Environmental contingencies and sustainable modes of corporate governance

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Abstract

Corporate governance systems in the historically market-based economies have evolved in such a way that the system reflects the extant cultural and economic environment. However, in the transitional economies of central and eastern Europe corporate governance practices are being imported from systems used in the historically market-based economies. As a consequence, systems may be introduced into economies where the necessary supporting environmental contingencies are not adequately developed. In this paper, a theoretical framework for analysing the transition of corporate governance systems is proposed. The model is applied to Slovenija, an example of a transitional economy from the region. Slovene accounting practices, corporation law and security market regulation practices, modelled on UK, Germany and US systems, respectively, may not be the best system for Slovenija. © 2000 Elsevier Science Ltd. All rights reserved.

1. Introduction

The diversity of corporate governance systems in the historically market-based economies (see, e.g. Monks and Minow, 1995) reflects the diversity of environmental contingencies under which companies in different countries operate (see, e.g. Hopwood, 1983; Loft, 1988; Nobes, 1994; Puxty et al., 1987). For the transitional economies of central and eastern Europe, these environmental contingencies are themselves in a state of flux. As a consequence the
choice of an appropriate system of corporate governance is a difficult one. Many of the economies of the region have adopted a portfolio solution to this problem by importing hybrid systems that reflect different mixtures of the systems found in the market-oriented economies (Frydman et al., 1996, p. 4). The effectiveness of such imported systems is the subject of my paper.

Analysis of the extant systems of corporate governance found in the historically market-based economies shows that systems of corporate governance and cultural, legal and institutional contingencies are inextricably linked (Franks and Mayer, 1990, p. 192). This raises the spectre of systems that are effective in one country being imported into other countries, where the environmental contingencies are sufficiently different that the imported system is ineffective. More pertinently, for the countries of central and eastern Europe, the development of systems of corporate governance is taking place at the same time as the economic system itself is changing radically and the economic infrastructure is being redesigned.

Current models of economic transition are fundamentally static (Stark, 1996) as they provide blueprints for transition from a known command-economy (where prices are set without regard to demand and supply) to a known market-economy (see, e.g. Sachs, 1989; Klaus, 1992; Peck and Richardson, 1992). However, the diversity of both the former command-economies and historically market-based economies is well documented (see, e.g. Garrod and McLeay, 1996a; Zeff, 1972). It, therefore, seems inevitable that the eventual market economies of the transitional economies will display considerable diversity. Any model of transition will need to accommodate such potential diversity. Building on the theoretical models of Harrison and McKinnon (1986), Streeck and Schmitter (1985) and Bailey (1995) a framework for the analysis of the transitional dynamics of systems of corporate governance is developed in Section 2. The historical links and current political and economic pressures on the transitional economies of central and eastern Europe probably explain why the predominant governance influences come from the United States (US), the United Kingdom (UK) and Germany (Garrod and McLeay, 1996b, pp. 3–5). In Section 3, the environmental contingencies in these three systems of governance are identified. In Section 4, these influences on the current hybrid system in use in Slovenija are described. By applying the transitional model developed in Section 2 to the Slovene situation, the gaps in effectiveness of this hybrid system are identified in Section 5. Concluding remarks on possible implications for the transitional economies are made in Section 6.

2. A theoretical model of corporate governance transition

The transition framework developed in my paper is a fusion of the models of Harrison and McKinnon (1986), Bailey (1995) and Streeck and Schmitter
The Harrison and McKinnon (1986) framework is concerned with generic change processes. Bailey (1995) focuses directly on the extreme change environment being experienced in the transitional economies of central and eastern Europe, while Streeck and Schmitter (1985) consider the role of environmental contingencies on locating regulatory systems within their institutional environment.

The Harrison and McKinnon model (1986) builds on the earlier work of Rogers (1962) and Rogers and Shoemaker (1971) by viewing the regulatory environment that is subject to change as a social system. This allows explicit recognition of the source of the change stimulus and the environmental contingencies of the recipient of the innovation. It also allows for the temporal dimension to be considered. This is important for the transitional economies, as the contemporaneous development of systems of regulation and institutional structures is crucial to the ultimate effectiveness of corporate governance systems.

Harrison and McKinnon (1986, p. 238) identify four critical aspects of the change process: the “intrusive event”, “intra-systems activity”, “trans-systems activity”, and “cultural environmental”. The intrusive event is exogenous to the system affected; it not only disrupts the subject system, but also the other systems with which the subject system interacts (Harrison and McKinnon, 1986, p. 239). As systems of corporate governance are themselves a nexus of separate system controls (Lawrence, 1994, p. 2), this characterization of the change stimulus is particularly useful for my analysis. Intra-systems activity is described by Harrison and McKinnon, (1986, p. 238) as the interactions among the structural elements of the subject system itself while trans-systems activity is described as the interactions across other system boundaries. The cultural environmental is claimed by Harrison and McKinnon (1986, p. 239) to pervade the whole change process. This is also an important element of my framework as the starting and ending points of the transition process are assumed to be unique to each transitional economy.

With regard to corporate governance in the transitional economies, the change in the economic system itself I take as the intrusive event. As systems of corporate governance are themselves an amalgam of distinct institutional and regulatory structures, I consider the institutional framework of the corporate governance system to be the intra-system activity, while the regulatory framework surrounding these institutional structures I characterize as the trans-system activity in my transition model. That is, the regulatory framework establishes the environment in which the institutional structures themselves can operate.

The model developed in my paper is equally applicable to market-based economies. The US intra-system activity is dominated by the depth and efficiency of capital markets and the manner in which ownership changes occur. The trans-system activity, on the other hand, relates to reporting regulation.
which creates a framework for the transmission of relevant, useful, audited and public information from companies to external stakeholders. The intra-system activity within the UK is more heavily dominated by professional structures, a preponderance of institutional share owners and the non-public transmission of information to analyst and institutional owners alike, while in Germany the two-tier management structure and a combination of ownership by other companies and bank ownership dominate. With regard to the trans-system activity, the UK regulatory environment is heavily influenced by professional codes of conduct and self-regulation while in Germany the commercial code and its influence on required internal management structures dominates. These differing aspects of the corporate governance framework in these three market economies are discussed more fully in Section 3 of the paper.

Bailey’s (1995) model looks more specifically at the accounting change process in the transitional economies of central and eastern Europe. Bailey (1995, p. 603) identifies three stages of development: “state directed”, “state regulated”, and “market driven”. Bailey (1995, p. 605) summarizes these phases as periods when accounting information is “a legally required historical record”, “a tool of administrative control”, and “a tool with relevance to entrepreneurial endeavour”, respectively. In the “state directed” former command-economies accounting amounted to no more than formalized bookkeeping and compliance with the letter of the law (Bailey, 1995, p. 599). In the transition economies, however, state regulation is seen as having a positive role to play in transforming politically driven accounting information into market driven, economically useful accounting information upon which transaction decisions can be based (Bailey, 1995, pp. 604, 605). Thus “state regulated” is characterized by an imposed normative accounting model, which is rather static and unresponsive to pressures brought to bear by market forces and economic development. Bailey’s (1995, p. 605) “market driven” state, on the other hand, is one in which changes in the economy and competitive pressures will lead accounting legislation which, in turn, will be responsive to, and reflect, such developments. Implicit in Bailey’s (1995, p. 605) model is linear development from “state directed” through “state regulated” to the ultimate goal of “market driven”. In line with my view that transition in central and eastern Europe has no fixed starting point nor ultimate destination, this characterization of the change process is unduly restricting. However, building on the insight from Streeck and Schmitter (1985), these three stages of economic transition can be considered limiting and ideal cases which define a set of feasible combinations within which economies in transition can be located.

The Streeck and Schmitter (1985) framework was designed specifically for analyzing regulation in capitalist economies. They (p. 6) also identified three limiting and ideal cases to define their feasible set: the “state”, the “community”, and the “market”. For the transitional economies, the “market” and the “state” can be considered equivalent to “market driven” and “state regulated”
in Bailey’s (1995, p. 605) framework. However, Streeck and Schmitter’s (1985) “community” has much more to do with pressure groups, professional organizations and societal norms and mores than the centralized and domineering role of the state in the former command economies. Thus, the Streeck and Schmitter (1985) and Bailey (1995) models can be brought together by combining the two triangular mappings of existing capitalist economies and the former command economies along their common dimension to create a more comprehensive mapping (see Fig. 1). Within this diamond set, it is possible to locate the full range of diversity to be found in both the transitional economies and the market-based economies.

Combining the Harrison and McKinnon (1986) framework with the diamond set of location leads to a matrix mapping (see Table 1) of the institutional structures (intra-system activity) and their related regulatory systems (trans-system activity). The two-dimensional impression created by this matrix is misleading on two major counts. First, the four transition stages represented by the columns do not represent linear stages of transition that must be traversed in order. Rather they represent descriptive delimiters of the possibility set, in the terms of Fig. 1. Second, for systems of corporate governance, the intra-system activity and the trans-system activity can be thought of as separate dimensions in their own right. It is the interplay between institutional structures (intra-system) and the nature of their regulation (trans-systems) which

![Fig. 1. A locational map for corporate governance in the transition economies. (The four corners of the diamond set represent ideal and limiting cases of corporate governance systems. State-regulated, state-directed and market-driven are the three limiting cases of Bailey’s (1995, p. 603) model, while state-regulated, market-driven and community are the three limiting cases of the Streeck and Schmitter (1985, pp. 1–2) model. The dashed line represents the commonality and proposed fusions of these two models. Puxty et al. (1987, p. 283) first represented these limiting cases as part of a triangle representing all feasible combinations.)](image-url)
provides the nexus of environmental contingencies which defines the corporate governance environment.

The effectiveness of the distinct corporate governance systems found in the market-based economies is assured by the regulatory structures of the trans-system activity being conditioned by the environmental contingencies exerted by the intra-system activity (see the discussion in Franks and Mayer, 1990, p. 193). Within our transition model this would be indicated by the intra- and trans-system activity of the elements of the corporate governance system being located in the same cell of the transition matrix and, therefore, the same area of the diamond set. Any mismatch between the transitional stage of the intra- and trans-system activity of the elements of the corporate governance system will lead to reduction in the effectiveness of that system.

The main influences of the transitional economies of Central and Eastern Europe are those of Germany, the UK and the US (Garrod and McLeay, 1996b, pp. 3–5). Thus the main elements likely to constitute the intra-system activity of corporate governance systems in the transitional economies will come from the systems of corporate governance used in these three

<table>
<thead>
<tr>
<th>Intrusive event</th>
<th>Intra-system activity</th>
<th>Trans-system activity</th>
<th>Cultural environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-directed</td>
<td>State-regulated</td>
<td>Community</td>
<td>Market-driven</td>
</tr>
</tbody>
</table>

*Table 1*  
A transition matrix of corporate governance

→ increasing progress in transition to a market economy  

"The rows of the matrix represent the elements of the Harrison and McKinnon (1986, p. 238) change model.


Collectively these represent distinct phases in the transition to a market economy.

The intrusive event is the change in the economic system.

The intra-system activity represents the nexus of institutional structures and operations which define the environmental contingencies within which the trans-system activity operates.

The trans-system activity represents the nexus of regulatory frameworks which constitute the corporate governance system.

The cultural environment reflects the country-specific characteristics which influence the intra- and trans-system activities.

When corresponding elements of the intra- and trans-system activities are not in the same column of the matrix, there is prima facie evidence of a non-coherent and, therefore, less effective system of corporate governance.
countries. The identification of these specific elements is the subject of the next section.

3. Concepts of corporate governance

Monks and Minow (1995, p. 268), among others, highlight the diversity of corporate governance in the market-based economies. A rudimentary, and often used, dichotomy of corporate governance systems is between the outsider systems (e.g. the UK and the US) and the insider systems (Japan and Germany) (Goergen, 1998, p. 1).

In the outsider systems, with the dominant characteristic being the arms-length relationship between owner and manager (Franks and Mayer, 1990, p. 193), issues of governance are dominated by this separation of ownership and management. Although the agency problems associated with such a separation have been known since the 18th century (Campbell et al., 1976, p. 741), Berle and Means (1932, p. 69) reinterpret this problem as the separation of ownership and control (see Garrod, 1996, p. 147). In more recent work (see, e.g. Manne, 1965; Alchian and Demsetz, 1972; Fama and Jensen, 1983) attempts have been made to identify potential mechanisms in the outsider system that might limit the agency problems that can arise from such a separation. These mechanisms include monitoring and control by non-executive directors and the design of suitable incentive mechanisms, but the ultimate sanction which enables these mechanisms to be effective is the market for corporate control itself (Schleifer and Vishny, 1997, p. 756).

For the market in corporate control to be effective in a governance role, Franks and Mayer (1990, p. 210) claim it must be constituted by a large number of listed companies, be a liquid capital market where ownership and control rights are frequently traded, and have few intercorporate equity holdings. US securities markets are characterized by all three of these necessary conditions (see, for example, London Stock Exchange, 1997, p. 37; New York Stock Exchange, 1995, p. 57). Under these circumstances Kim and Hoskisson (1997, p. 179) argue that in the US environment the market in corporate control is likely to dominate all other mechanisms for corporate governance (also, see Garrod, 1996, p. 147).

The market in corporate control is, itself, often equated simply with the corporate take-over market. While Scharfstein (1988, pp. 191, 192) has set out the theory as to how “informed raiders” can assist shareholders in distinguishing between poor management performance and an unfavorable external economic environment, the empirical evidence is unable to detect clear economic benefits ensuing from successful take-overs (Martin and McConnel, 1991, p. 686). The greater subtlety of the impact of security markets on management decisions is also illustrated in recent work in the field of
information asymmetry and agency (e.g. Brennan, 1995) in which the impact of the structure of claims on the income stream itself is highlighted rather than the impact of a particular allocation of a given income stream amongst competing claim holders (Modigliani and Miller, 1958, p. 268).

Literature on information asymmetry (e.g. Brennan, 1995) and take-over (in)effectiveness (Franks and Mayer, 1996, p. 180) suggests that even in the US, the market for corporate control is more subtle and extensive than just the take-over market (see Garrod, 1996, p. 148). A more comprehensive characterization of the US system is as one based on arms-length relationships which are regulated and monitored via efficiently operating markets (Fama, 1980, p. 289) and which rely on adequate flows of information between market participants (Fama, 1980, pp. 296, 297).

The UK market is also characterized by a large number of listings (London Stock Exchange, 1997, p. 37) and high volume (London Stock Exchange, 1997, p. 37) but ownership structures are quite different to those in the US (see Table 2). Personal investment is at a much lower level than the US while institutional holdings (excluding banks) are much higher than the US (see Table 2). In addition, while the number of individual shareholders on the New York Stock Exchange was reported to be about five times that of the London Stock Exchange it was also reported that there were 30 times as many institutional investors on the New York Stock Exchange than on the London Stock Exchange (London Stock Exchange, 1997, p. 37). This, in combination with the higher institutional stock holdings on the London Stock Exchange,

Table 2
Percentage of aggregate shareholder ownership of publicly listed companies

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Personal</td>
<td>50.4%</td>
<td>18%</td>
<td>17%</td>
<td>11.9%</td>
</tr>
<tr>
<td>Institutions – excluding banks</td>
<td>43.5</td>
<td>61</td>
<td>9</td>
<td>33.6b</td>
</tr>
<tr>
<td>Banks</td>
<td>n/a</td>
<td>1</td>
<td>10</td>
<td>n/a</td>
</tr>
<tr>
<td>Government</td>
<td>n/a</td>
<td>1</td>
<td>6</td>
<td>n/a</td>
</tr>
<tr>
<td>Overseas</td>
<td>5.4</td>
<td>16</td>
<td>17</td>
<td>n/a</td>
</tr>
<tr>
<td>Other companies</td>
<td>n/a</td>
<td>2</td>
<td>42</td>
<td>n/a</td>
</tr>
<tr>
<td>Internal</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>36.1</td>
</tr>
<tr>
<td>Other</td>
<td>0.7</td>
<td>1</td>
<td>n/a</td>
<td>18.4c</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>101%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Percentages are rounded. Germany is 101% due to rounding.


b Investment, restitution and pension funds.

c Restitution beneficiaries, banks and other creditors, co-operative, communities, state and foreign physical and legal entities.
suggests that the average stock holding of individual institutional investors on the London Stock Exchange is much higher than on the New York Stock Exchange. This can only result in the relative power of the institutional investor being much greater in the London Stock Exchange than in the New York Stock Exchange.

The larger proportion of more powerful shareholders suggests that company shareholder relations are much more direct in the UK than in the arms-length market of the US (Holland, 1996, p. 133). Typically institutional investors attempt to build a long-term relationship with their investee companies and do not expect to trade a large proportion of these shares for short-term gain (Holland, 1996, p. 146). Disinvestment decisions are made only if the relationship breaks down (Holland, 1996, p. 143; see the discussion in Garrod, 1996, p. 148). Indeed, empirical evidence from Franks and Mayer (1996, p. 169) indicates that the take-over process is just one extreme on the continuum of corporate restructuring. Jenkinson and Mayer (1992, p. 39) suggest that for UK companies there is more evidence of an association between poor corporate performance and direct institutional intervention than between poor performance and hostile take-over.

Following the publication of The Cadbury Report (1992), the concept of corporate governance in the UK has been dominated by issues regarding the shareholder–director relationship (Cadbury, 1993, p. 48). The focus of ensuring effective governance has been the structure of Boards of Directors and their subcommittees (Cadbury, 1993, p. 48; also, see Garrod, 1996, p. 147). Principally there is a major role for non-executive directors (Cadbury, 1993, pp. 48, 49) and for the separation of the roles of chief executive and company chairman (Cadbury, 1993, p. 48). This requires professional self-regulation by a Board of Directors which is not required under UK company law \(^1\) and for an increase in the number and influence of non-executive directors whose powers and responsibilities are not differentiated in the Companies Acts (1985 and 1989) from those of executive directors. These idiosyncrasies are indicative of the style of corporate governance adopted in the UK. Much greater emphasis is placed on professional self-regulation and private institutional shareholder–company communication than is the case in the more arms-length US market (Holland, 1996, p. 129).

Corporate governance in Germany reflects a very different style. In contrast to the Anglo-American system, it relies mainly on monitoring by committee rather than competition through markets (Franks and Mayer, 1990, p. 215). These committees derive from the two-tier or dual board system (see, e.g. Baums, 1993, p. 153; Ordelheide and Pfaff, 1994, p. 27) and ownership

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\(^1\) Section 282 of the 1985 Companies Act requires that each registered company shall have at least two directors but there is no requirement for these directors to constitute a board of directors.
structures. For companies with more than 500 employees, the dual board system consists of a supervisory board whose members are elected by the shareholders (or for companies with more than 2000 employees, a board where half of the members are elected by the shareholders and the other half by the employees and labor unions) and a management board which is appointed, usually, for a five-year period by the supervisory board (Baums, 1993, p. 153). Despite the appointment of the management board by the supervisory board, the day-to-day management decisions involved in running the firm are taken by the management board (Ordelheide and Pfaff, 1994, p. 27); consequently the German system is characterized by a high degree of discretion granted to management. Only where management is clearly revealed to be unsuitable does direct intervention by the supervisory board occur (Ordelheide and Pfaff, 1994, p. 27).

Ownership structures similarly reveal a very different pattern from those found in outsider system economies. In 1995, only 17% of German company shares were in the hands of individuals, 10% in the hands of banks, and 42% were in the hands of other companies (Table 2). While many individuals deposit their shares and their voting rights with banks (thereby increasing the banks’ significance), the cross company holding dominate the insider German system (Edwards and Fisher, 1994, pp. 180, 181).

In summary, the US model highlights the importance of the operational nature and structure of securities markets and the flow of information to them, the UK model underscores the importance of self regulatory management and professional controls, while the German system relies largely on a clearly defined legal and organizational structure within which control is effected. Crucially, for the effectiveness of corporate governance in these countries, the environmental contingencies identified above are mirrored and supported by the related regulatory frameworks. In the US security market, operations are enhanced by requirements for extensive information transfer between market participants (Taylor and Turley, 1986, p. 170). In the UK, financial-reporting regulation is largely in the hands of the accounting profession and the financial regulatory system is based on one of professional self regulation. In Germany, the importance of stable cross-company holdings is underscored via two-tier, participative board structure required under the German commercial code (Franks and Mayer, 1990, p. 208).

4. Corporate governance in Slovenija

Slovenija has developed a comprehensive corporate governance environment which displays aspects of the US, the UK and the German systems, as demonstrated below (see Garrod, 1996, p. 149). Stock market regulation follows the US Security and Exchange Commission model, financial reporting
and professional structures are modelled on the UK system, while company law is heavily influenced by the German company code (Ribnikar, 1996, p. 320; also see Garrod, 1996, p. 149). Despite such well recognized characteristics in the Slovenijan system, issues exist as to how effective corporate governance actually is (see Garrod, 1996, p. 149). In many instances the underlying regulatory frameworks (trans-system activity) are at different stages of transition to the institutional structures (intra-system activity) to which they relate. Thus, the current corporate governance structure in Slovenija does not ensure effectiveness (see Garrod, 1996, p. 149).

The three distinct areas of corporate governance adopted in Slovenija (securities market operations, financial reporting and professional structures, and corporate law and corporate structure) will be considered in turn to illustrate the problems associated with the importation of corporate governance systems without the requisite institutional framework to make such systems effective.

### 4.1. Security market operations

The regulatory structure of the Ljubljana Stock Exchange is heavily influenced by the structure of the US Securities and Exchange Commission. Market operations are regulated by the Slovene Securities and Exchange Commission which has developed an extensive and effective regulatory framework as witnessed by the action described in Kovac (1997, pp. 47–61).

Despite this regulatory completeness, the environmental contingencies surrounding the Slovene market are very different from those of the US. First, the market is extremely thin and shallow – 400,000 shares traded in 1996 (London Stock Exchange, 1997, p. 42) – and second, ownership structures are quite different (see Table 2). Slovene share ownership is dominated by internal owners and large minority holdings by investment funds. A recent study found that 70.9% of Slovene companies, by number, had majority employee ownership and, even by value the percentage is 34.6% (Simoneti et al., 1998, p. 131). Of the remaining companies, by value, 49.5% had employee ownership in the 26–50% range so that internal ownership is clearly significant (Simoneti et al., 1998, p. 131).

In this environment, the role of the securities market to affect management decisions is severely limited. Indeed the nature of the governance issue in the Slovene market is quite different to that of the US. While ownership structures in Slovenija imply that there is much less separation of ownership and management – or even ownership and control – than in the US, the power of minority shareholders is probably much less than in the US (Ribnikar, 1996, p. 317). The private and quasi-government investment funds, established as part of the privatization process, are effectively disenfranchised by the shallowness of the market and homogeneity of the majority shareholders.
The latter effectively rules out compromise if there is a policy disagreement between the majority and minority shareholders (e.g. Mramor, 1996, p. 330) while the former prevents disinvestment due to the limited availability of alternative investment opportunities (Ribnikar, 1997, p. 45).

4.2. Financial reporting and professional structures

The basic model for the role of independent auditors and their professional regulation has followed the UK model. The developing importance of independent auditing as the economy itself has changed can be judged by the change in title of the accounting and auditing body(ies) in Slovenija. In the early days of post Second World War Yugoslavia accounting academics were members of the Society of Economists in Slovenija, reflecting the dominance of macro-economic planning on accounting thought and procedures (Turk and Garrod, 1996, p. 147). In the early 1970s, the Society of Accounting Technicians changed its name to the Slovene Society of Accountants and Treasurers which subsequently became the Association of Accountants, Treasurers and Auditors (Turk and Garrod, 1996, p. 147). With each change of name, the growing independence of the accounting process from macro economic planning was underscored. Recognition of the importance of accounting information as an exogenous input to economic decision making was formalized when the Association of Accountants, Treasurers and Auditors established an independent professional auditing body – the Slovene Institute of Auditing – shortly following national independence in 1991 (Turk and Garrod, 1996, p. 152). This body now derives further authority from the Law on Auditing and is the parent body of the Slovene Accounting Standards Committee (Turk and Garrod, 1996, p. 147). Despite these institutional developments the size of the qualified profession is still very small. Petrovic and Turk (1995, p. 815) report that despite there being about 400 persons in ex-Yugoslavia (including Slovenija) who were trained within the framework of the Audit Department of the Social Accountancy Service, there was not a single professionally qualified accountant in the whole of Yugoslavia in 1992.

In the two years following independence in 1991, the Slovene accounting profession produced 32 standards (Turk and Garrod, 1996, p. 155). The process was undoubtedly helped by the Yugoslav adoption of a Code of Accounting Principles in 1989 upon which the Slovene standards were based (Turk and Garrod, 1996, p. 154). While the standards are designed to comply with International Accounting Standards as much as possible, Slovenija’s aspirations to join the European Union mean that the standards are primarily modelled on UK regulation which incorporates the EU 4th Directive (Turk and Garrod, 1996, p. 154).
The standards are based on the user perspective (Slovene Accounting Standards, 1993, p. 1), as in the UK and US. While recognizing multiple users, no explicit recognition of the specific characteristics of the Slovene reporting environment are made. For example, in the Slovene Accounting Standards (SAS), there is no explicit regulation, or recommendation, that internal employee oriented reports be produced in addition to the annual report, neither is there any specific recognition of the potential impact on information requirements of the predominance of employee share ownership. Thus the primary focus of accounting reports is to provide useful information for the security market decisions of external investors. Given a sophisticated securities market, those pricing securities can indicate their acceptance, or otherwise, of the appropriateness of definitions used for reporting such things as assets and liabilities via security prices. In the Slovene context this is not the case. The majority of Slovene companies are not publicly traded (Simoneti and Jasovic, 1996, p. 141) and the thin securities market is itself only slowly coming to terms with the information content of accounting numbers. This means that the necessary critical external evaluation of reporting regulation and practices is largely missing in Slovenija (Ribnikar, 1996, p. 322).

In addition, corporate accountants are themselves facing dramatically different definitions of basic accounting concepts from those with which they were familiar. Concepts such as assets, liabilities and income are defined quite differently in the SAS to what was the norm under command-economy accounting (Turk, 1988, p. 160). Assets, for instance, used to be subdivided into fixed assets, current assets, financial investments, reserve assets and common consumption assets (Turk, 1988, p. 160). Reserve assets consist of cash intended for the recoupment of losses, while common consumption assets consist of housing and recreational buildings and equipment for the use of workers, loans advanced to workers and other cultural expenditure (Turk, 1988, p. 160). Salary costs were not incorporated into work-in-progress inventory valuations but were treated as claims against future income (Turk, 1988, p. 161). Loans (initially directly from the Government and, more latterly, via state owned banks) were the main source of financing and generally had no repayment obligations (Turk, 1998, p. 161). The financial result or income was generated by deducting a form of accrual expenses from a modified cash revenue figure which resulted in a 100% reserve against all trade debts not settled in cash within the prescribed period (Turk, 1988, p. 162).

An additional special feature of the Yugoslav income statement was the segregation of expenses (Turk, 1988, p. 163). Gross income was defined as revenue minus material costs and depreciation charges attributable to the goods sold; net income was gross income minus taxes on gross income and common consumption asset expenditure; salaries and associated taxes were then deducted to generate residual net income which could be used to pay for
additional wages and salaries to the workforce or transferred to the common consumption fund; any remaining surplus could be used for investment within the organization (Turk, 1988, p. 163). If the net income was negative, then taxes would be decreased or eliminated (Turk, 1988, p. 164). Clearly much re-education was required (Petrovic and Turk, 1995, p. 815). This has been recognized in the standard setting process, in that seven of the standards cover issues not covered by International Accounting Standards (SAS 16 – “Costs in Terms of Types, Centres and Units”; SAS 20 – “Budgeting”; SAS 21 – “Bookkeeping Documents”; SAS 22 – “Books of Account”; SAS 28 – “Accounting Supervision”; SAS 29 – “Accounting Analysis”; SAS 30 – “Accounting Information”) and are designed to be educational as well as prescriptive (Turk and Garrod, 1996, p. 154). Laudable though the educational aspect of Slovene standards may be, it underlines the problems of any economy which changes its economic goals, aspirations and values over a short period of time. It is unrealistic to expect Slovene company accountants to assimilate these new concepts via accounting standards alone and to be producing substance over form and true and fair accounts (financial statements) immediately. The ongoing world-wide debate about asset and liability definitions, the nature and appropriate treatment of goodwill and accounting for brands and intangible assets indicates the complexity of the problem (International Accounting Standards Committee, 1997, Appendix 3, pp. 67–109).

Despite the development of professional auditing standards and guidelines by the Slovene Institute of Auditing, the general lack of appreciation of substance over form and true and fair (fair representation) in the accounting field also limits the effectiveness of the audit process (Turk and Garrod, 1996, p. 154). This is not, of course, limited to the transition economies of central and eastern Europe. It is often identified as the major difference between British accounting and continental European accounting (Walton, 1993, p. 49) and caused considerable difficulties when the term, true and fair, was incorporated into EU legislation. These difficulties were at both the linguistic level (Burlaud, 1993, p. 93; Van Hulle, 1993, p. 100) and the conceptual level (Alexander, 1993, p. 60; Ordelheide, 1993, p. 81). The basic problem being the relative importance of professional judgement as compared to compliance with a set of accounting (usually tax based) rules established in company law (Ordelheide, 1993, p. 83). Even in the English-speaking economies where true and fair developed, there are clear misgivings about the nature of auditor independence and problems arising from the expectations gap (e.g. Humphrey et al., 1992, p. 137). In an economy where the number of professionally qualified accountants is still very small and where those preparing financial statements are largely unfamiliar with the concepts behind accounting regulation, the regulatory roles of the audit and the true and fair convention are further diminished.
4.3. Corporate law and corporate management

Slovene company law is heavily influenced by the German commercial code (Ribnikar, 1996, p. 320). The relevant section for joint stock companies of the Slovene Law on Commercial Companies is Part 2, Chapter 4; Sections 4 and 5 being the most important from a corporate governance perspective (Law on Commercial Companies, 1993, pp. 29–36).

Management must be two-tiered if the company exceeds certain size limits or is listed (Law on Commercial Companies, 1993, Article 261). The supervisory board must comprise at least three members (Law on Commercial Companies, 1993 Article 262(1)) with at least one-third worker representatives if the company has less than 1000 employees – or one half in companies with more than 1000 employees – (Law on Worker Participation in Management, 1993, Article 79), with the remainder being elected by the shareholders at the annual general meeting (Law on Commercial Companies, 1993, Article 264) for a maximum of four years (Law on commercial Companies, 1993, Article 265). The management board has the responsibility of running the company (Law on Commercial Companies, 1993, Article 246(1)) and is appointed for a five-year term by the supervisory board (Law on Commercial Companies, 1993, Article 250(1)) and must contain at least one worker representative for companies with more than 500 employees (Law on Worker Participation in Management, 1993, Article 81). This would appear to concentrate a significant amount of power in the hands of the supervisory board members. However, on close inspection, their influence on day-to-day operating decisions is highly circumscribed as in the German system (Ordelheide and Pfaff, 1994, p. 27). While the scope of the powers of the supervisory board to supervise the conduct of the business and inspect the company’s books and documents is clearly established in Article 274(1 and 2) (Law on Commercial Companies, 1993), it is specifically forbidden in Article 274(4) (Law on Commercial Companies, 1993) for the supervisory board to manage the business directly.

The insider system of control, as exercised in Germany, depends crucially on cross-company shareholdings and bank influence (Edwards and Fischer, 1994, p. 194). As described above, the ownership structure in Slovenija is quite different to that which pertains in Germany. The question of minority interests is particularly relevant to the successful operation of supervisory boards. As ownership in Slovenija is concentrated in the hands of worker/manager shareholders, the privatization investment trusts are largely disenfranchised because they are minority shareholders (Simoneti and Jasovic, 1996, p. 141). This significantly reduces the power and influence of the supervisory board and allows an effective free hand to internal managers and the workforce (see, Article 274(4) of Law on Commercial Companies, 1993).

Article 274(4) of the Law on Commercial Companies (1993) indicates that while the supervisory board cannot manage a company, it can force
management to take a proposal to the owners if the supervisory board disagrees with it. However, the impact of that article is severely restricted when the worker/manager stakeholders and the owner stakeholders are largely one and the same. As noted earlier, one study found that 70.9% of Slovene companies had majority employee-ownership (Simonetti et al., 1998, p. 131).

In Germany, the operation of the supervisory board can be characterized as a form of managerial credit evaluation (Edwards and Fischer, 1994, p. 78). That is to say, the supervisory board not only screens managers before being appointed to senior positions, but also monitors and holds final approval of investment plans before being implemented (Edwards and Fischer, 1994, p. 79). The supervisory board then evaluates subsequent performance of management and their investment decisions in relation to earlier plans (Edwards and Fischer, 1994, p. 79). This raises the question of who should be on the supervisory board to undertake this evaluation. In Germany representatives on the supervisory board come from senior industry and finance positions in well-established firms and institutions, as well as representatives of the suppliers, purchasers, and other companies that have ownership interests in the firm (Windolf and Beyer, 1996, p. 219).

Given the state of economic development in Slovenija, there is some doubt as to whether there are sufficient well-established firms and institutions to provide members to ensure adequate supervisory board control. Carlin and Mayer (1994, p. 191) document how the Treuhandanstalt (state agency established to restructure east German enterprises) has created supervisory boards of east German companies that primarily comprise representatives from west German firms and banks, implying that an inadequate number of suitable candidates from the old economic system were available to sit on the supervisory boards of the newly created east German firms. In conjunction with the very different ownership structures prevailing in Slovenija, there must be considerable doubt raised about the effective control which the supervisory board structure currently offers in Slovenija.

5. The transition model applied to Slovenija

Within the terms of my transition model, the current cultural environment of Slovenija is heavily influenced by the political system of the former Yugoslavia and historical links with the Austro-Hungarian empire (Truk and Garrod, 1996, p. 143). The former is important due to the nature of Yugoslav socialism, i.e., the anti-Stalinist concept of decentralized self-management and social ownership (Kardelj, 1975). At the political level, self-management manifested itself in the repudiation of institutions of representative democracy and their replacement by the very complex delegational system of direct democracy (Phillips and Ferfile, 1992, p. 48). Thus nothing was ever owned by
the Yugoslav state; instead, it was the property of society in general and the workers in particular (Phillips and Ferfila, 1992, p. 48). Thus state directed in the former republics of Yugoslavia can best be interpreted in terms of independent ownership and self-management by the workforce (Ribnikar, 1997, p. 38).

The Germanic link is important due to significant Slovene minorities in the southern regions of Austria, traditional trading links with Austria and Germany and the Slovene perception of themselves as European rather than Balkan (Turk and Garrod, 1996, p. 143). As in Germany, the legal system in Slovenija plays a very important role in day-to-day life. An illustrative example of particular relevance to the corporate governance debate is that of takeovers. While the problems associated with current ownership structures are recognized, the ability to change them is limited by the current lack of a law on mergers and acquisitions (Simoneti and Jasovic, 1996, p. 142). Effectively, without an enacted law, actions are not perceived as possible.

As shown by recent election results throughout the Central and Eastern European region, the initial enthusiasm for market solutions has waned somewhat and reconstituted communist parties have seen a resurgence in their support (Rose, 1996, p. 14). This has been reflected in the political mood in Slovenija where the initial drive to market solutions of social problems has now been tempered by memories of the safety net afforded under socialist systems (Ishiyama, 1995, p. 147). Thus there tends to be ambivalence towards the market and entrepreneurs.

In the case of all the former command economies of central and Eastern Europe, the intrusive event of my transition model is the change of the economic model itself. The trans-system activity is equated to the relevant regulatory systems imported from US, UK and Germany, i.e., security market operations, financial reporting and professional structures, and corporate law and corporate management. Based on the analysis in Section 4, each of these can be located in my transition matrix. Regulations of the security markets has been placed in the hands of a non-governmental, non-professional body – the Slovene Securities and Exchange Commission (Jaklin and Heric, 1997, p. 489). This body comprises of academics, investors, and financiers and thus is located in the community end of the market driven cell. Financial-reporting regulation is carried out by an independent professional body (Turk and Garrod, 1996, p. 147) and so is located in the community cell. Company regulation, on the other hand, is dominated by government-generated law (Turk and Garrod, 1996, p. 150) and so is located in the state-regulated cell.

The intra-system activity I have equated to institutional operations. The analysis in Section 4 indicates clear differences in the stage of transition for the intra-system as opposed to the trans-system activity. Extant ownership structures in Slovenija mean that the operations of security markets and company
Table 3
A transition mapping of corporate governance in Slovenija

<table>
<thead>
<tr>
<th>Intrusive event</th>
<th>State-directed</th>
<th>State-regulated</th>
<th>Community</th>
<th>Market-driven</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change of economic and political system</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Intra-system activity**

<table>
<thead>
<tr>
<th>Security market operations</th>
<th>Thin and shallow trading dominated by internal ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial reporting and professional structures</td>
<td>Narrow-based profession with limited understanding of investor needs driven reports</td>
</tr>
<tr>
<td>Corporate law and corporate management</td>
<td>Supervisory Board nullified by internal ownership</td>
</tr>
</tbody>
</table>

**Trans-system activity**

<table>
<thead>
<tr>
<th>Security market operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial reporting and professional structures</td>
</tr>
<tr>
<td>Corporate law and corporate management</td>
</tr>
<tr>
<td>Cultural environment</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Influence of professional bodies still developing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entrepreneurs still regarded with some suspicion</td>
</tr>
</tbody>
</table>

both these aspects of the intra-system activity within the state-directed category.

While financial reporting and professional structures are not owner-dominated, the regulations developed by the new autonomous professional body are limited in their effectiveness due to their emphasis on investor usefulness and the limited depth and breadth of the securities market. In addition, cultural history would suggest that the accounting practitioners are used to a legalistic definition of accounting practice, as is the case throughout the transitional economies of eastern Europe (Bailey, 1995, p. 599), and, as the transitional market economy is underdeveloped, there is only a formal compliance with the requirements of the accounting reform (Bailey, 1995, p. 604). This legalistic perspective suggests that the information requirements of fully operating securities markets will not be well served by existing accounting disclosure and that commercially necessary accounting changes will lag legally specified accounting regulations. Combined with the major influence on the accounting profession in Slovenija by one person, who was given government sanction to develop accounting standards and the profession almost single-handed, (cf. my discussions with two individuals from Slovenija), the operations of the accounting and auditing profession are located in the state-regulated cell. Thus the transition matrix for Slovenija is as depicted in Table 3.

In Table 3, significant transitional mismatches are revealed between the regulatory systems imported from the historically market-based economies (trans-system activity) and their effective operating realities (intra-system activities). In each area of corporate governance, the transition of the regulatory framework is more advanced than that of their operating realities. Thus, while the nature of the accounting regulation and auditing practices places the trans-system activity in the community cell, the intra-system activity is placed in the state-regulated cell due to their emphasis on investor usefulness and the limited depth and breadth of the securities market. The latter limits the agency consequences of management decisions so that the intra-system activity of security market operations is located in the state-directed cell while the nature of the related regulation means that the trans-system activity is located in the market-driven cell. The control, which the financial economics literature indicates should be exercised by security market operations (Brennan, 1995, p. 10), is further eroded by current ownership structures which, in addition, locates the intra-system activity of corporate law and corporate management in the state-directed cell while the trans-system activity is located in the state-regulated cell.

In importing individual corporate governance mechanisms from historically market-based economies, Slovenija has focussed on the regulatory structures (trans-system activity) alone. While these appear comprehensive, the environmental contingencies, indicated by intra-system activity, largely negate their effectiveness.
6. Concluding remarks

The wide diversity of corporate governance models in the historically market-based economies raises an important question for the emerging market economies of Central and Eastern Europe as to which model(s) they should adopt. Given that these distinct methods of corporate governance have developed due to the historical development of management, ownership and regulatory systems in the different countries it is unlikely that any one system will work adequately within the emerging economies. However, an approach of drawing from multiple systems may lead to unforeseen gaps in the control mechanisms as has been suggested here for Slovenija.

Using a transition framework, developed from the intrusive-event model of Harrison and McKinnon (1986), Bailey's (1995) accounting–transition model and Streeck and Schmitter's (1985) regulation model, a mismatch between regulations affecting corporate governance and the institutional requirements for their effective operation has been identified. The mismatch is indicated by the different stages of transition of the intra- and trans-system activities of the model. The regulatory systems are more advanced on the transition spectrum than are their operational equivalents (see Garrod, 1996, p. 149).

The importance of maintaining a balance between the intra- and trans-system activities for effective corporate governance is illustrated by recent changes which have occurred in the US market. Despite the US market still being the largest and the most diversely held market in the world with over 50 million individual shareholders and more than 10,000 institutional investors (Grasso, 1995, p. 2), the dominant ongoing change in US share-ownership over the past 40 years has been the decline in personal share-ownership and the growth in institutional share-ownership (Friedman, 1996, p. 60). To reflect these changes, the US Securities and Exchange Commission has removed many of the rules which restricted communication among institutional share owners in publicly held companies (SEC, 1992, p. 276). Thus both the intra- and trans-system activities moved closer to the community end of the market-driven cell in our transition framework. Critically they moved in tandem.

In case of Slovenija this has not happened. There are two obvious solutions to this mismatch. First, encourage the intra-system activity to move further along the transition spectrum to match the stage of the trans-system activity; second, to rein in the trans-system activity to match the stage of development of the of the intra-system activity. Politically, the former might appear to be the most favored option. Practically, however, there may be significant difficulties associated with such an approach. For market-driven regulation to become more effective, securities markets need to become wider and deeper, so traditional agency constraints will become effective controls on management decisions. If more companies are encouraged to undertake a public flotation, then political rather than financial factors (see, e.g. Byrne and Rees, 1994, p. 35) will
be driving the decision and will not, necessarily, be to the benefit of the companies involved. In addition, for reporting regulation and company law to become more effective, there is a need for the nature of share ownership to become more dispersed and fluid. If trading is to increase then existing, largely small, shareholders must be encouraged to come to the market. With a recent cultural history in the economies of Central and Eastern Europe towards high propensities to consume and low propensities to save it is unlikely that there will be a high demand for share investment from the current small shareholders. As a consequence, the existing shareholders are likely to increase their share sales, with no related increase in purchase demand, thus undermining the development and confidence in the market (Ribnikar, 1997, p. 45).

On the other hand, if regulatory systems are to become less market-driven, there is a need to develop more comprehensive use of the state-regulated transition cell. The appropriate nurturing form of governmental regulation would not establish a static governance environment which will be suitable when the transitional economies have achieved transition but rather would allow dynamic development such that effective governance can be achieved at all stages of the change process. For state regulation to become effective in the governance field, institutions like banks or some government agency might become more actively involved in the supervisory role of companies. This would require a significant development on the part of banks in their commercial expertise and the role that they currently play in economic development. As bad loans made by banks in the past are gradually eliminated from their balance sheets by being expensed against profits (Stiblar, 1996, p. 37) it is likely that bank financing will play an increasingly important part in capital growth for companies in the region. This would act as a platform for greater participation of banks in the governance role. In the short term, this role might be more effectively played by a government agency of some kind. All countries in the region have some mechanism for co-ordinating the privatization of economic units within their economies and, by definition, these agencies are of finite life (Bohm and Simoneti, 1993, p. 11). Given the intimate knowledge of privatized companies by these privatization agencies, they could well play a useful role in the supervisory function post privatization.

Such a development would have significant implications for the speed and nature of the development of the securities markets. If banks are developed in this supervisory way, the whole corporate environment would move inexorably towards the insider, or German, model. In this case, securities markets are unlikely to develop into the deep and broad markets of the US or UK. Without this development, the securities markets will play only a limited role in corporate governance in the region. In addition, the accounting and auditing regulation, based on an assumption of informationally efficient securities markets and widely held company ownership will be out of place in an
environment which more closely mirrors that of the insider, or German, model. It is paradoxical that privatization schemes modelled on a broadly held, outsider system economy seem to have created the circumstances in which the insider system appears to offer the most effective structure for corporate governance in the short and medium term.

For the transition economies, the decision about whether to follow the insider or outsider system is crucial. Market development is likely to be held back in a governance situation resulting from a mixture of controls from both systems, as is currently the case in Slovenija. On the other hand, excessive state regulation is likely to have a dampening effect on security market development. Our transition framework has highlighted the difficulties that arise when the aspect of transition itself is ignored. Slovenija’s regulatory framework appears to have adopted a composition that may be appropriate once transition has been completed. However, institutional operations are in need of support to enable the transition itself to take place. My framework highlights the importance of the transition process and the need for careful nurturing of the corporate governance environment via the maintenance of a balance between institutional and regulatory development.

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