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Institute for Economic and Social Reforms

Seminar Bulletin - Corporate Governance

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CORPORATE GOVERNANCE AS AN EVOLUTIONARY PROCESS – COMPARISON OF DEVELOPED AND TRANSITION ECONOMIES

Our comparison has been envisaged as a summary view of some principal problems of corporate governance in its broadest perception, and as an international comparison of two groups of countries. Therefore, it leaves out of consideration details of the specific arrangements in the individual countries, with the exception of some cases which serve to demonstrate some more general or frequently repeated cases; rather, it focuses on the complex of issues which require solution in order to obtain overall higher effects from an improved governance and control of joint stock companies.

The term „corporate governance“ expresses the broader context of the relationship between the owners and the managers of large publicly traded corporations (in other words, in joint stock companies publicly traded at stock exchanges).[1] A good corporate governance should provide adequate stimuli to statutory bodies and the management to pursue objectives which are in the best interest of the company and its shareholders. At the same time it should mediate an efficient monitoring to make companies utilize their resources more effectively. Corporation governance is but one component of a wider economic environment within which companies operate and which also includes factors such as macro-economic policy and intensity of competition in product and production factors markets. Also, the framework of corporate governance will depend on the legal, regulatory and institutional environment. Moreover, factors like business ethics and sharing environmental and social interests of the community in which the company operates may impact on the image and the long-term prosperity of the company. Corporate governance keeps developing along with the development of the business environment.

Corporate governance issues gradually come to the foreground as the transformation progresses. This is a natural phenomenon manifesting itself in enhanced attempts of organizations such as OECD, World Bank or IMF at improving not only macro-economic but also corporate performance parameters. All the organizations mentioned see corporate governance as the very important factor of raising the competitiveness of the countries in transition. Institutional building in market economies was among the least preferred and at the same time the taughest areas of reform of the centrally planned economy. Corporation governance[2] as a set of relationships is above all dependent on the developed institutional environment. Since the institutional environment is formed based on the conflict of interests, it is but natural that its objective structuring as a part of the reform program is rather difficult with relatively poor outcome during the initial periods, if not impossible at all.

This statement may no more be a new discovery for many even if some years ago it may have sound not too trustworthy to some politicians. Institution building is a lengthy process, and corporate governance currently confirms this fact. It should however be stated that this process is a long-term and permanently changing one even in developed market economies, although its foundations show a qualitatively higher level also when looked at from the aspect of the activities of the courts.

The aim of this article is to compare the institutional situation in developed countries with that of the transition economies. We believe that corporate governance is an institution which – similarly as any other institution – develops and is the result of a long-term evolution. Its primary shaping represents a long-term process, and the very institution keeps developing in all economies. Depending on historical, socio-economic and other factors, it has assumed certain specific features in every country, the features

stemming from institutional constraints characterized as comprehensive structures. Referring to the paper by M.J. Roe (1994) we may state that isolated changes in the legislation cannot, from short-term perspective, bring in the effect of a principal change in corporate governance unless there is a developed comprehensive (institutional) structure in the economy.

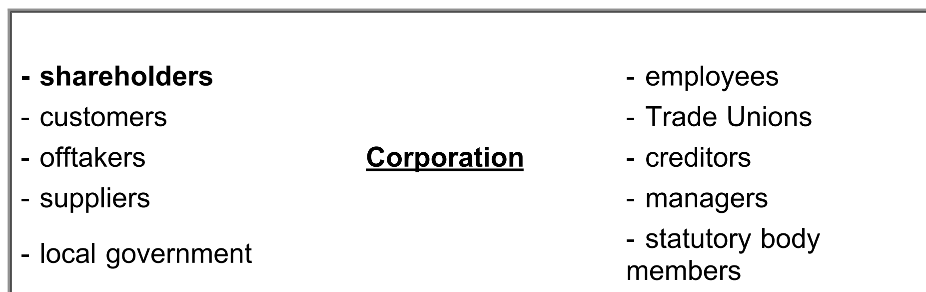
I. Developed economies: characteristic A

In developed market economies, the corporate governance process is connected with numerous changes which (above all in the USA) have occurred with the growing role played by mutual funds and their competing commercial banks. Moreover, discussions focused on the treatment of the legislative framework with respect to some important issues including the definition of the position of minority shareholders under conditions of the processes of the exercise of ownership rights becoming increasingly complex, or attempts to introduce proxy voting via Internet. Typically, analyses in developed economies frequently concentrate on the analysis of legislative changes concerning some segments of corporate governance.[3] Let us show some examples to document the areas involved. Preemptive right to new issue of shares, mandatory disclosure of non-financial information, or exercise of the right to apply voting by mail are but some of the measures aimed at protecting some groups of shareholders against other groups. Mergers and acquisitions, similarly as forced administration and defense mechanisms are among the frequently analyzed problems.

Developed countries as represented by OECD Member States, keep enhancing their preparedness for the treatment of the growing and increasingly complex issues of corporate governance. A recent initiative by the OECD Council and its meetings at the ministerial level (27 – 28 April, 1998) asked OECD to develop, in cooperation with national governments, other corresponding organizations and the private sector, a set of standards and guidelines for corporate governance.[4] The threat to disturb the equilibrated positions of the various entities and even countries as mentioned above, on the other hand results in the existence of several problems on which no agreement can be achieved and/or which make negotiations concerning full harmonization of European Union legislation much more difficult.[5]

Using data from international organizations, we tried to compare corporate governance systems from the aspects of three different characteristics: the rights of creditors, rights of shareholders, and enforceability of law. In this case, we chose a more detailed classification, and compared four systems: the English (18 countries), German (6 countries), French (21 countries) and Scandinavian (4 countries). For the purposes of the comparison, the external system corresponds to the English model, the remaining three systems are closer to the internal model. If we compared all the countries within each of the systems, then we would get the following ranking. The Scandinavian model would rank first, followed by the German, the English and the French systems. A better comparison would however be to take two developed countries from every group, thus eliminating the problem concerning the different numbers of countries applying the given model as well as differences in the levels of their development (e.g. the contrast among the four developed Scandinavian countries and the 21 countries applying the French model). Having selected two countries from every group, we get the following ranking: English system followed by Scandinavian, German and French systems. Certainly, this is but one possible way to compare, and not even using this comparison may we cast doubts on the typical conclusion arrived at by international economists claiming accordingly that it is not easy to assess the advantages of the individual models. Every model presents with some advantages as well as disadvantages. One system strengthens the mechanisms which ease the position of creditors, another one gives preference to shareholders who tend to „vote by feet“, i.e. to leave the company if the management does not behave in accordance with their expectations. Figure 1 presents an overview of the major groups of stakeholders.

Fig. 1: Major stakeholders of enterprises



Note: The highlighted group of shareholders is the focus of the interest of the institutional anchor of corporate governance, e.g. in the UK, in contrast to the continental model orienting itself towards the groups of stakeholders, including employees.

Currently, improvement in corporate governance is considered a priority area also within OECD. This is based on long-term outcomes of monitoring developed as well as transition economies, where the biggest competitiveness related problems concerned effectiveness and competitiveness of enterprises rather than macro-economic stability. The unsatisfactory outcomes and better success rates of companies with foreign capital participation are being accounted for by the insufficiently developed governance methods in transition economies. Moreover, macro-economic impacts of corporate governance are being considered nowadays, whereas they would be seen as an issue connected with the corporate and banking sector in the past.

Today, OECD has a program in place dealing with corporate governance and presenting a series of regulations companies are expected to voluntarily adhere to. The regulations are based on the known assumption that there is no single model of a good corporate governance. The OECD principles thus have not been made mandatory and binding, and do not provide any detailed instructions to be followed by national legislation. They at the same time are expected to be of evolutionary nature. In other words, they are expected to develop and be applied while accounting for the overall goals of companies operation support. The framework of corporation governance is expected to protect the basic rights of shareholders, including the right for: 1) safe methods of ownership registration, 2) transfer of shares, 3) obtaining of corresponding timely and regular information on the company, 4) participation in, and voting during general assemblies, 5) voting on statutory body members, and 6) shares on company's profits. The OECD principles are expected to assist the governments in their attempts to asses and improve the legal, institutional and the regulatory frameworks, and to provide stock exchanges, investors, corporations, and other parties involved, which play a role in the development of good corporate governance, with guidelines and recommendations. The principles are oriented towards publicly traded corporations, some of their elements however can also be used with respect to publicly non-traded companies, including State enterprises. The efforts spent by OECD to present a model solution are based, as claimed by themselves, on the notion that corporate governance represents a key element of economic efficiency improvement.

So, due to the lack of formal regulations on best conduct in the area of corporate governance in the new emerging markets, pension funds in the US started, during the late 80s, to actively utilize proxy voting (Dubiel, S., 1999). Initiatives to set up good practices have however started appearing much more frequently: Cadbury´s Committee, the South African King´s Committe (1994), Bajaja´s Committe in India, Toronto Exchange Administration (1994), etc. For more information on these issues, see Davis, M.S.(1999). M. Becht (1997) means that discussions on European corporate governance concentrated too much on comparing institutions and on the possibilities to import some foreign arrangements which seem outstanding. According to the opinion of this author, links between the corporate governance system and economic performance are so uncertain that they do not support the defense of such measures.

II. Transition economies: characteristic B

Numerous studies have appeared recently, dealing with corporate governance in economies in transition (e.g., Walsh, P.P.; Whelan, C., 1999; Tchipev, P.D.; Backhaus, J.G.; Stephen, F.H., 1998 Estrin, S., Wright, M., 1999 Estrin, S., Rosevear, A., 1999). After an initial disinterest, transition experts as well as economic policy makers in transition economies started increasingly dealing exactly with these issues.

In countries in transition, internal company audit systems have a variety of forms, due to different approaches to privatization, their different institutional framework, etc. So, Hungary introduced a self-governing system in 1984, similar to that applied by Poland, the former however reserving more powers to managers than to laborers. Contrary to the Czech approach, managers had it easier to control the enterprises (Aoki, M., Kim, H.-K., 1995). It has been typical of transition economies that it takes much time to generate a model which could be taken as characteristic for the individual countries. The lack of knowledge of the current practices of company financing may however enable some shareholders to exercise, within some systems, their ownership rights to an unproportional extent. It has been typical of the entire post-privatization period that both majority and minority shareholders keep looking for loopholes in the law. The special-purpose association OSMA (Fig.2) arose as a response to the situation where

some managers in the Czech Republic used illicit practices to restrict the tradeability of shares and subsequently attempted purchasing the shares at minimal prices to gain control over the company, and also pursued other actions to limit the rights of minority shareholders, who themselves could hardly find any protection of their rights at the State. OSMA´s mission is to initiate changes in the legislation, to pursue the interests of small shareholders, and to educate people.

Fig. 2: Case study: protection of small shareholders in the Czech Republic and in the world

The *Association to Protect Small Shareholders (OSMA)* is an association aiming at protecting the interests of small shareholders. It attempts to comment on hot legislative issues, such as the recently drafted amendment to the Commercial Code. OSMA, e.g. believes that the currently suggested bottom limit of 40% applying to bids to purchase shares through which the share on the vote reaches or exceeds the said limit, should be lowered to 33.33% of the overall vote. Also, OSMA offered its advice in cases when small shareholders´ rights were violated. Steps undertaken by small shareholders may not seem important. Under conditions of pointed competition however, the corporation image may become threatened, and institutional investors may lose interest in such a corporation.

Presently, also minority shareholders seem to be able to misuse the loopholes in the laws, and sometimes abuse their potential. As an example, they frequently exert pressure on convening general assemblies.

In their final effect, OSMA activities serve to improve the institutional environment and may assist enterprises in recruiting new small shareholders from among the general population. Their share may be expected to decrease – their record numbers in shareholder structures have been due to the voucher privatization method; they nevertheless may continue to participate on financing the enterprises via pension funds or investment funds.

Trying to look at corporate governance from the aspect of empirical analyses, problems are encountered which we have come across during our surveys as well. The results are different, and confirm hypotheses but rarely. Claessens and Djankov (1999) analyzed 706 Czech companies, and they arrived at the conclusion that a more concentrated ownership is associated with higher profitability and higher productivity of labor. This is one example of a conclusion that several authors have arrived at. However, there are also studies, such as that by P.P. Walsh and C. Whelan (1999), which suggested, based on data for 220 conventional processing companies, that the ownership structure has no effect whatsoever on the company performance. Individual studies focusing on corporate governance in post-socialist countries have mostly analyzed quantitative aspects of companies´ behavior. We believe that the above mentioned differences in conclusions are mainly due to the fact that the various aspects of the enterprise transition issues are insufficiently distinguished. Corporate control and governance, restructuring, management, privatization should each be subject of analysis, although their separation may be difficult in real life.

III. Comparison of situations A and B

Since the economic systems in the various countries are based on cultural, historical, social and economic specifics, this fact also resulted in the development of specific models of corporate governance. Historically, two basic models of corporate governance have evolved: external and internal model. Although substantial differences existed in the past between the two above models, some of their features started overlapping, and the models are converging to a certain extent, due to internationalization of business. The existing structure of banks, national legislation, social security systems, different position of the enterprise-bank relationship in these economies or the willingness of people to invest their funds into securities however make the differences persist.

Any comparison of situation characteristics in both analytically separated groups of countries is only possible under certain assumptions and limitations. First, the absence in virtually all the transition countries over long years of private ownership, capital market and joint stock companies has to be accounted for, which restricted the opportunity to implement corporate governance in practical life. The

entire system of planning was set so that it de facto prevented any treatment and regulation of the manager-owner relationships.

The future development certainly will bring in a gradual change of the underdeveloped system of corporate governance in transition economies towards internationally recognized usage and standards. Pressure on ethical conduct and presentation of companies towards outside shall become an increasingly important stimulus for changes, similarly as improving legislation. Figure 3 illustrates the problem connected with transition in the area of corporate governance. Let us leave aside the privatization issue which is determined by the interests of various groups in all transition, but also developed, economies and which itself presents with a relatively complex theoretical problem. Development of corporate governance has been influenced by poor initial institutions which have additionally been distorted by the system of the centrally planned economy. This has slowed down the evolution process of the formation of this important element of the institutional environment. Since transaction costs and revenues of any reform changes in this area are unpredictable, and – as stated by Roe (1994) – there is a threat of the coordination of the transition not being taken care of by government agencies, within which companies and institutions should move in parallel, this means that the selection of some institutional arrangement (e.g. the structure of the statutory body) should apply to the economy as a whole. And this very example with the statutory body model is a good example of something which did not occur in our country during the first period of the transition process. The then existence of the various hybrids however was not a part of a well thought over regulation connected with the competing models approach; rather, it meant the absence of a sufficient regulation of the individual approaches or the absence of the selection of one of the models.

Fig. 3: Comparison of developed (A) economies with economies in transition (B)

	laws/legal framework	other institutions		
VTE A	S	S	S	S
VTEm A	W	S	S	S/W
TE1 B	S	W	W	S/W
TE0 B	W	W	W	W
			COMPREH	**SEGMENT**

Legend:	S = strong feature	VTE = developed market economies
	W = weak feature	VTEm = less developed market economies
	S/W = strong or weak	TE1 = economies in transition
	COMPREH = comprehensive structure	TE0 = pre-transition economies
	SEGMENT = structure segment	

Source: D. Brzica

Based on Roe (1994) and his statement that structures depend on the financial organization and regulation rather than on the very characteristics of companies, as well as based on the assumption that it is important to support diversity, we may conclude that State should generate regulation and competition during the transition period. Figure 4 shows how such regulation and stimulation of competition should look like and what should become its objective.

Figure 4: Generating corporate governance structures

STRUCTURE A ***STRUCTURE B*** ***STRUCTURE C***

Advantages/disadvantages Advantages/disadvantages Advantages/disadvantages

CHANGE: - through regulation change

- through support to category(ies) of entities

- through support to diversity of forms

- through developing/changing institutions

- through changing taxation policy

ENTITIES: - banks

- non-banking financial institutions (institutional investors)

- stakeholders (internal and external)(continental model)

- shareholders (Anglo-Saxon model)

- companies

- individual investors

Source: D. Brzica

The generation of corporate governance structures is a long-term process, and it is a pity that it has not been sufficiently accepted right from the beginning of the transition process. There are several reasons for that, but the observation from transition countries applies: many measures from the area of regulation were not accepted because they represented conflict of interests of various groups, similarly as it was the case with respect to privatization.

Conclusion

Economic policy makers and regulators have to make the decision on the possibilities to develop competition of models. Changes in partial laws without changes of comprehensive structures may not lead to the target. This has been confirmed by the development in many countries which have liberalized their originally strict provisions, and which neither by now have achieved progress to the extent we may have expected with respect to the extent of the liberalization made.

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[1] More specifically, corporate governance includes a set of relationships between the company management, its statutory bodies, its shareholders, and other interested parties. It offers a structure through which company objectives are set, means to achieve the objectives are determined and performance is monitored.

[2] The main feature of corporate governance is the issue of the relationship between the owners (shareholders) and agents (managers) which is based on the objective existence of information asymmetry between the two groups. In reality, the existence of also additional groups both within the company and outside of it, presents numerous problems which go beyond the differentiation of interests as originally analyzed in the past.

[3] The legislation concerning corporate governance is relatively copious and detailed. This has to do with the fact that corporate governance represents hundreds of segments which, in developed economies, have been covered by legislation. Minute amendments to acts may then sometimes result in principal changes in the positions of the stakeholders within a single or multiple segments.

[4] One problem concerning the extensive regulation of the complex issues mentioned is the fact that the nature of problems covered by such regulations frequently changes while the regulations are still in the process of being drafted, approved and adopted. As an example, OECD regulation of transfer prices can be mentioned. New observations started appearing during the adoption stage of this document claiming that the regulation presents an advantage to mainly standard sectors, whereas it seems less suited to regulate activities in the area of modern technologies and/or companies operating in such sectors.

[5] The structure of the statutory bodies remains a significant issue. Not only the problem of single-tier/two-tier structure, but mainly the German requirement of the participation of employees on the administration and management of companies with 1,000+ employees remains hardly acceptable to the more liberal Anglo-Saxon model (Gavin, B., 1997). M.Becht (1997) refers to practical problems with the application of European directives, in particular the EU Transparency Directive No. 88/627/EEC and the 1st, 2nd,4th and 8th Company Directives, the Financial Institutions and Bank Accounting Directive No. 86/635/EEC, and the Insurance Company Accounting Directive No. 91/674/EEC. Becht questions the current efficiency of the disclosure procedure as applied at the European level. As an example, he refers to the fact that none of the Directives makes it mandatory to disclose ownership information (in contrast to information concerning voting rights). Investors who purchase exchange-quoted company shares, the company being a part of a group of businesses, are unable to exactly determine the portfolio acquired by them and/or who controls the group.

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CORPORATE IDENTITY – THE PRINCIPAL CORPORATE GOVERNANCE TOOL

Motto:

"Upon mixing a company drink, it is mainly CI which will have a significant influence on the taste of the other ingredients as well as on that of the resulting drink."

(freely adapted from H. Meffert)

Corporate Identity: What is it?

The term „Corporate Identity" has made its way not only in professional circles but also the general public is gradually becoming aware of it. More often than not, the abbreviation CI appears in the dictionary of firm and organization representatives. What does this abbreviation CI stand for?

The standardized and most frequently used translation of the English expression is equal to Corporate Identity that also includes identity of non-commercial organizations, associations, regions or events. What's behind it is the very essence of what forms the basis of any entity or organization – its history and past, its „personality", values professed by it, principles on which it was established, and visions which it set forth and attempts to achieve. Its visual style is the most visible form of this CI manifestation. Corporate Identity is something without which the company or the organization cannot virtually exist since it would lose its own identity.

Opinions differ when it comes to the definition of the contents of the very term Corporate Identity. Frequently, this term is understood as exclusively referring to the visual characteristics of the firm or organization. What is needed however is a more comprehensive view, which brings us to perceive Corporate Identity as an umbrella, an integrating base, the expression of corporate personality, a meaningful interlink between tangible and intangible elements of its very essence. The term identity may be looked at from the aspect of psychology of human personality – then, CI is a construction analogical to identity defined in this way.

Identity building is always a structured process running hierarchically in the downwards direction, it is relatively long-term in nature, and can only be implemented in sequential stages.

Corporate Identity represents the accumulated history of the corporation and its major strategy. As a rule, CI is subject to gradual developmental changes, but any important event may result in draconic changes in CI.

Why is CI important for corporations and organizations from the viewpoint of their social operations, building of their status and commercial and non-commercial success? Namely, it is presently common to see the same product (e.g. banking services) to be offered by almost all entities in many sectors (such as the banking sector) at the same price (e.g. interest rates), under approximately identical technological conditions (direct payments, payment orders) supported by the assistance of approximately equally professionally trained staff. Then, what will be the key factor of the success of the respective bank (or any other firm or organization)? We believe that the targeted and well-profiled Corporate Identity is the correct

solution. It is the carrier of the trustworthiness of products, services provided, it creates firm links between the organization and its clients as well as its own employees and, mainly, will impress upon the firm's or organization's image a seal which shall be accompanying it throughout its existence and give it numerous advantages.

It is uneasy to answer the question what is the essence of an entity's identity, of the identity of an organization, firm or region. What it should be is a key message, values or priorities which cannot be given up in any case, and which should be distinguishable in the individual manifestations of the entity's and its representatives´ conduct. If you wish to determine it, you would preferentially need a neutral look from the outside.

Sometimes, the very product of the company may be at the core of such an identity (IBM), sometimes it will be professionality of the employees (air companies) or relationship to the nature and the environment (many Scandinavian companies). The identity itself may be structured in a variety of ways – there e.g. is so-called monolithic identity type which means that the entire organization represents a single whole which personalizes its identity. Another example may, e.g. be so-called brand identity – the brandmarks of the individual products carry independent identities, and the mother company which produces them remains in the background. An example of an identity profiled in this way is e.g. the food industries. Another case is so-called delegated identity, where the mother company is represented through its products which however remain connected to it (e.g. the various marks of General Motors – Pontiac, Cadillac etc.).

The very term Corporate Identity need not be reserved to entities of commercial nature only. Corporate Identity does not only mean a narrowly specific firm identity; rather, in a broader sense, it may be perceived as the identity of any community governed by identical social or cultural standards. The principle of the CI issues reside in people and/or symbols and values they have created. It is therefore topical to consider CI not only in the context of the conventional market players but also in that of State organizations, sports, regional or cultural institutions, in other words everywhere where there is a community of people bound by certain objectives, values or visions.

History of CI

The field of Corporate Identity (CI) and its setting up presently belongs to the most rapidly developing phenomena of the public sector, and attracts economists, sociologists, psychologists, architects, designers as well as a variety of other professionals to work together. The history of CI dates back to that point in time where intentional and targeted distinguishing of a mark, product or a social group started. In a broader sense, it is the sophisticated visual style of the Napoleons soldiers´ uniform which can be taken as being the basis for CI – it is exactly from this example that the nestor of the field, Wally Ollins, has started unwinding his historically investigative study on CI.

The modern roots of the branch currently called Corporate Identity are tied to the period shortly after World War II. The boom od the American style of life was, to a considerable extent, based on advertisements where elements of a targeted CI came increasingly to the foreground. The fostering of positive identification with the firm (in both the clients and the own employees) became a rather efficient factor of CI creation. The legendary slogan „What's good for GM is also good for us" is nothing else but a little bit clumsy - and from our modern point of view transparent - attempt to launch the process of the identification with the firm which is unavoidable for the setting up of a stable and resistant CI.

The 60s were branded by stressing the visual style and the firm design. The heyday of the printing technologies as well as of the media stressing colors (the movies industry, TV) moved the focus of the CI towards Corporate Design. Colors, movements, presentation style have become the symbols of CI and the most effective way how to communicate to the target audience the principal messages of CI. This style of the setting up of CI would however almost exclusively put stress on the external aspect, and is now being perceived as slightly one-sided. It is not by chance that the expression Corporate Image is more frequently used in the USA than Corporate Identity.

The European scene looked for new approaches to CI issues. The English school, represented mainly by W.Ollins, took an eclecticistic approach integrating design into broader cultural and philosophical context, whereas the German school represented an approach based on positions of social psychology. For the first time corporate culture would be recognized as an integral part of CI, making up its subject matter background and a key to allow to enter it. Detailed, methodologically demanding and sometimes uneasily

understandable culturologic concepts relying on the analysis of interpersonal behaviors, motivation of employees or social-psychological aspects of management have become typical representatives of the continental approach to CI issues.

Also, procedures known from marketing would become a part of this process later on, and the debate going on until recently has gradually lost its justification since both areas rather closely complement each other and they are sometimes difficult to be distinguished from each other.

Globalization of the 90s brought new stimuli into the CI area: national specificities of identity started disappearing, CI started generally spreading into the virtual space through Internet and multimedia applications.

Corporate Personality

Corporate Personality is an important term relating to CI. What is the relationship between the two terms?

Let us use the parallel between the human individuality and an artificial man-made entity (firm, organization, event, seat) again. Personality is at the basis of the identity of every individual, i.e. his/her predispositions, skills, character, manifestations of his/her behavior, values he/she professes, as well as his/her physical appearance. However, also his/her past, the actual experiences as well as ambitions, objectives, and visions of the future are components of the human personality as an integrating category of his/her existence.

The same applies to the firm – every company has its own past, its current performances or specific standing and visions of the future. It may not be as easy to imagine all this at the first sight, but the firm may also have its character, temper, values, which determine its behavior and certain characteristics.

Such company value priorities should represent some principal azimuth determining the orientation of the firm in the market as well as in many, sometimes intricate social or economic situations. The company whose values and manifestations are firmly laid down and transparent to its communication partners (including own employees) becomes readable, and this is the first step towards being trustworthy. This trustworthiness will enable, at a later time, to rely on support of those without whom the company could not exist – visitors, investors, business partners, and – above all – the own employees. The importance of such a trust will be invaluably felt mainly in crisis situations, when each and every step is closely watched by the public opinion, and when it is unusually difficult to get the support of communication partners and the general public; the same is true when the firm is not liable alone for problems which occur. And it is exactly then that you mostly see whether the values of the Corporate Personality are but a declared cliché or whether they stem from the very personality of the company and thus represent an authentic reflection of its Corporate Identity.

Let us approximate Corporate Personality manifestations as we come across them in practical life. There are no identical personalities of any two people, and there similarly are no two identical Corporate Personalities of any firms or organizations. The variability of the Corporate Personalities will depend on the size of the entity, its history, current situation, as well as on a number of external circumstances.

Certainly, there will be a difference between the personalities of a large multinational bank institution and, let's say, a small private radio station broadcasting independent programs for the young. In the first case, it may be assumed that the corporate personality is based on the tradition of long years, seriousness, success achieved in preceding years, conservatism, credibility, and solvency. Such a corporate personality can be seen as an elegant, conservative aristocrat who always holds to what he says. The other case will probably present itself by values such as creativity, improvisation, youth, fantasy, etc. In this case, corporate personality will obviously be more diffuse, with more phenomena which may but uneasily be classified within a rigid box and which are subject to changes. This fully reflects the post-modern reality of the present society, and does not enforce upon itself any final and rigid attitudes to events the life brings with it.

Although Corporate Personality is an abstract construction created by human imagination, the major features of such personality are usually codified in the same basic document. Professionals usually call this document „prospective profile", the principal basis and the company characteristics however are frequently contained in so-called CI manual of the entity in question. The major features of such a

personality, then, secondarily appear in all the other outputs codifying the CI, e.g. in the code of ethics, strategy of external communication, principles of crisis management or in the design manual. The key factor of whether the personality is perceived in accordance with the imaginations of its authors however is the reality itself – whether the entity actually behaves in line with the declared principles and values, whether its conduct is compatible with the image of its personality, etc. The final mirror of Corporate Personality is namely the image. The final answer to the question to what extent Corporate Personality has been successfully profiled in accordance with the imagination of its authors can only be expected from the image perceived in a stable manner and over longer periods of time by all segments of communication partners.

Corporate Image

The image can be expressed as an image which the external environment gets of a firm or organization. A positive corporate image means good reputation, sound, prestige perceived by the public as well as a positive feeling upon hearing the name of the brand. At the same time, it represents the measure of the affinity of significant groups of perceivers to the very entity. To acquire and to maintain over longer time a favorable image is a rather demanding task requiring extensive and frequent surveys of the external environment, strategic planning, and – above all – a perfect organization and management within the entity.

Corporate Image builds upon Corporate Identity, it is an image created in the public. There may be two different types of corporate image assessment: the image may be substantially better that it is in reality – this gives rise to operation problem. If reality is better than the image, we speak about communication problem. We should always account for how reality compares with Corporate Image whenever setting forth final goals of Corporate Identity.

Many factors resulting in disproportions between CI and Corporate Image may be accounted for by so-called psychological noise. This includes internal factors that prevent communication. People tend to protect themselves from information which may be unpleasant. There are three ways how to do this: selective exposure, selective perception and selective retention. The psychological noise concept is based on the consistence theory which claims that people prefer information, ideas and attitudes which are compatible with their beliefs, attitudes and behaviors, and avoid information which contradict them.

Frequently, Corporate Image is something more than just personal experience created by medial communication. Media have an impact here which they but rarely have elsewhere. Large distances, transportation costs or mere convenience frequently represent strong hindering factors, leaving medial communication (in particular TV and Internet) the key role in creating Corporate Image.

Risks with respect to the creation of Corporate Image using this approach include the increasing disproportion between reality (and/or CI) and the media-created image. In extreme cases, this may become the crucial stage of failure of the CI project – authenticity disappears and what remains are but coulisses. The perceiver is rather sensitive to the discrepancies, and his trust may be lost forever.

CI in conditions of Slovakia's market

How does the application of the phenomenon Corporate Identity look like in Slovak economic entities? Many of them have already understood that CI building is a principal tool of corporate governance rather than an additive component of the firm activities which can do nothing more but to improve the presentation as compared to the communication partners. The impacts CI may have are difficult to measure – namely, so many areas may be affected that the impacts cannot be localized into a pre-determined area, such as marketing or HR management. Many Slovak companies have become aware of this, and are building their CI in a targeted, strategic and long-term manner. Also, the principal errors and mistakes most frequently committed by the Slovak companies in building their CI should however be mentioned in this context:

a. *identification of Corporate Identity with visual style*

   Visual style (corporate design) remains the most effective communication channel of corporate identity, it nevertheless does not represent its resource base. The basic values and ideal basis of the firm, its objectives, ambitions and communication style, in other words, its personality have to

be defined prior to creating the corresponding visual style.

a. *automatic adoption of the „mother“ CI from abroad*

If a foreign entity is the majority owner, it is but natural that it is interested in influencing the identity of the Slovak company. However, there is a wide field for new work in this area in addition to the principal features of the corporate identity, corporate philosophy and/or visual elements of identity.

a. *CI is not perceived as a long-term strategy concept*

In the real sense of the word, CI building is a never-ending activity (which does not mean that the achieving of partial targets cannot be controlled). It cannot be perceived as an advertising or image-creating campaign. Many components of corporate identity come to their full expression but after many years – and this even more should prompt us to start shaping our own identity as soon as possible.

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Seminar Bulletin - Corporate Governance

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OWNERS, MANAGERS, AND FINANCE: THE NEED FOR REFORM

Introduction

In their primary form, enterprises would be owned and managed by the same people. The need to concentrate large volumes of capital as a result of economic and technological development, as well as globalization of markets, resulted in the invention of joint stock companies, enterprises raising capital by debt and offers to outsiders to acquire interest in the company. In this manner, joint stock companies split ownership from control. Property owners are not remunerated by receiving stable payments such as interest in the case of credits; instead, their control rights over assets are secured, and expected to bring them a portion of divided profits (dividends) and the salvage value upon the wind-up of the company.

The owners rely on corporate governance to secure them yields on investments. As defined by Shleifer and Vishny (1997, p.737) „*corporate governance deals with ways how fund suppliers to corporations secure yields on their investments*." OECD (1999a) defines corporate governance more broadly as „*the set of relationships between the corporation management, its Board, shareholders and other stakeholders. Also, corporate management provides a structure for the setting of objectives of the company, and allocates funds to achieve them and to monitor company performance. Good corporate governance adequately stimulates the Board and the management to pursue objectives which are in the best interests of the company and the shareholders, and enables effective monitoring of the utilization of resources*." According to Zingales (1997), the system of corporate governance is „*a complex set of constraints which shape ex-post negotiations on quasi-rents generated during the relationship*."

In the present article, we shall attempt to systematically point to the importance of corporate governance to transition economies. The article is a concise attempt to clarify the role and the relationships of owners (investors) and managers, as well as the necessity to modify these relationships on the part of the government to secure competitiveness of the country within the global economy. The present article is a shortened version of a study to be published in the 2/2000 issue of Finance and Credit.

Importance of corporate governance, stimuli and contracts

Since splitting the ownership form control creates the need for a complex corporate governance, three principal questions have to be dealt with first: 1) what managers need owners for, 2) what owners need managers for, and 3) why the relationship between the two parties cannot be resolved by competition in the product market.

1) Managers are business people who need funds from investors to finance their projects as they themselves do not have sufficient funds. That is why many corporations in family ownership decided to issue shares in public markets or to at least accept bankers among themselves.

2) Investors (owners) do have funds, but they lack the ability to generate revenues. That is why they „employ" managers. It is a relationship between the principal and the agent, where in general the agent may be replaced any time.

3) Competition in the product market would resolve the problem in an efficient manner if managers did not

convert liquid funds of investors into highly specifically burried capital. With burried funds, competition in the product market is unable to prevent managers to expropriate competitive revenues. That is why investors require securitization of yields on invested funds they expect to acquire through the mechanism of corporate governance.

Managers have two contradictory stimuli. One of them is a long-term stimulus of reputation building which secures them access to capital in the future, the other one is the short-term stimulus of the expropriation of a portion of owners´ profits.

The first stimulus is in accordance with the owners´ preference for a performing enterprise, with the performance being measured by the worth of the enterprise in the securities market and by stable flows of dividends. The theory has however difficulties to explain the concept of reputation building because of problems with backwards recourse. The second stimulus leads to potential expropriation of funds, transfer pricing, sales of assets, consumption of perquisites, building of imperia securing private benefits from the control, as well as to maximization of turnovers, growth or the utility function of managers. This makes it strictly contradict the goals of the owners.

Maximization of yields on investments represents the stimulus to the owners. Depending on their equity share and the legal framework, the interests of owners may contradict those of other shareholders and stakeholders.

No problems of corporate governance would exist if owners and managers could draft a perfect and binding contract enforceable by courts, which would forecast all potential future situations (such as market developments, changes in economic policies and changes of prices) and set the responsibilities of every party to the contract, along with penalties for defaulting. The Principal and Agent theory assumes that drafting of such contracts is cheap. In real world however. the drafting of a detailed contract may be too costly or even impossible at all. Moreover, if owners knew how managers should respond in any unforeseeable situation, they would not need to hire them. That is why owners and managers draft incomplete contracts leaving space for future revisions and renegotiations. In this way, owners temporarily assign their residual control rights to assets to managers in situations which the contracts have not foreseen.

Ownership

The approach based on *property* rights sees ownership as the source of power if contracts are incomplete, as „*The owner of the assets has residual control rights over them: the right to make decisions on any use of the assets in any way which is not inconsistent with the preceding contract or law.*“[6]

Because of the incompleteness of the contract, the relationship between the manager and the owner includes uncertainty concerning future behaviors of each of them, thus concerning the owner’s demand for the volume and quality of services, and their offer by the manager - , what makes the incomplete contract „costly“ is the investment into the specific relationship. What prevents the owner to do the job of the manager, and vice versa, is the lack of specific capital.

The situation if further complicated by the fact that large joint stock companies tend to have numerous small owners (shareholders). The reason for this is that investors do not like risks and they are constrained by the property. Fractionated owners are unable to exercise daily control and are not interested in monitoring the management. Managers in such a case do *de facto* possess ownership rights and maximize their private benefits. The existence of the Board of Directors prevents such a behavior but theoretically since it may pursue its own objectives rather than those of the fractionated owners, Board members may make secret arrangements with managers.

Mechanisms of corporate governance

The mechanisms of corporate governance include economic and legal institutions which can be modified through political processes.[7] Such mechanisms try to overcome the problem of the split of ownership from control.

Stimulatory contracts (ownership of shares by managers, share options or threat of dismissal) require correlation of well defined and court-verifiable performance measures with managerial efforts. To find such

measures is problematic. Moreover, stimulatory contracts create opportunities for self-prioritization of managers.

The most important *legal rights of shareholders* include the right to vote on important corporate matters and to elect the Board of Directors (which however in general needs not represent their interests). It is costly to exercise and enforce voting during general assemblies, and the effectiveness of such voting depends on the legislation and court protection of the voting rights of the shareholders. In many countries, shareholders´ voting rights are supplemented by the mandatory loyalty of managers vis-a-vis the shareholders. Such approach is usually accepted by courts in OECD Member States.

Big shareholders concentrate shares. They are stimulated to gather information and monitor the management, thus preventing the problems of black passengers which is so typical of fractionated ownership, where monitoring costs are covered from private funds, but the information acquired remain a public domain. Big shareholders are interested in maximizing profits and in sufficient control over the assets, their actual powers however depend on the legal protection of their votes. The problem of this mechanism is that big shareholders are stimulated to expropriate the property of the other, minority owners. Minority owners would not invest to purchase company shares unless they are sufficiently protected by law.

Big creditors, usually banks, have control similar to that of big shareholders. Their control stems from short-term credits (which forces enterprises to come back) as well as from the rights of creditors upon the enterprise becoming insolvent or upon defaulting on its credit commitments. Big creditors significantly participate in corporate governance in Germany and Japan where their rights are well secured by law. The problem of this mechanism is that the bank ownership is associated with a conflict of interests resulting in the affiliated enterprises paying higher interest rates. Also, banks may not complete projects into which they have invested but which do not generate profits, since continuing such projects may be more advantageous to them than winding them up. Debt financing is typical of enterprises with tangible assets since new enterprises usually do not have anything to offer to banks as collateral.

Takeovers are typical for the UK and the USA. Takeover means that the bidder makes a public promise to purchase shares from fractionated owners to acquire control over the management of the given company. This is a rather costly mechanism which is usually put in place after substantial failures of companies.

Leverage buyout means that shareholders of a publicly traded company are bought out by a new group of investors who usually comprise old managers of the company, a specialized company, banks and public debt owners.

The prevailing corporate ownership will be dependent upon the legal protection of investors. Since the legal protection in the continental Europe and Japan is weaker, corporate governance there depends more on big investors (sometimes families) and banks which have long-term relationships with companies. This system is sometimes called *insider* system. On the contrary, *outsider* system is typical for United States and the United Kingdom. Its characteristics include: scattered ownership of assets, big institutional investors, recognition of the supremacy of the shareholders´ interests in Company Act, protection of minority investors by Securities Act, and strong disclosure requirements. Generally, the efficiency of the corporate governance depends on the transparency of the disclosure and utilization of information, protection of legal and contract-making rights, as well as on the liabilities of the management.

The insider and the outsider systems of governance mutually converge, due to a number of reasons:

1) International portfolio diversification brings higher yields with a smaller risk compared to purely domestic portfolio.

2) companies issuing shares in international capital markets are able to reduce capital costs.

3) Institutional investors (pension funds, companies providing life insurance and mutual funds) require international governance standards to be developed.

4) Globalization in product markets sharpens competition, thus forcing companies to use efficient governance. Globalization intensifies competition for resources since domestic savings are no more monopolized by domestic companies.

Importance for transition economies

Private ownership does not guarantee an improved efficiency unless there is a detailed legal framework guaranteeing the right of the owners to exercise control, and courts willing to enforce laws. Moreover, private ownership is unable to markedly improve company performance if soft budgetary constraints prevail and if the new ownership structure prevents access to competitive external funds.

Many transition countries have failed to improve the performance of State owned companies through privatization programs which stimulated new owners to maximize property within a short-term frame to the account of other stakeholders. Why should a manager – owner prefer private benefits from control over building his reputation? A direct explanation is that managers have monopolistic information available on companies they manage, and this provides them with immediate opportunity to exchange it to make financial profits. On the contrary, reputation building may be too costly in term of lost opportunities, since the entire economic environment is too uncertain.[8] Transfer pricing and sales of assets are two ways for the manager – owner to exchange private information for profits.

In transition economies, the system of corporate governance is rather dependent on the political environment. Collusion of politicians and managers may be observed, e.g. in Russia and Slovakia. Postponement of the establishment of a framework for corporate governance may be dangerous. Studies of the economies of Eastern Asia have suggested that weak corporate governance is not only one major reason for recent crises. Their business environment, similarly as in many transition economies, used to be based on relationships with the ownership, family ties and political negotiations establishing ties among companies, banks, and the government. The government implicitly guaranteed to companies soft budgetary constraints but failed to incorporate the corresponding measures to its budget.

OECD principles of corporate governance

The principles introduced in April 1999 were aimed at assisting governments "*to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide them with guidelines and suggestions for stock exchanges, investors, corporations and other parties playing a role in the process of good corporate governance development*."[9]

OECD sees corporate governance as the key element to improve economic effectiveness that depends on the overall economic environment (such as macro-economic policy and the degree of competition in the product and labor markets), as well as on the legal, regulatory and institutional environment. A well-structured system of corporate ownership enables companies to access funds in the international investment market. The Principles cover five areas:

1) Shareholders´ rights. Generally, they include ownership rights and the right to acquire information, to vote and to have a share on profits. OECD recommends proxy voting, including voting per telephone and electronic voting.

2) Equal treatment of shareholders, including the minority and foreign ones. It is important to raise the trust of investors that the capital they provide will be protected from abuse or expropriation. This also includes the prohibition of illicit utilization of information and illicit acting on own behalf by insiders. Shareholders must be given the opportunity to initiate legal and administrative proceedings against managers and Board members.

3) Role of the stakeholders. The rights of stakeholders laid down by law (including labor code, commercial code and contract making act, as well as the insolvency act) should be protected. Stakeholders are invited to cooperate in the generation of wealth, creation of job opportunities, and sustainability of financially strong businesses.

4) Disclosure of information and transparency. Documents concerning a corporation, its financial standing, ownership and management should be effectively published. An independent auditor should perform the yearly audits. Unsatisfactory or unclear information may prevent markets from functioning, it may increase capital costs and result in poor allocation of resources.

5) Board liability. Board members should act based on full information, in good faith, with due diligence

and care, to the best interests of the company and its shareholders. They should monitor the management and be liable vis-a-vis the company and the shareholders. In some countries Boards are liable by the operation of law to act in the company´ s interest while accounting for shareholders´ employees´ and welfare interests.

Conclusion

Transition economies, in particular Czechoslovakia, embarked on the privatization process based on a simple assumption that a well defined owner shall restructure businesses, To this also corresponded the policy of postponing the adoption of some legal acts, the non-existence of the law protecting minority shareholders was thought to enable concentration of ownership thus making the exercise of ownership rights more effective. The outcome was rather poor, at the best. The countries have derived a lesson from this, telling them that no transition of previously planned economies to those based on the market principle is possible unless a reform is made of the entire system of corporate governance. At the same time, they are unable to take lessons from the static model of any developed country since the governance systems are subject to marked changes. A suitable example are OECD principles and the system in place in the United States which may be the closest to the system all states tend to converge to.

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[6] Hart (1996, p.30).

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

[8] In addition: „*If markets do not work well so as to enable businesses to thrive, because of price distortions, monopolistic power and nepotism, or administrative and bureaucratic allowances, then probably company performance will not provide too many information about the managerial abilities in the market environment*." Brada (1996, p.13)

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

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MAKE YOUR AILING FIRM A HEALTHY AND PERFORMING ONE!

Under the influence of globalization and increased environmental turbulence, the world economy has entered a new stage. Perception of the company as an economic entity is no more sufficient for successful corporate governance and securing long-term success. Economic parameters are no more sufficient. The company behaves as a living organism, and whoever is able to understand the governing principles, will be able to find the shortest way towards a successful future.

Main ideas of the paper:

- **Businesses behave as living organisms, and their „health condition" is superior to economic assessment**
- **For the future of companies, the key term is the entropy value which can be measured and corresponds to afunctionality of firm processes**
- **The firm will be able to be successful over prolonged period of time if it is able to control the amount of its entropy**
- **The ability of the firm management and of other employees to permanently cope with changes is unavoidable for the long-term success**

What are the questions that the new approach shall offer answers to?

- Will our new organizational structure be functional?
- What shall be better for my company now: to centralize or decentralize?
- What shall ISO 9000 bring to my company?
- How aggressive should we be in penetrating the new market?
- Shall we have enough money from our clients in the future?
- What shall our strategy be built on? How shall we know whether it's good?
- How to make decisions on required investments – how to verify the „paper" IRR on investments?
- Makes it any sense to invest into the firm, or is my firm „deadly ill"?
- Should we invest into technology, people or into markets? What should be the ratios?
- Should we look for new people or is there a chance to modify the behavior of the present employees?
- Does it make sense to provide my people with financial incentives?
- How to efficiently energize my employees, how to enhance their involvement to the benefit of the company?

New principles of corporate governance:

- Environmental turbulence – a risk for those who are not prepared, a huge opportunity for the others (how Slovak companies overtake the developed competitors)

- The firm behaves as a living organism, and it needs a corresponding governance
- The task of the top managers is to secure the long-term success of the company
- Economic approach is no more sufficient
- Long-term company success exists as a dynamically stable state rather than a statistical interplay of circumstances
- The long-term success depends on the internal company setting
- Full performance of the company is prevented by entropy – clocked company processes
- Qualitatively, there are two different company types – League I and League II
- The pros and cons of League I and League II:

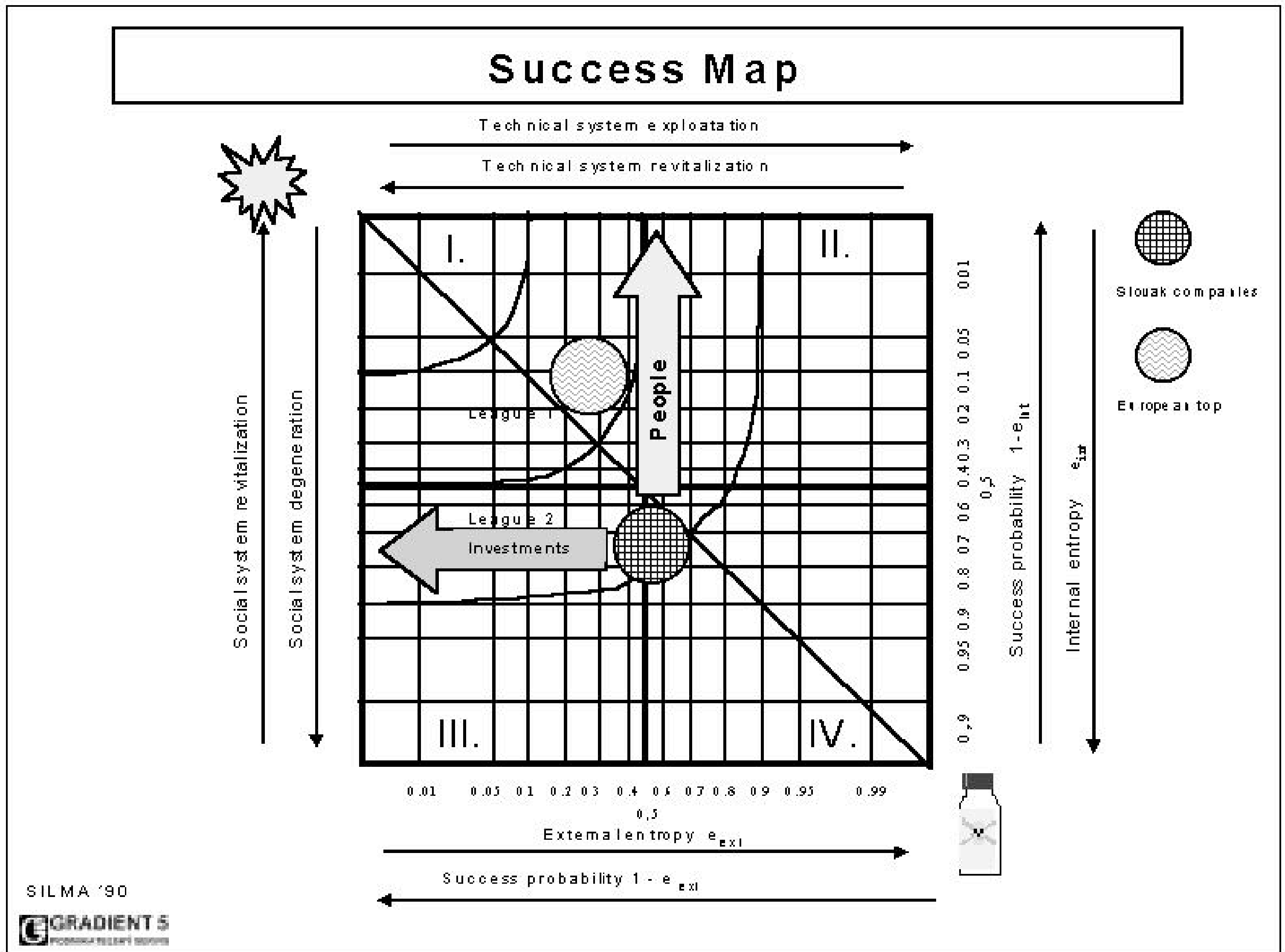
  a/ League I companies experience market oscillations, the bottom of League II is sacrificed
  b) League I decides on the existence of League II
  c/ money is allocated within League I, League II fights for what remains
  d/ League II companies assist League I companies to become even wealthier

- Differences in League I and League II behavior:
  a/ League I is motivated by excellence, and therefore it has money, League II is motivated by money (survival) and therefore it cannot reach excellence
  b/ League I implements 20% of the activities with a contribution of 80%, League II implements 80% of the activities with a contribution of 20%
  c/ League I tends to open up its environment (market globalization), League II tends to close up before the world
- The company´s entropy corresponds to the ability of its processes to function or not
- Entropy corresponds to the ability of the company to continuously undergo changes – adjust itself to the turbulent environment
- There is an effective and easy way to measure entropy
- Entropy 0.9 – clinical death
- There is life „while being connected to devices" – supply of energy (money) from the outside
- The average entropy value for Slovak and Czech companies is 0.85
- The average entropy value for successful Western companies is 0.3 – 0.4
- Entropy has two independent components – the technical and the human one
- Optimal setting of changes in a company requires localization of the company on the success map (see the Figure)

What are the practical consequences of the new approach?

- The company – as a living organism – may live forever
- A long life is not enough, what is desirable is also quality of life
- Any company may become rejuvenated – the only thing needed is to measurably reduce its entropy
- The most efficient (shortest and fastest) way towards a healthy company is to utilize the entropy-related approach
- There are ways how to make a meaningful comparison of the status of companies within the various sectors, regions or the status of various company processes
- Don't invest into technology unless having measured the entropy of the people!

- Reduction of social entropy is connected with energization of employees
- Employee energization is a task to be performed by managers
- We have such clients, employees, suppliers and other partners that we deserve
- External success can be achieved but after we have internally changed
- Don’t believe advisers who come with „proven“ methods!
- Different entropy values need different managerial methods (energization curves)



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Seminar Bulletin - Corporate Governance

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A. WHAT THE 21st CENTURY CORPORATE GOVERNANCE REQUIRES MEMBERS OF BOARDS OF DIRECTORS AND SUPERVISORY BOARDS OF CZECH JOINT STOCK COMPANIES TO DO

1. To understand what corporate governance at the end of the 20th century is all about

The major problem of the current corporate governance in the Czech Republic is the inability to generate new added value for shareholders and other investors. Today, there are but few members of Boards of Directors of Czech companies who understand that for the global era, corporate governance means responsible management of risks of business processes leading to deliberate shaping of the market value of the companies while respecting justified parties involved.

The verbal assessment, as Hrabal would put it, „Go for it, Mr.director, you have to spend efforts...“ is easier than trying to introduce measuring of performances of the Board of Directors and the Supervisory Board. The general belief prevails of some „anointed heads of the administration officers“. The appointment has usually and as if naturally brought in intellectual enlightenment and released the appointee from the obligation of critical autoreflexion. Therefore, as a rule, large joint stock companies do not have an effective structure of supporting bodies (committees) built up, they lack personnel management of the administrative body, and measurements and evaluation of the team and individual performances of the administrative body members is non-existent at all. In contradiction to Commercial Code, the professional non-executive members of administrative bodies (State representatives as shareholders) are equipped, just for the case, with mandates, and it is best to protect them with MP´s or Senate Member immunity. The report for the next decade discussed throughout the world, including the assessment of the ethics, liability and conscientiousness of the administration exercise is usually not attractive to members of our corporate administrative bodies. No doubt, all this needs to be changed.

2. To build legal awareness

The principal problem is the intricate and non-transparent legal environment. About a dozen legal standards, often without any mutual links (Commercial Code, Civil Code, Bankruptcy and Settlement Act, Penal Code, Labor Code, Securities Act, Banking Act, Investment Companies Act, accounting bills and taxation law, etc.) makes the management of personal risks associated with the membership in Board of Directors and Supervisory Board difficult. Protection of the interest of the company and criminal liability of persons authorized to act on behalf of the company in situations such as change in the company´s property structure, dissolution without and with liquidation, bankruptcy and settlement, are described, there nevertheless is a lack of willingness to adopt specific procedures, type solutions to situations from the daily practice, as well as desirable behavioral models for members of administrative bodies in such situations. Collisions between the interests of the company and the personal and collective legal security of administrative body members occur day after day. The setting up of an efficient legal support to the administrative body which at the same time would be in accordance with the interests of the company is not a priority. The expected trends in the development of the Czech commercial law, the Czech case law along with the above mentioned groups of legal standards – all this should at least once a week become subject of individual studies by administrative body members. A Board of Directors or a Supervisory Board is behind the majority of businesses which have been „tunneled“: by failing to actively cope with the legal framework of doing business, they failed to stand up to the rides of the tunnellers.

3. To understand the legal framework of how others are doing business, and to understand its specifics, which makes globalization processes easier to understand

Czech members of administrative bodies lack an overview of the principles of corporate governance beyond the frontiers of the Czech Republic. As a rule, they don't know how much effort is being spent on these issues within the EU, OECD efforts at outlining the European standard of corporate governance going across the national systems (Anglo-Saxon, German, French, Swedish systems of corporate governance) will also touch our country. Attempts to utilize strengths and to suppress weaknesses of corporate law in Western Europe, to be able to recognize the specifics of Eastern European countries, to know selected legal aspects of governance in Russia and Ukraine, and/or Canada and the US, to understand opportunities and threats of the current commercial law in China and the South-Eastern Asia, to become aware of the principles and procedures of establishment of businesses in various parts of the world – these are the basis of the understanding of the global legal framework of doing business. Here are the principles of what members of Boards of Directors should be familiar with upon their company being taken over by a foreign investor, and what they should know upon making decisions on trying to conquest new territories. The State Treasury (i.e., all of us) shall be paying billions to remedy the consequences of unsuccessful international raids of our „administrative giants", just because the Boards of Directors and Supervisory Boards have been ignorant in this area.

4. To adopt effective corporate communication

More often than not, communication within the Board of Directors and the Supervisory Board slides into funny Kondelík-like clichés, in an attempt to avoid potential conflicts and not to lose a profitable position. Both, the Board of Directors and the Supervisory Board are small social groups similar to any other one, just their members often do not have an idea about the forces operative in internal communication, and that if those forces are let to play alone, they principally act against them. Terms such as individual communication style and strategy of communication style changes seem superfluous to the „overburdened" members of Boards of Directors and Supervisory Boards. Communication between administrative bodies, effective communication patterns, communication flows from administrative bodies towards the company interior, and efficient external communication of the company markedly influence the ability of the administrative body to effectively railroad the strategic goal. With respect to external relationships, it is an important art to be able to communicate corporation objectives towards the capital market, to deliberately generate consensus with rather differentiated social groups, effective communication of the relationship to the State and the region is needed. Of the same importance is to be proficient in the art of leading strategic communication activities, to understand how State and regional policies are made and how they are utilized to the benefit of the company. Communication of conflict situations and its administration, forecasting of, and coping with serious situations which may negatively impact on the business, communication techniques and trust building in the public and the media in intricate situations, techniques of dispelling gossip, rumors and speculations must all be principally mastered. The administrative body has to positively set its relationships to the media, to develop personal skills unavoidable to be able to effectively utilize media opportunities and to take control of the situation during interviews, corporate image presentation or to be able to effectively lead a press conference. Communication is one of the most complex roles members of Boards of Directors and Supervisory Boards must be able to master if they want to be professionals. Amateurishness of the Board of Directors and the Supervisory Board with respect to internal and external communication can be fatal for the corporation.

5. Effective mastering of the corporate financing process

Members of administrative bodies frequently move at two extremes when it comes to the financing. They

a. either too thoroughly "examine the dead body", i.e. the past of the joint stock company from dozens of pounds of statements and reports, doing nothing else in good faith that this is the way they are expected to show their expertise and due diligence,
b. or delegate these activities entirely to the management, since they do not understand reporting and finances at all, and hope that everything goes well.

Both are incorrect. Controlling financial stability by the administrative body represents a specific approach to financial planing, different from executive's role. Basic and alternative ways of debt financing of the company, effective management of the long-term financial plan process, forecasting the successful

implementation of business strategies, forecasting the needs for changing the structure of assets and liabilities – all this must pass in front of the eyes of the administrative board member. The entire financial strategy as well as the split of roles between the administration and the executive with respect to raising resources to cover the needs of the company must be a result of a deliberate decision making by the administrative board. It is therefore unavoidable that at least the principles of the securitization of the company against interest and FX risks and transactions with securities (shares, provisional certificates, option certificates, share certificates, bonds, deposit certificates, investment vouchers, promissory notes, cheques etc.) be understood, and this also in situations when all these transactions are reliably managed by the executive. Control of the company's profitability is the responsibility of the administrative body as is consolidation and decisions on tax optimization. There is no need to discuss lack of professionality in the field of finances – its consequences are obviously disastrous.

6. To be successful in the implementation of business goals

Depending on chosen model of corporate governance, either the Board of Directors or the Supervisory Board becomes the strategic body of the company. Why are the success rates of the administrative bodies of Czech corporations with respect to business goals as poor? Experience from both the creation and implementation of strategies in Czech companies show how difficult it may be to prevent crisis processes and situations to occur, how companies fail in translate general assembly instructions into action. No doubts, the key competencies of any member of the administrative body include the ability to generate consensus in the strategic architecture of the company, to be ale to avoid the traps of unclearly defined expectations. The ability of the administrative body to proactively implement business strategies is a key ability. Business success means the ability of the administrative body to identify weaknesses of the strategy-forming process, to control implementation process risks. This requires knowledge of the practical tools and techniques of effective control of implementation processes. It means to orient the administrative body's information system towards the probability assessment of achieving targets of the business plan. A member of the administrative body must be able to understand the business strategy building process, he/she must be able to recognize faults and errors in strategies presented to him/her, and must be able to control risks associated with their implementation. He has to learn all of this, or he/she has nothing lost in the administrative body.

7. To manage the role of the leader during the period of global competition

The trust in the Bata-like self-salvation of privatization gradually cools down during the postprivatization period. Human dilemmas concerning corporate governance and control of private companies come markedly to the foreground: ownership, leadership and prosperity, what dimensions requirements put on the „top man" may reach, is ownership a game or exhausting slavery? Where gets success born, how to resist resonance and dependence in the executive's behaviors, what are the strengths and the weaknesses of „one man company" with respect to corporate governance and control? Are juniors and heirs formable? The diagnosis of unhealthy phenomena in the organization and corporate culture represent a difficulty to many an owner of medium-sized enterprises. Issues concerning the owner's personality, his/her leadership style and the corporate culture are pressing even the more the better the success of the company. How leaders are formed for the period of global competition, what's the life cycle of the company's „top man", what are the career stages of a manager. To what extent personal relationships should be subordinated to career and property? What does workaholism mean at the Board of Directors, and what are its impacts on the company? Can negative manifestations be prevented, and what are the parameters of a successful owner in the role of a member of the administrative body at all. And there is a lot be learned again, this time from authentic statements of private owners of large and medium-sized firms, who have experienced success as well as conflicts, and are able to openly talk about them.

Any of the principles mentioned in the foregoing paragraphs is being violated in the Czech practice day by day again. Here, I could show realistic examples of the failure of Boards of Directors and Supervisory Boards of Czech companies, many of them begging now, with more or less arrogance, to receive State subsidies. I would strongly advocate that any single penny from State funds be given to the hands of only people who **are able to demonstrate their preparedness for the role of a member of the Board of Directors or the Supervisory Board.**

B. PROFESSIONALIZATION OF POSITION EXERCISE

What is not measured, is not controlled – individual performance measurement of members of Boards of Directors and Supervisory Boards

Current practice

The often discussed topics of the Czech corporate governance also includes the issue of the remuneration of members of Boards of Directors and Supervisory Boards. The previous practice has introduced a certain standard of equal remuneration to both, the Board of Directors and the Supervisory Board. Bonuses paid to members range between five and ten thousand for each session of the collective body. Chairpersons and Vice-Chairpersons get slightly more. Some companies, then, set up larger compensation packages for the members of their administrative bodies, not infrequently at the limits of the law. All such bonuses however have a common disturbing feature: they are relatively independent of the yields on the property administered which the shareholders receive, and of the due care on the part of the administrators. What is being remunerated is the participation in the sessions, lobbying is paid, along with the provision of information, loyalty and readiness to be forthcoming to the powerful, readiness to sponsor special-interest groups (from political parties to sports and education, to e.g. environmental activities), etc. There are no standard models in place to measure and to value individual performance of the Board members.

Where are the roots of this unsatisfactory condition?

Relatively well developed criteria of remuneration of performances of the executive based on financial parameters seems to be non-transferable to full extent to be used with respect to the performance of administrative bodies. For executive boards, remuneration for administration is based on criteria used for operations or it even copies it. Problems occur when it comes to non-executive members of Boards of Directors and Supervisory Boards as such, since the time-related requirements on the exercise of their positions are not comparable with those put on the executive at all, and the executive protests against the high bonuses paid to externists. Corporation governance and management are communicating vessels, and failure of any of both is connected with a reduced performance of the whole company – in no case are the two identical categories. And it is the splitting the role of the property manager from that of the executive which cause problems to our administrative bodies. Inability to identify what administration is all about and how it differs from management, results in the fact that the administrative bodies are unable to name competencies which the non-executive members of the Board of Directors and the Supervisory Board should be equipped with, and thus they are unable to define criteria or measurable parameters of how they are being met. And that is why they don't even try to assess individual performance. It is a pity since it is one tool enabling to exert pressure on the performance of property managers and the competitiveness of joint stock companies.

What are the characteristic traits of a personality ready to govern a corporation?

A successful member of the Board of Directors or the Supervisory Board excels a manager by mainly

- ***strategic and conceptual thinking***
- ***creativity and innovative attitudes***
- ***ability to work in teams***
- ***informal leadership***
- ***ability to analyze and interpret information***

Ethics and a responsible approach to the exercise of the assumed role should be but natural. It is not difficult to take these categories to determine how they manifest themselves in the activities of a member of the Board of Directors or the Supervisory Board during the sessions, and to assess the contribution each individual members makes to the performance of the collective body. Let us show some examples.

Strategic and conceptual thinking – criteria and the level achieved

- ***targeted efforts to manage the present from the future***
- ***deliberate preference of long-term objectives, ability to operationalize strategic priorities***
- ***targeted creating of long-term competitive advantage of the company and development of***

its key abilities/skills

- ***attempts to identify and create alliances and strategic partnerships as a means to leverage the company's resources***
- ***taking care of generating long-term yields on property***
- ***prediction of the development of strategic processes in the company, and targeted attempts to deliberately control them***

Creativity and innovative attitudes

- ***application of unconventional, original ideas also beyond the borders of the existing company's experience***
- ***developing own and others´ ideas in a variety of contexts***
- ***active defense of the right for innovative approaches***
- ***open attitude to risk management, willingness to make decisions***
- ***business ambitions, drive and orientation towards opportunities***
- ***high level of creative thinking connected with team sharing***

Informal leadership

- ***endeavor to organize work, coordinate activities, accepted by the Board, time management respected by others***
- ***deliberate resolution to controversial situations through getting Board members support the own idea***
- ***deliberate forceless leading of the Board towards change of the so far differing positions***
- ***splitting problems and assigning them to smaller groups lead by individuals, and to subgroups***
- ***integration of partial positions and opinions of Board members accepted by the entire Board***
- ***readiness to delegate***
- ***readiness to make timely decisions on matters of importance to the company and assume responsibility for joint decisions***

Analytical way of thinking

- ***continuous effort to give the problem a structure and to present the problem in a comprehensive manner to others***
- ***continuous effort to identify the strengths and weaknesses of solutions suggested to strategic problems of corporate development***
- ***interpretation of developmental trends in the business environment significant for the company***

- ***identification of specific threats and initiative suggesting of steps to eliminate them***

The extent of a Board member's participation in decision making important to meet the business plan targets and effective with respect to the implementation of the corporate strategy represent his/her performance measure. The highest value, then, is being contributed by that member of the Board of Directors or Supervisory Board who is always willing to participate, in a qualified manner, on decision making in matters of high importance for the company which rather effectively affect inter-company strategic processes.

The Chairpersons of the Board of Directors and the Supervisory Board have the irreplaceable role to **putting across the establishment of a climate enabling to discuss the assessments by every individual member of the administrative body, and to set criteria for measuring individual performance. The time schedule of the Chairperson of the Supervisory Board should contain pre-determined dates to discuss both the collective and the individual contributions of every member. Such reflective meetings provide the Chairperson with sufficient documents to enable him/her to present to the general assembly a suggestion for bonuses to be paid to the individual members.**

This procedure surely will result in an improvement of the work of the administrative bodies, and thus also in an enhanced business performance of the corporation.

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INEKO

Institute for Economic and Social Reforms

Seminar Bulletin - Corporate Governance

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LEGAL ASPECTS OF CORPORATE GOVERNANCE

What does the concept of corporate governance comprise? It is essentially the rules of the game on how to govern and manage a corporation **inside** as well as rules influencing a corporation from the **outside**. Since the topic of corporate governance and the related institutional framework is rather new in Slovakia, many content and terminological issues are still unresolved. This presentation attempts to point out the broader aspects of corporate governance, namely the legal and institutional framework in which economic agents function.

Corporate Governance

- Network of **relationships** (shareholders, management, employees, suppliers, customers and third persons)
- **Rules**
- **Mechanisms and procedures**
- **Institutions**
- **Values and principles**
- **Attitudes**

Corporate Governance

- **System** that ensures the return on investment to those who invested in an enterprise
- **System of relationships in management and oversight over the functioning and efficiency of an enterprise**
- **System of rules that regulate the internal functioning of an enterprise as well as ensure the optimization of the entrepreneurial function**
- **System of public oversight**
- **System of institutions ensuring the fulfillment of the above functions**

- **System based on a combination of ECONOMIC and LEGAL instruments**

  - Economic – incentives and disincentives
  - Legal – rights, limits/prohibitions and enforcement mechanisms

<u>Rule of Law or Law-Based State</u>

The Anglo-Saxon concept of the Rule of Law (usually translated as „rechtsstat“ – a concept based on the German legal tradition in which the state plays a dominant role)

Rule of Law – System of:

- **Rules**
- **Processes which brings the rules into life**
- **Institutions which implement (or enforce) the rules through the processes**
- **Attitudes of citizens to the rules, processes and institutions**

Rules and Processes Must Be:

- **transparent and predictable**
- **clear and precise (only one interpretation)**
- **applied to everybody the same way**
- **enforceable through courts**

<u>Law and Economics</u>

Separate field of legal scholarship: „law and economics“

- **Law – collection of written-down principles and policies**
- **Law – support institution for the functioning of the economy**
- **Law – one of the supporting normative systems, together with ethics and informal rules**

<u>Role of Law in Economy</u>

Law is one of the most important normative systems in every modern society. It fulfils a key role in the existence of democracy (it protects the citizen from the arbitrariness of the state and its institutions) as well as the functioning of the economy. In the sphere of economic activity, it regulates the creation, existence and exit of economic agents.

<u>ENTRY into the market</u>

- **Establishment of enterprises, registration**

EXISTENCE in the market

- **Protection of property rights**
- **Ability to transfer these rights (contract relations)**
- **Rules on economic competition**
- **Regulatory function (e.g., regulation of natural monopolies or telecommunications)**

EXIT from the market

- **Bankruptcies (not only liquidation but also financial restructuring)**

<u>Access to Information</u>

One of the main pillars of corporate governance

One of the most effective means of protecting shareholder rights

Access to information – „disclosure“

- **Publicly traded companies – usually a higher standard of information duty than with small privately owned companies (direct correlation applies: the smaller the amount of information provided, the lower the amount of financing from external sources)**
- **Ease of access to information – for example, the commercial registry or annual financial reports on the Internet**
- **Cost of access to information**
- **The Anglo-Saxon model of broad disclosure obligations assumes that a large number of people invests (including individual investors) versus the Austrian model looking at an investor as a person able to bear the „intellectual and economic risk“ of investing**

<u>Minority Shareholder</u>

Minority shareholder – finances but does not manage (ownership separated from management and control)

Preventive protection of shareholders: ACCESS TO INFORMATION

- **Ability to review financial records**
- **Ability to attend shareholder meetings**
- **Ability to elect corporate organs**
- **Duty of LOYALTY of the management and board of directors**

ENFORCEMENT of shareholders‘ rights

* **Mainly through the court system**

Enforcement of Shareholder Rights

One of the most reliable instruments of effective protection of minority shareholders is the ability of shareholders to sue the management in the name of the enterprise. Introducing the institution of „derivative claims“ would considerably strengthen shareholder rights.

DERIVATIVE action

* **main element – precise legislative definition of the „duty of loyalty“ of managers and directors vis-a-vis a corporation and its shareholders**
* **in a derivative law suit, a shareholder „enters the shoes“ of a corporation and sue managers/directors on its behalf**

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