CORPORATE GOVERNANCE IN TRANSITION ECONOMIES, WITH REFERENCE TO INSTITUTIONAL FRAMEWORK IN MACEDONIA

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Abstract

Good corporate governance involves a set of relationships amongst the company's management, its board of directors, its shareholders, its auditors and other stakeholders. These relationships, which involve various rules and incentives, provide the structure through which the objectives of the company are set, and the means of attaining these objectives as well as monitoring performance are determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations; the accountability of managers and the boards to shareholders; and corporate responsibility towards stakeholders. This paper discusses the importance of corporate governance, with special reference to transition economies. Directors, owners and corporate managers have started to realize that there are benefits that can accrue from having a good corporate governance structure. Good corporate governance helps to increase share price and makes it easier to obtain capital. International investors are hesitant to lend money or buy shares in a corporation that does not subscribe to good corporate governance principles. Transparency, independent directors and a separate audit committee are especially important.

Keywords: *corporate, governance, transition, principles;*

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1. Introduction

Current processes such as globalization, the financial crisis and the transition process in many countries and in ours, conditioned complex economic reality and a higher level of uncertainty in the contemporary operating companies in which adequate and relevant business decisions should be based on comprehensive, reliable and comparable accounting information of financial and non-financial nature. The demands of stakeholders for information becomes more complex in terms of content, scope and quality of information presented in the financial statements, and quality financial reporting has become imperative for the survival and development of companies in the new business environment With more evident process of globalization of the world market, the concept of corporate governance gains importance. The global economic crisis highlighted the problems of corporate governance both in developed countries and developing economies. Analyzing the effects of the global economic crisis, including striking collapse of many companies, the huge increase in unemployment and the increased number of people living on the poverty line and below, it can be concluded that some of these problems are result of various weaknesses and failures of corporate governance. Even though the introduction of a number of rules, codes and practices of corporate governance have been made, the global economic crisis has shown that more effective application of the standards of corporate governance is necessary. Corporate governance issues are especially important in transition economies, since these countries do not have the long-established financial institution infrastructure to deal with corporate governance issues. Before 1989 there was no need to discuss corporate governance issues, because all enterprises were owned by the state and there were no shareholders. Good corporate governance contributes to sustainable economic development of each country in a way that: Improve business performance of companies and their operational efficiency; Promotes and facilitates access to capital markets; Reduces costs of companies on the acquisition of capital and increases the value of the property; Contributes to improve the reputation of companies.

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

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

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

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

Table 1: Calendar of corporate governance events [1]

Year	CORPORATE EVENT
1600s:	The East India Company introduces a Court of Directors, separating ownership and control (U.K., the Netherlands)
1776:	Adam Smith in the «Wealth of Nations» warns of weak controls over and incentives for management (U.K.)
1931:	Berle and Means publish their seminal work «The Modern Corporation and Private Property»

	(U.S.)
1933/34:	The Securities Act of 1933 is the first act to regulate the securities markets, notably registration disclosure. The 1934 Act delegated responsibility for enforcement to the SEC (U.S.)
1968:	The EU adopts the first company law directive (EU)
1987:	The Treadway Commission reports on fraudulent financial reporting, confirming the role and status of audit committees, and develops a framework for internal control, or COSO, published in 1992 (U.S.).
Early 1990s:	Polly Peck (‡1.3bn. in losses), BCCI and Maxwell (‡480m) business empires collapse, calling for improved corporate governance practices to protect investors (U.K.)
1992:	The Cadbury Committee publishes the first code on corporate governance; and in 1993, companies listed on U.K.'s Stock Exchanges are required to disclose governance on a «comply or explain» basis (U.K.)
1994:	Publication of the King Report (S. Africa)
1994, 1995:	Rutteman (on Internal Control and Financial Reporting), Greenbury (on Executive Remuneration), and Hampel (on Corporate Governance) reports are published (U.K.)
1995:	The Russian Law on Joint Stock Companies is adopted (Russia) Publication of the Vienot Report (France)
1996:	Publication of the Peters Report (the Netherlands)
1998:	Publication of the Combined Code (U.K.)
2001:	Enron Corporation, then the seventh largest listed company in the U.S., declares bankruptcy (U.S.)
2001:	The Lamfalussy report on the Regulation of European Securities Markets (EU) is published
2002:	Publication of the German Corporate Governance Code (Germany)
2002:	Publication of the FCSM Russian Code of Corporate Conduct (Russia)
2002:	The Enron collapse and other corporate scandals lead to the Sarbanes-Oxley Act (U.S.); the Winter report on company law reform in Europe is published (EU)
2003:	The Higgs report on non-executive directors is published (U.K.)
2004:	The Parmalat scandal shakes Italy, with possible EU-wide repercussions (EU). Source

The busy agenda of corporate governance development in two recent decades is obvious. It is not hard to notice that this is a result of the extremely increased dynamics of capital flows in global realms, as a consequence of globalization, as well as of the opening up of emerging markets and transition economies. With a view to protecting investors against risks from entering unregulated environments, there is a growing tendency toward regulation of relationships in corporate governance area by specific legal (and other) regulations, i.e. toward standardization of corporate governance structure, systems, and processes, following unified principles.

2. Good corporate governance

When we talk about corporate governance, there are many definitions of the term that depart before the level and scope of purely economic ("shareholder" approach) or wider ("stakeholder" approach) concept [2].
The Organization for Economic Cooperation and Development (OECD) defines corporate governance as: "a set of relationships between a company's management, its board, its

shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Thus, in its narrower sense, observed from the perspective of companies, corporate governance can be defined as a set of rules governing the relations between the owners and management of the company. As defined by the OECD in 2001, "Corporate governance is a public and private institutional framework, including a legal infrastructure, legislative and business practice, created with the aim for editing an efficient relationship between managers from one side, and those who invest in the company, from the other side (owners). "World Bank broadly defines the term corporate governance - as an institutional framework that allows more quality relationship between managers, owners and other stakeholders (employees, state, public, etc.).

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

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

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

Well-governed companies are better contributors to the national economy and society. These companies tend to be healthier and to add more value to shareholders, workers, communities, and countries, in contrast with poorly governed companies that may cause job losses and loss of pensions, and may even undermine confidence in securities markets. Some of the levels and specific benefits of good governance are summarized in Figure 1, and discussed in further detail below [4].

Figure 1: Levels and Potential Benefits of Good Corporate Governance

THE FOUR LEVELS OF CORPORATE GOVERNANCE		**POTENTIAL BENEFITS**
Level 4: Corporate governance leadership		Improved Operational Efficiency
Level 3: Advanced corporate governance system		Access to Capital Markets
Level 2: Initial steps to improve corporate governance		Lower Cost of Capital
Level 1: Compliance with legal and regulatory requirements		Better Reputation of the Company, its Directors, and Managers

The ten Principles of Corporate Governance:

1. Corporate governance framework - The Company shall adopt a clear and transparent corporate governance framework for which it shall provide adequate disclosure.

2. The Board of Directors' remit - The Board shall be responsible for the management of the company. As a collective body, it shall act in the corporate interest, and shall serve all the shareholders by ensuring the long-term success of the company.
3. Composition of the Board of Directors and of the special committees - The Board shall be composed of competent, honest, and qualified persons. Their choice shall take account of the specific features of the company. The Board shall establish the special committees necessary for the proper execution of its remit.
4. Appointment of Directors and Executive Managers - The Company shall establish a formal procedure for the appointment of Directors and Executive Managers.
5. Conflicts of interest and business ethics rules - The Directors must show integrity and commitment. Each shall represent the shareholders as a whole, and shall make decisions solely in the company's interest, and independently of any conflict of interest.
6. Evaluation of the performance of the Board - The Board shall assess regularly its operating methods and its relationship with the Executive Management.
7. Management structure - The Board shall set up an effective structure of executive management. It shall clearly define the assignments and duties of Executive Management and shall delegate the powers required for the proper discharge of these assignments and duties to the latter.
8. Remuneration policy - The Company shall secure the services of qualified Directors and Executive Managers by means of a fair remuneration policy that is compatible with the long-term interests of the company.
9. Financial reporting, internal control, and risk management - The Board shall establish strict rules that are designed to protect the company's interests in the areas of financial reporting, internal control and risk management.
10. Shareholders - The Company shall respect the rights of its shareholders and shall ensure that they receive equal treatment.

Mechanisms of corporate governance

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

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

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

more favorable and more compensation. From this spot, comes the danger of this mechanism, if not properly controlled.
External mechanisms of corporate governance relate primarily to the market of corporate control, which effectively monitor the management of companies, so that those companies that are not efficient enough, or whose management is not working efficiently, it can quickly be taken from more efficient companies. Also, one of the efficient mechanisms of corporate control represents the market manager, who forces them to operate effectively, because there is always the possibility of replacing them.
In summary, the business practice has demonstrated the need for institutionalization of corporate governance within companies, through whose full implementation enables effective problem solving related to the conflict of interests between owners and management, fully respecting the rights of all stakeholders, from suppliers through employees, to financial institutions [7].

The importance of corporate governance for the development of transition economies

Recent experiences from transition countries show that the assumption that an effective system of corporate governance will develop an automatically, as a result of ownership transformation, is quite unrealistic. Even in developed market economies, the differences in the ownership structure and the level of concentration or dispersion of owners, affect a lot on the selection and adaptation of corporate control mechanisms. In transition countries, the problem of setting good corporate governance becomes even more complex, as a result of underdeveloped institutional infrastructure. For this reason, we need a thoughtful and serious approach to corporate restructuring, in order to establish a strong private sector, through which be realized a successful economic transformation to a developed market economy [8].
The importance of developed and efficient corporate governance in transition economies can be explained simply through its impact on the following areas:

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

The development of corporate governance demands the establishment of certain market economy institutions necessary for economic growth. Without good corporate governance, corporations cannot fulfill their main mission – profit making and contributing to the social welfare, with maximum effectiveness. Companies cannot operate successfully without setting the adequate rules of governance and institutions that support them, without embracing a culture of corporate governance among managers, owners and other stakeholders.
For countries in transition, companies and associated institutions are the key factors in the process of economic transformation. Well laid out and developed corporate governance requires that all relevant actors in this process recognize and well understand their roles. Mass privatization created a lot of managers who are not active participants in ownership relations, because they simply do not understand their essential roles, rights and responsibilities. Most of them simply wait for the paying out of dividends, which are often worthless in their value. They also, often, cannot understand the role of agents they have in relation to owners, and they run the companies as they were their property, by satisfying their own interests, to the detriment of the owners and the company as a whole. Corporate governance requires coherent and strict national regulations, which is the basis for setting the mission and goals for the makers of economic policies of the country. Furthermore,

indispensable are recruit, train and reward professional managers who can be held to high standards of competency, ethics and responsibility.

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

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

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

Effective corporate governance cannot be considered in isolation. Regarding the financial sector of the country special attention should be given to measures to strengthen the banking system and financial institutions as a whole. In the real sector, as recommended by the OECD, special care should be dedicated to competition policy, as well as sector specific reforms. The problem with the OECD guidelines, in particular when applied to developing and transition economies, is that they cover a broad range of rules and principles without specifying clear priorities among them. Given that the guidelines assume many of the institutions that are lacking in these countries they also do not provide priorities across policy areas. Furthermore, even the watered-down language of these prescriptions is often too ambitious for policymakers. Nevertheless, we believe the OECD guidelines provide a useful start. We indicate, therefore, in the following paragraphs how we view the priorities for developing and transition countries [9].

1. *Any international guidelines must recognize the international differences in governance systems***.** Generalizations are often more harmful than helpful. Ownership and control structures differ tremendously and so do the basic mechanisms for correcting governance failures and the roles of different governance institutions. General principles do exist, however, and should be articulated, in particular when they are unlikely to be so locally. At least, they force domestic actors to make explicit their own preferences.
2. *The general accounting rules and transparency requirements of the OECD guidelines should be a benchmark.* Transparency concerning ownership and control arrangements is desirable, in particular in improving the liquidity of shares and attracting foreign investors. It is hard to see how there can be any significant social costs to such disclosure, and the benefits seem substantial. The puzzle is to explain why companies in need of external finance have not implemented these guidelines on their own initiative. Doing so would presumably lower their cost of capital. The failure of the Transparency Directive of the European Union also shows that resistance or inertia is considerable. Either companies do not need (or want) outside funds or there are substantial private costs to disclosure. One hypothesis is that insiders to these arrangements are concerned that their legitimacy would be undermined.

3. *Protection of external investors is more important in transition economies than in developing countries.* The emphasis in LLSV is most appropriate in transition economies where many managers have entrenched themselves in formerly state-owned companies. However, the necessary pressure for change will not come from small shareholders or takeover threats in anonymous equity markets, but rather must come from strategic investors with large stakes, or even from the labor force, political authorities, or others.
4. *The development effect from any program that focuses solely on the plight of small shareholders is likely to be very small.* It is not clear that access to external funds is a binding constraint for most firms in developing countries. Even where it is, small, anonymous shareholdings will in most cases not be the dominant source of capital. Protection of strategic equity investors can be important, but most finance is likely to come through family ties or, possibly, peer group arrangements. The conclusion is equally valid for transition economies. This is not to say that small shareholder protection should not be part of corporate governance, it just should not be the main focus.
5. *Protection of creditors is more important than that of shareholders in developing and transition economies.* Debt is the dominant source of external finance in developed market economies. In relative terms, equity currently is more important in developing countries. But equity is typically raised not in public markets but through family ties or personal relationships. In the short term, substantial increases in external finance are likely to take the form of debt, probably from banks. Recent studies show a strong link between creditor protection and the development of the banking sector. In most transition economies companies have not been successful in raising external finance, but the need is great. Strategic shareholders are important to achieve restructuring, but most external capital in these countries, too, is likely to come as debt.
6. *The short- and medium-term emphasis on investor protection should not be on creating liquid markets for shares and corporate bonds.* The reason is not that liquid markets and liquidity, as is sometimes argued, are undesirable. Liquid markets generate information and facilitate control transactions in many developed market economies. In developing economies, liquidity is most important when families have to sell out, but this does not seem to be a first-order problem in the short and medium term. In some transition economies liquid equity markets could play a role in helping strategic investors build positions, but it is not clear that insiders will issue shares to let this happen.
7. *In the long term, liquid securities markets can be important for attracting foreign portfolio investment.* These markets are hard to create, take time to develop and are difficult to sustain. In most countries they do not have an important role as a source of finance. The recent problems in Asia and Russia have also demonstrated how volatile these markets are, but the vulnerability of individual countries seems to be closely related to how well protected external investors are. This may be the type of investment where investor protection matters most. Foreign portfolio investment has important benefits in relieving domestic capital constraints, and the lure of such investment can be important in the implementation of governance reform.
8. *Reforms focusing on enforcement are more important, and more difficult, than are changes to the letter of the law***.** This obvious point needs to be made. Unfortunately, we have not had much to say about how to strengthen enforcement and promote the rule of law. Self-enforcement is necessary, given the weakness of the legal institutions, but as the experience from Russian corporate law reform demonstrates it is not sufficient.
9. *Reforms must recognize the complementarity of different parts of the law and political institutions.* In countries with strong law enforcement, legal protection and obligations of economic actors must be different from those in ones with weak enforcement. The efficiency of legal procedures, such as the scope of criminal or civil law in business court cases or the use of circumstantial evidence in court, will depend on the overall legal framework and the political structure of the country.
10. *In many contexts the most immediate concern is to protect stakeholders other than shareholders.* In many transition countries, Russia in particular, the main governance

problem is entrenched managers' outright theft from, or at least failure to pay, the government and employees. Ruthless managers also exploit suppliers and customers locked into inherited technological relationships. Weak labor laws in many developing countries discourage firm-specific investment by employees and could also undermine general skill formation. Obviously, a stakeholder approach can allow managers and individual stakeholders to exploit blurred corporate objectives and paralyze decision making. But corporate governance reform must strike a balance between financial and non-financial stakeholders and recognize the needs, and in particular the potential value added, of stakeholders other than shareholders.

11. *Implementation and enforcement of fundamental corporate governance reform will in many cases require external conditionality.* Governments in developing and transition countries are generally weak. This weakness has many sources, but one important reason, in particular in transition economies, is the political deadlock over central parts of reform. These deadlocks arise out of the distribution effects of reforms. External conditionality can relieve these political constraints. The role of the European Union as an outside anchor to the reform process has been crucial to institutional reform in Central and Eastern Europe. Unfortunately, EU membership has not been in the cards for most of the former Soviet Union (the Baltic countries excluded). Conditionality from the international financial institutions could also go some way and should be systematically used, but it can never have the same leverage effect. For corporate governance reform, explicit or implicit conditions formulated by foreign investors are also important, but this pressure is likely to be less consistent and less coordinated. Here OECD and other guidelines may be useful.
12. *Effective corporate governance reform will often require a combination of threats and co-optation of the main actors.* Given the weakness of governments and the absence of credible outside anchors in most developing and transition economies, fundamental reform will not be undertaken against the will of the main actors. Pivotal groups will somehow have to be co-opted. In other cases, threats may be necessary. In the extreme case of Russia, re-nationalization of strategic assets followed by renewed privatization may be the only way to break resistance. Yet, this measure has obvious reputation consequences and the government may not be strong enough to act on such a threat.

3. Institutional framework of corporate governance in Macedonia

Building a system of institutions, which play a key role in the development of the Macedonian corporate governance framework, is of utmost significance regarding the implementation of this concept by companies. The Securities Commission and the Macedonian Stock Exchange (established in mid nineties), along with the Central Securities Depository (established in the beginning of the millennium), are key institutions that ought to respond to the challenges brought about by recent corporate governance trends. Below are listed some of the institutions and organizations which have directly or indirectly participated, or have somehow been engaged in setting up the Macedonian corporate governance milieu [10].

Table 2: Institutions and Organizations Relating to Corporate Governance Issues in Macedonia

Public Sector
Securities Commission **Ministry of Economics** **Central Securities Depository** **Judiciary (all levels of jurisdiction)** **Ministry of Finance**

National Bank of the Republic of Macedonia
Private Sector
Macedonian Stock Exchange **Chamber of Commerce** **Chambers of Commerce Association**
Other Organizations
Shareholders Rights Protection Union “Shareholder 2001” **Union of Jurists** **Corporate Governance Council** **Macedonian Trade Union** **Consumers Union** **Institute of Chartered Auditors**
Universities
Law Faculty, University of Goce Delcev, Shtip **Faculty of Economics, University of Goce Delcev, Shtip** **Law Faculty, University of Ss Cyril and Methodius, Skopje** **Faculty of Economics, University of Ss Cyril and Methodius, Skopje** **Institute of Economics, University of Ss Cyril and Methodius, Skopje**
International Organizations
International Finance Corporation (IFC) **United States Agency for International Development (USAID)** **World Bank** **Organization for Economic Co-operation and Development (OECD)**

4. Conclusion

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

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