DEVELOPING COUNTRIES AND CORPORATE GOVERNANCE. THE CASE OF ROMANIA

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Abstract

During the past years, developing countries have become extremely interesting for researchers, as well as for capital investors. Dominated by growth and industrialization, but lacking macroeconomic indicator stability or sufficiently mature financial markets, these countries make it acutely necessary to identify measures that will stimulate foreign investors to invest and that will ensure the financial stability for SMEs. One such measure is increasing the quality of corporate governance at the level of small and medium-sized enterprises, where it is currently almost absent. This article aims to help raise awareness of the need to implement good corporate management practices at the level of companies in developing countries and especially in Romania. This paper uses a questionnaire in order to evaluate the state of the corporate governance in Timis county and offers some suggestions on what should be done for a higher corporate governance quality in the case of small and medium-sized companies in Romania, with the purpose of establishing a connection between governance quality and business performance of SMEs.

Key words: corporate governance, protection of minority investors, information asymmetry, SME

JEL Code: G34, G32

1. Introduction

During the past decades, the international business world has been confronted with many changes, including the growth and development of business organizations, which has led to the emergence of the corporate governance concept.

Although corporate governance has proven its importance for companies observing its rules and in spite of the abundant literature and numerous theoretical models of corporate governance, we can still not say it is being applied consistently in all companies and all countries.

The concept of "corporate governance" designates the set of rules by which a company is led and controlled; more simply put, we can say it sets the "rules of the game" within the company, being made up of a set of control elements operating together to regulate the relationship between all those that have an interest in the company, also known as stakeholders: shareholders, managers, employees, customers, suppliers, and, last but not least, the state, all with the purpose of increasing the company's performance and harmonizing the different interest groups which are often in a position of continuous contradiction.

The term "governance" comes from the Latin word "gubernare", which can be translated as "to direct", "to lead" or "to govern". In Romanian, it is often translated by "to lead", which could suggest the idea of leading an ensemble, leading the entire organization, considering the term "corporate" comes from a word meaning "body", which suggests the idea of an ensemble, of a whole, of unity. The development of this concept started only towards the end of last century, when, as competition grew on the international markets and companies developed further and further, the ties between managers and shareholders grew increasingly weaker. In 2012, Tricker believed the 21st century would be governed by the concept of corporate governance, and countries would need to stimulate the emergence of complex corporate governance codes by passing proper corporate laws.

Corporate governance does not merely refer to managing the relationships between stakeholders and to the actual management of the entity, but also to the social responsibility undertaken, to business ethics, to the truthfulness of financial data provided to third parties, to institutional and reporting transparency.

Taking into account the general context of corporate governance, this study aims to highlight the limitations that arise in developing countries (especially in transition countries as Romania) and the factors underlying SMEs' reluctance towards the concept of corporate governance.
Without being intended as an exhaustive study, this article follows the evolution of the corporate governance concept, identifies the main models used worldwide, and then zooms into the atypical case of transition countries, with a special focus on Romania.

Concerning Romania, we show the general framework, as well as the results obtained from the analysis of a set of companies in Timiș County in terms of the connection between their bankruptcy or survival and the observance of corporate governance principles.

2. Corporate governance evolution

The OECD is among the first organizations to propose a general set of principles of corporate governance, which forms the foundation of many subsequent codes of governance. Its set of principles is centred round the transparency of financial-accounting information, because there is the information underlying the entire decision-making process. The OECD thus lays the foundations needed to ensure stability of the increasingly integrated financial markets. The purpose of the principles mentioned above is to improve the regulation framework concerning the company management, so as to protect the interests of both majority and minority shareholders.

Several years later, the Higgs Report states that the role of governance is to ensure the enterprise is managed in the interest of its owners. The Greenbury Report (1995) takes into account, in addition to the range of good practices applicable to companies, several examples to be followed in small-sized companies: the existence of a payment committee, information transparency, the payment policy, and the limited contract duration. By mentioning small-sized companies, the Greenbury Report fills a significant gap in corporate governance literature. However, even though it does bring a range of models applicable to small and medium-sized enterprises, this report does not generate a major effect on small enterprise owners either, the pattern continuing to apply corporate governance models only on an optional basis (and rather seldom).

The concept of corporate governance has attracted the vivid interest of many researchers, who have attempted to define corporate governance and to establish various corporate governance models that different companies could apply. The literature is thus becoming abundant. In this context, differentiating the concept of corporate governance from that of management is also important. Management has an executive function, being charged with the administration of the company, while corporate governance is there to make sure the company is headed in the right direction.

Corporate governance should never be understood as representing the company's relation with society and does not manifest itself through the legal framework, which is dealt with by the legal system. It should not overlap with company operations; instead, it should improve the fulfillment of the goals set by the shareholders, as corporate governance refers exclusively to making sure that the company's assets and shares are guided towards meeting the shareholders' goals. This idea is based on the fact that a corporation's foremost responsibility is towards its stakeholders, unlike public policies, which are addressed to all citizens.

The first corporate governance theory sketched in the literature is the agency theory. This theory, as defined by Blair (1995) is based on the assumption that the main role of organizations is to maximize their owners' wealth. The agency theory studies and solves the differences arising between the principals (shareholders) and the agents (managers). The agency relationship expresses a delegation of authority, by which the principal entrusts the management of his/her own interests to an agent. It is currently all the more difficult to estimate and estimate agency risk as there has been an increase in the complexity of financial investments, so that it is nearly impossible to quantify the agency risk when an individual investor can entrust his/her savings to a financial adviser, who, in turn, contacts a mutual fund, which finally invests in a hedging fund. In this type of investment relationships, the direct connection between the principal and the end-agent managing the principal's wealth is significantly diluted.

In most companies in the world, the connection s between shareholders and managers or boards of directors are relatively weak, which means that, even though the shareholders are the ones hiring the management teams, managers maintain their independence, which allows them to manifest their own interests in various situations, which interests differ significantly from the shareholders'. These differences of interests concern the results, efficiencies, and benefits pursued, as well as the corporate risk taken, with the agents having the tendency to take higher risks than the principals would accept. Managers often prefer to reinvest profits, to the detriment of paying dividends, their purpose being to preserve their control over the organization's financial resources. On the other side there are the shareholders, looking for the best return on their invested capital, monitoring indicators such as remuneration level, degree of freedom in using the risk capital etc.

The more scattered the shareholding and the less informed the members of the management board are, the more powerful the management becomes.

Berle and Means (1932) are the first ones to tackle the problem of separating property from control and its consequences, showing that there is sometimes a certain tension between a company's shareholders and its managers, due to their different interests. Basically, while the shareholders' main purpose is to get as high a remuneration as possible for the invested capital, managers may set their own goals, such as their reputation and prestige of running and controlling a company. Information asymmetry is also felt between the two stakeholder categories, with managers having access to a range of information within the company, which may be unavailable to the owners, especially in companies whose ownership is dispersed.
The company's value often cannot be maximized, because managers have certain confidential information allowing them to expropriate value for their benefit. Although most managers sign a contract stating their tasks when they assume their position, as Shleifer and Vishny (1997) point out, many of the future events are too difficult to describe and to foresee.

In 2001, Mulili and Wong (Mulili & Wong, 2001: 16) talk about an adverse selection, when a principal—i.e. shareholder—cannot ascertain whether an agent—manager—uses his/her powers to do the job he/she is paid for; they also talk about the moral hazard, which is when the principle does not know for sure that the agent is making all efforts to meet the goals for which he/she has been granted power of attorney.

McCahery et al. (2006) believes that Berle and Means' study from 1932 strictly applies to large enterprises present especially in the Anglo-Saxon world, but not in all states. They point out that a high-quality system of corporate governance requires institutions and mechanisms to ensure a management focusing on shareholders' welfare, a management board made up mainly of non-executive managers, and a corporate regulating system to protect minority investors.

Barna and Nachescu (2014) analyse the need to protect the interests of minority investors in the context of reducing information asymmetry on financial markets and propose a series of methods to reduce the conflicts arising in international investment operations. This study insists on the need for specific regulation measures to ensure sufficient transparency of the information made available to third parties, with the level of protection granted to minority investors' rights having a high impact on the development degree and the stability of capital markets.

Another theory developed is the stakeholder theory, which shows that managers serve a complex system of people, which does not solely include the shareholders and managers, but also creditors, clients, suppliers, the state, and other people from the company's environment, each of them having their own set of objectives and purposes.

The stakeholder concept was developed by economist Richard Edward Freeman, who realized that, in addition to the interests of shareholders, there are additional people interested in the life of the company. Stakeholders are those groups without whose support the enterprise would cease to exist. The stakeholder theory maintains that any company is dependent on the resources owned by its stakeholders, whether it concerns cash flows (provided by shareholders and customers), effort and labour (provided by employees) or raw materials (provided by suppliers). A sound and efficient interaction with certain stakeholders may contribute to securing resources that are difficult for the competition to imitate (Supriti & Damodar, 2010: 4).

According to Fontaine (Fontaine et al., 2006), the main goal of a company's management is to integrate and administer the relations between investors, suppliers, creditors, employees, customers, the community, and other groups that can guarantee the organization's success in the long run. None of these stakeholders can be excluded from the success formula of a company's operation. Each of them has his/her own role and, together, they form the company's complete operation mechanism. Considering that each of them is indispensable to the entity's operation, the manager needs to create cohesion among them, based on respecting the interests of each of them, while also remembering that he/she is the agent mandated by the shareholders, i.e. the capital holders.

According to this theory, the company needs to create value for all the interest groups around it, without any difference among them. This is based on the concept of corporate social responsibility. Disregarding the expectation of various categories of groups interested in the decision-making process has been viewed by some authors as being one of the causes that have triggered resounding bankruptcies in some large corporations, such as Parmalat, Enron or WorldCom.

Another corporate governance theory is the stewardship theory, which originated in psychology and sociology. It is based on the assumption that, in their actions, managers will give priority to the benefit of the organization and its shareholders, putting the interest of the collectivity above their own. The main motivation of such behaviour resides in the fact that, if the manager acts in the interest of the company, he/she will also benefit from the company's prosperity.

According to this theory, managers work to obtain high profits for the company and higher returns for the shareholders (Donaldson & Davis, 1994), without taking advantage of the opportunities that arise for themselves as individuals. Their own benefits stem only from the benefits they generate for the company. According to the theory, company managers must take into account stakeholders' wishes and expectations and carry out their activity in a responsible manner in relation with them. This way, a possible participation of the stakeholder groups in the decision-making process may lead to higher organization efficiency and to fewer conflicts of interests. (Mulili & Wong, 2001)

Managers are believed to be people whose activity is guided by a set of fundamental ethical values and principles, based on altruism and good reputation, to the detriment of their individual interest and their personal short-term financial purposes. After the great corporate financial collapses during the past two decades, this theory has been viewed as being slightly outdated, as it has been shown that managers do not always act strictly in the owners' interest, which means they cannot always be acting in good faith, so that their behaviour may often cause losses to shareholders, creditors, employees or the community.

The managerial hegemony theory shows that, although owners own companies from a legal point of view, managers are the ones that effectively control them, so that the role of the management board is a merely symbolic one. The theory is based on some managers' perception regarding their central role and position within a company, having a tendency to dominate both the organizational process and the entity's external links with business partners or with stakeholder groups. Thus, organizational behaviour, the decisions being taken, and the company performance are most
often influenced by such authoritative managers; even the appointment and approval of independent members of the management board is strongly influenced by executive managers’ power, dominance, and personality.

The political model of corporate governance views the allocation of corporate power as being determined by the political factor (Turnbull, 1997), while enterprises also play a part in shaping political, legal, and regulatory systems. The current political model focuses on contemporary issues, such as an inclination towards liquidity vs. towards institutional control (in case of the Anglo-American model). The political model also includes issues connected with the shift between an investor's possibility of expression and the possibility of market exit. All these issues are influenced by government laws and regulations also form the topic of a public discussion for change and reform.

The resource-dependency theory views the environment as the main source of the resources needed for business; in order to obtain these resources, the company needs to establish relations with other individuals. Pfeffer and Salancik (1978) have identified three influence factors of organizations' dependence on specific resources. These were the global importance of resources, the resource deficit (the rarer a resource, the more dependent the company), and the competition between organizations in order to control the resources. The cumulated influence of these factors has determined the company's level of dependence on a specific resource. The company management liaises between the company and the resources needed for meeting goals.

Although the literature abounds in corporate governance theories, there is no single clear or common definition shared by all the researchers of this concept. Some authors are even asking themselves whether this might be just a "whim" (Solomon & Solomon, 2004).

Sir Adrian Cadbury believed that the main preoccupation of governance should be to maintain balance between the company's economic and social goals, as well as between individual and collective goals, in an attempt to "align as much as possible the interests of individuals, of the company, and of society". This can easily prevent corporate scandals or fraudulent operations (F. Lipman & K. Lipman, 2006). Moreover, good corporate governance can increase an entity's success, improving its reputation in front of all actual or potential stakeholders.

From a practical point of view, the term "corporate governance" concerns the possibility to implement risk analysis, checking, evaluation, and control systems that will contribute to achieving an efficient management. Taking all of this into account we aim to test two hypotheses:

H1: That not all small and medium size companies in Timis county give importance to the corporate governance concept and that those who take more measures in this direction tend to reduce the economic risks they are exposed to.

H2: That the approach used by small and medium size companies towards the corporate governance in this region is similar to the one common for the developing countries

3. Methodology and results

In order to test our hypothesis, we have performed a study on 100 small and medium size companies from Timis County, from different fields of activity. The data collected through a questionnaire and direct interviews with the management teams of these companies, referred to the time period between 2008 and 2013. The questionnaire used as a data collection instrument was highly structured and contains mostly closed questions, with a few open ones as well.

We believe that the lack of efficient corporate governance, especially in the case of small and medium-sized companies, is one of the major factors that can lead to their closing. The study confirmed that only 62 of the 100 companies that we’ve investigated are still operating normally, while 32 are bankrupt and the others have ceased to operate for economic and personal reasons. We have found that the companies that willingly closed down were generally small companies (with up to 5 employees), having a turnover of less than 50,000 Euros. Interviews with company administrators/shareholders have revealed that they had too high expectations (in terms of profit rate) with too little efforts or in a too short time span.

The companies that filed for bankruptcy had customers with long overdue invoices (though this did not result in their concluding cautious contracts or seeking legal advice regarding framework contracts); they were faced with the boomerang effect of not having paid their dues to the state budget, correlated with having made payments without documentary proof, simply to avoid a correct recording of taxes as payment obligations; they had unjustified expenses with luxury cars, houses, expensive holidays, etc., all paid from the company account. Perhaps the most serious thing is that, in case of all these companies, there was no information transparency even between departments, so that problems identified by the financial-accounting department were not even signalled to the company management.

One important aspect that we’ve took into account when analyzing the results we’ve obtained was that the companies we’ve investigated are companies that perform their activities into a developing economy.

Developing economies are characteristic of countries whose economic activity is dominated by growth and industrialization, but whose financial markets are not mature enough. These countries usually have volatile macroeconomic indicators and a high degree of risk regarding investments, due to the lack of a system to properly regulate markets. Bollard (2003) claims that corporate governance can make a difference for these countries, as it can contribute to ensuring the soundness of the financial system while ensuring the mechanisms needed to overcome economic shocks.

In countries without a sound and mature financial infrastructure, companies have few options to secure the financial resources they need and can only fund themselves based on their own profit, on bank loans or supplier loans.
A corporate governance system can increase their chances of accessing the funding sources available. Abor (2007) even proved that there is a positive and statistically significant correlation between the capital structure, the size and composition of the management board, and the duality of the general manager.

The importance of shareholding as a corporate governance mechanism has been studied for various cases by Jensen & Meckling (1976); Cueto (2007), Godfred & Arko (2009), and Claessens & Yurtoglu (2012).

A feature of developing economies is that there are a small number of large companies, with high financial potential. These markets are populated mostly by small and medium-sized businesses, for which corporate governance codes are not necessarily specific. Authors generally believe that the rules, standards, principles, and practices ensuring good corporate governance are found in joint-stock companies, which is why approaching corporate governance in developing countries is a delicate undertaking, as we are talking about the quality of corporate governance in companies for which this cannot be imposed in any way.

Transition countries have a range of common features, but not identical features, due to their highly heterogeneous past. For instance, some countries were developed before the rise of communism, and private property had generated a strong economy, based on small and medium-sized enterprises. These countries found it easier to return to a market economy, mainly due to the existence of a mentality based on public property, which was absent in the case of other countries.

However, whatever the past of the countries analysed, there is a series of factors that can increase their chances of sustainable development. Of these, the most important one is that the state should be willing and able to protect the right to property by well-defined and properly applied laws. The state should also have the ability to exclude or at least limit corruption and the underground economy. Economic development can only occur by stimulating the development of sustainable entities, created based on sound principles and closely supervised by well-defined regulation and control institutions.

Attempting to implement corporate governance principles in developing countries and especially in transition countries is no easy undertaking. In the early 1990's, many of these countries resorted to taking over codes of good practice and models that had proven successful in Western countries, without taking into account the lack of the needed institutional structure. Success stories involved countries that took into account their own initial conditions, their economic development stage, the economy structure, the credibility of the government, etc.

If we look at the 8 economies that joined the EU in 2004, we can see that they all had a similar past and, thanks to their desire to become EU members, they applied the same political and economic measures. The EU has provided the stability and guidance needed for institutional restructuring, increasing their credibility in the eyes of investors.

Even though the application of Western governance models has not yielded the desired results in all cases, the literature shows that most transition countries still apply models taken from Western countries, they still have a weak institutional structure concerning corporate governance, which makes it difficult to impose rules and laws connected with the protection of property and therefore weakens investors' trust in these countries' capital markets. Vasilescu (2008) says that the insider corporate governance model of a European continental type is specific to certain countries in Central and Eastern Europe, including Romania, due to the forced privatization of pre-1989 state-owned enterprises, which gave control rights to those companies' managers and employees.

In Romania, corporate governance is a relatively new concept. Although important steps have been taken in recent years to adopt some codes of governance, of behaviour or of ethics, the corporate sector in Romania is still dominated by acute informational opacity. This lack of transparency, doubled by the lack of a sound system for governing corporations, sends a negative signal to potential foreign investors, who have no guarantees regarding the stability of the business environment.

The state of fact in Romania (as in other former communist countries) is obviously rooted in the radical transformations of the corporate environment as the country moved from a planned economy to a market economy. The 2001 OECD report showed that Romania was making significant efforts to improve corporate governance and recommended that special priority should be given to reforms, which would contribute to improving the legal framework in effect, as well as to ensuring the independence of authorities whose tasks involved the corporate sector. The same organization was asking Romania to strengthen property and control structures in the private sector, so as to prevent situations of expropriation at the initiative of majority shareholders or of managers enjoying unlimited powers.

The governance of corporations is legislated and organized by a series of post-1989 regulations, namely by the Companies' Law 31/1990, as amended, by the Capital Market Law 297/2004 or by the Corporate Governance Code of the Bucharest Stock Exchange. The Companies' Law 31/1990 protects shareholders' rights and facilitates the exercise of their decision power, ensuring that owners have voting rights within the general shareholders' assembly, the right to dividends, the right to elect management board members, and the right to be informed regarding the company's financial situation. To ensure fair treatment of the shareholders (a fundamental concept in corporate governance), the Companies' Law 31/1990 provides that shares should have an equal value. The same law defines the responsibilities of managers and of the management board, both in the case of a single-level corporate management system (represented by the management board) and in the case of a two-level system (where a supervisory board is also present).

The first initiative to establish a sound corporate governance system belonged to the Bucharest Stock Exchange (2001), which developed a first governance code applicable to listed company from the first category. This initiative was continued by the setting up of the Corporate Governance Institute, which was responsible for training the
executive managers of listed companies with the purpose of promoting adequate governance standards. The BSE Corporate Governance Institute promotes OECD’s governance principles. In 2008, the Bucharest Stock Exchange developed a code of corporate governance applicable to listed companies within this regulated market, by which listed companies in the first category are asked to adhere to at least 14 recommendations, submitting annual reports as to which recommendations they have followed and which not. This code is based on the OECD principles. The main goal is to adopt clear and transparent governance structures on the capital market, which should provide and establish the rights, competences, and responsibilities of executives or of management board members, as well as to establish a fair treatment of investors in the same class of shares. The code adopted also provides the obligation to observe the shareholders' right to information and to exercising decision-making power. This code also ensures information transparency by recommending periodic reports of all relevant events connected with the property structure, the company management, and the financial situation and performance. The IFRS must be used and an English translation of the reports is required.

To ensure the company's financial sustainability, it is recommended to establish cooperation relationships with interested third parties and to observe their legal rights, as a way to implement social responsibility practices.

However, even though there is a BSE Corporate Governance Code, a 2011 study (Feleagă et al., 2011) shows that many of the listed companies disregard it either partly or entirely. The most serious issues found by the authors concern the transparency level and the independence degree of managers and audit board members.

The analysis of the activity of the 62 companies that survived the 2008-2013 crisis period reveals that, even though they had no actual written codes of good practices, they did apply corporate governance principles and their business organization revealed a series of common elements:

- rigorous procedures for management supervision and control and for eliminating the risks of wrong or fraudulent management;
- analysing and rethinking activities by eliminating unprofitable ones;
- reorganizing the company by eliminating inefficient positions;
- the existence of a regularly updated manual of accounting procedures with the presentation of accounting rules and treatments;
- systematic cash-flow monitoring;
- drafting revenue and expenditure budgets and making sure to stick to them at all times.

The study shows that most bankrupt companies (73.08%) did not implement a risk control system. Also, quite many of them (92.31%) did not draft a good practice guide or defined a risk management system. 30.77% of them believe cooperation between management and accounting to be just necessary. 46.15% of them perform an economic-financial analysis each month, 15.38% do it on a quarterly or half-yearly basis, and 23.07% do it once a year. Furthermore, most bankrupt companies (92.31%) use a percentage-based system for management payment, they have a rule-based governance method and are self-funded, and only 3.85% of them have medium-term strategies.

4. Conclusions

The study allowed us to identify problems at the level of the Timis County SMEs, problems that are in many cases connected with the absence of corporate governance rules, which increases the opacity of information provided to third parties, lowers the protection of minority shareholders, decreases the definition of tasks within the entity's management bodies, and last, but not least, generates a negative impact on the performance obtained.

Of course that the study also emphasised the context in which these companies are developing their activities, which is a very unstable one, with very specific conditions as in the case of all developing countries. It also showed that Romanian small and medium size companies are hardly concerned about developing a clear corporate governance system, even though, the same study shows that the companies that managed to stay on the market and develop are those that, consciously or not, apply corporate governance principles. This conclusion also opens a door to new research perspectives, towards establishing a link between corporate governance and the performance of SMEs, not only at county level but also at the whole country level.

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