender their regulatory control to financiers, which would decrease the value of their control. Furthermore, large companies under the current bad protection of outsiders receive large part of credits through banks. In that way they also receive political influence and protection from competition, that would come if smaller firms had access to external capital for their development.

There is no list of steps of corporate governance reform. But there exist several principles that such reform should be based upon:

• Rules should have a form of laws. Laws do formulate financial markets.
• Legal rules must be enforceable. The goal is not to create a set of ideal rules and then think about ways of their enforcement, but rather to prepare rules that could be enforced by existing structures.
• If it is not possible to rely on enforcement of private contracts or laws by courts, then it is better to apply government regulation of financial markets. Poland can serve here as an example, as it adopted tough law on securities intended to protect shareholders. Issuers are required to disclose complex information. The law established a strong commission for securities and bourse with enforcement rights independent from courts.

Corporate governance reform is connected to convergence of systems that compete to attract foreign investment and also functionally by sales of domestic companies to foreign corporations that operate in different system. Corporate governance systems converge for several reasons:

• International diversification of a portfolio yields higher returns with lower risk than a purely domestic portfolio.
• Firms issuing shares on foreign capital markets can decrease their cost of capital.
• Institutional investors (pension funds, life insurance companies and mutual funds) demand international norms of governance.
• Globalization of product markets increases competition, forcing firms to use efficient governance. Globalization makes competition for resources more intense because domestically generated savings are no longer monopolized by domestic firms.[28]

Obstructions to functional convergence exist especially in area of creditors' rights. Assets placed in a certain country are subject to its jurisdiction, therefore also to it Bankruptcy act. Without reform of local legislation, functional convergence may have only limited impact.

In Slovakia, it is necessary to make several significant changes. Commercial code requires most urgent reform in areas of co-ordination with changes in Civil code, Act on securities and Penalty code, so that expropriation of outsiders will not be perfectly legal. It is not enough to adjust Commercial code to the Directives of European union, because yet there is no consensus in this area in the union and directives hence do not form complex legal framework. It may be also considered to extract parts related to the company and create separate Company act as Germany and France have. Reform of corporate governance may be also based on principles recommended by OECD[29], which are:

• The rights of shareholders. Generally, they contain ownership rights, and the rights to receive information, vote and share profit. The OECD recommends proxy voting, including telephone and electronic voting. Each shareholder must have access to the list of other shareholders in the company for a reasonable price.
• The equitable treatment of shareholders, including minority and foreign shareholders. This implies also the prohibition of insider trading and abusive self-dealing. Shareholders should be able to initiate legal and administrative proceedings against management and board members.
• The role of stakeholders. Rights of stakeholders established by law (including labor law, commercial code, contract law, and insolvency law) should be protected.
• Disclosure and transparency. Materials regarding corporation, its financial situation, performance, ownership and governance should be efficiently disclosed.
• The responsibilities of the board. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders. They should monitor management and be accountable to the company and shareholders. In some countries, the board is legally required to act in the interest of the company, taking into account the interests of shareholders, employees, and the public good.

Current legal framework in Slovakia does not prescribe managers to be loyal to outsiders, but it merely prohibits conduct of certain pre-defined activities. At the same time, it is necessary to adjust regulation of representation of minority shareholders in supervisory board, eventually in executive board, and their cumulative voting. Minority shareholders should be given chance of exit especially in cases, when they are locked-in by qualified majority shareholder (67% of shares). The exit would be possible by sale of shares to majority owner or to the company. Act on securities indeed stipulates that the investor (or a group acting in accord) may cross limit of 30% of shares only by public promise, but this regulation do not refer to the old cases. Simultaneously, it is rather difficult to identify a group of investors that acts in accord.

It is necessary to disclose ownership and control and follow strictly transactions with persons with special relation to the company. Managers should keep register of conflict interests. Since courts are overloaded, it is desirable to use more often commercial arbitrage, for example when suspicion of violation of minority shareholders' rights arise.

Many current problems have their basis in non-existence of good commercial register and real estate register. Registration of changes is therefore tedious and corruption at registers is well known. This creates

especially bad situation to smaller enterprises. the system of registration in commercial register must be, according to the example of other countries, removed from courts and replaced by administrative computer registration system.
Finally, it is also necessary to pay special attention to the profession of accountants and auditors, which are essential for providing of adequate disclosure of information. Currently, a responsibility of auditors is only symbolic and Chamber of auditors has never adopted any disciplinary proceedings against any of its members. The chamber should be made by law responsible for control of audit quality. Also obstacles to entry of new potential members of the chamber seem to be more about attempt of current members to avoid competition of the new, young and foreign auditors. Practical use of Accounting act overestimate assets of companies, which decrease the value of financial reports of Slovak companies. It is absolutely unavoidable to adjust to international accounting standards (IAS) especially in areas of unrealized incomes, format of financial reports (for example classification of assets and liabilities) and accounting of leasing.

5. CONCLUSION

According to the Join report of the Slovak government and European Commission *„..the main reason of insufficient restructuring and continuous loss in significant number of enterprises is weak mechanism of internal and external corporate governance.“*[30] In 1999, certain improvement was registered in restructuring, but it was rather the year of the end of recession, then of the beginning of recovery. Total loss decreased significantly, but profits decreased, too. Number of profitable companies outmatched loss makers, but number of loss makers increased, too. Payment discipline improved, but most likely because of shift to the cash payments, that is reasonable solution in emergency situation, but not enough to truly recover the economy.

The aim of this short study was to explain the concept of internal and external corporate governance, and the origins and need for reforms in this area. Origins of the reform in our opinion are:

• Fraud at enterprises and neglected restructuring as a rational reaction of agents to the existing entrepreneurial environment and therefore it is necessary to make systemic change in entrepreneurial environment in Slovakia.
• Concentrated ownership in Slovakia has in majority of cases rational justification and in near future majority of enterprises will not enter public market.
• Larger enterprises will try to get part of the resources on foreign public market and therefore will have to adjust to international standards.
• Reform is needed in order to modify current ownership structures (usually concentration and exit of small locked-in owners) and restoration of trust in collective investment.
• From the point of view of near future, the reform is needed for development of innovative firms.

Corporate governance reform should be based on the following principles:

• Rules must take form of laws. Laws shape financial markets.
• Adherence of new laws must be enforced by existing structures.
• If courts are not able to enforce private contracts or laws, then it is better to apply government regulation of financial markets.

Many laws and activities of institutions must be changed to allow companies to operate “normally”. These are mainly commercial code, definition of personal criminal responsibility of managers, improvement in work of auditors, change in charts of accounts and financial reporting forms and availability and complexity of commercial register.

• It is necessary to co-ordinate modifications in commercial code to modifications in civil code, act on securities and penalty code, so that expropriation of outsiders will be illegal.
• It is not sufficient to adjust commercial code to the EU directives, because there is no consensus in this area in the EU, yet, and therefore the directives do not form a complex framework. When reforming commercial code, principles recommended by the OECD may be applied.
• It is necessary to require by law the loyalty of managers and supervisory board to outsiders and define their criminal responsibility to shareholders and stakeholders.

• It is necessary to regulate representation of minority shareholders in supervisory board, eventually also in executive board, and their cumulative voting.
• Minority shareholders should be allowed to exit the company especially in the cases 67% shareholder when there are locked-in by the shareholder with 67% of shares.
• Transparency. It is necessary to disclose ownership and control and strictly follow transactions with persons with special relation to the company.
• It would be reasonable to use more the commercial arbitrage to resolve business disputes, for example in cases of suspected abuse of minority shareholders.
• It is necessary to establish good commercial register and real estate register. This will help especially the smaller and potentially innovative firms.
• It is necessary to pay special attention to the profession of accountants and auditors, which are essential for disclosure of adequate information.
• Slovak accounting standard should be replaced by international standard.
• Content of financial reports of enterprises must be improved and their frequency increased
• Banks are important creditors of enterprises. It is necessary to improve efficiency of banking supervision activities, define criminal recourses for bank managers and increase involvement of savers in the bank prosperity.
• The state as a creditor needs more effective tools for enforcement of its interests. It is necessary to improve and unify legislation, so that public and state institutions could act against the debtors more actively.

It is obvious that such a deep and broad reform has and will have many opponents among those who benefit from the current situation, i.e. employers, courts and prosecution. Their arguments will be based on the fear of further increase in unemployment, a domino effect caused by bankruptcies and a necessity to support domestic entrepreneurial class. In fact, these are and will be the same arguments as were the arguments and real economic policy of the previous governments. But today there is a high likelihood that economic recession brought by postponement of reforms has already persuaded critical mass of voters that changes are necessary.

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[1] There was no corresponding term for ‘corporate governance’ in Slovak and Czech languages. After discussions with the Slovak and Czech colleagues, a term ‘správa obchodných spoločností’ was selected (literally administration of business companies), where obchodné spoločnosti means “…entities defined by Commercial Code (join stock companies, companies with limited liabilities, company commanded with shares, partnership…). Control of business companies (as a real execution of administration) then is, within this consensus, adequate to the English corporate control.“ Marcinčin (2000a, editorial note, p.97).

[2] Amendment of Bankruptcy Act no. 328/1991 available at www.justice.gov.sk.

[3] Monitoring of bank management by owners of deposits was weakened by law on deposit protection no.118/1996 by 100% and relatively fast recovery of deposits.

[4] See Act on the National Bank of Slovakia no.566/1992 para2e and para36. The situation is likely complicated by the fact that next to the supervision by NBS, also Department of banking and insurance and Department of financial market supervision of the Ministry of Finance are active in supervision of banks. As it seems, competencies and responsibility of these bodies are sill not very clearly set.

[5] See information on Slovak consolidation agency at www.finance.gov.sk

[6] According to the study Corruption index (2000, p.VIII), entrepreneurs consider as most corrupted institution courts and prosecution, while households consider courts and prosecution second most corrupted (behind health care).

[7] In the Slovak terminology sunk investment would usually be “utopená investícia”.

[8] Fischer and Gelb (1991) suggested on the very beginning of reforms that legislative and institutional reforms were needed. In the first case they recommended changes in tax and property laws, commercial code and laws concerning foreign direct investment. In the latter case issues of tax administration, composition of state budget and legislative and regulatory institutions were included.

[9] Shleifer and Vishny (1997, p.738).

[10] The strategic owner is usually, if not always large join stock company with dispersed ownership.

[11] According to the opinion poll by Žitňanský and Rintel (2000), respondents indicated as two main problems in legislation and justice enforcement of law (67% of respondents) and relations between creditors and debtors (59%).

[12] According to the Annual report 1998 of National property fund (FNM). FNM (2000) presents value 365.5bn. SK.

[13] Source: Privatisation ministry (1999b) and authors’ calculations.

[14] See for example Laštovička et al. (1995) and van Wijnbergen and Marcinčin (1995).

[15] In reality, there is only one share of IPF traded at stock exchange. All political powers in Slovakia consistently avoid deep analyses of development in former IPF.

[16] Annual report of Bratislava stock exchange 1999, p.15.

[17] In a book of Marcinčin and Beblavý (eds., 2000), several authors touch this theme.

[18] According to the data of Datacentrum (Join evaluation…, 2000, p.8.), total profit in 1995 reached 27.8bn. SK, in 1996 18.3bn. SK, in 1997 loss 2.5bn SK and in 1998 profit 31.3bn. SK. More than half of all firms in 1998 made loss.

[19] Shleifer and Vishny (1997, p.738)

[20] See for example Claessens et al. (1999), who confirmed such expropriation on a sample of 2,658 East Asian corporations in 1996.

[21] Dahya and Powell (1999) provide a good survey of take-over empirical studies.

[22] Japan decided to move from a bank centred system to a capital market based system, and from a system of concentrated investor ownership to a system with more dispersed investors (Kanda, 1999).

[23] Mayer (1999): Total market capitalisation of firms as a proportion of GDP in UK was in average 75% in 1982-91, in France 19%, Germany 20%, and OECD 30%. Ratio of credit to GDP was in average 42% in 1980-90 in UK, 82% in France, 86% in Germany and 55% in OECD.

[24] Transfer pricing and asset stripping.

[25] Approach “law and economics” further assumes that investors recognise risk of expropriation and penalise firms which do not agree in written contract to disclose information and treat investors well.

Because a penalty means to issuers more costly capital, they are stimulated to enter such contracts. Regulation then is not necessary, if these contracts are enforced.

[26] Fiduciary in terms of trustee that is loyal to the principal.

[27] Claessens et al. (1999) discovered that ten richest families in eight Asian countries controlled 18% to 58% of total volume of publicly traded assets.

[28] Nestor and Thompson (1999).

[29] See OECD (1999a) and OECD (1999b).

[30] Join evaluation… (2000).

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7. APPENDIX

TABLE 1: Privatization by methods and waves

	First wave			Second wave			Total		
	Num.	Property		Num.	Property		Num.	Property	
		mil. SK	%		mil. SK	%		mil. SK	%
Companies for privatization	678	169,097		610	136,804		1,288	305,901	
Privatized companies	1,010	169,097	100	1,366	136,804	92	2,376	305,901	96
1 Property sale	330	12,428	7	813	52,226		1,143	64,654	21
11 Direct sale				645	45,072	33	645	45,072	
12 Public tender				155	7,140	5	155	7,140	
13 Public auction				13	14	0	13	14	
2 Free transfers	116	2,086	1	303	2,822	2	419	4,908	2
3 Restitution	7	19	0	16	22	0	23	41	0
4 Joint stock companies	557	154,564		234	81,734		791	236,298	
41 Own equity		154,564							
411 Basic equity		134,705			70,933			205,638	
4111 Standard methods		3,419	2		36,041			39,460	13
41111 Direct sale					34,801	25		34,801	
41112 Public tender					1,240	1		1,240	
4112 Voucher privatization		79,752	47		0	0		79,752	26
4113 Free transfer					2,414	2		2,414	1
4114 Restitution IF		3,797	2		2,161	2		5,958	2
4115 In admin. of FNM		47,737	28		30,317	22		78,054	26
412 Reserve and other funds		19,859	12					19,859	6

Note: Num. is a number of enterprises. Source: Author's calculations based on data of Ministry of privatization, www.privatiz.gov.sk.

TABLE 2. Investor ownership stakes

Investor	50%	30%	20%	10% (0%*)

Vouchers total	468	489	499	503
Holders of investment booklets	244	381	438	494
Investment funds	173	305	365	406
Group of 3 funds	55	255	339	401
Group of 4 funds	110	276	349	402
Group of 5 funds	145	290	351	402
Direct investors total				
Foreign	3	6	8	10
Domestic	11	14	22	31
FNM	10	30	56	77

*Note: Data of 1992. Table indicates, in how many enterprises holds given type of investor more than x percent. Groups of funds indicate shares of n largest funds by size in every enterprise. * Valid for direct investors. Source: Marcinčin (1995).*

TABLE 3. Estimation of current status of investment privatization funds

Current status of funds	Num. IPF	Num. Investment booklets	Nominal value of assets
Operating	20	107,655	5,051
Transformed	59	1,313,934	42,915
Liquidated	14	46,276	1,857
License revoked	2	188,017	6,570
Other	17	45,777	2,250
Total	112	1,701,658	58,643

Information on current stage of registration at Ministry of finance. Transformed funds are join stock companies with subject of enterprising other than investment fund. Liquidated funds are mostly those liquidated by decision of their shareholders. It is assumed that residual value of assets belonged to the controlling shareholders. Number of investment booklets serve as estimation of number of dispersed shareholders of original funds, while nominal value of assets is a value of assets acquired in voucher privatization. Source: Author's archive.

TABLE 4. Development of ownership structures

Property privatized			Prevailing ownership structure		
	mil. SK	%	After privatization	Now	%
Total	305,901	97			97
1 Sale of property	64,654	21	Solo owner	Solo owner	
2 Free transfers	4,908	2	Solo owner	Solo owner	
3 Restitution	41	0	Solo owner	Solo owner	24
4 Join stock companies	236,298				
-Free transfer	2,414	1	Solo owner	Solo owner	
-Standard methods	39,460	13	Majority owner	Majority owner	

-Voucher privatization	79,752	26	Dispersed owners	Majority owner	65
-FNM	78,054	26	Different shares	Strategic owners	
-RIF	5,958	2	Minority shares	Minority shares	8
-Funds of FNM	19,859	6	Minority shares	Minority shares	

Source: Calculations and estimations by the author.

TABLE 5. Statistics of trading with shares on Slovak capital markets

year	Volume of trades (milSK)				%	Number of traded shares ('000)			
	BCPB	RMS	BOB*	Total	GDP	BCPB	RMS	BOB	Total
1993	89.4	43.3	40.0	172.7	0.0	106.9	na	na	106.9
1994	5,428.0	388.5	1,700.0	7,516.5	1.7	8,445.9	1,001.1	na	9,447.0
1995	24,730.4	17,951.7	1,100.0	43,782.1	8.5	43,623.4	32,296.6	na	75,920.0
1996	83,130.0	23,876.5	0.0	107,006.5	18.6	128,602.8	55,885.6	0.0	184,488.4
1997	82,671.6	12,768.9	0.0	95,440.4	14.6	136,561.3	41,698.6	0.0	178,259.9
1998	37,267.5	5,423.1	0.0	42,690.6	6.0	74,419.5	19,285.5	0.0	93,705.0
1999	20,233.6	3,807.3	0.0	24,040.9	3,1	49,092.3	10,139.8	0.0	59,232.1

**Under assumption that only shares were traded on BOB and on RMS in 1993-95. Data of BOB (Bratislavská opčná burza) were available only in billions SK.*

TABLE 6. Large privatization, join stock companies

year	Number of original firms	Number of buyers	Index
1992	18	57	3.17
1993	9	9	1.00
1994	85	86	1.01
1995	141	349	2.48
1996	162	165	1.02
1997	49	54	1.10
1998	39	39	1.00
1999	2	2	1.00
Total	505	761	1.51

Privatization of 505 join stock companies. Index in 1992 and 1995 was high for few outliner firms. Source: Privatization ministry, register_priv_sub_230699 and author's calculations.

TABLE 7. Number of publicly traded shares on Bratislava stock exchange

year	Quoted *	Registered	Free market	Total
1993	11			512
1994	17			521
1995	21			850

1996	21			970
1997	14	45	859	918
1998	14	40	779	833
1999	11	33	786	830

* Contains several duplicate issues of companies. Source: Bratislava stock exchange.

TABLE 8. Legal origin and investors rights

Legal origin	Common law	French civil law	German civil law	Scandinavian civil law	World average
Number of countries	**18**	**21**	**6**	**4**	**49**
Panel A: Measures of shareholder protection					
Antidirector rights index	4.00	2.33	2.33	3.00	3.00
Proxy by mail	39%	5%	0%	25%	18%
Shares not blocked before meeting	100%	57%	17%	100%	71%
Cumulative voting / proportional represent'n	28%	29%	33%	0%	27%
Oppressed minority	94%	29%	50%	0%	53%
Preemptive right to new issues	44%	62%	33%	75%	53%
%Share of capital to call ESM ? 10%	94%	52%	0%	0%	78%
Panel B: Measure of creditor Protection					
Creditor rights index	3.11	1.58	2.33	2.00	2.30
No automatic stay on secured assets	72%	26%	67%	25%	49%
Secured creditors first paid	89%	65%	100%	100%	81%
Restrictions for going into reorganization	72%	42%	33%	75%	55%
Management does not stay in reorganization	78%	26%	33%	0%	45%
Panel C: Measures of enforcement					
Efficiency of the judicial system	8.15	6.56	8.54	10.00	7.67
Corruption	7.06	5.84	8.03	10.00	6.90
Accounting standards	69.92	51.17	62.67	74.00	60.93

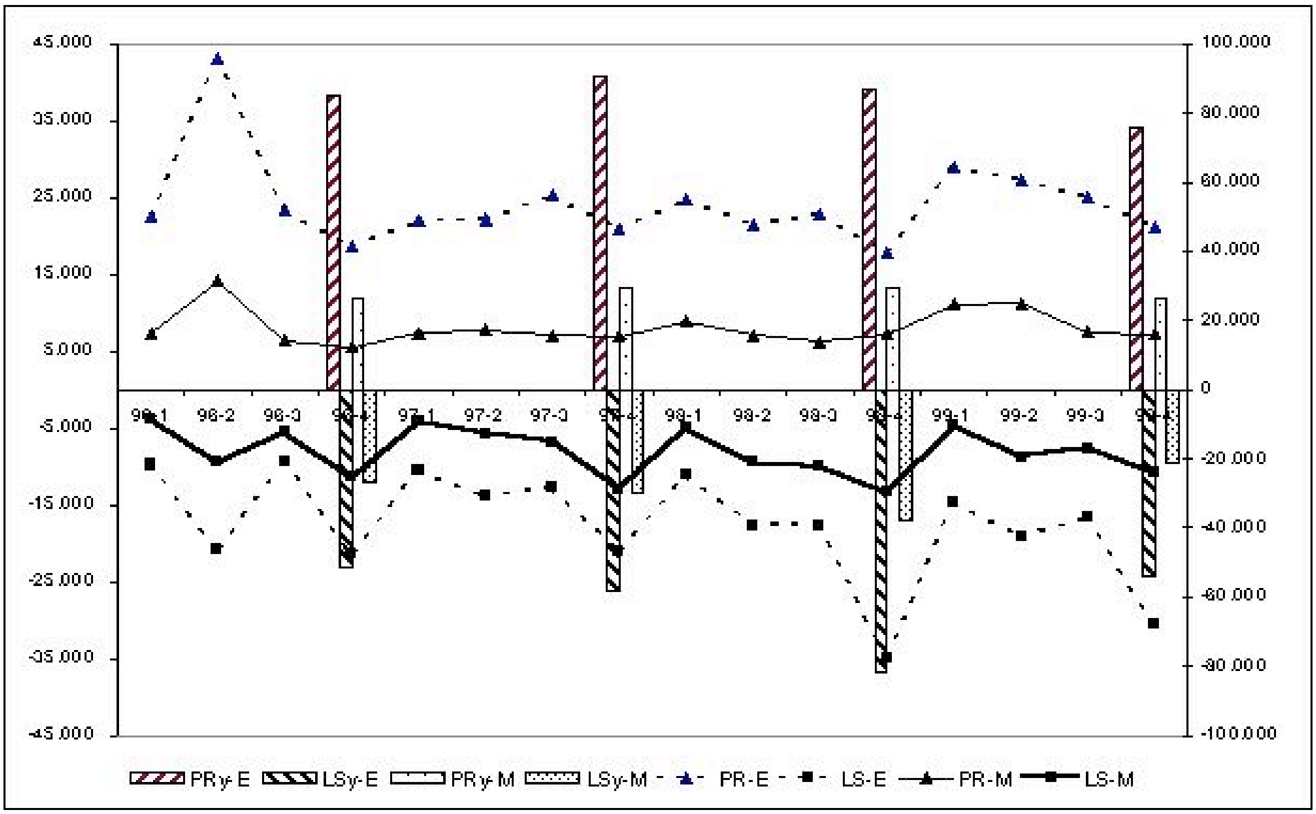
Source: La Porta et al. (1998) in La Porta et al. (2000). This table presents data on measures of investor protection for 49 countries classified by their legal origin.

***Panel** A shows the measures of shareholder protection. The "antidirector rights index" is a summary measure of shareholder protection. This index ranges from 0 to 6 and it is formed by adding 1 when: the country allows shareholders to mail their proxy vote to the firm; shareholders are not required to deposit their shares prior to the General Shareholders' Meeting; cumulative voting or proportional representation of minorities in the board of directors is allowed; an oppressed minorities mechanism is in place; the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting is less than or equal to 10 percent (the sample median); or shareholders have preemptive rights that can only be waved by a shareholders' vote. The rest of the rows in Panel A show the percentage of countries within each legal origin for which each component of the "antidirector rights index" is provided by the law.*

***Panel B** shows the measures of creditor protection. The "creditor rights index" is a summary measure of creditor* *protection. This index ranges from 0 to 4 and is formed by adding 1 when: the country imposes restrictions, such as creditors' consent or minimum dividends to file for reorganization; secured creditors are able to gain possession of their security once the reorganization petition has been approved (no automatic stay); secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm; and the debtor does not retain the administration of its property pending the resolution of the reorganization. The rest of the rows in Panel B show the percentage of countries within each legal origin for which each component of the "creditor rights index" is provided by the law.*

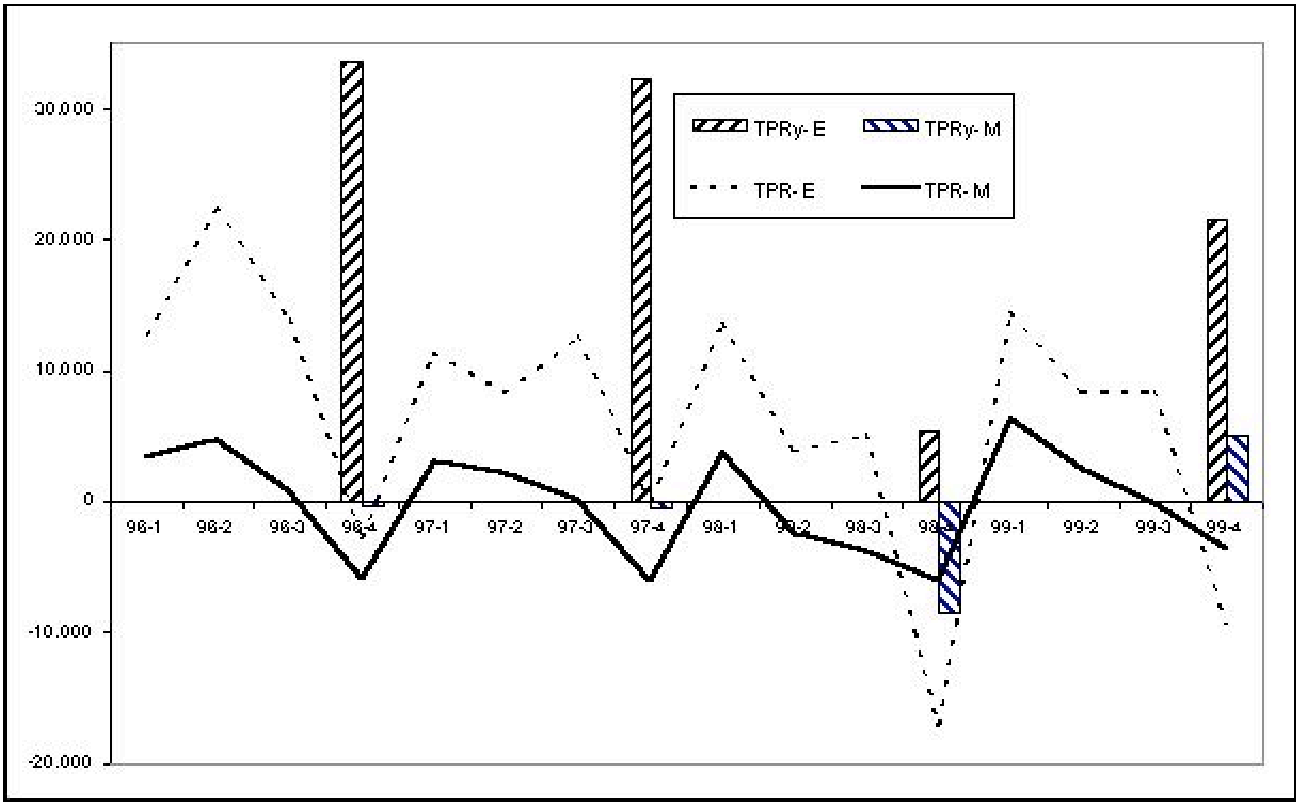
***Panel C** shows measures of legal enforcement. "Efficiency of the judicial system" is an index ranging from 0 to 10 representing the average of investors' assessments of conditions of the judicial system in each country between 1980-1983 (lower scores represent lower efficiency levels). "Corruption" is an index ranging from 0 to 10 representing the average of investor's assessments of corruption in government in each country between 1982-995 (lower scores represent higher corruption). "Accounting standards" is an index created by examining and rating companies' 1990 annual reports on their inclusion or omission of 90 items falling in the categories of general information, income statements, balance sheets, funds flow statement, accounting standards, stock data and special items.*

GRAPH 1. Economic results 1996-1999



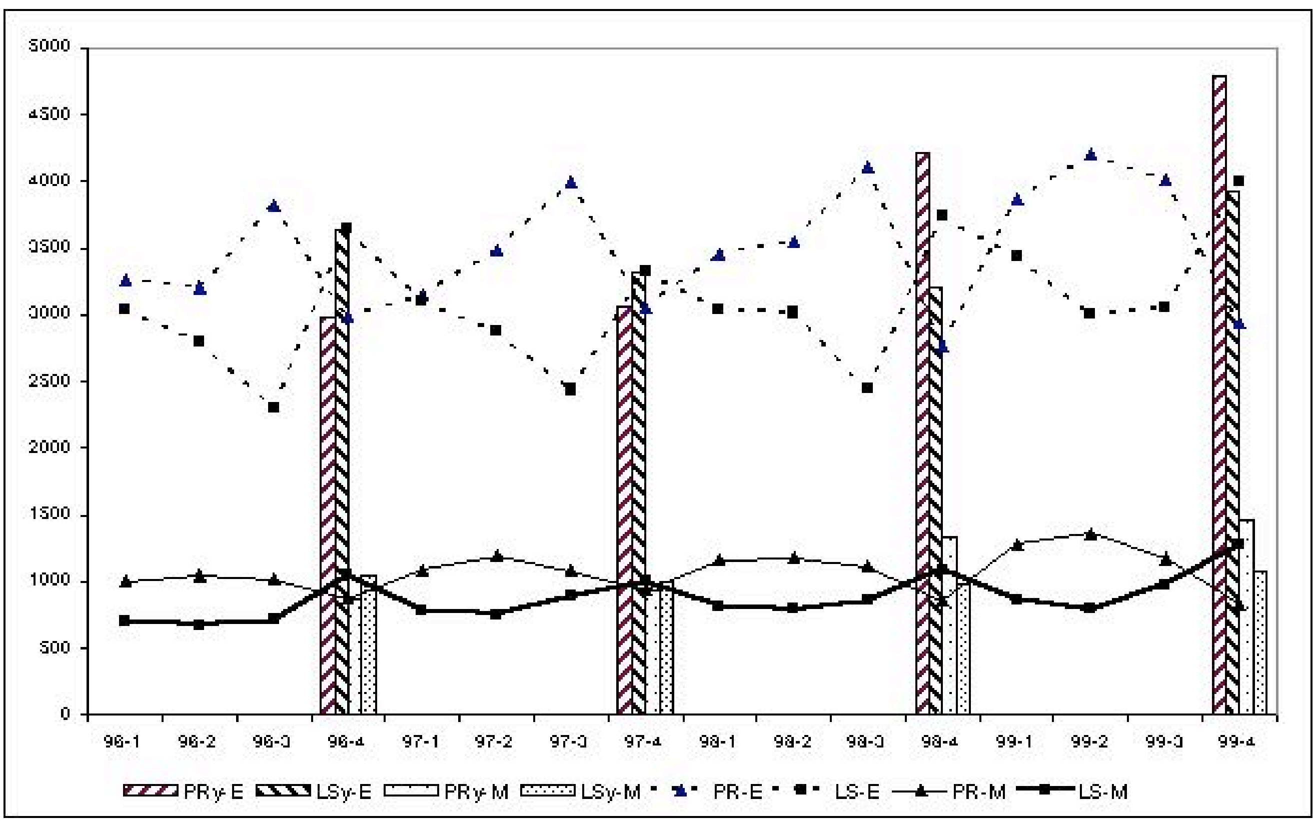
PR denotes quarterly profit while PRy annual profit. Similarly, LS denotes loss. E relates to the whole economy, while M only to manufacturing. Quarterly values are displayed on the left y-axis, annual on the right axis. Source: Infostat.

GRAPH 2. Difference in profits and losses 1996-1999.



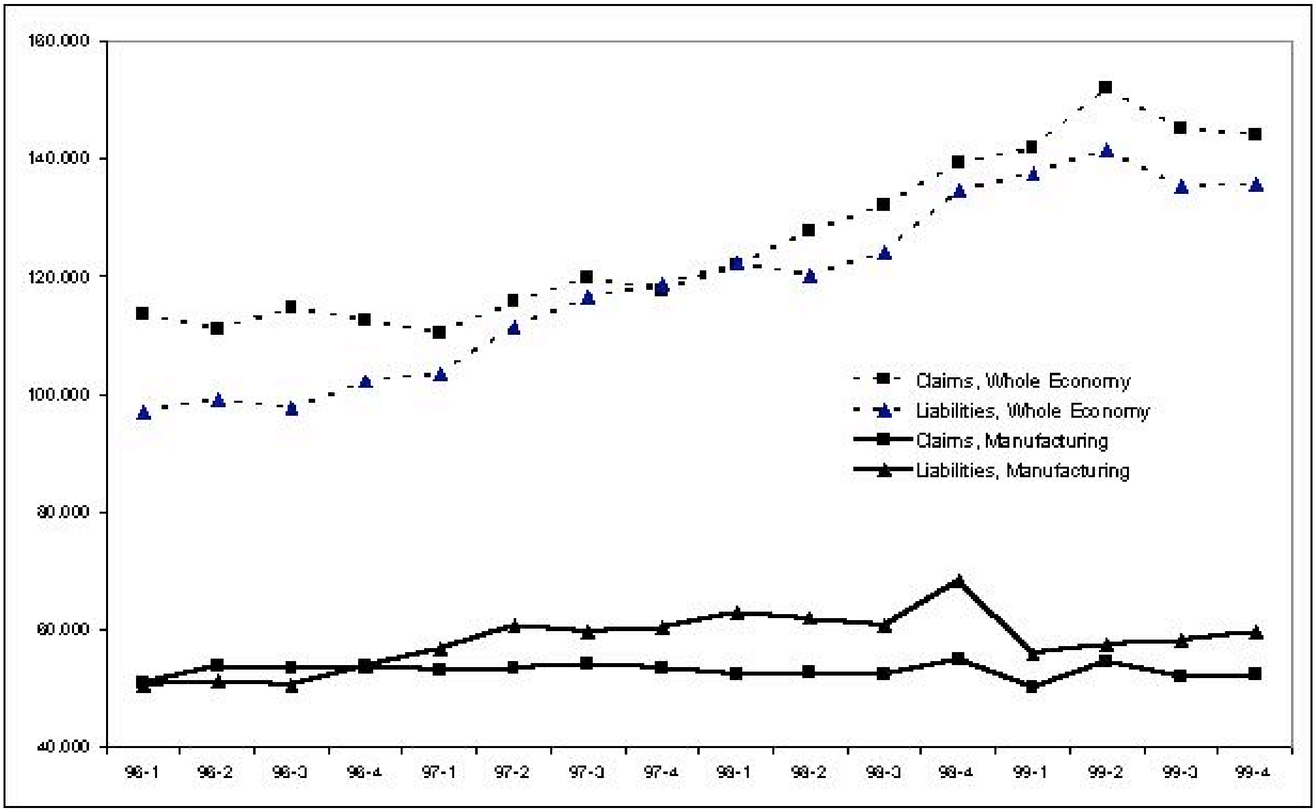
TPR denotes a difference in quarterly profit and loss, while TPRy relates to annual values. E relates to the whole economy and M only to manufacturing. Source: Infostat.

GRAPH 3. Number of profit or loss making firms 1996-1999.



PR denotes quarterly profit while PRy annual profit. Similarly, LS denotes loss. E relates to the whole economy, while M only to manufacturing. Source: Infostat.

GRAPH 4. Past due liabilities and claims 1996-1999.



Source: Infostat.

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INEKO

Institute for Economic and Social Reforms

Best Practices Pamphlet

BEST PRACTICES[31] (English Summary)
Eugen Jurzyca, Pavlo Shostak

GROWING IMPORTANCE OF BUSINESS SECTOR AND CORPORATE GOVERNANCE IN SLOVAKIA

In the late 80-ties/early 90-ties practically almost 100% of GDP was created by the sector fully controlled by the state. Moreover, the whole local and national legal and regulatory framework was set up by the same body represented by the central government. Ten years later, more than 80 per cent of GDP is being produced by the private sector and the rules of the game is heavily influenced by multinational companies either directly or through international organizations. Taking into account the fact that the central government has delegated some powers to municipalities and international bodies, one should probably move attention from it towards business sector. Namely, that is becoming the main factor affecting economic performance of the country, as well as the quality of life there. So far, the most of the attention of both foreign and local experts has been focused on functioning of the public sector. Although it is still very important matter, more care deserves the area determined by the links connecting all subjects influencing business environment, so called Corporate Governance (CG) The main of them are managers, owners, suppliers, employees, customers, state, municipalities, general public.

> *The proper governance of companies will become as crucial to the world economy as the proper governing of countries.*
>
> James D. Wolfensohn,
> President of the World Bank

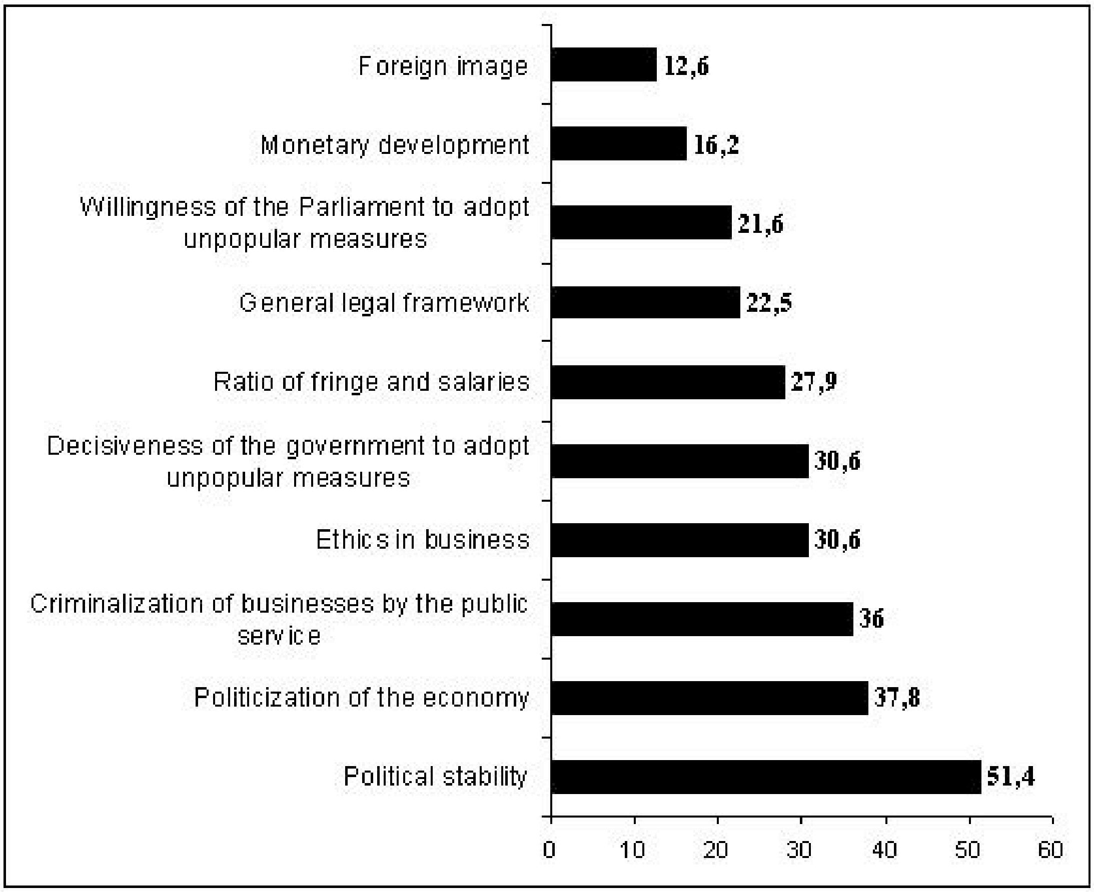
Traditionally, the respective attention was driven to internal issues of firms. At the time being, the external one is becoming more frequently discussed, as the concept of stakeholders is becoming more recognized. As an example illustrating the necessity to expand the focus on corporate governance beyond the framework of firms can be so called tunneling of businesses.[32] The recent cases of Chirana-Prema Stará Turá, Oravské ferozliatinové závody, a.s., Pratex, a.s. Čadca represent only marginal sample of the widely spread phenomenon in Slovakia. Hunger strike of the former employees of Pratex Čadca showed clearly how such failure in corporate governance may influence not only interests of shareholders, managers, or employees, but also local community (almost entirely without other access to regular income), and the whole country. Namely, the information has been spread among potential foreign investors, international organizations, rating agencies, etc.

> *Here, in Slovakia they allow you to steal a lot, but they never allow you to earn a lot.*
>
> T. Janovic

Another negative consequence of the corporate governance failure on the whole society is high and growing indebtedness of commercial sector. Currently, the total debt among firms exceeds SK 400 bn, which represents doubled state budget income or 50% of GDP. This not only undermines possibilities of businesses to make profits, pay good salaries and dividends, but also discourages foreign business partner and investors to come to the country. Furthermore, it significantly diminishes the integration chances of the country.

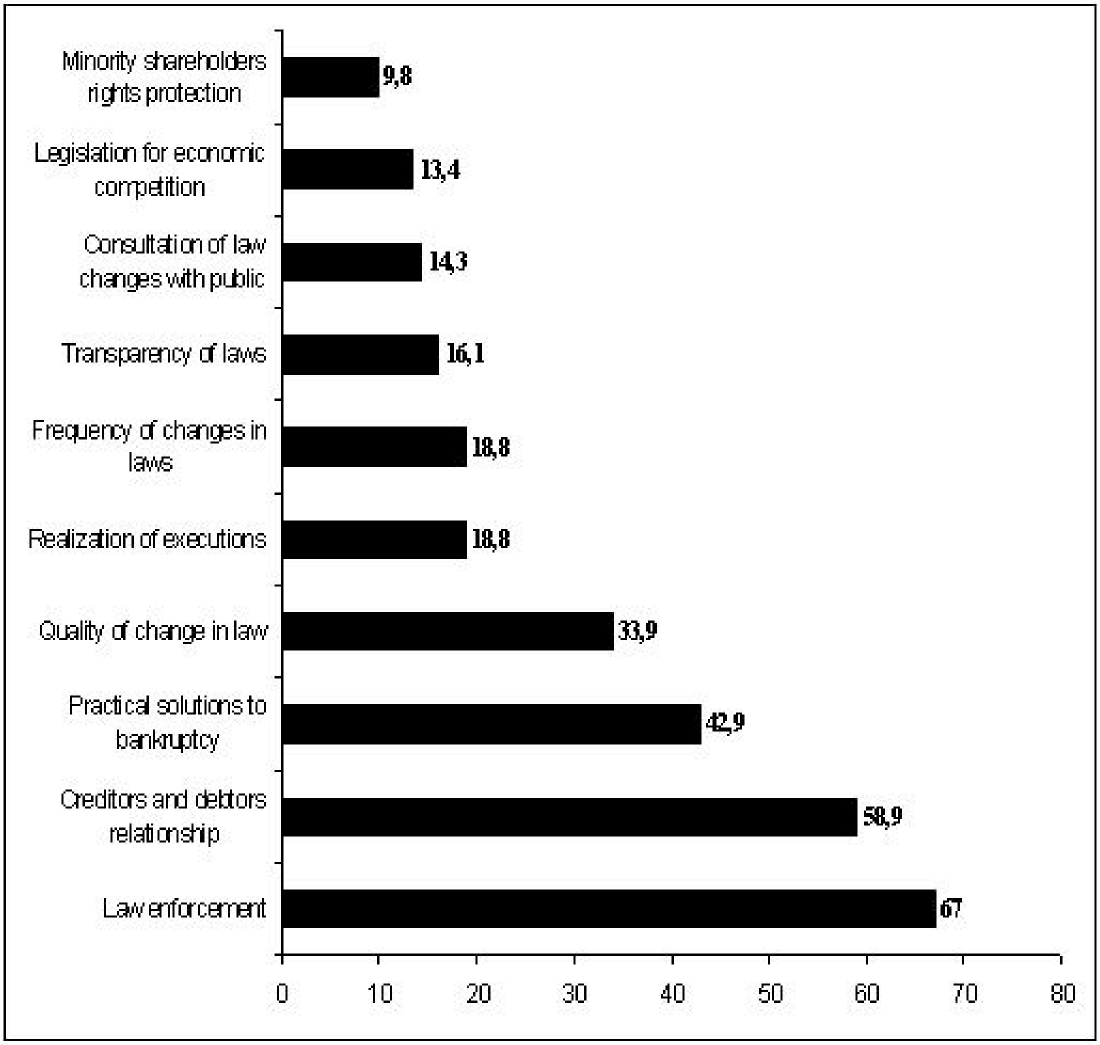
The survey organized in Slovakia in May 2000 showed clearly that, according to the Slovak economic elite, the most important problems of the local economy are linked to corporate governance issues:[33]

The main problem of the general business conditions: (%)



Similarly, the next set of questions linked to legislation and law exclusively proves the same finding:

The main problems of the legislation and law: (%)



Also the most negative changes during the last year have been related to the corporate governance issues:

No.	Change	Average evaluation	Per cent of negative attitude
1.	Lack of domestic capital	3,96	61
2.	Access to credits	3,87	71
3.	Clientelism and protectionism	3,73	54
4.	Inflexible housing system	3,68	50
5.	Creditors and debtors relations	3,66	53
6.	Politicization of economy	3,65	58
7.	Administration of taxes	3,61	50,4
8.	Criminalization of businesses	3,58	48,7

Based on the strong and gradually growing impact of corporate governance on the fate of the society and based on the respective awareness of elite, one can claim that the focus of the general public and experts should move to searching for the best CG practices. Taking into account the broad and relatively heterogeneous scope of the concept, it should be approached from two angels: Particular subjects of the external environment to a firm may, and very often are, more integral part of it than some subjects operating within traditional firm's borders. Internally, the relations among a firm's subjects have their own features deserving special attention. Ronald Coase's definition of a firm from 1937[34] is, of course, still valid. Nevertheless, with the dramatic development of communication technologies, with globalization, privatization, better access to information and enhancement of laws, networking among various subjects is accelerating. Thus the border between external and internal environment to a firm is becoming much more flexible than before.

Borders among people, regions, states, as well as firms become flexible.

EXTERNAL ENVIRONMENT

External subjects to a firm as, for example, state, municipality, loyal customers, traditional suppliers, etc., play often very important roles in its development. It is deeply in their natural interest that the firm undertakes its activities successfully. In fact, they become dependent of the firm's fate, they become its stakeholders. That is the main reason, why special attention should be paid to the issues linked to relations among them, if the system of corporate governance in a country is to be optimized.

In Slovakia, as well as in many transitional countries, the state, as a stakeholder should in close co-operation with businesses play much more active role in improvement of entrepreneurial environment. Particular attention should still be paid to the process of firm creation. The whole operation is not only complicated by red tape, but does not comply with the recent trends in the development of communication technologies. Ultimately, the business register should be placed on Internet with free access and the registration should be allowed through the net, as well. Also, the need for foreign investment and other globalization trends have not been reflected in the local legislation. For example the barriers to do business for foreigners are still relatively high. One can mention complicated application process for getting an approval for long-term residence, or the absence of automatic residence prolongation possibility. The respective law covering corporate activities has its own loopholes. Among them, the most important are non-transparent board activities (EU respective Directives should be applied, at least, including their enforcement), the absence of clearly defined board's duty to act in the interest of a corporation, as well as its legal responsibility and accountability. Derivative and individual appeals are not incorporated in the law appropriately, minority shareholders' rights are not protected optimally, leaving a corporation without liquidation is not covered by law. Transparency of business activities is not secured enough. As a positive example, one can mention laws valid in the USA.[35] The first type of law is the incorporation statute. Every company in the United States must file a basic document in one or more of our 50 states (or the District of Columbia) that establishes that company. Every state has its own laws and procedures on how this is done, but the same general principles are used. The document contains the name of the company, the names of its original directors or persons who incorporated the company, and a registered agent who can be served with papers in the event someone wants to begin legal proceedings against that company. Some states also require that the names of the officers of the company also be listed. This document is called the "Articles of Incorporation" and it must be renewed each year. If there are any changes in the names of the officers, directors, or registered agent, those changes must be filed as well. The Articles of Incorporation and the annual statements that update the Articles are filed in one or more states and are available to the public. Usually, a small fee is charged to search for and copy the document and send to whoever requests it.

Another type of law is designed to get important information to the public – the securities laws. All companies in the United States may issue stock. Often, very small companies, like family-owned businesses, do not actually issue stock, even though they may do so. However, when companies need to raise capital they often try to sell stock to large groups of people or to the public. Before they may do so, U.S. federal securities laws require that these companies make available important information about the company, its finances, its officers and directors, the industry in which it competes, and even how the global and U.S. economies may impact on the company.

The laws and rules that govern when, how and what information publicly-traded companies disclose in the United States are derived from a simple and straightforward concept: all investors, whether large institutions (like insurance companies, pension funds and mutual funds) or private individuals, should have access to certain basic facts about an investment prior to buying it. To achieve this, the Securities and Exchange Commission ("SEC"), an independent federal regulatory agency requires publicly-traded companies to disclose meaningful financial and other information to the public. The disclosure of this information provides a common pool of knowledge for all investors to use to judge for themselves if a company's securities are a good investment. Only through the steady flow of timely, comprehensive and accurate information can people make sound investment decisions. Collateral law is clearly underdeveloped. For example a central register of movable property is absolutely missing.

Business partners has to have a deep interest in improvement of their relationship. As it was mentioned above, the payment discipline among them is very low. Nevertheless, the bankruptcy law as a main rectification tool has never been proposed or promoted by business community. Without understanding the role of suppliers and customers as stakeholders and their responsibility for creation a proper legal framework, the law will hardly smooth the bankruptcy procedure.

Another, non-traditional stakeholder is international community. Only recently, it came with proposals to harmonize various parameters of business activities. For example, International Accounting Standards Committee (IASC) has proposed a Standards Development Committee (SDC) to undertake most of the work in standard creation. In this field, strong trend is visible: Anglo-American standards are being increasingly adopted by continental Europe:[36] Among the implications one can find greater board independence, smaller boards, and upward pressure on director remuneration.

Different stakeholders in the Czech Republic and Slovakia joined their forces to promote more transparency in business. One of the measures to promote transparency is organization of competition for the best annual report. Another one is the EBR (European Business Register)[37], which creates a network of publicly available information on businesses. In Poland, the Camber of Commerce started to organize Fair Play competition searching for the fairest firms, which promotes ethics in business.

INTERNAL ASPECTS

If the market was absolutely perfect/costs less, if there were no transaction costs, there would be no reason to create firms. Only individuals would co-operate among each other to reach optimal output. However, the price for using the market, transaction costs, practically force some of the individuals to merge and build firms. Although the main subject to research should be contract[38] regardless of whether the particular subjects are located out outside a firm, one should put particular stress on internal ones. Namely, the existence of firms proves that there is still special need to isolate internal subjects from external environment, despite wide development of networking structures.

The modern trend of developing corporate governance guidelines and codes of best practice began in the early 1990's in the United Kingdom, the United States and Canada in response to problems in the corporate performance of leading companies, the perceived lack of effective board oversight that contributed to those performance problems, and pressure for change from institutional investors. The Cadbury Report in the U.K., the General Motors Board of Directors Guidelines in the U.S., and the Dey Report in Canada have each proved influential sources for other guideline and code efforts.

Over the past decade, governance guidelines and codes have issued from stock exchanges, corporations, institutional investors, and associations of directors and corporate managers (the most influential probably are OECD Principles of Corporate Governance[39]). Compliance with these governance recommendations is generally not mandated by law, although the codes linked to stock exchanges may have a coercive effect. For example, listed companies on the London and Toronto Stock Exchanges need not follow the recommendations of the Cadbury Report (as amended in the Combined Code) and the Dey Report, but they must disclose whether they follow the recommendations in those documents and must provide an explanation concerning divergent practices. Such disclosure requirements exert a significant pressure for compliance. In contrast, the guidelines issued by associations of directors, corporate managers and individual companies tend to be wholly voluntary. For example, the General Motors Board Guidelines simply reflect an individual board's efforts to improve its own governance capacity. Such guidelines can have wide influence, however. For example, in the case of the General Motors Guidelines, institutional investors encouraged other companies to adopt similar guidelines. In developing nations, both voluntary guidelines and more coercive codes of best practice have issued as well. For example, both the Code of Best Practices issued by the Brazilian Institute of Corporate Directors and the Code of Corporate Governance issued by the Corporate Governance Committee of the Mexican Business Coordinating Counsel are wholly aspirational and not linked to any listing requirements. Similarly, the Confederation of Indian Industry Code and the Stock Exchange of Thailand Code are designed to build awareness within the corporate sector of governance best practice, but are not, at this time, linked to stock exchange listing requirements. In contrast, Malaysia’s Code on Corporate Governance, the Code of Best Practice issued by the Hong Kong Stock Exchange, and South Africa's King Commission Report on Corporate Governance, all contemplate mandatory disclosure concerning compliance with their recommendations. Some of the key elements of governance guidelines and codes of best practice are summarized below. The summary has been structured so as to reflect a typical pattern of code of best corporate governance practices. Throughout the summary, the emphasis is placed upon board issues as a major concern of codes of best practices.

DISCLOSURE ISSUES

Disclosure is an issue that is highly regulated under securities laws of many nations. However, there is room for voluntary disclosure by companies beyond what is mandated by law. Most countries generally agree on the need for directors to disclose their own relevant interests and to disclose financial performance in an annual report to shareholders. Generally this is required by law, but some guidelines and best practice documents address it as well. Similarly, even though directors are usually subject to legal requirements concerning the accuracy of disclosed information, a number of codes from both developed and developing nations describe the board's responsibility to disclose accurate information about the financial performance of the company, as well as information about agenda items, prior to the annual general meeting of shareholders. Generally, guidelines and codes of best practice place heavy emphasis on the financial reporting obligations of the board, as well as board oversight of the audit function. Again, this is because these are key to investor confidence and the integrity of markets. South Africa lays out the key points that the directors must comment on, whereas other countries do not go to this level of detail, but the distinction is not necessarily substantive since disclosure tends to be heavily regulated in many nations through securities laws.

THE CORPORATE OBJECTIVE

Variations in societal values lead different nations to view the corporate objective or "mission" distinctly. Expectations of how the corporation should prioritize the interests of shareholders and stakeholders such as employees, creditors and other constituents take two primary forms. In the Anglo-Saxon nations -- Australia, Canada, the U.K., and U.S. -- **maximizing the value of the owners' investment** is considered the primary corporate objective. This objective is reflected in governance guidelines and codes that emphasize the duty of the board to represent shareholders' interests and maximize shareholder value. Among developing nations, the Brazilian Institute of Corporate Governance Code, the Confederation of Indian Industry Code, and the Malaysian Report on Corporate Governance, all expressly recognize that the board's mission is **to protect and enhance the shareholders’ investment**. *The mission of the board of directors is to maximize shareholder value.*[40] *The single overriding objective [of] all listed companies . . . is the preservation and enhancement over time of their shareholders’ investment.*[41]

In other countries, more emphasis is placed on a broader range of stakeholders. There is a growing recognition that shareholder expectations need to be met in order to attract patient, low-cost capital. Likewise, there is growing sensitivity to the need to address stakeholder interests in order to maximize shareholder value over the long term. As the General Motors Board of Directors Mission Statement recognizes, "the board's responsibilities to shareholders as well as customers, employees, suppliers and the communities in which the corporation operates are all founded upon the successful perpetuation of the business." Simply put, shareholder and stakeholder interests in the success of the corporation are compatible in the long run.

BOARD RESPONSIBILITIES & JOB DESCRIPTION

Most governance guidelines and codes of best practice assert that the board assumes responsibility for the stewardship of the corporation and emphasize that board responsibilities are distinct from management responsibilities. However, the guidelines and codes differ in the level of specificity with which they explain the board's role. For example, Canada's Dey Report, France's Vienot Report, Malaysia's Report on Corporate Governance, Mexico's Code of Corporate Governance and South Africa's King Report all specify board functions such as strategic planning; risk identification and management; selection, oversight and compensation of senior management; succession planning; communication with shareholders; integrity of financial controls; and general legal compliance, as distinct board functions. Other governance guidelines and codes of best practice are far less specific. For example, the Hong Kong Stock Exchange Code simply refers to directors' obligations to ensure compliance with listing rules as well as with the "declaration and undertaking" that directors are required to execute and lodge with the Exchange. The different approaches among codes on this point likely reflect variations in the degree to which company law or listing standards specify board responsibilities, rather than any significant substantive differences.

The main functions of a board are. . . :[42]

- *to direct the company both as to strategy and structure;*
- *to establish from time to time a strategy for the company, including a determination of the businesses that the company should be in and those that it should not be in;*
- *to ensure that the executive management implements the company's strategy as established from time to time;*
- *to ensure that the company has adequate systems of internal controls both operational and financial;*
- *to monitor the activities of the executive management;*
- *to select the chief executive, ensure succession and give guidance on the appointment of senior executives;*
- *to provide information on the activities of the company to those entitled to it;*
- *to ensure that the company operates ethically;*
- *to provide for succession of senior management;*
- *to address the adequacy of retirement and health care benefits and funding.*

BOARD COMPOSITION

Most governance guidelines and codes of best practice address topics related to board composition including: director qualifications/membership criteria; the director nomination process; and board independence and leadership.

Criteria. The quality, experience and independence of a board's membership directly affects board performance. Board membership criteria are described by various guidelines and codes with different levels of specificity, but tend to highlight issues such as experience, personal characteristics (including independence), core code competencies and availability. *Every non-executive director must ensure that he can give sufficient time and attention to the affairs of the issuer ... and satisfy the Exchange that he has the character, integrity, experience and competency to serve as a director of a listed company.*[43] *The board should have a diversity of background, knowledge and experience.*[44] [Non-executive directors should] *know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios, and have some knowledge of various company laws.*[45]

[A] candidate should have integrity and independence of thought; the courage to express their independent thought; a grasp of the realities of business operations; an understanding of the changes taking place regionally, nationally and internationally; [and] an understanding of business and financial "language."[46]

Director Nomination. The process by which directors are nominated has gained attention in many guidelines and codes, which tend to emphasize a formal and transparent process for appointing new directors. The use of nominating committees is favored in the U.S. and U.K. as a means of reducing the chief executive officer's influence in choosing the board that is charged with monitoring his or her performance. (See, in the U.S., the Report of the National Association of Corporate Directors Commission on Director Professionalism (1996), and the General Motors Board of Directors Guidelines (1994); in the U.K., the Hampel Committee Report (1998)). The Malaysian Corporate Governance Report expresses a similar view: "[T]he adoption of a formal procedure for appointments to the board, with a nomination committee making recommendations to the full board, should be recognized as good practice." At the same time, however -- and as advocated by the King Report (South Africa) -- it is generally agreed that the board as a whole has the ultimate responsibility for nominating directors.

Mix of Inside and Outside or "Independent" Directors. Most governance guidelines and codes of best practice agree that some degree of director independence -- or the ability to exercise objective judgment of management's performance -- is important to a board's ability to exercise objective judgment concerning management performance. In the U.S., U.K., Canada and Australia, although not required by law or listing requirements, best practice recommendations generally agree that boards of publicly-traded corporations should include at least some independent directors. This viewpoint is the furthest developed in the U.S. and Canada, where best practice documents call for a "substantial" majority of the board to be comprised of independent directors. Elsewhere best practice recommendations are somewhat less stringent and seek to have a balance of executives and non-executives, with the non-executives including some truly independent directors. (Although "non-management" or "non-executive" directors may be more likely to be objective than members of management, many code documents recognize that a non-management director may still not be truly "independent" if he or she has significant financial or personal ties to management.) Nonetheless, a general consensus is developing throughout a number of countries that public company boards should include at least some non-executive members who lack significant family and business relationships with management. *The majority of the board members should be* *independent.*[47] *No board should have less than two non-executive directors of sufficient caliber that their views will carry significant weight in board decisions.*[48] *[I]t is recommended that Independent Directors represent at least 20% of the total number of Board members.*[49]

Definitions of “independence” vary. For example, according to the Brazilian Institute of Corporate Governance, a director is independent if he or she: has no link to the company besides board membership and share ownership and receives no compensation from the company other than director remuneration or shareholder dividends; has never been an employee of the company (or of an affiliate or subsidiary); provides no services or products to the company (and is not employed by a firm providing major services or products); and is not a close relative of any officer, manager or controlling shareholder. *Every listed company should have independent directors, i.e., directors that are not officers of the company; who are neither related to its officers nor represent concentrated or family holdings of its shares; who, in the view of the company’s board of directors, represent the interests of public shareholders, and are free of any relationship that would interfere with the exercise of independent judgment.”*[50] *In February 1998, the Korea Stock Exchange adopted a listing requirement that will mandate that outside directors soon comprise at least a quarter of the board of every listed company. Included among the list of persons who do not qualify as "outside directors" are: controlling shareholders; a spouse or family member of a director who is not an outsider; current or recent officers and employees of the corporation, its affiliates, or of corporations that have "important business relations" with the corporation; and persons who serve as outside directors on three or more listed companies.*[51]

In comparison, the Cadbury Code simply refers to directors who -- apart from their fees and shareholdings -- are independent from management and free from any business or other relationship, which could materially interfere with the exercise of independent judgment. And many of the best practice documents -- such as the Cadbury Report and the National Association of Corporate Directors Report on Director Professionalism (U.S.) -- view the ultimate determination of just what constitutes "independence" to be an issue for the board itself to determine.

Independent Board Leadership. Independent board leadership is thought by some to encourage the non-executive directors' ability to work together to provide true oversight of management. As explained by the National Association of Corporate Directors (U.S.): "the purpose of creating [an independent] leader is not to add another layer of power but . . . to ensure organization of, and accountability for, the thoughtful execution of certain critical independent functions" -- such as evaluating the chief executive officer (CEO); chairing sessions of the non-executive directors; setting the board agenda; and leading the board in responding to crisis.

Many guidelines and codes seek to institute independent leadership by recommending a clear division of responsibilities between Chairman and CEO. In this way, while the CEO can have a significant presence on the board, the non-executive directors will also have a formal independent leader to look to for authority on the board. Documents that place less emphasis on the need for a majority of independent directors seem to place more emphasis on the need for separating the role of Chairman and CEO. For example, the Indian Confederation Report expressly relates the two concepts -- recommending that if the

Chairman and CEO (or managing director) are the same person, a greater percentage of non-executive directors is necessary. (Recommendation 2) The Malaysian Report on Corporate Governance similarly emphasizes that “[w]here the roles are combined there should be a strong independent element on the board.” (Best Practice AA.II) This is in accord with the Cadbury Report, which states that, where the Chairman is also the CEO "it is essential that there should be a strong and independent element on the board." (Section 1.2)

BOARD COMMITTEES

It is fairly well accepted that many board functions are carried out by board committees. For example, a *nominating committee*, an *audit committee* and a *remuneration committee* are recommended in Australia, Belgium, France, Japan, the Netherlands, Sweden, United Kingdom and the United States. While composition of these committees varies, it is generally recognized that non-executive directors have a special role. The functioning and composition of the audit committee receives significant attention in most guideline and code documents because of the key role it plays in protecting shareholder interests and promoting investor confidence. *Special emphasis has been placed on the need for all listed company boards to establish audit committees to ensure the effective and efficient control and review of a company’s administration, internal audit procedures, the preparation of financial statements and the general disclosure of material information to investors and shareholders.*[52] *[There should be] a mechanism that lends support to the Board in verifying compliance of the audit function, assuring that internal and external audits are performed with the highest objectivity possible and that the financial information is useful, trustworthy and accurate.*[53]

Certain countries specifically recommend the size of an audit committee. In India, the minimum size recommended is three members, as it is in Malaysia and the United Kingdom. And South Africa and India both emphasize the extra time requirements demanded of audit committee members, and the importance of written terms of reference for this committee. Malaysia also refers to the need for written terms of reference for audit and other board committees.

REMUNERATION

Remuneration typically consists of salary, performance bonus for surpassing the expected, and benefits. The amount of remuneration is to be determined by a remuneration committee. Criteria such as performance and a company's position among other companies should factor into the determination of all incentive schemes. *Companies should establish formal and transparent procedures for determining remuneration. No director should be involved in determining his or her own remuneration.*[54] *There should be a separate full and clear disclosure of the total of executive directors and non-executive directors' earnings broken down into headings such as fees, share options, benefits, bonuses, etc.*[55]

ROLE OF SHAREHOLDERS

Shareholders have a responsibility to make considered use of their votes. Local institutional shareholder associations should formulate guidelines for the development of a constructive relationship between the company and the owner. Shareholders and the board communicate primarily through annual general meetings (AGM). Boards must employ a communications policy that enables management to communicate effectively with shareholders, stakeholders and the general public. This policy should interpret the company's policies to its shareholders and accommodate feedback from shareholders, which should be factored into a company's business decisions. *Companies should have a free hand to explain their governance policies in the light of the principles, and shareholders and others must evaluate the company's statement and explanations.*[56]

FINANCIAL REPORTING/TRANSPARENCY & AUDIT

Most codes of best practices stipulate that the financial statements are the responsibility of the directors. The auditor is responsible for reporting on the financial statements.
… auditors, as watchdogs, have a duty to report breaches of the law and fraud; therefore, they should be afforded protection in defamation lawsuits, etc., if they acted without malice.[57]

Transparency is one of the most important issues of corporate governance and therefore is given considerable attention in the codes of best practices throughout the world. *Companies must constantly strive for transparency.*[58] Transparency is reached by introducing procedures of internal control and appropriate accounting standards. Furthermore, the accounting standards used must be approved by the International Accounting Standards Committee. The board establishes formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors. Auditor independence appears one of the key factors of transparency. *Not only should the auditors discharge their duties in total independence from personal interest or managerial interference, they should perform a regular review of their independence, along with their cost-effectiveness and objectivity.*[59]

WORKER PARTICIPATION / EMPLOYMENT EQUITY

Workers - as distinct from management - should participate in the governance of affected corporations. Corporations should evolve their own system of worker participation whether by way of workers' committees or at management, executive committee or board level.

The influence of international capital markets will likely lead to some convergence of governance practices. *As regulatory barriers between national economies fall and global competition for capital increases, investment capital will follow the path to those corporations that have adopted efficient governance standards, which include acceptable accounting and disclosure standards, satisfactory investor protections and board practices designed to provide independent, accountable oversight of managers.*[60]

The above-mentioned guidelines, as well as the OECD Principles of Corporate Governance (although they need probably some further specification[61]) and many other related codes have created a basis for implementation of a number of practical procedures, techniques, and patterns in business.

For hundreds of years the society has moved from vertical structures to horizontal ones. The same seems to happen with firms. Classical structure with top leaders and poorly motivated and uniformed employees is being withdrawn by more flat organizations, where all players should be not only properly motivated, but also well informed. This is one of the reasons for introduction of <u>more transparency to internal business operations</u>. In practice, one of the example may be so called “Open book management” (OBM)[62]. Every employee in an open-book company sees--and learns to understand--the company's financials, along with all the other numbers that are critical to tracking the business's performance. Ideally, everybody in the firm knows everything about its finances. Other examples of practical application of the guidelines may be property rights, conflict of interest policy, special labor standards, environmental policy, contract enforcement, consumer protection, bribery rules, approach to competition, information disclosure, science and technology policy, etc.

CONCLUSIONS

The main message we should probably accept if we are to improve corporate governance is similar to the one valid generally, in the whole society. Namely, the optimal outcome of the system can be reached only if all players follow simple, enforceable and predictable rules of the game – if the transaction costs are minimal.

If you do not take care of your property, somebody else does. Slovak entrepreneur

The main problem in this respect seems to be the inherited passivity of general public. Namely, traditionally, the society has relied on the strong leaders, who were supposed to protect the rights of all the society members. There is absolute lack of initiative: creditors have never come with the proposed change in bankruptcy law, employees do not require legislative protection of their rights, business sector do not formulate proposals for improvement of the business environment, minority shareholders do not propose the change of their hopeless position, etc. Instead, all the parties almost exclusively complain of bad situation hoping that somebody will “show the light”. Yes, the truth is that the government should take care of public goods and protection of property in the general sense is, in fact, a public good. However, the government will never do it without proper pressure from all stakeholders. And even if it did, the role of all other parties involved would be still crucial.

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[31] Written by Eugen Jurzyca (INEKO) and Pavlo Shostak (AI NOVA).

[32] Stripping assets of a firm at the expense of some of its stakeholders, most often in favor of one of them.

[33] IVO, SOPK, EU: "Názory ekonomických elít na aktuálne otázky vývoja slovenskej ekonomiky".

[34] The Nature of the Firm, Ronald Coase, Economica 4, 1937.

[35] Presented at the CED seminar in Bratislava by David Frankel.

[36] Russell Reynolds: Summary in Governance, April/May 1999, issue 6729 Bristol Gardens, London, W92JQ

[37] http://www.ebr.org/

[38] Oliver E. Williamson and Scott E. Masten, The Economics of Transaction Costs, Edward Elgar Publishing, Ltd., UK, 1999.

[39] http://www.oecd.gov/

[40] Brazilian Institute of Corporate Governance Code of Best Practice at 1.

[41] Report on Corporate Governance (Malaysia), Introduction § 1, 3.3.

[42] The King Report (South Africa), Ch. 4:1.

[43] The Hong Kong Stock Exchange Code, Code of Best Practice 10 and Guideline A.5.

[44] The Brazilian Institute of Corporate Governance Code of Best Practice at 3.

[45] The Confederation of Indian Industry Code, Recommendation 4.

[46] The King Report (South Africa), Ch.9:8.2.

[47] Brazilian Institute of Corporate Governance Code of Best Practice at 3.

[48] The King Report (South Africa) 2.2.

[49] Mexico Code of Corporate Governance, Principle at 6.

[50] Malaysian Report on Corporate Governance, Explanatory Note 4.23.

[51] Article 48-5 KSE Listing Regulation.

[52] President's Message, Stock Exchange of Thailand Code and Guidelines, pp. iv-v.

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