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Institute for Economic and Social Reforms

Seminar Bulletin - Corporate Governance

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Anton MARCINČIN
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CORPORATE GOVERNANCE: A CHALLENGE FOR SLOVAKIA

Introduction

- The delay in microeconomic reforms was reflected in inadequate investment influx. Resources available to the country were used inefficiently thanks to the existing legislation.
- A *tunnelling* became a rational behaviour of owners and managers, and is only nicer term for robbery and fraud of vested property.
- The Slovak growth as not sustainable for lack of new resources and bad employment of existing resources. The reason lies in design of legal and institutional framework of enterprising, which motivates economic agents to seek rents rather than combine efficiently production factors in order to create profit.
- Still problematic is corporate governance.[1] Schematically, regulation of the following areas is considered:

- *Company - suppliers of inputs*. Bad payment discipline is liquidating especially small suppliers. This area is solved by an Execution law no.233/1995 and amended Bankruptcy Act by its 30-days limit: para.1 (2) "*A debtor shall be declared bankrupted if it has more creditors and is unable to cover its liabilities for more than 30 days after agreed maturity day*."[2]
- *Company - banks*. In this relationship, a problem in the regulation was on both sides. The Bank supervision was a weak point, since it allowed both large and small banks to systematically issue credits disadvantageous from the very beginning to minority shareholders and creditors of banks. On the side of banks, there was no effective assurance of rights of commercial banks as creditors, so that commercial banks had no disposal of tools for recovery of unpaid credits. At the same time, valid tax legislation forced banks to replace bad credits by new credits in order to decrease their tax base by fictitious income from principle, interest and penalties. One of the results of weak regulation of relationship company - bank and insufficient activity of bank supervision is for example 100 billion debt in recovery organisation Slovak consolidation. The other result is a credit crunch. It is rational reaction of banks to the situation, in which they do not have secured their rights in any legal way. In this area, it is necessary to improve efficiency of bank supervision, currently in responsibility of the National Bank, introduce criminal recourse to managers of banks and enterprises, and increase interest of savers in bank prosperity.
- *Company - state*. If enterprise stopped to pay taxes and fees for its employees to the Social insurance, health insurance funds and National labour office, these institutions had very little possibilities to recover their claims. According to the estimations of Ministry of Finance, indebtedness of enterprises towards the state and public institution reached about 130 billion SK. The aim of Ministry of Finance is to improve and unite current legislation so that above mentioned institutions could restructure their claims (by sale to the third person, asset swap and following sale and mandating the third person to recover existing claim), forgive penalty fees and part of principle if claim cannot be recovered.
- *Managers - owners*. Enterprises with lower amount of capital are usually owned by a single person, who is able to perform monitoring and management. Enterprises that for their optimal operation need bigger amount of capital use as the source of financing issue of shares which bear certain rights to their holders. This is because of diversification of risk connected to the deposition of capital

in company on the side of investors. If rights of shareholders are in reality not enforced, enterprise cannot use this source of financing. This model requires delegation of part of rights of owners to managers, creates complications in monitoring and control of managers and a need of complex system of legislative norms and institutions regulating the relationship. Its advantage is, however, possibility to accumulate "any" amount of capital. Relationship between owners and managers is a subject of corporate governance in its narrow understanding. This area is covered by many laws, but especially by Commercial Code, Bank Act, Bankruptcy Act, Stock Exchange Act, Securities Act, Bonds Act, Act on Collective Investment and Act on Competition and legislative regulation of income tax, prescribed chart of accounts, differences between the Slovak and international accounting standards, quality of work of auditors and ability of their punishment, differences in understanding of scope and frequency of publication of enterprise and bank information, and in understanding of content requirement of reports, that currently are more seen as information for tax purposes rather than about financial situation in enterprise. In Slovak environment, understanding of position of manager and owner is usually distorted because of privatisation method - majority owner often takes over managerial function.

- *Managers - employees*. Special attention should be paid to the relationship between a company, represented by managers, and employees. Investment of employees into specific human capital (collection of knowledge and abilities, which in combination with particular capital produce output of the enterprise) should be considered sunk.[3] This is a source of interest of employees in good operation of enterprise.
- *Managers - other stakeholders*. Other stakeholders are municipalities, suppliers of inputs and other parties, whether persons or institutions, that share the interest in good operation of the company, even if this interest is not linked with ownership or employment in the company. It is generally accepted, that the company and its management must act responsibly also towards these stakeholders.

<u>Development of ownership structures</u>

- Ideally, there would be three main forms of prevailing ownership structure in Slovakia: Solo owner, majority strategic owner and dispersed owner. Investment funds were expected to become an important source of capital for enterprises and an engine of trading on capital markets. The true situation has diverted from this ideal conception for the following reasons:

- Non-existing protection of minority owners. The situation went that far that smaller than 67% shareholder could in fact be considered as a minority shareholder.
- Corrupted courts. They are, next to political instability, perhaps the second largest obstruction to economic development in Slovakia.[4] Corruption at courts may explain the best why influx of foreign direct investment to Slovakia stayed so low.
- Non-existing market tools for forced exit of companies from market, for example by bankruptcy. This area is linked to rate of corruption at courts and state interference to business sphere.
- Reluctance to disclose information, unavailability of records from commercial register, design of financial reports, reluctance of institutions to demand information from companies and make them public.
- The state support of rent seeking and different forms of the state assistance like toleration of tax and prescribed funds arrears, state guarantees, loans from state-owned banks under special conditions, public orders and toleration of *tunnelling* of state-owned companies and banks.

- The development of ownership structure happened in two phases - privatisation and post-privatisation. During the privatisation phase, nomenclature *insiders* struggled at securing the best position in the process. So for instance they achieved to cancel the second wave of voucher privatisation and to replace it by direct sales at symbolic prices. In post-privatisation phase, new owners maximised their income in different ways - from resale of a company to drafting of legislation (like a Revitalisation law).
- Investment privatisation funds (IPF) were expected that within management of their portfolio they would either actively restructure companies, or sale their shares to direct investors. However, there were two problems of governance on the side of IPF: On the one hand, owners of funds had no real chance to influence closed-end funds and usually had no chance of exit, so that the true owners of funds were their managers with small percentage holdings. On the other hand, funds

themselves appeared in a bad position of minority shareholder in companies.

- A comparison of post-privatisation development in companies originally privatised by different methods leads to the estimation that almost all companies are, or soon will be (after privatising public utilities) owned by majority or solo owner.
- A majority of the Slovak companies were forced to enter bourse because or voucher privatisation and they do not consider (especially Slovak) bourse as a source of capital, but rather only as a source of displeasure. The frequency and volume of trades at bourse is minimal. There are several reasons for that:

- Many companies are in fact closely held and do not have interest to be publicly traded. They should leave the bourse, but there is a requirement that 100% of shareholders must agree to cancel public trading of shares.
- Loss of confidence in collective investment. The regulation is such, that Join evaluation of midterm priorities of Slovak economic policy by the Slovak government and European commission (2000, p.28) states: „*manipulation with prices of shares and abuse of confidential information in trading with securities have become a norm*."
- Small and poor domestic market. Does country of five million people really needs its own stock exchange? Especially small transition countries, where a need of new legislation is great but resources too limited, should consider whether existence of national bourse has any rational ground. A domestic bourse may become an obstruction, if the very fact of its existence is the reason to limit activities of companies and investment funds.

- Corporate governance regulation is connected with development of existing companies and establishment of new companies. Therefore, from the current point of view, the reform is necessary for correction of ownership structures (usually concentration and exit of small shareholders) and restoration of trust in collective investment. From the close future perspective, the reform is necessary for development of innovative enterprises.

Restructuring of enterprises

- Several studies analysed level of restructuring of Slovak enterprises.[5] We shall assume that if adequate restructuring of enterprises was happening in Slovakia, it would be possible to observe improvements in all analysed trends already now.
- According to the data of Datacentrum (Join evaluation…, 2000, p.8.), total profit in 1995 reached 27.8bn. SK, in 1996 18.3bn. SK, in 1997 loss 2.5bn SK and in 1998 profit 31.3bn. SK. More than half of all firms in 1998 made loss.
- In 1999, certain improvement was registered in restructuring of enterprises, but still most likely it was a year of the end of recession (which went through observed period) rather than a beginning of recovery.

Corporate governance

- According to La Porta et al. (1999), the difference in ownership structures of publicly traded companies, size of capital markets, dividend policy and access of companies to outside financing in different countries is given by a design of legislation protection of investors (owners and shareholders) against expropriation by managers and large shareholders. They consider managers and large shareholders as *insiders*. An expropriation takes form either of a simple robbery of profit or a sale of output or assets to other company for lower than market price.[6] Even if this activities usually are perfectly legal, their effect is the same as a theft.
- Rights of outsiders are in general protected by the enforcement of regulation and laws. Regulation by government agencies and stock exchange contain some critical requirements on companies like disclosure and accounting rules, which are providing investors with necessary information for executions of their ownership rights. Among other rights of shareholders, possibility to sue directors or the majority for suspected expropriation is essential. In most countries, laws and regulations are enforced in part by market regulators, in part by courts and in part by market participants themselves. Countries with a common law have the strongest and countries with French civil law the weakest protection of outsiders (shareholders and creditors). Countries with German civil law are in the middle with an accent on protection of creditors' rights. The differences between legal

systems are best described as better or worse protection of outsiders a not as either protection of shareholders or protection of creditors.

- In a system of common law, judges usually make legal rules, based on precedents and inspired by general principles, like fiduciary duties.[7] Judges apply general principles even if specific conduct was not described or prohibited by law. As far as expropriation of investors is considered, judges investigate whether insiders did not violate their fiduciary duties even in yet unprecedented way. On contrary, legal rules in civil law are made by legislatures and judges cannot go beyond the exact letter of the law. As a consequence, insider that finds a way of expropriation of outsiders that does not violate explicit wording of the law can proceed without being afraid of prosecution.
- An important conclusion of La Porta et al. (1999) is that corporate governance reform should be directed towards protection of rights of outsiders, i.e. both shareholders and creditors, rather than only one of the two groups.
- There is no list of steps of corporate governance reform. But there exist several principles that such reform should be based upon:

- Rules should have a form of laws. Laws formulate financial markets.
- Legal rules must be enforceable. The goal is not to create a set of ideal rules and then think about ways of their enforcement, but rather to prepare rules that could be enforced by existing structures.
- If it is not possible to rely on enforcement of private contracts or laws by courts, then it is better to apply government regulation of financial markets.
- In Slovakia, it is necessary to make several significant changes. Commercial code requires most urgent reform in areas of co-ordination with changes in Civil code, Act on securities and Penalty code, so that expropriation of outsiders will not be perfectly legal. It is not enough to adjust Commercial code to the Directives of European union, because yet there is no consensus in this area in the union and directives hence do not form complex legal framework. It may be also considered to extract parts related to the company and create separate Company act as Germany and France have.

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[1] There was no corresponding term for ‘corporate governance’ in Slovak and Czech languages. After discussions with the Slovak and Czech colleagues, a term ‘správa obchodných spoločností’ was selected. See Marcinčin (2000a, editorial note, p.97).

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

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

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

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

[6] Transfer pricing and asset stripping.

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

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IS MANAGER THE WORST TYPE OF THE LARGEST COMPANY OWNER?

Aiming to evaluate levels of governance and management in medium-sized and large Slovak companies, the Institute for Economic and Social Reforms (INEKO) conducted a questionnaire survey in Spring 2000.

1. A description of sample data

In the selection of companies, we used the 'Albertina' database of Slovak businesses. Over 2500 Slovak companies met the following criteria:

Selection criteria:

	% of companies
Size - 50- 249 employees	79%
250+ employees	21%
Legal form - joint stock company	60%
limited liability company	40%
Type of company - active for-profit organization	
Sector - industry and services (codes 10-45, 51, 60-64 and 74).	
Predominant ownership - private domestic	77%
foreign	9%
international, predominantly private	9%
state enterprises	4%.

Through random selection, we sent questionnaires to 1,500 companies. Of these, 160 responded and gave us permission to include them in our sample. The questionnaire data were provided on an anonymous basis, which prevented us from combining 'soft data' from the questionnaires with the companies' closing financial statements. We classified questionnaire answers according to the type of the largest owner and the largest ownership share.

2. An analysis of research results

2.1. Ownership characteristics

Table 1. The largest company owners

Largest share of ownership	Type of owner (%)					
	Manager	Foreign investor	Company in a group	Domestic investor	State	Total
Medium-sized company						
0-50%	11	0	3	6	2	**23**
51-66%	4	3	1	1	1	**10**
67-100%	11	8	8	4	1	**32**
Medium-sized companies total	**26**	**11**	**12**	**11**	**4**	**65**
Large companies						
0-50%	3	0	1	1	1	**5**
51-66%	0	0	0	3	1	**3**
67-100%	0	8	4	3	6	**21**
Large companies total	**3**	**8**	**5**	**7**	**8**	**29**
Total	**31**	**21**	**18**	**18**	**12**	**100**

Source: author's calculations. The table shows the percentage of companies in which a certain owner holds x%. Percentages are calculated from the total number of companies.

In most companies, **the managers are the largest owners** (31%).

In over half of companies (53%), the largest owner has **at least** a **two-thirds** share; a minority share is held in 28% of companies, and a share of 51-66% in only 13% of companies.

A majority share of above 50%, but less than two-thirds is only interesting for a small number of investors, which is evidently related to current legislation. To make decisions such as changes to the statutes, changes to equity, or the dissolution of the company, the support of at least a two-thirds majority is required (of owners present). Many investors, especially from abroad, are interested in completely securing their ownership rights, testifying to their mistrust of the Slovak business environment.

In medium-sized companies, the largest owner has a **minority** share in 23% of them, a share of over one half (51-66%) in 10%, and a share of over **two-thirds** (67%+) in 32% of companies. In the case of large companies, the largest owner holds a minority share in 5% of them, a share of over one half (51-66%) in 3%, and a share of over **two-thirds** (67%+) in 21% of companies. **In the case of medium-sized companies, the structure of shareholders has remained fragmented; in large companies, it has been concentrated.**

Managers focus primarily on **medium-sized** companies, where they have either a **minority share**, or a majority of over two-thirds. As regards minority ownership shares, it is also necessary to take into account hidden or silent shares not in excess of 5%, aiming to avoid situation when the largest owner holds above 30% of shares, which requires a public assurance.

Foreign investors, as largest owners, usually hold **a share of over two-thirds, and a minimum of over one half**, which is related to their efforts to secure their ownership rights in an unstable environment as much as possible. Their distribution amongst large and medium-sized companies is almost equal.

The state is the most frequent largest owner in **large companies**, where it has a **majority share of over two-thirds.**

2.2. Company financing

Table 2. Company financing

Type of largest	Owner deposits	Domestic banks	Branches of	Foreign banks	Suppliers	Company in a	Public institutions	Capital market	Other form	Total

owner			foreign banks			group				
Manager	54	16	1	5	7	1	3	0	12	**100**
State	20	27	3	13	18	0	0	0	18	**100**
Company in a group and domestic investor	32	16	5	4	20	11	1	0	9	**100**
Foreign investor	41	5	9	7	17	15	0	0	6	**100**
Total	**40**	**15**	**4**	**6**	**15**	**7**	**1**	**0**	**11**	**99**

Source: author's calculations. Percentages are calculated from the total number of companies.

The **average** Slovak medium-sized and large company is financed by owner deposits (40%), domestic banks and suppliers (15% each), foreign banks and their branches (10%), companies in the group (7%), and other forms (11%) (see the last line in Table 2).

In companies with managers as their largest owners, owner deposits represent as much as 54%, and banks and their branches only 6% – banks in total represent 22%.

In companies with the state as the largest owner, on the other hand, the proportion of bank financing represents as much as 43%, indicating that they are probably able to obtain loans more easily and cheaply from state-controlled banks, or through credit guarantees, resulting in a certain distortion of the business environment as a whole.

Companies with a **foreign investor** have a larger proportion of financing from foreign banks and their branches (15%); evidently, this is linked to their better credibility and reputation amongst foreign banks, and to the fact that they can borrow more cheaply. In the cases of these companies, a larger proportion of financing comes from other companies in the same group (15%).

2.3. The provision of credit and profitability

As many as 55% of companies with a foreign investor as the largest owner have lately perceived a positive change in the behavior of banks towards their clients, while this figure is only 38% as an average of all companies. The least positive changes were recorded by companies with a domestic investor or a company in the same group as the largest owner.

Table 3. Interest rates and profitability (%) according to the type of largest owner

Type of largest owner	*long-term credit*	*short-term credit*	*return on investment*
Manager	15.42	17.45	9.58
Foreign investor	11.04	15.06	10.62
Company in the group	12.72	14.60	10.55
Domestic investor	15.56	16.73	10.77
State	12.83	12.78	9.88
Total	**13.84**	**16.35**	**10.51**

Source: author's calculations.

Table 4. Interest rates and profitability (%) according to the largest owner share

Largest owner share	*long-term credit*	*short-term credit*	*return on investment*
0-50%	14.77	17.05	9.69
51-66%	16.93	17.50	8.64
67-100%	12.70	15.23	10.83
Total	**13.84**	**16.35**	**10.51**

Source: author's calculations.

The paradoxical situation still prevails that most companies are able to obtain long-term credit at a lower interest rate than short-term credit – long-term at 13.84%, and short-term at 16.35%. This paradox applies to companies with all types of largest owners. **Moreover, both interest rates are higher than rates of return on investment, which means that a company cannot pay its loans from the project it is used to finance**. The average return for all types of owners fluctuates around the level of 10%.

Companies with managers as the largest owners borrow at the most expensive rates, which also display the lowest return on investment; in comparison to other groups of companies (with the exception of the state), as much as a 1% difference. Therefore, managers are most likely to launch ineffective projects.

Companies with foreign owners are able to obtain long-term credit at the cheapest rates. Only just under 10% of companies had interest rates of less than 5.5%, as regards companies with their largest owners being foreign investors or a company in the group. Better connections to banks and greater credibility of companies with foreign participation may be the one reason, and getting credit from companies in the same group being the other.

Companies with the **state** as the largest owner can obtain approximately the same interest rates for short- and long-term credit; moreover, this rate is relatively low in comparison with other types of largest owners. This can be interpreted as access to credit from state-controlled banks, or to guarantees by the state.

High variability, whether in the case of interest rates or return on investment, can be seen in the case of companies in the same group. For example, as regards long-term credit, the range can almost be as much as 8%. The lowest variability can be seen in the case of companies with managers as the largest owners, which means that there are no significant differences in interest rates for individual companies in this group, and that they all borrow at high rates. In the case of companies within a group and the state, we can see a high variability in return on investment; that is, companies exist with significantly lower or significantly higher profitability than average.

The trend towards provision of credit according to the type of the largest owner is beginning to appear. Companies with managers as their largest owners should, according to this hypothesis, be perceived by banks the highest-risk organizations, approximately all at the same level. Banks evidently regard companies with foreign investors or companies within a group as the most secure; however, there are significant differences between individual companies within groups.

Companies with owners holding at least a two-thirds share are able to obtain credit at lower rates when compare to the average; they also display the highest profitability, while companies with owners holding less than a two-thirds share borrow at higher rates and show lower profitability.

It seems, therefore, that the concentration of ownership has a positive effect on the price of credit, as well as on profitability. This could be caused by a better rating on the part of the creditor, as these companies manifest greater stability, and it could be expected that, with such a high share of ownership, the owner is interested in the operation of the company, not in stripping its assets. The risk of major influence by minority shareholders is also reduced.

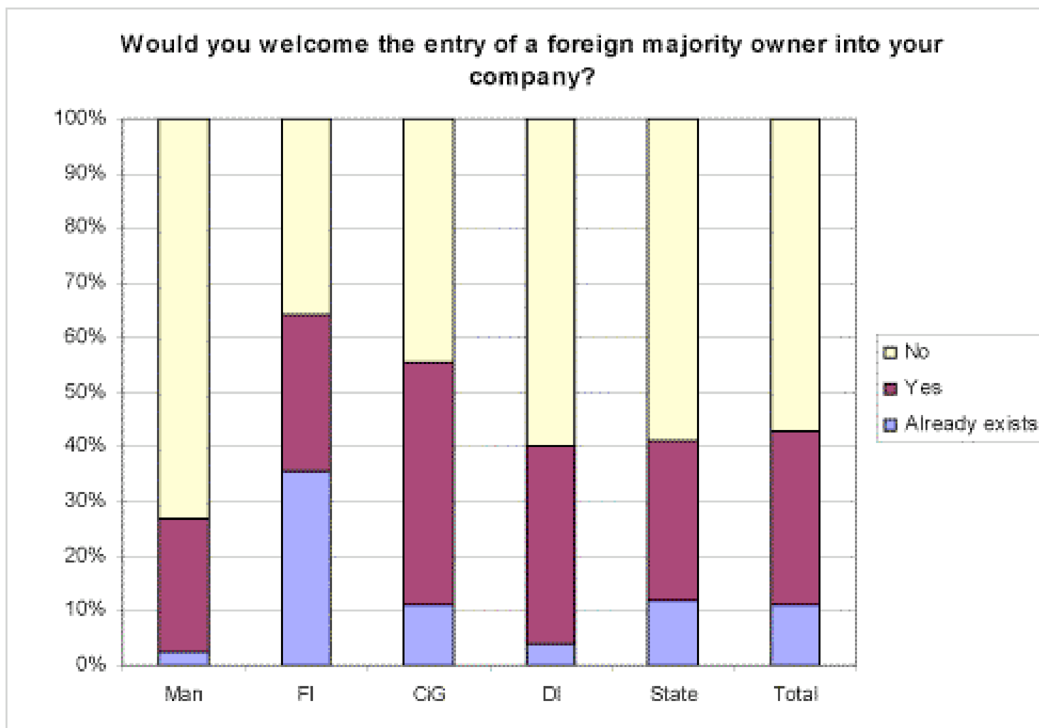
2.4. Owners and the new capital

Only just under a third of entrepreneurs would welcome a foreign investor in their company. Over a half of companies, on the other hand, would not desire a majority foreign owner. In the case of a minority foreign investor, the results are just the opposite. Nearly 60% of companies would welcome foreign capital not in excess of 50% of the company's assets, and only just under 30% do not desire a minority owner. Approximately 11% of companies already have a foreign investor.

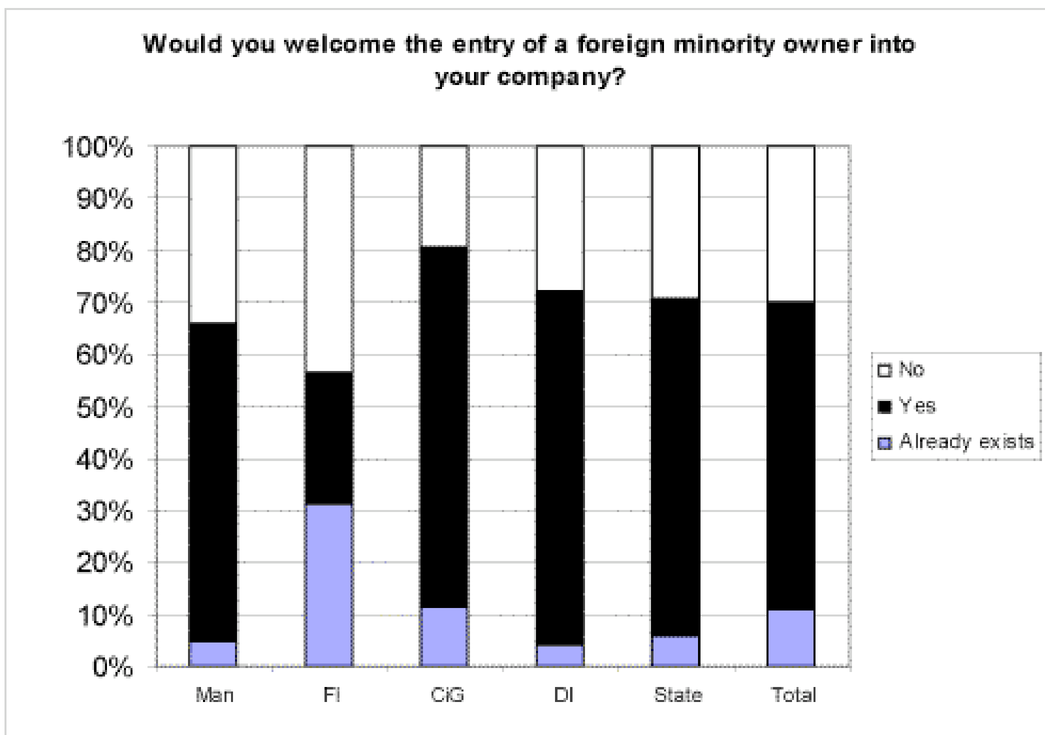
The CPHR also organized similar research in 1997. The results do not differ greatly from this year's survey.[8]

It can therefore be observed that even unfavorable overall development in the Slovak business sphere, a decline in profitability, an increase in indebtedness, and a decline in liquidity, have not caused companies to exchange their decision-making rights for foreign capital.

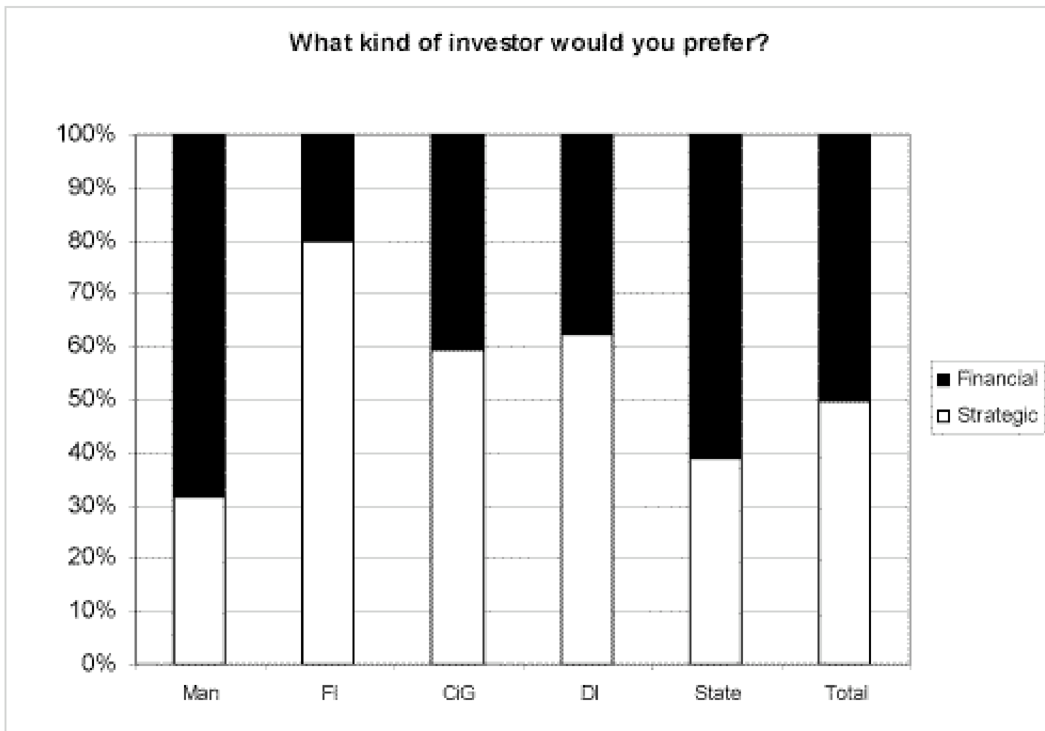
Graph 1.



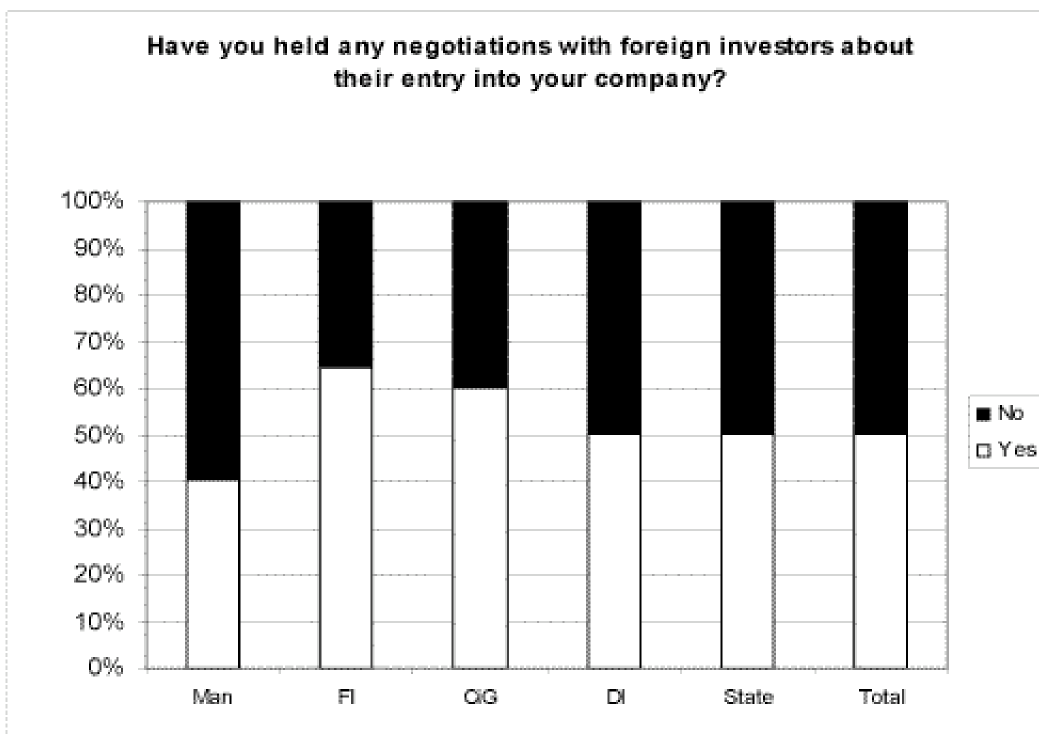
Graph 2.



Graph 3.



Graph 4.



A relatively small number of companies with managers as the largest owners already have a foreign investor (only 5%), and display the greatest aversion to both majority (73%) or minority (34%) foreign ownership, which are significantly higher values than the average of 57% or 30% respectively.

Companies with a domestic investor also have a small number of foreign investors (4%), but would be more willing to accept them in their company than managers (60% would not desire a majority, and 28% a minority foreign investor). In 12% of cases, companies within a group already have a foreign investor, and one-half of the remainder would welcome a majority, and nearly 70% a minority foreign investor.

Despite the balanced proportion in the sample as a whole (50% of businesses would favor a financial investor, 50% a strategic investor), there are significant differences according to the type of the largest owner. While managers favor a financial investor (68%), companies with domestic and foreign investors, and companies within a group favor a strategic investor (80%, 62%, and 59% respectively). The effort of managers to obtain financing without subsequently submitting control is therefore noticeable.

50% of companies had held conversations on the entry of a foreign investor; as regards companies with managers as the largest owners, this occurred in only 40% of cases.

Despite the fact that a company failed to obtain credit, only 37% of them turned to a potential investor with a proposal for entry; the most active companies in this area were those within a group and those with domestic investors (approximately 44%). In the case of companies owned by the state or managers, these figures were 23% and 32% respectively.

2.5. The rights and obligations of company bodies[9]

2.5.1. The composition of the board of directors

Members of the board of directors are mainly employed within the company; as many as 59% of companies revealed that less than a third of their board members are not their employees. In 55% of cases, two-thirds of board members even hold managerial positions. Managers are the largest owners in only 31% of companies, and in approximately half of these cases, their share of ownership does not exceed 50%. Only 9% of companies have an independent board (non-employee members making up over 2/3 of the board), and only 10% of companies have a board of directors where over two-thirds of members do not hold managerial positions.

In regard to companies with managers as the largest owners, in as many as 71% of cases, over two-thirds of

board members are employed by the company; in 61% of cases, over two-thirds even hold managerial positions.

In such cases – that is, where managers have strong representation on the board of directors – it would be logical for them to use the powers of the supervisory board – a subject to which we shall return later.

In small joint stock companies, there is also a 'lack of people', because the board of directors and supervisory board should, by law, be composed of at least three members, which is relatively expensive. Greater flexibility and operability are also reasons for the frequent conjunction of managerial functions with board membership.

Table 5. How many members of the board of directors are not employed by the company?

	Percentage share of board members not employed by the company				
Type of the largest owner	**-32%**	**33-50%**	**51-66%**	**67-100%**	**Total**
Manager	71	4	2	2	**100**
Foreign investor	42	15	0	12	**100**
Company in group	64	0	11	7	**100**
Domestic investor	45	10	17	17	**100**
State	63	11	5	11	**100**
Total	**59**	**8**	**6**	**9**	**100**

Source: author's calculations. Percentages are calculated using the number of companies with a certain type of the largest owner, and express the percentage share of companies with non-employee board members, according to the particular type of the largest owner.

Table 6. How many members of the board of directors do not hold managerial positions (in the company)?

	Percentage share of board members not holding managerial positions in the company				
Type of the largest owner	**-32%**	**33-50%**	**51-66%**	**67-100%**	**Total**
Manager	61	10	4	4	**100**
Foreign investor	48	9	0	12	**100**
Company in group	54	4	11	11	**100**
Domestic investor	45	7	14	21	**100**
State	63	11	5	5	**100**
Total	**55**	**8**	**6**	**10**	**100**

Source: author's calculations. Percentages are calculated using the number of companies with a certain type of largest owner, and express the percentage share of companies with board members not holding managerial positions, according to the particular type of the largest owner.

2.5.2. The rights and obligations of the supervisory board

In our evaluations, we only took joint stock companies into account, as limited liability companies are not obliged by law to create such a body. All the joint stock companies in our sample have a supervisory board.

Despite the fact that activities such as supervising the actions of the board of directors, overseeing the data contained in accounting books, examining the closing financial statements, and issuing reports to general meetings are required by law, the proportion of companies where the supervisory board performs such activities is low. The right to oversee the activities of the board of directors is held by the supervisory board in just under 79% of companies. In companies with managers as the largest owners, this figure is only 46%. The supervisory board oversees data in accounting books in only 65% of cases. The closing financial statements are examined in only 78% of companies, and reports are issued to general meetings in 74% of companies; in the case of foreign owners, this figure is only 56%. Other rights and obligations fall by law into the competence of the board of directors, if the statutes do not state otherwise. The number of companies where these activities are executed by the supervisory board is significantly lower in comparison with the first four activities.

The percentage of cases when rights are respected and obligations are fulfilled is always above the overall average in the case of companies with the state as the largest owner; where managers are the largest owners, this figure is significantly less than the average, and less than other types of owner, especially in the following activities: supervising the actions of the board of directors, approving and removing members of the management, determining managers' pay, and approving fundamental decisions such as strategic plans and joint ventures. For example, no supervisory board in companies with managers as the largest owners determines managers' pay; evidently, this competence falls to the board of directors, where managers have significant representation. The percentage of companies in which the supervisory board can approve or remove managers is also very low. Again, this competence probably falls to the board of directors, where the management is in a strong position and *de facto* determines its own existence.

Table 7. Rights and obligations of the supervisory board (%)

Type of the largest owner	1	2	3	4	5	6	7	8	9	10
Manager	46	62	62	69	8	0	39	38	23	0
Foreign investor	91	46	82	56	36	9	37	36	46	9
Company within a group	88	75	100	88	38	31	50	50	56	25
Domestic investor	76	67	67	71	14	14	19	19	24	24
State	93	64	79	79	29	50	50	50	64	43
Total	**79**	**65**	**78**	**74**	**23**	**22**	**39**	**39**	**43**	**21**

Source: author's calculations. Percentages are calculated on the basis of the number of companies with a particular type of the largest owner, and express the percentage of companies in which supervisory boards perform a given activity.

1 - supervising the actions of the board of directors,
2 - overseeing the data contained in accounting books,
3 - examining the closing financial statements,
4 - issuing reports to general meetings
5 - approving and removing members of the management,
6 - determining managers' pay,
7 - approving fundamental decisions: changes in ownership
8 - investments
9 - strategic plans
10 - joint ventures

2.6. Making information public

Table 8. The frequency of information disclosure (%)

Type of the largest owner	Once a year	More often	Not stated	Total
Manager	69	27	4	100
Foreign investor	64	30	6	100

Company in group	68	32	0	100
Domestic investor	52	41	7	100
State	47	53	0	100
Total	**63**	**34**	**3**	**100**

Source: author's calculations. Percentages are calculated from the base number of companies with the given largest owner.

Only 34% of companies disclose information more often than once a year, of which 20% disclose information more than twice a year. Most companies (63%) are still satisfied with the legal requirement of disclosing the closing financial statement once a year. In the case of companies owned by managers, the disclosure of information is the least frequent; only 27% disclose information more often than once a year. In the case of state-owned companies, this figure is as high as 53%. However, it is necessary to take into account the fact that managers are the largest owners mainly in medium-sized companies; the state is the largest owner chiefly in large companies.

Table 9. The method of disclosing information

Method of disclosure	Number of companies %	
In the Commercial Bulletin	82	58.6%
On the internet	15	10.7%
Other methods	64	45.7%
Total	**140**	**100.0%**

Source: author's calculations

Most organizations disclose information on management in the Commercial Bulletin, as required by law for all joint stock companies and other organizations which meet two of three quantitative criteria (number of employees, turnover, and profit). In a special analysis of joint stock companies, we discovered that only 66% of them fulfil their legal obligation to disclose information. Over 10% of companies use the internet; for companies with the state as the largest owner, this figure is 21%. Respondents stated that other methods of disclosing information include the press, the Bureau of Statistics, the Ministry of the Economy of the Slovak Republic, the Bratislava Stock Exchange, etc., which are used by 46% of companies.

2.7. Evaluating the business environment and legislation

2.7.1. Evaluating the business environment

Companies regard the unstable business environment, low enforcement of law, and non-transparency and corruption as the most serious problems. At the other end of the table, customs regulations, the instability of the Slovak Crown, and the lack of qualified employees were listed.[10]

Table 10.

Evaluation of the business environment	Grade
low enforcement of the law	4.27
unstable business environment	4.12
non-transparency and corruption	3.97
corruption and protectionism	3.88
high security payments	3.84
payment ability	3.79
insufficient access to credit	3.78
absence of action by state bodies	3.64

market instability	3.56
non-functional bankruptcy law	3.53
government economic policy	3.52
the protection of the internal market for domestic producers (certificates, licenses, customs duties)	3.12
customs regulations	2.88
volatility of the Slovak Crown	2.67
lack of qualified employees	2.40

Source: author's calculations. Grades: 1 – least serious problem, 5 – most serious

2.7.2. The evaluation of legislation

Companies were asked to grade legislation from a level of 1 (excellent) to 5 (inadequate). The Commercial Code and the Act on Securities were evaluated by entrepreneurs relatively favorably (with respective scores 2.77 and 2.86). Conversely, the worst rating was conferred on the (old) Bankruptcy Act– 4.1.

Table 11.

Evaluation of legislation	**Grade**
Bankruptcy Act	4.08
Act on the protection of minority shareholders	3.56
Regulation of the insurance and retirement payment industries	3.33
Act on securities	2.86
Commercial Code	2.77

Source: author's calculations.

Conclusion

A number of studies from abroad have shown that the worst results are shown by managers' organizations. For example, Blanchard and Aghion (1995)[11] predicted that the value of a company is different for managers and external investors, and showed that managerial ownership can lead to a sub-optimal level of restructuring and a slowdown in the sale of the company to another investor. The Transition Report 1995[12] noted that companies privatized by managers showed results inferior to those of companies privatized by external investors.

The results of this research reveal that companies with managers as the largest owners are prevalent in Slovakia, and equally corroborates their tendency to be the least effective.

If managers are the largest owners, then

- on average, they need an officially smaller share of ownership to exercise control (watch out for hidden stakes under 5%),
- they are concentrated in medium-sized companies,
- these companies have higher managerial representation on the board of directors,
- they provide the supervisory board with less authority,
- they borrow at the highest rates,
- they have the lowest rate of return on investment,
- despite the fact that they borrow at the highest rates, they are the least willing to relinquish their control due to the entry of an investor (although it is true that owner's capital is, with regard to tax aspects, the most expensive, in cases where banks do not provide credit, other long-term possibilities do not exist),

- the most significant sources of financing are owner investments and, to a lesser extent, loans,
- they call general meetings the most frequently (to approve changes in the statutes, changes in the board of directors, etc.), and
- they disclose information the least frequently.

- From this it emerges that managers with a small share of ownership which, however, enables them to control the company, are little interested in the successful functioning of the company, and completely rationally orient themselves more towards the increase of their own wealth, as long as the law (enforceable regulations or their absense) and mutual 'agreement' with the owner (within the framework of company statutes) allow.

- Distorted governance and management of companies leads to their functional failure. It would therefore be necessary to legally acknowledge and amend the relationship between the principal and the agent, because if this is not well defined, managers follow their short-term interests and reject the entry of new financing. Moreover, such organizations – making up almost one-third of the total – are not interested in restructuring or legislative changes. The development of personal wealth at the company's expense is, however, only a short-term goal, as stripping the assets of the company cannot continue indefinitely.

- Furthermore, organizations with managers as the largest owners are closed institutions, both internally and externally. 'Internally' means that they resist the entry of external investors and the division of decision-making powers to the greatest extent. On the other hand, the external business environment does not guarantee the risk-free entry of minority investors, which is connected to the poor enforcement of the law and an unstable business environment. This could mean that portfolio investments have no meaning in Slovakia, and it is only worthwhile entering a company with a majority, and even better, majority of over two-thirds. The capital market in this case does not fulfil the function of depositing free financial resources into shares.

- Although most members of the board of directors are employed by the company, or even hold managerial positions (leading to the conjunction of managerial function with membership of the board), it appears that the model using two bodies within an organization (according to German law) does not function, at least in the case of medium-sized joint stock companies, where there is a real lack of people and appointments to company bodies are carried out formally. The single-body American model would possibly be more advantageous for such companies.

Literature

Blanchard, O. and Aghion, P.: On insider privatization, MIT, 1995 Transition Report 1995, EBRD

Marcinčin, A.: Restructuring Companies, Economic Policy in Slovakia 1990-1999

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[8] Only 28% of companies would desire a majority foreign investor, while 72% would oppose the entry of such an investor into their company. As regards minority foreign participation, 64% of companies expressed support for entry, while 36% were against it.

[9] Data processed only for joint stock companies.

[10] From similar research amongst companies in previous years, it was revealed that high insurance payments, low enforcement of the law, and an unstable business environment were the main problems between 1991 and 1993. From 1994-1998, these were also high insurance payments, corruption and protectionism, and an unstable business environment. Finally, from 1998-1999, entrepreneurs chiefly complained of high insurance payments, an unstable business environment, and insufficient access to credit.

[11] Blanchard, O. and Aghion, P. : On insider privatisation, MIT, 1995

[12] Transition Report 1995, EBRD

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PRIVATIZATION BY INSIDERS: UNDER WHAT CONDITIONS DOES IT PAY OFF TO STRIP ASSETS?

Introduction

This paper presents a relatively simple model of behaviour by owners-managers in transition countries. It is based on the Slovak experience of privatisation preferring top managers or government cronies. The model tries to take into account several important features of insider control of companies in Eastern Europe. In transition countries, due to weak institutional and legal constraints and ineffective government bureaucracy, general problems of insider control are exacerbated and lead to absence of any checks on managers' activities. Therefore, profit transfers and illegal asset stripping become a management strategy that can be considered equal to other, more legitimate ones - sale to an outside investor, restructuring or 'business as usual'. Additional factors contribute to the perverse environment mentioned above: highly uncertain postcommunist economic, political and legal environment often causes probability of unpunished 'looting' to be higher than that of successful restructuring; frequent absence of interested outside investors and/or financial resources available to owners to restructure also point to illegal asset stripping as a superior option; need to invest substantial sums of money into restructuring make it less rewarding.

A general conclusion from all four versions of the model presented in the paper is that in Slovakia, the risk of illegal asset stripping by rational majority owners of a company is relatively high and constitutes a realistic option. This becomes even more true if two alternatives that can prove more attractive - sale to an outside investor and restructuring including additional investment - are removed. The manner in which the model is constructed allows it to be used for many other transition countries where there is significant management control. The reason is that the environment and its perverse incentives are largely the same though things such as prices or specific policies differ.

Policy proposals that can alleviate the problem should start from considering what variables in the model can government policy influence. The most realistic approach is probably based on taking some basic steps to decrease probability of undetected and unproven illegal asset stripping.

Underpinnings of the Model

Before constructing the model, it is important to explicitly look at factors distinguishing the environment in which the new owners are active from the 'conventional' Western business and legal environment. The following factors can be considered most important as far as privatisation and its aftermath are concerned:

1/ Underdevelopment of legal and institutional underpinnings for the market economy. This makes it very difficult for any player to rely on government or judicial system to play their role properly. Consequently, the 'rules of the game' are different. Malfunctioning courts, weak and sometimes corrupt regulators and ill-developed capital markets [Black, Kraakman and Hay 1996, p. 247] are often quoted as the most pronounced symptoms. What adds to the disregard for the law is that,

for example, "Russian enterprise managers cannot follow the law or accurately disclose their financial results and stay in business." [ibid., pp. 254-255] This is true to a degree for all the other transition countries. Consequently, breaking law for personal benefit does not constitute crossing any psychological Rubicon for managers.

2/ In addition to the overall legal and institutional vacuum, rapid privatisation created its own problems. Because of the large number of enterprises privatised in a short time span and lack of expertise, it is virtually impossible even for well-meaning bureaucracy in relevant government institutions to detect illegal asset stripping early or sometimes even gather evidence afterwards whether the bankruptcy was a case of illegal activities or an honest business failure. "These bodies suffer from much the same incompetence and political interference - habits inherited from the socialist era - as any other part of transition country government." [Frydman, Murphy and Rapaczynski 1998, see section 1.6.] Consequently, with low probability of detection and punishment, illegal asset stripping becomes a strategy that agents consider one of several essential options rather than an aberration.

3/ Due to their relative technological backwardness and underdevelopment, privatised enterprises often need a large catch-up investment from new owners. However, with such an investment, companies usually stand to gain much from the hitherto underutilised human capital and market potential.

4/ Even though this is also true of many corporations in the West, privatised enterprises in the Eastern Europe predominantly have clear owners in the sense that there is an individual or a small group controlling majority of shares. The model explicitly aims at modelling cases where managers are this group.

Strategies

In examining the outcome of privatisation in Slovakia, there were essentially four possible outcomes of such sales observed in practice. [see Miklos 1996, Miklos 1997, Miklos 1998 and Beblavy 1998]

The first strategy is illegal asset stripping. A model case is that new owners pay only the down payment and then, using profit transfers via distorted prices, loans secured by privatised company's property but effectively lent to other companies or persons and other similar techniques, empty the company. Because of the slowness of the judicial system and ineffectiveness of the government in reclaiming the companies, it often takes years to get an unpaid-for enterprise back. By that time, it becomes an empty shell full of debts.

The second strategy is sale of the company, by its new owners, to an outside investor, usually, but not necessarily a multinational corporation active in the same field. The price paid by investors is usually higher than the price originally paid to the government, with domestic buyers pocketing the difference. (Within the model, this strategy also includes a liquidation of the company by its owners even though that was an outcome seldom observed in reality. Therefore, availability of outside investor will mean either that there is a buyer for the whole company or for its parts at a price close to their liquidation value. Non-availability of an outside investor will mean that there is essentially no market for the company or its principal assets.)

The third strategy is that new owners act as proper investors, trying to restructure the company and invest into it and lead it to prosperity, the implicit assumption being that all companies in transition countries need such restructuring and investment after 40 years of Communism. This implicit assumption is built into contracts by including a requirement that new owners invest certain sums into the company during next 10 years.

There is also a fourth strategy called `business as usual' - which is that owners do essentially nothing (except for paying for the company to FNM) and run the company without restructuring, sale or looting. We can assume that value of the company will decrease substantially over the next 10 years as a result of its increasing uncompetitiveness.

Assumptions

A simple model of how certain factors determine which of the four strategies actually takes place with a given company is based on following assumptions:

1/ Our model company is a medium or large-size industrial enterprise and its business can be anywhere from food processing to steel. Because of the Communist heritage, it lags significantly behind its Western competitors in technology as well as in other areas.

- Interest rate is not included in calculations as everything is discounted to its present value.

2/ Majority ownership by managers:

- new owners, who make the decision which of the four strategies to choose, are either company's managers (predominant situation) or install themselves in this position immediately following the purchase. Therefore, in this model, managers will be considered identical to owners and they will be the agents optimising under constraints imposed by other factors. Individual or individuals holding more than 50% of shares can be considered an owner. The variable share of managers' ownership, SOMO, is thus > 0.5

3/ Need for large-scale investment:

- in addition to usual continuous investment necessary for every company, a relatively high sum needs to be invested in next 5 - 10 years to make the company viable and competitive in the long term. If the investment is not made, the value of the company will significantly decrease. For the sake of simplicity, let us equate this necessary level of investment with the actual level stipulated in the sales contract between FNM and the new owners.

- due to catch-up effect and current underutilisation of the company's market potential, the value of the company after the investment program is likely to be more than just the original value and additional investment.

4/ sales price significantly lower than the value of assets:

- the price for which the company was sold is set to 25% of the book value of its assets. In its turn, the actual down payment is only 10% of the purchasing price, thus being 2.5% of the book value. What remains to be paid in remaining 10 years is 22.5% of the book value of assets. This reflects the average actual practice in Slovak privatisation in 1995-98. [see Miklos 1996 and 1998] The managers only pay for their share of the company. Within the model, book value is equal to liquidation value.

5/ illegal asset stripping as a risk-free option equal to others:

- due to institutional and legal vacuum mentioned above, illegal asset stripping is very likely to go unpunished. The only caveat is that usually not all assets can be stripped away as much of the company's value lies in assets that cannot be utilised in illegal asset stripping.

I. Default model

Let us denote liquidation value of the company's physical assets as LV. By looking at the company as a bundle of tangible assets rather than a firm in the traditional sense of the word, it is possible to avoid complications arising from necessity of including a production function etc.

- value of the block of shares owned by managers is then LV*SOMO.

- necessary investment multiplied by managers' share of ownership: I = a*SOMO*LV, (a)

  being a coefficient of how much of the company's liquidation value needs to be invested for it to catch up with its Western competitors. a > 0.

- value of the managers' block of shares after the investment program is finished:

  (1+a+x)*SOMO*LV, x denoting the effect of previous underutilisation of company's potential. x > or equal to 0.

- value of the managers' block of shares after 10 years, if there is no major investment program: d*SOMO*LV. 0 < d < l.

- value that can be stripped away: w*LV, w denoting the coefficient of stripping potential, o<W<l.

Let us now review total costs and total revenues managers stand to gain from each strategy presented. The only identical cost is that they pay 0.025*SOMO*LV as the down payment for their block of shares and have to decide which strategy to pursue.

strategy l: (illegal asset stripping)

- they will not pay anymore, bringing their total costs to:

  $$TC = 0.025*SOMO*LV$$

- their total revenue:

  TR = w*LV (how much they can illegally strip away)

- their total profit will be:

  $$TP = (w/SOMO - 0.025)*SOMO*LV$$

strategy 2: (sale to an outside investor)

- they will not pay anymore, bringing their total costs to:

  $$TC = 0.025*SOMO*LV.$$

- they will sell their block of shares to an outside investor for SOMO*LV (what the stake is worth in assets) - 0.225*SOMO*LV.

  $$TR = 0.775*SOMO*LV$$

- their total profit: TP = 0.75*SOMO*LV

strategy 3: (restructuring)

- they would have to pay 0.25*SOMO*LV to the government over 10 years, plus necessary investment a*SOMO*LV over those 10 years:

  $$TC = 0.25*SOMO*LV + a*SOMO*LV$$

- the value of their block of shares would then be:

  $$TR = (1+a+x)*SOMO*LV$$

- total profits would be (1+a+x)*SOMO*LV - 0.25*SOMO*LV - a*SOMO*LV:

  $$TP = (0.75+x)*SOMO*LV$$

strategy 4: (`business as usual')

- **they would have to pay 0.25*SOMO*LV to the government over 10 years:**

    TC = 0.25*SOMO*LV

    the value of their block of shares, giving them potential revenue, would go down because they would further lose competitiveness:

    TR = d*SOMO*LV

    - **total profits would be:**

    TP = (d-0.25)*SOMO*LV

Summarising the total profit:

strategy 1: TP = (w/SOMO - 0.025)*SOMO*LV

strategy 2: TP = 0.75*SOMO*LV

strategy 3: TP = (0.75+x)*SOMO*LV

strategy 4: TP = (d-0.25)*SOMO*LV

Several quite unsurprising things are clear from this basic model:

a/ to use game theory vocabulary, since d<1, strategy 4 is always dominated by strategies 2 and 3 i.e. if managers can sell or restructure the company, they should prefer it to running it the old way.

b/ strategy 3 weakly dominates strategy 2. It dominates if there is a premium additional return measured by coefficient x that comes from investing into a underutilised company. If there is none, it clearly does not matter whether owners do the restructuring themselves or leave it to foreign investors.

c/ however, there are other, more interesting features of the model. First of all, let us compare TP from illegal asset stripping to TP from the presumably more welfare-augmenting strategy 2 This is particularly important if new owners are both unable to secure loan capital for the necessary investment and do not possess the necessary capital themselves - a bitterly realistic assumption in transition economies - which means exclusion of strategy 3.

The next step is to calculate, for each level of SOMO (from 0.5 upwards), what would be the value of the asset-stripping coefficient w for which the total profit from two strategies would equal. (Consequently, for w larger than the indifference value, asset stripping would be preferable for profit-maximising owners.)

TP 1 = TP2

(w/SOMO - 0.025)*SOMO*LV = 0.75*SOMO*LV

w/SOMO - 0.025 = 0.75

w = 0.775*SOMO

SOMO	equivalent w
0.5	0.387
0.6	0.465

0.7	0.542
0.8	0.620
0.9	0.697
1.0	0.775

We see that even for majority shareholders, it might be more attractive to strip their company of assets rather than sell it to an outside investor, because the indifference values of w are quite low, especially for $0.5 < SOMO < 0.7$. Because it was rare that managers were allowed to buy more than 67% of the shares, these values are particularly alarming.

d/ let us augment the model even further. It is very often the case that there is no outside investor available or willing to buy the company so strategy 2 is also excluded. ("Except for natural monopolies and a few lucrative plums such as telecoms, transport, and even television, foreigners, contrary to the region's naive belief, were not keen on buying postcommunist dinosaurs." [Frydman, Murphy and Rapaczynski 1998, see section 1.5.] There is only rarely domestic capital available for such investment.) In such a case, only strategies 1 and 4 are left to owners.

Performing analogous calculation to the one made above, indifference values of w are

computed for various levels of SOMO and for d = 0.5 (assuming the company is going to lose half of its value in 10 years if it does not manage to catch up with its Western competitors):

$$TP1 = TP4$$

$$(w/SOMO - 0.025)*SOMO*LV = (0.5-0.25)*SOMO*LV$$

$$w/SOMO - 0.025 = 0.5 - 0.25$$

$$w = 0.275*SOMO$$

SOMO	equivalent w
0.5	0.137
0.6	0.165
0.7	0.192
0.8	0.220
0.9	0.247
1.0	0.275

The w equivalents are so low as to make asset stripping a dominant strategy (it is not realistic to expect that new owners would not be able to gain at least a third of LV by asset-stripping). The result of the basic model is that in the world of weak legal and institutional constraints and little available capital that is all too familiar to entrepreneurs active in Eastern Europe, the best course for rational managers-owners possessing even majority of shares might often be to illegally strip the companies they bought of their assets, even in situations where they might be able to find an investor or continue to manage the company without bankruptcy.

2. Model with intangible assets

The default model perceived an enterprise as a bundle of physical assets. However, companies are also an organisational form, a 'nexus of contracts' [Miller 1992, p. 5] and other relationships. This is even more so in the postcommunist countries where the value of machinery, buildings or receivables is often dubious. Those assets which are intangible (brands) or not included in the balance sheet (market share, human capital) can be of a substantially greater value than physical assets. The extension of the default model in this section tries to take this into account by adding

‘intangible value’ (IV) to ‘liquidation value’ (LV) of a company. Present value (PV) of a company is thus a sum of IV and LV: $PV = LV + IV$. Within the model, this is reflected in revenues of owners (in some cases), but not in their costs - whether they pay the government for a company or invest in it, costs are based on physical assets (because they are based on the book value from balance sheets where even the brands had low valuation due to communist accounting).

Consequently, owners face the same costs as in the default model:

Strategy 1 - $TC1 = 0.025*SOMO*LV$

Strategy 2 - $TC2 = 0.25*SOMO*LV$

Strategy 3 - $TC3 = 0.25*SOMO*LV + a*SOMO*LV$

Strategy 4 - $TC4 = 0.25*SOMO*LV$

However, their revenues change in some cases:

Strategy 1: the illegal asset stripping obviously allows only stripping of physical assets. Therefore, the total revenue for ‘looting’ does not change. However, to make matter simpler in the more complex case, the asset stripping coefficient w will be left out. (In the default model, it was present precisely to reflect that large part of the company’s value could not be extracted through asset stripping.) Therefore,

$$TRI = LV$$

Strategy 2: on the other hand, outside investors tend to buy postcommunist companies not as much for their machinery or attractive real estate location, but precisely for their market share, brands and employees. So if an outside investor is willing to buy the company in the model, it is reasonable to expect that it is willing to pay for the present instead of liquidation value. Therefore, owners’ revenue

$$TR2 = SOMO*PV = SOMO*LV + SOMO*IV$$

Strategy 3: much the same applies to restructuring. It is the point of additional physical investment as a part of restructuring to increase utilisation of intangible assets. Therefore, the owners’ revenue in case of restructuring is also calculated on the basis of present instead of liquidation value. On the other hand, inclusion of IV allows us to leave out the coefficient x that represented the underutilisation in the default model where there were no intangible assets.

$$TR3 = SOMO*PV(1+a) = SOMO*LV(1+a) + SOMO*IV(1+a)$$

Strategy 4: the present value also has to be reflected in the ‘business as usual’ strategy because its aim is to demonstrate what would happen to the company’s overall value. Therefore,

$$TR4 = d*SOMO*PV = d*SOMO*LV + d*SOMO*IV.$$

We can now calculate total profits for owners from all 4 available strategies:

$$TP1 = LV*SOMO(1/SOMO - 0.025)$$

$$TP2 = 0.75*SOMO*LV + SOMO*IV$$

$$TP3 = 0.75*SOMO*LV + SOMO*IV$$

$$TP4 = (d - 0.25)*SOMO*LV + d*SOMO*IV$$

The principal difference between this and the default model is in the visible equality of strategies 2 and 3. It reflects the fact that in a model where intangible assets are included in the price, it should

not really matter who utilises them - whether owners or an outside investor. Strategies 2 and 3 can then be treated as identical. Preference of owners for either of them is then based on other factors - availability of investor, availability of funds for restructuring, personal preferences. (On the other hand, uncertainty and risk aversion extension of the default model will point out the differences between two strategies for owners in the world of uncertainty and risk aversion.)

Comparing strategies:

1. sale or restructuring vs. asset stripping:

For strategies 2 and 3 to be superior to strategy 1, $IV*SOMO + 0.725*SOMO*LV > LV$. Since we know SOMO ranges from 0.5 to 1; we can look at extreme value to get some indication of results

- for $SOMO = 0.5$, $IV > 1.28*LV$ for asset stripping to be inferior.

- for $SOMO = 1$, $IV > 0.275*LV$ for asset stripping to be inferior.

Therefore, the range of ratios between IV and LV for which owners are indifferent between these 3 strategies is from 0.275 to 1.28 as the percentage of shares controlled by owners decreases from 1 to 0.5. Therefore, although this extension of the model does not make asset stripping impossible, it shows that if substantial percentage of the company's value is in intangible assets (more than 56% in the worst case scenario of the model), selling company to an outsider or restructuring should be preferable to looting it.

2. asset stripping vs. 'business as usual strategy':

If continuation of the corporation's life without significant changes is to give owners more value than to illegally strip it bare, $(d - 0.225)*SOMO*LV + d*SOMO*LV > LV$. To give us an upper boundary, if we set $d = 0.5$ (the company in the model is a lagging postcommunist enterprise which is quite likely to lose markets or even go bankrupt in 10 years if it is not overhauled, so stipulating that even with 'business as usual' strategy, it will still be worth half of its current value in 10 years is quite generous) and then again examine range of values given by

$SOMO = 0.5$ and 1, the results are:

- for $SOMO = 0.5$, $IV > 3.45*LV$ for 'business as usual' to be superior.

- for $SOMO = I$, $IV > 1.45*LV$ for 'business as usual' to be superior

Therefore, asset stripping remains a very significant risk if the owners cannot develop or sell the company and are forced to choose between continuation without major change or pillorying the company. If they own only a slight majority, intangible assets would have to represent an overwhelming majority of the company's value for asset stripping not to pay. Also, it needs to be noted that 0.5 was set as an upper boundary and in the extremely risky postcommunist environment, its values are bound to be very low in many cases. However, to model these situations better, uncertainty is going to be introduced.

(3. We should also be comparing strategies 2 and 3 with strategy 4. However, the result there is that if $(1-d)*SOMO*LV + (1-d)*SOMO*N > 0$, strategies 2 and 3 are superior. Since $d<1$, this is obviously always the case within this version of the model.)

Conclusion: in model without uncertainty and risk aversion, but with intangible assets included in the value of company's assets, case for restructuring or a sale to an outside investor is strengthened. However, it is by no means assured. Particularly with low majorities (which, as noted above, was usually the case in Slovak privatisation), case for 'looting' is often still strong.

3. Model with uncertainty and risk aversion

In the third part, the same model is going to be augmented to take into account effects of uncertainty and risk aversion. Highly volatile economic, political and international conditions

characterise postcommunist business environment even more than they do its Western counterpart. Therefore, its inclusion is extremely valuable for the model. On the other hand, it is very easy for the model to become too complex to yield any meaningful results. Therefore, some simplification has to be made, including:

1. in order not to make the model too complex to yield any meaningful results, it will revert to perception of a company as a bundle of physical assets. The point of including intangible value in the previous model was to highlight how it might shift some of the owners' incentives towards more 'legitimate' use of their property instead of pillorying it. That point applies here as well and inclusion of intangible value would not have a major influence on what this version is looking at: how uncertainty and risk aversion influence the incentives.

2. for the sake of simplicity, amount that needs to be invested into the corporation under the restructuring scenario is set equal to its current liquidation value - LV. The effect of restructuring on the value of company's assets is denoted by constant x. Value of owners' shares, which is SOMO*LV at the beginning, would be x*SOMO*LV after successful restructuring. Since additional investment made by owners under this scenario is SOMO*LV (their share of burden of additional investment), x> 1 to give any owners a rationale to restructure. (If this is not so, the net value of the company at the present is negative which is not an option discussed within the model.)

3. again, for the sake of simplicity, 'value stripping coefficient' will be left out. It will be assumed that if illegal asset-stripping is successful, owners succeeded in transferring all of its value away and their revenue equals liquidation value, LV.

3.a. Uncertainty without risk aversion

The augmented model involves two possible principal outcomes:

a) The strategy chosen by owners fails and their revenue is zero (since all strategies involve some costs, the total profits are negative and depend on amount of costs involved). This includes the following cases:

1. in case of illegal asset stripping, the activity is detected early and proven and the company is taken away from new owners

2. in case of restructuring, the restructuring does not succeed and the company goes bankrupt, with lenders taking possession of enterprise's assets

3. in case of 'business as usual' strategy, the same applies - bankruptcy and loss of property for owners

b) The strategy chosen by owners succeeds and their revenue is equivalent to strategy chosen - in case of illegal asset stripping; it is the liquidation value of the whole company, LV; in case of 'business as usual' strategy, it is the owners' share of the liquidation value - SOMO*LV. In case of restructuring, it is the liquidation value of the owners' share multiplied by a constant x which denotes the effect of additional investment and restructuring - x*SOMO*LV. This means:

I. with the asset stripping strategy, owners succeed in transferring, mortgaging etc. of assets and profits, thus leaving it a hollow shell to be returned to the state.

2. in case of restructuring, corporation successfully reengineers itself and becomes a respected competitor in the region.

3. in case of 'business as usual', this means, that despite no restructuring, company managed to stay afloat and preserve some of its market position. (Naturally, likelihood of this is far smaller than the likelihood of a successful restructuring strategy.)

Probability coefficients for each strategy will now be defined:

a_k is the probability that the k-th strategy fails

b_k is the probability that the k-th strategy succeeds

$(a_k + b_k = 1)$

The strategy of a sale to an outside investor is not involved in calculation of probabilities as selling shares is an option available to owners, not an event guided by probability . If there is a willing buyers, the option is open, if it is not, the option disappears.

Thus, based on the assumptions of the model, we might calculate revenue from each option in the following way:

$$TRI = a1*0+b1*LV$$

$$TR2 = SOMO*LV$$

$$TR3 = a3*0 + b3*x*SOMO*LV$$

$$TR4 = a4*0 + b4*SOMO*LV$$

Costs of all strategies do not depend on outcomes and can be therefore determined regardless of probabilities (based on the previous model):

$$TC1 = 0.025*SOMO*LV$$

$$TC2 = 0.25*SOMO*LV$$

$$TC3 = 1.25*SOMO*LV$$

$$TC4 = 0.25*SOMO*LV$$

Therefore, total profits for all strategies can be calculated:

$$TPI = (bl/SOMO - 0.025)*SOMO*LV$$

$$TP2 = 0.75*SOMO*LV$$

$$TP3 = (b3*x - 1.25)*SOMO*LV$$

$$TP4 = (b4 - 0.25)*SOMO*LV$$

Profit from each strategy can be compared to other strategies

1. restructuring strategy vs. other strategies

- restructuring is superior to the sale strategy if $x*b3 > 2$

- restructuring is superior to asset stripping if $x*b3 > 0.225 + b1/SOMO$

- restructuring is superior to the ‘business as usual’ strategy if $x*b3 > b4 + 1$

Use of few examples should explain what this means:

- if there is a 50% chance that the restructuring will succeed (not an ungenerous figure given uncertainties of the postcommunist environment), $x > 4$ for restructuring strategy to be superior to the sale. The enterprise liquidation value at the time of the sale plus its equivalent in additional investment bring x only to 2. Therefore, pure restructuring (finding new markets, utilisation of underused potential etc.) would have to bring about another doubling of the company’s liquidation

value. Conclusion is that unless the enterprise has a high potential, it usually does not pay to new owners to try and develop it.

- how much this is true for the asset stripping strategy depends on the actual percentage of shares new holders own (SOMO). If it is close to 0.5 (and assuming probability bl of successful 'looting' is quite high - even close to 1) then values of x*b3 for which restructuring is superior to illegal asset stripping increase above 3. For this to be true, both the value added by restructuring and probability of success have to be high - a rare case.

- the third instance is relatively straightforward though yielding no clear answers. It defines rather than solves the following situation - owners can either try to invest large sums of money risking zero return but hoping for a much higher return in case of success or they can try to run the company without additional investment, realising they face a high chance of collapse and bankruptcy anyway.

2. other strategies versus each other

- sale to an outside investor is superior to 'business as usual strategy' if 1> b4 (i.e. always)

- asset stripping is superior to 'business as usual' strategy if 0.225 + bl/SOMO > b4 (nearly always - in the unstable postcommunist environment characterised by weak legal constraints, probability of successful 'looting' b1 in itself should be equal or higher than probability of successful survival b4 without restructuring. What adds to this argument is multiplication of b1 by 1/SOMO coefficient and addition of 0.225.)

- sale to an outside investor is superior to asset stripping if 0.775*SOMO > b1. (Uncertainty added lure to the risk-free sale compared to previous models, however if b1 is high and owners control only a slight majority (e.g. 51 % instead of 90%), attractions of illegal asset stripping can still be high.)

3. conclusion: conditions of uncertainty make it *ceteris paribus* less likely for new owners to be attempting restructuring by themselves, because probability of successful restructuring is usually much lower than probability of successful asset stripping or certainty of sale. This is not true in cases where there is both a high restructuring potential and high probability of successful restructuring. When choosing between other strategies, asset stripping tends dominates unless owners have a very powerful majority interest or the chances of being caught in the 'looting' increase significantly. If there is no available buyer, likelihood of illegal asset stripping compared to restructuring is higher *ceteris paribus* under uncertainty because the low risk of being caught in asset stripping contrasts with probability of successful restructuring which is often not high enough for restructuring to be the superior strategy for owners.

3.b. Uncertainty with risk aversion

An important factor now added to the model is risk aversion of owners. It stems from a simple fact: managers and others did not amass substantial property during the egalitarian Communist period. Consequently, value of shares in the company they manage and co-own within the model usually dwarfs their other property by magnitude of tens, often hundreds or thousands. Therefore, it is safe to guess they will be on average highly risk averse as far as the shares which constitute their only avenue to real wealth are concerned.

Risk aversion is incorporated into the model with uncertainty using expected revenue, risk premium and certainty equivalent. [see Milgrom and Roberts 1992, pp. 210-211]. Total revenue TR for each strategy is used as the expected revenue. Risk premium is then determined for each expected revenue as 1/2*r*Var(TR), r being the coefficient of absolute risk aversion and not dependent on TR. [see ibid.] Total costs which are fixed and not determined probabilistically are then subtracted. Results - certain equivalents of total profit from individual strategies - can then be compared.

To do this, variance for each strategy must be calculated. They are:

1. $Var(TR1) = bl*(1 - b1)*LV^2$

2. $Var(TR2) = 0$

3. $Var(TR3) = b3*(1 - b3)*LV^2*SOMO^2*x^2$

4. $Var(TR4) = b4*(1 - b4)*SOMO^2*LV^2$

Certain equivalents then are:

I. $TP1 = (b1/SOMO - 0.025)*SOMO*LV - 1/2*r*b1*(1 - b1)*LV^2$

2. $TP2 = 0.75*SOMO*LV$

3. $TP3 = b3*(1 - b3)*LV^2*SOMO^2*x^2 - 1/2*r*(b3*x - 1.25)*SOMO*LV$

4. $TP4 = b4*(1 - b4)*SOMO^2*LV^2 - 1/2*r*(b4 - 0.25)*SOMO*LV$

Profit from each strategy can be compared to other strategies. However, complexities arising from creating a more advanced model preclude any meaningful conclusions in the following case:

1. restructuring is superior to asset stripping if $LV*SOMO*(x*b3 + 0.0025/SOMO - bl - 1.25) - 1/2*r*LV^2*[x^2*SOMO^2*(b3 - b3^2) - (bl - b1^2)] > 0$ which is not very meaningful because it is impossible to determine under what circumstance the risk premium $1/2*r*LV^2*[x^2*SOMO^2*(b3 - b3^2) - (bl - bl^2)]$ is negative or positive. Therefore, it is impossible to say whether introduction of risk aversion increases likelihood of asset stripping compared to restructuring.

2. However, restructuring can be compared to a sale to an outside investor which can be compared to asset stripping:

- restructuring is superior to the sale if $x*b3 - 2 - 1/2*r*(b3 - b3^2)*LV*SOMO*x^2 > 0$.

Even though this expression is also complicated, isolating risk premium $1/2*r*(b3 - b3^2)*LV*SOMO*x^2$ yields some information. Since r, LV, SOMO, x and $(b3 - b3^2)$ are all positive (latter because $0<b3<1$), risk premium as a whole is positive. Since it is subtracted, risk premium (as it should) makes the risk-averse owner more likely to prefer the risk-free alternative - the sale. More importantly, we can identify the factors determining the size of the risk premium: r, LV, SOMO, x and b3. Since x and b3 work the other way in the rest of the equation (their increased value makes restructuring more attractive), the result is unambiguous only for r, LV and SOMO. Ceteris paribus, higher values of absolute coefficient of risk aversion, liquidation value or owners' share make the sale more attractive compared to restructuring.

- sale is superior to asset stripping if $0.775*SOMO - b1 + 1/2*r*LV*(bl - b1^2)] > 0$. Again and unsurprisingly, risk premium is positive which increases attractiveness of the sale ceteris paribus, r, SOMO and LV unambiguously contributing to it.

3. The same applies when comparing a sale to an outside investor to the 'business as usual' strategy, where the former was always superior to the latter even without risk aversion which

only increases its allure: $SOMO*LV*(1 - b4) + 1/2*r*SOMO^2*LV^2*(b4 - b4^2) > 0$.

4. A more complex situation arises when two risk premia 'clash', i.e. are involved. One of these cases was already set aside as too complicated. The remaining two yield some information:

- 'business as usual' strategy is superior to asset stripping if

$LV * [(b4 - 0.225)*SOMO - b1 - 1/2*r*LV*(SOMO^2*(b4 - b4^2) - (bl - b1^2))] > 0.$

- restructuring is superior to 'business as usual' strategy if

$LV*SOMO[x*b3 - 1 - b4 - 1/2*r*LV*SOMO(x^2(b3 - b3^2) - (b4 - b4^2))] > 0.$

The finding in the previous versions of the model was that asset stripping is usually superior to 'business as usual' strategy. Inclusion of risk aversion into the model strengthens this argument if $SOMO^2*(b4 - b4^2) > (b1 - b1^2)$. If the inequality sign is reversed, risk aversion makes asset stripping less likely. Because of the shape of the $b - b^2$ curve, the results are ambiguous. The same applies to restructuring vs. 'business as usual' strategy.

Conclusion

In this paper, a relatively simple model of behaviour by owners-managers in transition countries was introduced. In transition countries due to weak institutional and legal constraints and ineffective government bureaucracy, general problems with insider control are exacerbated and lead to absence of any checks on managers' activities. Therefore, profit transfers and illegal asset stripping become a management strategy that can be considered equal to other, more legitimate ones - sale to an outside investor, restructuring or 'business as usual'. Additional factors contribute to the perverse environment mentioned above: highly uncertain postcommunist economic, political and legal environment often causes probability of unpunished 'looting' to be higher than that of successful restructuring; frequent absence of interested outside investors and/or financial resources available to owners to restructure also point to illegal asset stripping as a superior option; need to invest substantial sums of money into restructuring make it less rewarding.

To capture the situation, a simple model was constructed to look at incentives owners face when choosing between the four strategies. In addition to perverse environment depicted above that applies to all postcommunist countries, it reflected the specifics of the Slovak way of privatisation - low prices and their division in instalments paid over the period of 10 years. Value of the corporation was defined as a sum of the liquidation value of its physical assets.

The results of the basic model were that perverse incentives can account for a seemingly ludicrous situation - majority owners pillaging their own company. Asset stripping becomes particularly attractive if the managers own only slightly more than 50% (the usual case in Slovak privatisation) The less those who control the enterprise owns the more profitable it is for them to steal from the company as a whole compared to gaining from their share only. (Also, due to the cumbersome bureaucracy, asset stripping strategy meant that owners paid only the down payment for the company and managed to empty it before the government was able to reclaim it. Therefore, it saved the owners significant costs vis-à-vis other strategies.) Particularly alarming was the finding that even if owners had alternatives such as a sale to an outside investor or restructuring the company themselves, illegal asset stripping could often be financially superior. On the other hand, something that can be called the 'trap of empty hands' was also considered. If (as is often the case) there are no funds or investors available, new owners who are supposedly millionaires face only one legitimate option - 'business as usual' with no investment and restructuring - vis-a-vis increasing competition in their markets. In such a case, it is easy to see what the basic model documented: it usually pays off to owners to salvage even a part of their new property by illegal asset stripping rather than face decreasing value of the company that is trapped by lack of funds and investment (not to mention high probability of bankruptcy).

In following sections, more complex modifications of the model were introduced and their effect on conclusions drawn from the basic model were analysed.

The first modification examined what happens if the company's value is considered to rest not only in its tangible, but also in intangible assets such as brands, market share or human capital. The result was that such a model increases payoffs for strategies other than asset stripping compared to the previous one. Therefore, it partially offsets fears that illegal asset stripping is nearly inevitable for rational owners. However, even with intangible property, such outcome is by no

means assured. It appears again that if owners' share consists of little more than 50%, there might be significant attraction to asset stripping compared to sale or restructuring. This is not true, however, if value of intangible assets is higher than value of the tangible ones. More disturbingly, while this modification increases attractiveness of 'business as usual' strategy, it still pales compared to asset stripping unless company's value lies overwhelmingly in its intangible assets. Therefore, 'trap of empty hands' still applies.

The remaining two augmentations of the model took into account how uncertainty and risk aversion influence owners' incentives. (In order not to make the model overly complex, it reverted to perception of company's value as consisting purely of tangible assets.) In the previous two models, outcomes were deterministic based on coefficients. In these modifications, probabilities were assigned to outcomes.

Uncertainty alone increases attractiveness of sale to an outside investor precisely because it entails no uncertainty. The finding is that unless there is high probability of successful restructuring and significant underutilisation of the company at the moment, restructuring would not be the preferred alternative. Instead, two most likely ones are asset stripping and sale. ('Business as usual' should not be an option again as 'trap of empty hands' continues to apply.) However, even though uncertainty added to profitability of sale compared to asset stripping, expected high probability of successful 'looting' largely offsets it. Also, if there is no investor, likelihood of asset stripping is high.

The last modification of the model incorporated risk aversion of new owners which is likely to be significant as their shares in the company usually constitute an overwhelming percentage of their property. Inclusion of risk aversion made the model sufficiently complex to prevent any numbers from emerging, but it offered some comparison with uncertainty without risk aversion. The result is that sale to an outside investor is made more attractive in comparison with both restructuring and asset stripping strategies by increasing following variables: risk aversion coefficient, value of companies' assets and percentage owned by managers. In other respects, it was not possible to draw unambiguous conclusions.

A more general conclusion from all four versions of the model is that in Slovakia, the risk of illegal asset stripping by rational majority owners of a company is relatively high and constitutes a realistic option. This becomes even more true if two alternatives that can prove more attractive - sale to an outside investor and restructuring including additional investment - are removed. The manner in which the model is constructed allows it to be used for many other transition countries where there is significant management control. The reason is that the environment and its perverse incentives are largely the same though things such as prices or specific policies differ.

Policy proposals that can alleviate the problem should start from considering what variables in the model can government policy influence. The government can take steps to decrease probability of undetected and unproven illegal asset stripping. Examples of those are:

I. government's public pledge it will thoroughly investigate all bankruptcies of privatised companies. This increases the probability of ex post asset stripping detection. Such measures should discourage primarily those owners who are not willing to face criminal proceedings or escape abroad.

2. mandating more openness for all privatised companies - duty to publish regularly (e.g. quarterly) most important financial documents.

3. transferring the burden of watching new owners to other, more vigilante actors. Those should be primarily employees or banks. This can be achieved either by transfer/cheap sale of shares in privatised enterprises still remaining under government control to either of these two groups.

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Institute for Economic and Social Reforms

Seminar Bulletin - Corporate Governance

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CORPORATE GOVERNANCE – FINANCIAL ASPECTS

As its title suggests, this paper deals with certain financial matters. First, it is necessary to explain what we mean by Corporate Governance, an English term hardly used in Slovakia up till now, and to translate it. Before we start any discussion about financial aspects of this term, it is also necessary to look at its much broader context.

Almost everything around us is affected by financial matters and itself has some influence over them. In addition to finances, the field of Corporate Governance is connected also to such different disciplines as microeconomics, organizational economics, organizational theory, information theory, law, accounting, management, psychology, sociology, and politics. Each of them can view Corporate Governance in a different light, not unlike the group of blind people in the well-known story, who attempted to describe an elephant through their touch, each touching a different part of the animal's body.

The approximate translation of the term Corporate Governance could be "rule inside a company" or perhaps "administration of a company" in a broader sense. Below, we will be using the latter meaning, being aware of its deficiencies, and the new character of the topic not only in central but also in western Europe. In this regard, we need to note that unambiguous understanding of expressions by all relevant parties is of key importance because words are the basic tools for thinking. If we use the wrong words, we will arrive at the wrong conclusions, even if using the same facts. The situation is particularly problematic when a word has a different meaning for experts, whether economic or other, and the wide public.

Consistency is of fundamental importance when it comes to such terms as "company," "shareholder," "control," "administration" or "governance" which can be understood quite ambiguously. Equally often, the term "governance of a company" wrongly denotes activities which would be better described as "management/administration/organization of the board or supervisory board," or perhaps "management/working guidelines of an organization or its board."

According to one definition, ***corporate governance describes factors influencing its institutional processes, including designation of supervising and regulatory bodies which organize the production and the sale of goods and services.***

Such definition of corporate governance applies to all types of companies and organizations even though publicly traded companies are affected by more external factors. Such outside influences are exerted by the so-called **company stakeholders—**people who influence activities of a publicly traded company in some way. The term "regulatory body" includes not only outside bureaucrats but also managers inside the organization.

One interesting definition of a **stakeholder** states "*Stakeholders can be identified by potential damage they can suffer and potential benefits they can gain as a result of the company's activity or inactivity.*" "*Strategic stakeholders*" are then "*those groups without whose help the organization would cease to exist.*" The table below shows typical kinds of stakeholders who have influence over the functioning of a publicly traded company:

Influences from the private sector	***Examples of relevant***

	legislation/regulation/guidelines
customers	business practices
competition	anti-monopoly measures
shareholders	regulations on company stock
employees	labor and any relevant legislation
trade unions	arbitration trials, etc.
suppliers	rules of fair business practices
banks and financial entities	credit standing, bankruptcy action
auditors	Commercial Code
stock exchange	trading, public announcements, tax issues
media	environment
professional bodies	quality

Other important terms and their possible definitions include:

Control – "*any process in which a person, a group of people, or an organization determines, i.e. intentionally influences, what other people, groups or organizations should do."*

Regulation – in contrast with control, this term includes also an element of a performance standard required by a company manager or an outside institution.

Managing – "*communicating responsibilities for a specific work performance to individual members of the organization."*

A different definition of **corporate governance** states that *"corporate governance is a process through which companies respond to demands and wishes of their stakeholders."*

Other fundamental concepts in any discussion about corporate governance include the concept of agency and related agency costs, the concept of accountability and related moral aspects such as honesty and self-control of members of the board and the supervisory board.

The understanding of corporate governance varies significantly in individual countries, also according to their culture and traditions. Why is this issue interesting and relevant for Slovakia? The fundamental argument is that economic activity and good prosperity can only be achieved through high standards of corporate governance which includes a comprehensive set of relations between its management, board of directors, supervisory board, shareholders, and other stakeholders. Governance of a company also provides a structure through which its goals are set, as well as tools for their fulfillment and performance monitoring.

Corporate governance represents only one part of a broader economic context in which companies work and which includes also macroeconomic policy, level of competition, and production factors. The framework of governance depends also on a specific legislative and institutional environment. Such factors as business ethics and corporate awareness of environmental and social interests of the local community can also have an effect on its reputation and long-term prosperity. We need to consider that there is no single correct model for corporate governance. There are, however, a great number of examples of good practice, which can be followed.

Well aware of these facts, OECD initiated development of standards and guidelines for high-quality company governance in 1998. These standards focus mostly on companies in OECD countries, with publicly traded stock. The resulting guidelines can, however, be used by other companies and organizations. We need to note that the above-mentioned standards and guidelines are not binding which gives companies even higher motivation to comply.

Narrow financial aspects of corporate governance relate to such issues of company behavior as:

- compliance of processes, measures and accounting and record-keeping guidelines with the legislation and the best practices;
- accountability to shareholders, providing sufficient information and supporting notes, while maintaining a balance between transparency and strategic interests of the company;
- development of mechanisms for and performance of efficient internal control and internal audit;
- objective evaluation of members of the board of directors and the supervisory board;
- using professional advising services by members of the supervisory board and the board of directors;
- relations with an external auditor, the issue of professional responsibility, changes of auditors, and level of auditor responsibility for final reports; and
- issues of dishonest behavior, fraud, and embezzlement.

The level of compliance with the principles of good corporate governance in a particular society becomes an ever important factor in investment decisions. Of particular importance is the relation between governance and an increasingly international character of investing. Globalization of capital flows gives companies access to greater sources of financing. Therefore, companies able to introduce and maintain higher standards of corporate governance will enjoy an incomparably better position regarding competition in mid- and long-term.

There is only one conclusion for Slovak companies: it is good to get to know the best world practices in corporate governance as soon as possible and to start implementing them in the interest of one's own prosperity and the prosperity of shareholders.

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Seminar Bulletin - Corporate Governance

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THE SIGNIFICANCE OF INFORMATION FROM THE VIEWPOINT OF THE COMPANY

If you were asked the question, "what is the significance of information from the viewpoint of the company?", you would surely agree with the opinion of P. F. Drucker, one of the greatest analysts of the future and the founder of the science of management. In his article 'The next information revolution'[13], he relates that information access represents a fundamental condition for company success. According to Drucker, it is no longer about application of computer-generated, information-rich economic models, which will themselves determine and drastically alter the processes into which they are introduced. It is about using information in the management of the company in such a way that managers will make judgements based on information. They will be able to respond flexibly to demands and needs of the company and its environment.

P. F. Drucker[14] has identified information which serves to create wealth and information about the results. He then divided company information into:

- **tactical information, which serves to direct the day-to-day operation of the company,**
- **strategic information, which deals with the external environment (information about the markets, commercial and non-commercial partners, technical advances in the field, world finance, and changes in the world economy).**

Tactical information is produced by the company; it is greatly detailed, but is internal in character. The prosperity and long-term existence of the company is, however, in the centre of attention for a number of interested parties – long- and short-term creditors, shareholders, and competitors. These external interested parties do not, as a rule, have access to all internal information. From the available resources, they need to ascertain primarily ownership relations, in order to evaluate the long-term perspective of the company's operation and the fulfilment of company strategy. They also need to ascertain financial information, with the aim of analysing the company's financial stability and minimising risks. The public themselves may search for registration data on a particular company, and state institutions are also especially interested in financial data. Employees should display constant interest in all the available information on the company, in order to scrutinise that from internal sources through external information; this is especially relevant in domestic companies.

Experience shows that the need to obtain and utilise available information on the external environment has asserted itself in many of our companies a great deal earlier (even though certain reserves remain in this area) than their need to provide such information about their own company. Managers in Slovak companies often still resist to provide such information. Sufficiency of information on the company is, however, a certain cohesive element and a representation of the wider economic environment in which, and to the benefit of which, a company develops its activity. Access to such information can be equally regarded as a certain sign of social assurance. It is undoubtedly in the interests of a good and thorough manager that the company under his direction creates a positive image to the outside, and is perceived as a trustworthy, reliable partner and an employer with good prospective. Only the path of openness and transparency leads to this, on which it is necessary to comply with legal regulations on the provision of company data.

The Company as a Provider of Information

In order to prevent information vacuum, legislature defines certain company data to be public and available to anyone; this should not be taken to mean, however, that access is necessarily free of charge. It is concerned with registration (identification), financial data, and some additional data, which create a more realistic image of company's operation and prospectives. Legislature on this issue is necessary, also in order that the information requested should be provided by companies in an equal structure, so as to allow comparison. This process is in accord with European Union directives.

Registration Data

Basic identification data on commercial organisations, cooperatives, and foreign entities, and on other legally defined legal bodies, are filed in the Business Register[15]. This public list is maintained by the registration court. Any new entries or changes to it are published in the Commercial Newsletter. Identification data on sole entrepreneurs who work on the basis of a license are filed in the Register of Sole Entrepreneurs[16]. Offices for Sole Entrepreneurs register such information for all entrepreneurs in their administrative area. The Register of Economic Subjects is maintained by the Statistics Bureau of the Slovak Republic[17]. An entrepreneur is obliged to register with the appropriate tax administrator[18] within a legally define time period.

Since 1992, the European Union has been developing the EBR project – the informational interconnected European Business Register, with information accessible on-line. A similar information system was created in the Czech Republic under the name ARES – *A*ccess to *R*egisters of *E*conomic *S*ubjects. Its database is accessed directly through the FINet network of the Ministry of Finance of the Czech Republic. Expansion of the ARES system requires the interconnection of public data with the aim of enabling access from one location to the most significant business-related databases and registers in the Czech Republic.

Starting on January 1, 2000, the Ministry of Justice of the Slovak Republic is planning a project to make data from the Business Register available on the Internet. In connection with this project, it is necessary to proceed towards the interconnection of public registers, and furthermore, towards the interconnection of public information. The goal is to make it possible to identify an entrepreneur or commercial organisation in all public registers. This would allow certain level of verification of legitimacy of registration in a particular register, and eliminating the possibility of misuse through the registration of non-existent entities.

Financial Data

The scope of financial information, which a company is legally bound to publicize, submit, or announce in Slovakia depends primarily on its legal status. A high level of transparency is fixed by law for joint stock companies[19] and state enterprises[20]. According to Slovak legal provisions, joint stock companies and the issuers of publicly traded securities[21] should be the most transparent. In regard to commercial organisations, limited liability companies and cooperatives[22] are also conditionally obliged to provide information if, in the year preceding that in which the evaluation of the financial statement is performed, they meet at least two of three conditions (pertinent to the amendment of the Act on Accountancy of November 18, 1999):

a) the total sum of business assets exceeded SKK 20 million,

b) their net turnover exceeded SKK 40 million, or

c) their average number of employees exceeded 20.

Information obligation is also held by agent companies, which administer the property of share funds, and financial institutions.[23]

In the Slovak Republic, a transparent joint stock company or the issuer of publicly traded securities, which fulfils legal provisions, should make available the most information about itself in the following way:

- **to publish data from audited accounting reports to the minimum extent set out by measures of the Ministry of Finance, in the Commercial Newsletter,**
- **to write an annual report, subject to audit, which should be submitted along with the financial statement within the specified time limit to the appropriate registration court, and should contain the following information: data from the financial statements, an auditor's report on the closing financial statements, important facts related to the closing financial statements, and a clarification of the previous and predicted business trends and the financial situation,**
- **to publish in the Commercial Newsletter, from the closing financial statements consolidated by audit[24], data to the minimum extent set out by measures of the Ministry of Finance and to write an annual report,**
- **to prepare, and publish within the specified time limit, a prospectus of a security paper, including basic information about the issuer, financial situation of the issuer according to the IAS, data on the issuer's area of trade, and data on the security paper; for evaluation of the financial situation, the issuer must submit the most current Profit and Loss Statement of the current year, not older than three months, and yearly financial statements for the preceding two years, complying with the IAS and evaluated by an auditor,**
- **to publish, within the specified time limit, a report on its economic results for the first half-year (the half-yearly report), which must contain a report on economic results for the previous half-year, including a report on the financial situation, major facts related to the previous half-year, and information concerning the expected economic and financial situation in the half-year to come,**
- **to publish, within the specified time limit, an annual report on its economic results, which must comply to the International Accounting Standard (IAS), and the International Information Standard (MDA), and which must include an audited financial statement, including a report on the financial situation, major facts related to the previous year, and information concerning the expected economic and financial situation in the year to come,**
- **to submit a report on economic results to the state supervisory body and the administrators of the public market for trading security,**
- **to allow, if so requested, the shareholder to examine the half-yearly and annual reports; administrator of the public market on which the issuer's securities are traded, is obliged, for a fee, to make available the issuer's half-yearly and annual reports,**
- **to notify without delay, over the course of the year, of any changes in its financial situation, or other facts which could cause a significant change in the value of the issued security, or impair the ability of the issuer to fulfil its obligations from the issue of the security and, according to demand, make them public,**
- **to submit, within the specified time limit, two copies of a balance sheet and income statement to the appropriate tax authority, together with an income tax statement; one copy of the annex is provided (the law does not stipulate that these data be made public),**
- **to inform, in writing and within the specified time limit, the Centre for Securities[25] and the issuer of increases (decreases) in the legally set limits, as well as the amount of its stake if it comes into possession of publicly traded shares, which represent more than a 5% 10%, 20%, 30%, 50%, or 65% stake as a total of the nominal values of all the shares of one issuer,**

with which voting rights are connected.

From the viewpoint of the company, it is important to follow the laws stipulating which institution should provide which data, and within what time limit, even though this is not an easy task, due to complex formulation and frequent amendments. The legislature also has certain gaps, which means that companies can interpret the law in various ways. This applies, for example, to the inconsistent differentiation between the terms 'yearly report' and 'annual report' in the Act on Securities, while the contents of annual report is defined by the Act on Accountancy, and cannot equal that of the yearly report. In addition to their contents, the annual and yearly reports also differ in timing of audits set the law. The Act on Securities does not provide a closer definition of 'the nation-wide periodical publishing stock market reports'.[26] It is, therefore, unclear where it is possible to regularly find data published by the Centre for Securities. The imposition of sanctions is also problematic, which are specified in a number of laws for the non-observance of obligations to disclose, submit, and notify of specified data. For example, the obligation to disclose data in the Commercial Newsletter is clearly not subject to supervision, and the time limit for their disclosure is not legally specified. A certain contradiction can also arise from the fact that the Commercial Newsletter is published by the Ministry of Justice, while the extent of financial data to be disclosed is determined by the Ministry of Finance.

Apart from legal obligations, companies can also provide certain identification or financial data voluntarily, with the aim of enlisting in a system of commercial information for the appropriate fee, which serves as a source of information for business partners both at home and abroad. They can also provide data by filling in a form, or participating in surveys. Their aim is to achieve a good position in the top list of a significant periodical, thus making their image more positive and publicity stronger.

The Company as a User of Information

To search for information in paper form is time-consuming, and therefore rather ineffective. The electronic media, on the other hand, can literally bury the user in information. The electronic world of information today, thanks to the Internet, has practically no limits; the distribution of information is also assisted by data carriers with an ever greater capacity. It is ever more important in this maze of information resources to orient oneself effectively and obtain the required information quickly. As this document also states, it is essential to be familiar with valid legislation, and at the same time, it is necessary to follow information on the economic environment.

The demand for up-to-date legal information can be met by electronic collections of laws or systems of all the up-to-date legal information, accessible in user-friendly form, especially with regard to research. It is no longer possible to cover the economic environment with one resource; electronic resources originate on the basis of data of both public and non-public nature, or those individually obtained. Public registers, official bulletins, and data from the capital market in particular inform about the microenvironment; the macroenvironment is covered by comprehensive statistical data and regularly monitored macroeconomic categories.

In the attempt to obtain information on Slovak firms, it is possible to use data from the micro-level, identification data from the Business and Sole Entrepreneur's Register, from the Statistical Register of Economic Subjects, as well as data from the official Commercial Newsletter, which are contained in the following products: 'Obvest' from Junkers Software Prešov, spol. s.r.o., 'Infosystem Slovakia' from Europrint spol. s.r.o., and 'Company Monitor' from Albertina Data, spol. s.r.o. Information is provided on CD-ROM, or on-line through the Internet. The extent of data offered by these resources does not differ as a rule – the difference lies in the software tools and the form in which the data is accessible by the user. Current validity of the information depends not only on the frequency of updates provided by the publisher, but also the method of connection to the original data resource, which is processed into electronic form. In addition to data from the registers, users of the above information resources are also focused on financial statement information. However, this is where the greatest deficiencies can be seen, translated into the electronic information product from the original source – the Commercial Newsletter. The problem lies in the insufficient breadth and quality of published financial data, and is the result of disrespect for the legal obligations to publish data and, at the same time, the failure to observe the prescribed structures of data published. In order to utilise these resources for analysis of the

company's financial situation, it is necessary to apply high-quality analytical software capable of checking entries and links between statements. Some of the electronic resources also enable the export of data into various formats; however, without thorough checks, it is not possible, for example, to aggregate financial data with the aim of analysis of a particular business field.

The source of financial data, the information resource on market prices and ownership shares in a company, is the capital market. The minimum range of data from the Information System on Issuers – the ISE, which is run by RM-System Slovakia, a.s., is available on CD-ROM under the title 'The RMS Book of Facts'. This electronic book of facts has three user formats for the examination and analysis of data – HTML, DBF, and MS ACCESS. Selected data for 1998 are accessible on the Internet. The information is reliable, the financial data are less wide-ranging than published data, and the circle of providers is confined to organisations with securities registered on the RMS market. Through the Internet, the latest information is offered by both licensed organisers of the capital market – apart from RM-System, also the Bratislava Stock Exchange, a.s.; RM-System also offers this information on-line.

The information product 'Financial Analyses' has been created on the basis of non-public sources. The Bank Accounting Centre of Slovakia, a.s. (BZCS) offers a CD-ROM under this title, offering statistical characteristics of business fields, divided according to to the OKEČ classification. They are based on the widest database of information from financial statements in both comprehensive and concise formats, submitted along with tax statements. Thanks to checks on data entered, characteristics of business fields are reliable, and can be applied to compare the company with the sector, or different fields against each other. The resource base cannot be publicly distributed; the BZCS provides the possibility to order an alternative, exclusive analysis.

Commercial information systems originate on the basis of data provided by the company itself, thus gaining certain advantages as a client of the publisher. Slovak companies can register themselves in SKKOD – the Slovak Compass On Disc from KOMPASS Slovakia, a.s., in the EDB Product Database from the European Databank, spol. s.r.o., in the WIC[27], BRE[28], and others.

On the basis of data sent by solicited companies in an individual form, the Top 100 list was created by the Trend Holding, a.s. This narrower range of data includes interesting information (amongst others, exports, and the average number of employees in the parent company and a consolidated group of companies), and serves as a foundation for the composition of sector league tables.

The current trend lies in the creation of products which integrate financial data from a number of public sources, enable the addition of one's own data, and which also include analytical tools. The necessity of data conversion is dwindling, and so are problems related to different data structures. In the Czech Republic, this somewhat powerful trend has led to the creation of new products: 'WEBOvel', 'Financial Analysis', 'Spider Analysis', 'Ariadna', and 'Sofia'. Some of these products also integrate data from annual reports, which are provided in a clear tree structure, or the latest press data, while publishers, for example, provide weekly updates. In the Slovak Republic, only the 'Amadeus' product from the Dutch company, Bureau Van Dijk, is available. Its wide range of integrated analytic tools enables the analysis not only of a company, but also sectors, and therefore the position of the company in relation to its competitors within the sector, region, or group, limited, for example, by the legal status. A company can be entered into a sector from the entire database according to a number of indicators. The European database of the 'Amadeus' product is filled by a number of information providers; in the case of the Czech and Slovak Republics, it is composed of publicly accessible data, so results of analyses can only be used in practice with great caution.

It is also possible to obtain information in different ways, also about entities which are not subject to mandatory information provision. Specialised companies provide special information products, offering commercial or economic information based upon up-to-date reviews of the Business Register. The branch offices of three foreign companies are active in Bratislava – Creditreform, k.s., the European Databank, spol., s.r.o., and Intercredit, spol. s.r.o., which are involved in this activity. The data provided are highly up-to-date, and the method of evaluating company credibility is reliable.

Accessibility of macroeconomic data arises from the participation of Slovakia in the information project of the International Monetary Fund. In accordance with the *S*pecial *D*ata *D*issemination *S*tandard, amongst other matters, a binding agreement has been reached to publish 17 data categories, explicating the fiscal, real financial, and foreign sectors with a predetermined scope, regularity, and time limit. The national coordinator, the Statistics Bureau of the Slovak Republic, performs comprehensive collection of data on the national level; the procurement of regulation data is performed in cooperation of the Ministry of Finance of the Slovak Republic and the Slovak National Bank (SNB). SNB publishes on the Internet the analytical accounts of the banking sector and that of the central bank, interest rates, the international investment position, exchange rates, the balance of payments, and international reserves, as well as an advance data calendar (at the moment, for the period July-December 2000). A wide-ranging database on the development of the economy is also provided by the 'Statistical Almanac of the Slovak Republic' in electronic form; the goals of government economic policy are presented by a number of ministries on their Internet sites.

Using Information in Company Management

According to Drucker, very few information needs are new today. What is new are the technical possibilities for data processing, which allow fast and cheap performance of that which was time-consuming and expensive only a few years ago. Those ideas are important, which enabled the formation of various technologies, used in isolation and for special purposes, towards one integrated information system, creating possibilities for company analysis (diagnostics), the creation of company strategies, and supporting company decisions. This is a new and radically different view of the meaning and aim of information - presented as an indicator, upon which future activities are based – as opposed to the past, which only serves as a reminder of that which already happened.[29]

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[13] Forbes, 08/24/98, Database: Academic Search Elite

[14] Drucker, P. F.: The information executives truly need. InformationWeek, 5/1/95, Database: Academic Search Elite

[15] Act no. 513/1991 Coll. on the Business Register as amended, section 28.

[16] Act no. 455/1991 Coll. on Sole Entrepreneurship as amended.

[17] Act no. 322/1992 Coll. on State Statistics as amended, section 32.

[18] Act no. 511/1992 Coll. on Tax Administration and charges as amended.

[19] Act no. 513/1991 Coll. Commercial Code as amended, section 39.

[20] Act no. 111/1990 Coll. on State Enterprises as amended, section 9.

[21] Obligations of information provision established in the commercial code are associated with the obligation of information provision pursuant to act no. 600/1992 Coll. on Securities, section 80.

[22] Act no. 563/1991 Coll. on Accountancy, section 20.

[23] Act no. 385/1999 Coll. on Collective Investment, section 53; Act no. 21/1992 Coll. on Banks as amended

[24] Act no. 563/1991 Coll. on Accountancy; section 22 sets out the obligation to compose a consolidated financial statement and verify it through a company auditor, which has at least a twenty percent stake in another company, or is authorised to direct another company by contract or statute regardless of the level of the holding.

[25] Ensuring the immediate publication of these actualities in the nation-wide periodical press publishing stock market reports.

[26] In the Czech Republic, for example, the 'Stock Market Newsletter' is published.

[27] The WIC – *W*eb *I*nformation *C*entre – project, aimed at incorporating Slovak companies into electronic trade, is supported by: The Ministry of the Economy of the Slovak Republic, the Association of Employer's Unions and Associations of the Slovak Republic, NARMSP, the Slovak Chamber of Trade and Industry, and the firms COMPAQ, KOMPASS, and FPZO. Registration and presentation in the system represents the first phase, the initiative for the support of incorporation into electronic trade is the second. FPZO charges each interested party an entry fee of SKK 3000; both export and non-export companies may register. Companies registered in the WIC are simultaneously registered in the KOMPASS Company's databases.

[28] The BRE system (*B*ureau de *R*approchement des *E*nterprises) enables the search for business partners in 67 countries throughout the world. The charge for processing and posting the offer is SKK 500. It is also possible to register in the system through the European Databank.

[29] Drucker, P. F.: The information executives truly need. InformationWeek, 5/1/95. Database: Academic Search Elite.