Corporate governance in developing and emerging countries. The case of Romania

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Abstract:

The experiences of the developed countries reveals that a good corporate governance could reduces risk, stimulates performance, improves access to capital markets, enhances the marketability of goods and services, improves leadership, increases the value of the corporations, enables the corporation to acquire external finances more easily and at a lower cost.
In the case of developing and emerging economies the need for corporate governance extends beyond resolving problems resulting from the separation of ownership and control. Developing and emerging economies are constantly confronted with issues such as the lack of property rights, the abuse of minority shareholders or contract violations. But in order that corporate governance measures have a strong impact in the economy, a set of democratic, market institutions and legal system should be settled up.
The Romanian governance system follows the patterns of the Continental European model based on the internal control of the employees and the management but with some particularities in function of the specific economic, political, cultural conditions.

Key words: corporate governance, developing countries, principles, models, firm, performance

JEL Classification: G32, G34, P2

Introduction

The concept of corporate governance is a multi-faceted subject and can be defined in different ways. Generally, corporate governance is a set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered and controlled.

Narrowly defined, corporate governance reflects the relationships among many players involved – the stakeholders - and the goals for which the corporation is governed. The principal players are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large. Therefore, corporate governance is the relationship among various participants in determining the direction and performance of corporations (Monks and Minow, 1995).

From another point of view, corporate governance is about "the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated." (Blair, 1995).

Different practices and structures of corporate governance need to be analyzed in strong correlation with the agent theory, taking into consideration that they reflect actually, the concern for reduction of agent costs and minimization the conflict between shareholders and managers. The separation of ownership from control implies a loss of effective control by shareholders over managerial decisions. As a result of this separation, it is introduced a system of corporate governance controls in order to assist in aligning the incentives of managers with those of shareholders. So the efficiency of different systems of corporate governance is being appreciated in function of their capacity to solve different inevitable conflicts that appears between social partners of the firm (stakeholders), especially between shareholders and managers.

A related issue focuses on the impact of a corporate governance system in economic efficiency, through which the corporate governance system should aim to optimize economic results, with a strong emphasis on shareholders welfare.

Taking in consideration that corporate governance is an economic field that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms (such as contracts, organizational designs and legislation), this is often limited to the question of improving financial performance: for example, how the corporate owners can secure or motivate that the corporate managers will deliver a competitive rate of return (Mathiesen, 2002) or the way suppliers of finance sources assure themselves of getting a return on their investment. (Shleifer and Vishny, 1997).

The performance of the enterprise does not resume itself just to superior financial accounting results, respectively maximum profit, stabile financial balance, the capacity of generating cash flows for its functioning and expanding, but regards all non-financial and financial aspects of its activity. The performance of quoted firms is significantly influenced by the form of corporate governance, respectively the capacity of decision factors to identify and harmonize the interests of the social partners.

The importance of corporate governance was underlined, in a surprising way by the economic crisis around the world. In a globalized economy, companies and countries with weak corporate governance systems are likely to suffer serious consequences beyond financial crises.

Furthermore, global forces are shaping the continuing development of corporate governance. Although implementing corporate governance is beneficial for firms and countries, the rapid pace of globalization has made this need urgent, especially for developing and emerging countries. More and more, it becomes clear that good corporate governance is a key for the integrity of corporations, financial institutions and markets, an important factor for the health of the economies and their stability.

Principle and codes of corporate governance:. Particularities for developing and emerging countries

The key elements of good corporate governance principles include fairness, accountability, responsibility and transparency. Thus, focusing the attention of the business community on trusting investors and on basic principles of corporate governance has materialized internationally on the OECD Principles of Corporate Governance. The original principles were released by OECD in May 1999 in response to the growing awareness of the importance of good corporate governance for investor confidence and national economic performance. In April 2004 there were released the revised principles of corporate governance.

Starting from different codes and practical models of governance, there were identified certain elements which define an efficient corporate governance. Thus, commonly accepted principles of corporate governance include the followings:

- *The rights and equitable treatment of shareholders*: Organizations should respect the rights of shareholders and support shareholders to exercise those rights, including secure ownership of their shares, the right to full disclosure of information, voting rights, participation in decisions on sale or modification of corporate assets including mergers and new share issues.

- *Interests of other stakeholders*: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

- *Role and responsibilities of the board*: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. These include concerns about corporate strategy, risk, executive compensation and performance, as well as accounting and reporting systems.

- *Integrity and ethical behavior*: Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.

- *Disclosure and transparency*: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting.

Drawing up these principles reflects the main advantages offered by the corporate governance codes:

- stimulate debates about problems of corporate governance;
- encourage companies to adopt recognized standards of governance;
- offer explanations to investors about requirements and practices of corporate governance;
- ensure informational base necessary for improving the regulations of the capital market and company law.

In essence, the corporate governance code is a set of principles, standards and good governance methods whose implementation does not have a compulsory character, but an optional one.

The corporate governance codes are issued by different entities, such as: stock exchanges, corporations, institutional investors, or associations (institutes) of directors and managers with the support of governments and international organizations. The variety of issuers generates implicitly a different official status of these corporate governance codes in issuing countries, and the codes present their point of view about what a good practice of corporate governance has to be.

The main differences concerning governmental practices applied in different EU countries devolve from legislative regulations and rules of the capital market and not from the recommendations of the corporate governance codes which present important similarities. These differences do not generate unbreakable barriers for the functioning of the common capital market, so they do not impose the elaboration of a unique code of corporate governance. The existence of misunderstandings between these codes imposes the adaptation of specific measures in order to eliminate the regulation barriers of capital markets (informational) which could allow fair and easy evaluation of corporate governance of companies by the investors.

The principal pro's and con's of the corporate governance codes from different countries concern various aspects of corporate governance, such as: representing employees, the rights of social partners of the company (stakeholders), rights of shareholders, the structure and responsibilities on the board of directors, the independence of the board of directors, the achievement of financial/non-financial results.

These are the reasons why many codes, including the OECD principles, fail to address some corporate governance issues and this could have negative effects in developing and emerging economies. But it should be also taken into consideration the general challenges confronting developing, emerging and transitional economies (CIPE, 2002), as follows:

- establishing a rule-based (as opposed to a relationship-based) system of governance;
- combating vested interests;
- dismantling pyramid ownership structures that allow insiders to control;
- establishing property rights systems that clearly and easily identify true owners;
- de-politicizing decision-making and establishing firewalls between the government and management in corporative companies where the state is a dominant or majority shareholder;
- protecting and enforcing minority shareholders' rights;
- preventing asset stripping after mass privatization;
- finding active owners and skilled managers amid diffuse ownership structures;
- promoting good governance within family-owned and concentrated ownership structures;
- cultivating technical and professional know-how.

A crucial weakness of the existing guidelines consists in the fact that the rules do not apply to all corporations equally (for example, do not apply to unlisted corporations). Besides, the role of debt and exit mechanisms is insufficiently addressed in many corporate governance codes and clear standards are needed to prevent connected lending which is widely practiced in some developed and developing economies. Therefore, in order to be effective, existing guidelines need to be supplemented to address these types of corporate governance issues as well.

Moreover, in most developing economies, even the most basic democratic, market institutions may be undeveloped. In these circumstances, instituting corporate governance in these countries requires more than exporting well-established models of corporate governance that function in the developed economies. Therefore, in the developing and emerging countries, the institutional framework for effective corporate governance imposes the followings:

- *property rights* is one of the essential conditions necessary for a democratic, market-based economy and for ensuring the function of corporate governance measures;
- *a set of institutions that provides the essential legal and regulatory framework* and a competitive self-enforcing environment (otherwise known as external controls). In the developing or emerging economy this regulatory framework is either absent or weak and these institutions can provide a playing field and ensure that internal corporate governance procedures adopted by firms are enforced and that management is responsible to owners and other stakeholders;
- *a well-regulated banking sector* is an absolute prerequisite for a efficient functioning stock market and corporate sector because it provides the necessary capital and liquidity for corporate transactions and growth;
- *efficient capital markets* can discipline insiders by sending price signals rapidly and allowing investors to liquidate their investment quickly and inexpensively; this affects the shares' value of a company and a company access to capital;
- *competitive markets* represent an important external control on companies forcing them to be efficient and productive. The lack of competitive markets discourages entrepreneurship, fosters management entrenchment and corruption and lowers productivity;

- *transparent and fair privatization procedures.* The way enterprises are privatized not only affects the ownership structure but reflects a country's corporate culture;

- *transparent, simple and fair taxation regimes.* Tax laws and regulations should require adequate and timely disclosure of financial information, and should be enforced, consistently, timely and effectively;

- *an independent, well-functioning judicial system* is one of the most important institutions of a democratic, market-based economy because it can enforces laws consistently, efficiently and fairly;

- *anti-corruption strategies.* It is important to implement effective anti-corruption measures by specifying and streamlining legal and regulatory codes, clarifying laws on conflict of interest.

Special attention needs to be given to establishing the necessary political and economic institutions that are tailored to every country specific needs. But the properly functioning of institutions can only enforce existing corporate governance guidelines and codes. If these guidelines or codes fail to address key corporate governance issues, even the best institutions will be unable to offer solutions.

Models of corporate governance

There are many different models of corporate governance around the world according to the variety of capitalism systems in which they are embedded. In order to analyze the models of corporate governance in the developing and emerging countries should be presented the main models used in the developed countries.

In members states of European Union there are used two general models of corporate governance which present different characteristics: the Anglo-American model and the Continental European one.

The Anglo-American Model of corporate governance (specific for firms from U.K., but also for those from USA, Hong Kong and Australia) tends to give priority to the interests of shareholders and encourages radical innovation and cost competition.

This is an outsider-based system pursued by active capital markets trough the acquisitions and merges over listed companies. Thus, through the active capital markets it is developed the control of companies and transaction of securities, in condition of existence of dispersed shareholders. All countries which are characterized by this model have strongly developed capital markets, and protecting investors. As a result, in the Anglo-American countries (U.K., U.S., Australia and Canada) the companies have generally similar models of corporate governance, respective one independent board of directors, which monitories and controls management's activity for the purpose of improving it, but the latest control possibility, improving and recovery of company's performances it is done throughout hostile takeovers.

The Continental European (German) model of corporate governance (specific to companies from continental Europe, as well from Japan) is an insider-based system; it is not focused on the strong influence exerted by active capital markets, but on the existence of strong stakeholders, such as banks. This model recognizes the interests of workers, managers, suppliers, customers and the community and it facilitates innovation and competition.

The characteristics of this model emerge from particularities of the social and commercial environment where they first appeared. Thus, in Germany, as well as in Japan, shareholders who own high portfolios of stocks usually get actively involved in the management of the respective companies. Their role is to sanction low quality management, to stimulate economical efficiency and to harmonize the interests of the firm's social partners, including its staff. Human capital is considered having the biggest importance in the German model.

Unlike the Anglo-American model, which is based mainly on the capital market, the German model is concentrated on the banking system. Although in Germany and in Japan banks do not have high stocks as a part of firms they finance, yet they exert a strong influence and control over their governance system. The main advantage of this model is monitoring and flexible financing of firms, as well as efficient communication between banks and companies. The strong involvements of banks in managing firms give a special stability and a priority orientation to this system towards economical development.

It is evident that both insider and outsider systems have to face inherent risks. Corporate governance systems are designed to minimize these risks and to promote political and economic development. An effective corporate governance system relies on a combination of internal and external controls. Internal controls are arrangements within a corporation that aim to minimize risk by defining the relationships between managers, shareholders, boards of directors, and stakeholders. In order for these measures to have a meaningful effect, they must be buttressed by a variety of extra-firm institutions tailored to a country’s environment (referred to as external controls).

The comparing analysis of advantages and disadvantages of both models of corporate governance, the Anglo-American model and the German-Japanese model, suggests that a company's system of governance may be improved as an effect of the next factors:

- the firm acquisitions - in developed countries, such as Great Britain, U.S.A., France, Germany, Japan there is a regulated market of acquisitions;

- the competitiveness of products and services influence the corporate governance of a company, but the action of this factor is slow, shareholders may lose huge amounts of money as a result of damaging the quality of the products, losing clients and some market segments because of low efficiency of firm's management;

- capital market, which actually offers official recognition of a firm's performances and implicitly of management through the level of the firm's share prices;

- institutional investors represent a potential force of influencing the governance of a company, especially in Great Britain and U.S. Meanwhile, they constitute a danger from the point of view of the powerful control they may exert over firms despite a big percent of holdings in their social capital;

- the labor market for managers, who sanctions the managers which get excessive benefits without having performances, by replacing them in the managing board.

Although there are considerable differences between the Anglo-American and German system, they all define the subject of corporate governance within the context of functioning market systems and highly developed legal institutions. But, many developing and emerging economies lack or are in the process of developing the most basic market institutions. Hence, corporate governance in these contexts involves a much wider range of issues.

Solving corporate governance problems in developing and emerging economies involves going beyond a narrow view of how interrelate the owners and managers of capital. In these economies, the corporate governance systems depend on a set of institutions (laws, regulations, contracts and norms) that enable self-governing firms to operate as the central element of a competitive market economy.

These institutions ensure that the internal corporate government procedures adopted by the firms are enforced and that management is responsible to owners (shareholders) and other stakeholders. The key point is that the public and private sectors have to work together to develop a set of rules that are binding on all and which establish the ways in which companies have to govern themselves.

Specific features of corporate governance in Romania

The enterprises from Central and Eastern European countries (including Romania) have a common governance model based on internal control, as a result of the privatization and reorganization process. In this context, the insider - based model could be redefined as a form of organization of firms resulted from buying up control rights by the managers or the employees of ex-enterprises owned by the state during the privatization process, from owning substantial stocks portfolios by insiders in case of the privatization process, or from exerting their interests in the decisions process at the level of the strategic enterprises, when they are still in the state property.

The inside control is considered an essential issue because the managers who own an excessive control on the enterprises may act in the detriment of shareholders, employees and other stakeholders, affecting thus the financial results and firm performance. In these circumstances it should be underlined the necessity of getting efficient this system by developing capital markets and banking systems as ways to influence internally or externally the systems of corporate governance for firms in the developing and emerging economies.

Inevitably, establishing some adequate mechanisms of corporate governance of privatized enterprises in these countries was difficult in the conditions of the lack of a legal infrastructure, as well as lack of regulations about property rights, demands of accounting-financial reports, firms bankruptcy etc.

The structures of firm's governance in European countries in transition were strongly influenced by the objectives of the privatization process, such as political responsibility, legal regulations and the efficiency of the privatization. Taking into consideration the priority of these objectives and political and economic conditions, the privatization process has registered relatively different forms in Central and Eastern European countries. As a result, the corporate governance systems from Central and Eastern European countries are inefficient, as a result of focusing power by the employees, management and as a result of the lack of outside or inside control exerted by the other stakeholders, such as banks, institutional investors, or through active capital markets.

Although there are signs that the financial results of privatized firms are in average superior to ex-state enterprises, the reorganization is still done in a slow rate, and the process of investing is very low, which will affect long term performances of respective firms. Although the extent of remaining government ownership differs from one country to another, private ownership dominates everywhere. Ownership and control are becoming increasingly concentrated, with the emergence of corporate groupings and significant foreign owners in most countries. As firms grow in size, ownership and control are separated, primarily by the use of a pyramid structure. Most firms in Central and Eastern Europe are still owner-managed, but professional management is becoming more common (Berklof, Pajuste, 2003)

In Romania, the companies are characterized by the same general model of corporate governance, the insider - based control of employees and management, but with certain particularities regarding national, economical, social, politic, cultural conditions, where governance forms appeared and developed.

The corporate governance of Romanian enterprises and at the same time the trend of their performances can not be analyzed and understood just through the evolution of the reform process, in the context of transition from planned economy to market economy, what determined deep changes in the macroeconomic universe.

The main methods of privatization which generated the formation of the private sector in Romania were: MEBO method, mass privatization program or privatization through sales to investors outside the enterprises. As a result of the privatization process in Romania there are the following types of corporate governance of enterprises:

- Firms owned by the state (total or partial) - where the state is still the main shareholder. In these firms there is inevitably a conflict of interests between managers, employees and the state, caused by contradictory objectives: maximizing the profit, maintaining jobs, raising the income from taxes, satisfying political or individual interests. Economical performance is not the major objective of these economical entities; the interests of managers from these enterprises are rarely subordinated to shareholders interests.

- Private closed firms (small, medium or large enterprises, whose shares are not traded on an official market). Owners are usually also managers, so there is not a conflict of interests between the two parts. In return, there are numerous conflicts between shareholders. Managers do not have the priority to maximize the value of the firm, but expanding the business.

- Privatized or opened companies, which know a variety of forms, from the very dispersed ones in which the shareholders' rights are usually neglected, till those where shareholders have a strong control over the enterprise. In such enterprises there is a conflict between management and shareholders or between the stakeholders and shareholders. As in the case of private closed firms, the decisional and operational autonomy of the managerial team is high, the organizational structures and informational systems are flexible, dynamic and efficient.

The principles of corporate governance imply a series of measures that lead, finally, to the growing of transparency of listed companies, what makes them more attractive. That is why implementing the corporate governance code of OECD has preoccupied the representatives of Stock Exchange from Bucharest for many years. A first step was made in August 2001, when the Bucharest Stock Exchange elaborated a *Code of Corporate Governance* and introduced a virtual tier, the Plus tier, for the listed companies which wanted to implement the principles of corporate governance. In 2003, it was founded the Institute of Corporate Governance of BVB (Bucharest Stock Exchange) in order to increase the professional standards for managers.

The principles of the corporate governance were included in the capital market legislation. But the new capital market law has yet its disadvantages: it is too general, leaving place for interpretations, being implemented just partially the principles of corporate governance.

Even in the last years there were registered positive effects regarding the opening of the managers towards the communication with the investors, the expected results regarding the implementation of corporate governance principle did not appeared. Therefore, Bucharest Stock Exchange intends to elaborate in 2008 a new Code of Corporate Governance, more complex and more adapted to the European legislation.

Besides the principles of corporate governance or more strict rules regarding the informing of investors, the new code will introduce a new issue for the Romanian market: the concept of independent leadership. Another novelty is the fact that the listed companies can implement voluntary the code, but they should mention it in the yearly report and they have to motivate the rejection/inobservance of some of the stipulations (the principle "comply or explain").

An argument in favor of implementing the principles of transparency consist on the fact that the well administrated companies, with strong corporate governance structures, with appropriate social and environment programs register a higher performance on the market in comparison with the competitors.

By contrary, the inefficient governance of listed companies influences negatively the economic-financial results and their possibilities of future developing taking in consideration the followings:

- the decrease of the rhythm for the restructuring and reorganization;
- following mainly short term purposes of employees and managers, such as rising salaries and other bonuses, stability and protection of work places;
- lack of investments for modernization or developing the productive potential of enterprises;
- excessive mobility of staff as a result of intern conflicts;
- the delayed/lack of dividend distribution to the other shareholders in order to offer premiums for the managers and employees at the end of the year;
- restricting the transactions of securities on the capital market which determines the increase of volatility and the investment risk for these securities;
- existence of conflicts between managers and/or employees and shareholders, or the conflict between stakeholders and shareholders;
- low prestige on the market for the listed firms, etc.

Among the most important ways of encroaching upon the rights of shareholders in Romania are the followings: dilution of the shareholders' earnings; transferring profits outside the company; abusive allocation of the profits; delay in offering the dividends; limited access for shareholders to information.

The main problem of corporate firms in Romania is the conflict of interests between stakeholders and shareholders which generates misunderstandings between management and shareholders, as well as between shareholders and business partners of the company, typical especially in developing economies, leading to the decrease of long term performances of the companies and even their bankruptcy.

Conclusions

A healthy and competitive private sector is becoming increasingly important for developing nations. In the context of globalization and integration of national economies, corporate governance is considered as an important comparative advantage of companies and countries, because it increases foreign investors' confidence in the private sector. Besides, as a result of the reducing the public sector that occurred during the last two decades, the private sector has become an increasingly important provider of public assets. Therefore, corporate governance is a tool of oversight that provides information about the functioning and performance of private firms but also about the economies.

The corporate governance system of listed enterprises becomes a condition for the level of current economic-accounting performances, but also for the expectations of investors concerning their future developing. Thus, on one side, the quality of managing systems represents an essential non-financial variable for appreciating the global performance of enterprises listed on the capital market. On the other side, the capital market through the functions of redistributing the available capital and financing profitable investments, may contribute to the improvement of the governance system for listed companies and implicitly to increase their performances, through mergers and acquisitions or through active involvement of institutional investors in their management.

The corporate governance of Romanian enterprises have to be analyzed taking into consideration the evolution of the transition and reform process, which determined many changes in the economic framework.

Romanian companies listed on the capital market have merged from the privatization process, which determined the formation on one side, of extremely dispersed shareholders, inactive in administrating firms, and on the other side, the appearance of a very strong group of shareholders. These companies have a form of governance dominated by management and employees or shareholders control, despite the interests of stakeholders and other social partners. The most important problem is the violation of the rights of shareholders and minimizing their incomes. The managing board and censors have just a formal role of approving manger's or shareholder's decisions.

The efforts toward an effective corporate governance system are more and more justified, especially in the developing and emerging countries, taking in consideration the followings advantages:

- it could promote the efficient use of resources both within the company and the economy. The debt and equity capital should flow to those corporations capable to invest it efficiently, with the highest rate of return;

- it as a mechanism which can contribute to the development of financial and equity markets. because corporate governance generates lower transaction costs associated with corporate information access and diminishes the managerial incentives for risky profits;

- it facilitates the access to capital. Insufficient and inadequate access to capital is one of the most common problems that developing countries have to face. Better corporate governance practices influence the perception of investors the firms could have as effect an easier access to financing sources;

- it could be a complement to institutional and legal framework. A solid institutional framework promotes private sector development, reduces transaction costs and encourages an effective private sector;

- it could contribute to the reduction of corruption in business. Although it may not prevent corruption, effective governance could allow that corrupt practices to be discovered early and eliminated.

In conclusion, it is increasingly clear that having a transparent and fair system to govern markets, fair treatment of all stakeholders, and a chance for every entrepreneur to be successful, are crucial for developing and emerging economies. Corporate governance creates safeguards against mismanagement and corruption and can promote fundamental values of a market economy in a democratic society.

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