

## BOARD SIZE AND COMPOSITION: THE MAIN TRADEOFFS

Alexander N. Kostyuk\*, Victoria Koverga\*\*, Helen V. Kostyuk\*\*\*

### Abstract

The purpose of this research is to find the factors influencing size and composition of the supervisory boards in a transition economy with application to Ukraine. This paper is based on the research of 50 largest companies in Ukraine. Period of research is 1998-2005. Methodology of research is based on observations (the first stage) and questionnaires (the second stage). The research found that there is strong dependence of the size of supervisory boards in Ukraine on the degree of concentration of corporate ownership and origin of the controlling shareholder. Size of the company has a very conditional influence on the board size. Professional skills diversification as a fact that could contribute to the efficient work of the supervisory board is still very weakly developed in Ukraine. Particularly this concerns such expertise as auditing, finance, executive compensation. Experience of the supervisory board members in Ukraine is quite poor. Only 24 per cent of members of supervisory boards have a five and more year experience as supervisory board members. the supervisory board members had the strong links with the company in the past as executives. Thus, about 74 per cent of members of the supervisory boards in Ukraine worked as executives of the same company at least during a year for the last ten years. This makes the negative impact on the independence of the members of the supervisory boards.

**Keywords:** supervisory board, board size, composition, Ukraine

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### Introduction

Boards of directors are a crucial part of the corporate structure. They are link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers). The board's primary role is to monitor management on behalf of the shareholders. As Tricker says, in the common definition corporate governance "addresses the issues facing boards of directors". In this view, corporate governance in the task of the directors and therefore attention must be paid to their roles and responsibilities. In the broader view, boards of directors are the part of the governance system.

The way how this part of the governance system influences corporate governance depends on the governance concept used - monistic, dualistic or pluralistic. At the same time, certain governance concept shapes the boards practices.

Fundamental governance concepts are developed in industrial countries. But, at the same time, bankruptcies of large corporations and corporate scandals that attacked the USA at the beginning of

the third millennium, destroyed traditional view on the role of corporate boards.

Jay Conger (2001) noted that boards are under fire. Investors, governments, agencies, communities, and employees are scrutinizing boards' performance and challenging their decisions like never before - and it is likely this attention will only increase. Shareholders and stakeholders do not want to consider corporate boards as "rubber stamps for management" as Philip Styles said. Directors should be strategists, controllers and advisors for management at the same time.

As Bob Monks said, recovering corporate world is possible in the case of development of shareholder activism. Corporate sector needs shareholders who would be active in decision making on composition, roles and duties of their representatives inside of corporations - directors.

Shareholder involvement in decision making on board practices was supported by legislative initiatives, such as *Sarbanes-Oxley* in the USA, codes of best practices by Higgs, Turnbull, Tyson, Smith. All these efforts were done to make boards become

more transparent, accountable and responsible to shareholders.

Countries of the Eastern and Central Europe, so named "post-communist", are still looking for an optimal concept to put it into the basis of the best board practices. One of the countries where there is not still a firmly defined and well-developed governance concept is the Ukraine. After a ten-year history of privatization of the state property there is a lack of research in the field of the board practices. There are no still corporate governance codes and white papers on corporate board best practices. Therefore, the primary objective of this research is to improve transparency of the board practices in the Ukraine through answering the main research question of this paper, i.e. "What are the factors influencing the board size and composition in transitional economy?"

### Methodology of research

Very detailed investigation of the most active, top-performing Ukrainian joint stock companies has been undertaken to reach the major objective of research. The following items of board practices have been researched: size of the boards; board composition.

Size of the board is investigated from the point of view of several factors:

1. Size of a company.
2. Ownership concentration.
3. Origin of the controlling shareholder.

Board composition was divided into several criteria:

1. Type of shareholder representation.
2. The age of the supervisory board members.
3. Professional skills diversification.

4. Experience of the supervisory board members.

5. Employees on the supervisory boards.

6. Share of the independent members of the supervisory board (to be described at the separate section).

Research was comprised of two stages. At the first stage, we delivered questionnaires to Heads of Supervisory Boards and Deputy-Heads of Supervisory Boards of 240 companies. Feedback on questionnaires was received from 53 companies. They belong to the most developed industries - metallurgy, machine-building, energy generating and energy distributing. Further, we selected the most completed questionnaires (50) to conduct research and process questionnaires.

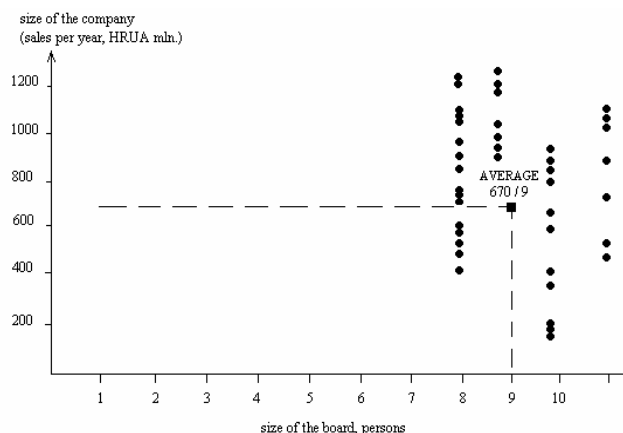
At the second stage of research we used observation. We observed 50 companies whose directors had provided us with questionnaires completed. The following data sources were used to observe corporations:

- annual reports of Ukrainian joint stock companies;
- annual reports of the State Securities and Exchanges Commission in Ukraine;
- annual reports of the First Stock Trade System in Ukraine;
- stock market reports, developed by famous Ukrainian investment companies.

The period of investigation is years 1998-2005.

### Size of the board and ownership concentration

The only factor that could evidently influence the size of supervisory board in Ukraine is the type of controlling owner, including ownership structure and concentration.



**Figure 1.** Size of companies and size of supervisory boards in Ukraine

Average number of members of supervisory boards at Ukrainian joint stock companies is about 8-10. By this feature, the Ukraine's board practices are

closer to Anglo-Saxon model than to German model of corporate governance.

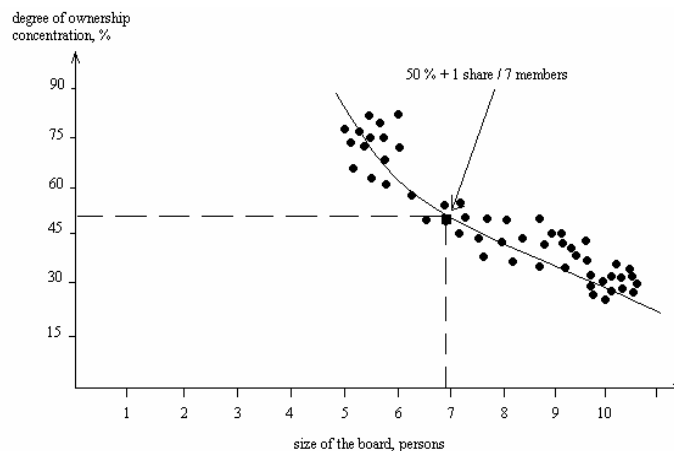
There is strong dependence of the size of supervisory boards in Ukraine on the degree of

concentration of corporate ownership. Thus, the higher degree of concentration of ownership the fewer members are on the board. Companies, where controlling block of shares (50 percent + 1 share) belongs to one owner, have boards with 5-6 members, who completely represent interests of the controlling shareholder.

Reason, to explain these practices, is the following. Controlling owners, as a rule, want directors on the board to perform mainly the role of control. The role of strategy is performed by executive board. The role of service is not performed by directors because of lack of an appropriate decision system in companies. To perform only the role of control, controlling shareholders do not need

many their representatives on the board to control the companies they own (Kostyuk, 2005).

Moreover, it should not expect that controlling owners allow other shareholders to place their own representatives on the board to perform control too. Controlling owners in Ukraine do not want to share control of the company with other shareholders. Minority shareholders rights are violated by controlling owners are not unusual in Ukraine. Proportional representation on the supervisory board, that could protect minority shareholders rights, is not allowed. Therefore, controlling shareholders are free to control their companies through placing even a few their representatives on the supervisory board.



**Figure 2.** Size of the supervisory board and ownership concentration in Ukraine

Companies, where there is no one shareholder, owing even 10 percent of shareholder equity, have as a rule, more than 12 members on the board. The same concerns those companies that are under control of employees. It should not be expected that larger size of the supervisory board at companies, controlled by employees, than at those with concentrated ownership, is explained by diversity of roles, performed by directors. Directors perform mainly the role of control. They are not strategists and advisors. The reason for so large size of the board is so named "trade-union democracy". It is labeled with the following principle in the board practices: "The more the better". Number of members on the board reaches 15-16 persons. Besides that, there is strong correlation between size of the board and origin of the controlling shareholder. Thus, companies under control of Ukrainian financial-industrial groups are supervised by the boards, consisting of 4-6 persons. At the same time, companies, controlled by foreign institutional investors or Ukrainian investment companies, have about 7-9 members on the board.

The last factor, influencing the size of the supervisory boards at Ukrainian joint stock companies is the number of committees on the board.

Those boards, where there are professional committees, consist of the higher number of persons in comparison to those without committees.

Therefore, that means, that such feature of the board as its size is positively correlated to the degree of concentration of corporate ownership, origin of controlling shareholder and number of committees on the board. Size of the company has a very conditional influence on the board size. We have noted that the companies with the annual revenues over USD500 mln. have the supervisory boards consisting of 5-6 members. As a rule, large companies belong to the Ukrainian financial-industrial groups who are very strong controllers. At the same time, the larger companies should perform much more functions that smaller ones that should require the large supervisory board. Probably, the desire of the large shareholders to grasp the corporate control and corporate information through establishing quite small, but very strongly controlled supervisory board is stronger than the rationale to secure the supervision over the numerous functions to be performed by the large company.

The size of the supervisory board is suggested, discussed and approved by shareholders at the

shareholder meeting. At the same time, influence of the company executives on that process could be very sufficient. Executives, consisting the management board could influence the process of the board size change through participating in the work of an organizing committee, responsible for preparation of the agenda of the shareholder meeting, and lobbying or ignoring interests of various groups of shareholders (Kostyuk, 2003). As a rule, the size of the board is not written in the charter of the firm. It could be written in the supervisory board statement. It is clear to understand that under such circumstances it becomes much easier to make changes to the size of the supervisory board. Any changes to the charter require much more strict procedure and responsibilities than making changes to internal documents of the corporation, i.e. the supervisory board statement.

### Board composition

Supervisory board structure in Ukraine is very specific and determined by various factors, the most important of which are ownership structure, type of the industry, market position of the company and so on. Taking into account that the Ukraine practices of supervisory board composing are grounded on the position of a prohibition of a simultaneous membership in the supervisory and management boards, composition of the supervisory board is free of the executives and can not be compared to the board of director composition applied in the unitary board countries. It is really difficult to study the board composition from the point of view of numerous criteria. Many investigators of the board composition introduced many criteria which need a classification. That will help in studying the supervisory board composition.

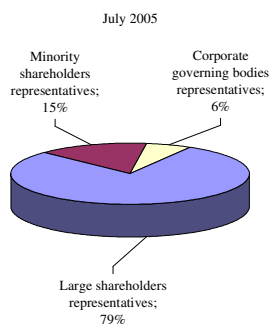
We introduce the following classification of the supervisory board composition criteria:

1. Type of shareholder representation.
2. The age of the supervisory board members.
3. Professional skills diversification.
4. Experience of the board members.
5. Employees on the supervisory boards.
6. Share of the independent members of the board (to be described at the separate section).

*Type of shareholder representation.* Employee representation on the supervisory board is not written by the legislation as it is in Germany. That is why employees could hope for having their own representatives on the supervisory board only if they own the company shares and can be taken for the controlling owners (Kostyuk, 2003). Works councils which are required by the Ukrainian legislation to establish at any join-stock company have no any legally allowed mechanism to let employees take part in the corporate board formation.

Corporate and civil legislation in Ukraine allows only shareholder become members of the supervisory board. The companies where the corporate control is concentrated at the hands of large shareholders have the supervisory boards where members are rather nominal shareholders than real ones. As a rule, large shareholders present such members with one share of the company to meet the requirements of law.

All members of the supervisory board in Ukraine are the shareholders representatives. This is the requirement of the Ukraine corporate legislation to allow only shareholders to choose the supervisory board members. There is only one allowed exception, i.e. when the supervisory board members are suggested by the supervisory board, management board or audit commission autonomously from the shareholders. As a rule shareholders are more active in nominating directors.



**Figure 3.** The Ukraine supervisory board composition

Minority shareholders representation on the supervisory board is very interesting from the point of view of the type of the minority shareholder. As a rule, among 15 per cent of the members of the supervisory boards in Ukraine representing interests of minority shareholders there are only 2 per cent of members of supervisory boards who represent interests of outside minority individual shareholders.

The rest minority shareholders representation belongs to other groups of shareholders who are minority shareholders in the certain ownership structure, i.e. employees and managers.

From the point of view of the absolute representation on the supervisory board in Ukraine there is no dominative position of any shareholder. Thus, 42 per cent of members of the supervisory

boards in Ukraine represent interests of large institutional shareholders including the national and foreign. Employee shareholders have 28 per cent of members of the supervisory boards. Executive shareholders have about 17 per cent of the supervisory board representatives. The rest belong to the state (about 11 per cent of the members of the supervisory board) and outside individual minority shareholders (2 per cent).

*The age structure* of the supervisory board in Ukraine differs from a company to a company. The average age of members of the supervisory board in Ukraine is 48. There is a slight increase in the average age of the board members during the last five years (beginning from the year 2000) for 2 years.

At the same time the supervisory board members had the strong links with the company in the past as executives. Thus, about 74 per cent of members of the supervisory boards in Ukraine worked as executives of the same company at least during a year for the last ten years. This makes the negative impact on the independence of the members of the supervisory boards.

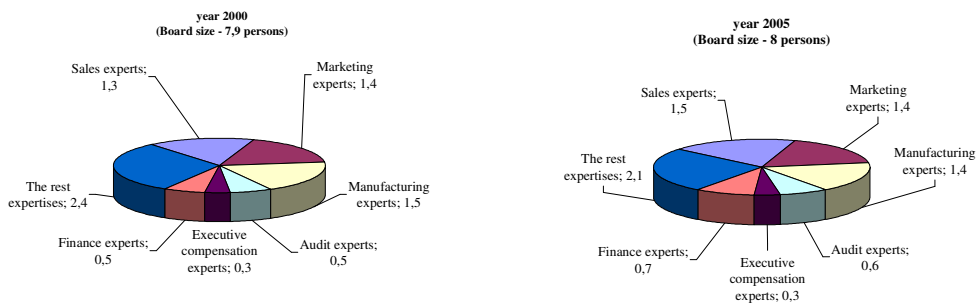
*Professional skills diversification* as a fact that could contribute to the efficient work of the supervisory board is still very weakly developed in

Ukraine. There are 38 per cent of the supervisory boards where there are no members with the audit activity expertise that is so much welcome internationally. Other 32 per cent of board members had never worked in the field of finances. Thus, about a third part of the supervisory boards in Ukraine have no opportunities to develop the best practices within the audit and finance committees.

The most pessimistic situation concerns such expertise as executive compensation. 78 per cent of Ukrainian supervisory boards have no members experienced in executive compensation development and monitoring. This gives a way ahead for executives to manipulate with financial results and, as a result, with their compensation, i.e. the threat for overcompensation grows remarkably.

The most popular expertise, represented by the members of the supervisory boards in Ukraine is commerce (sales). All 100 per cent of the supervisory boards in Ukraine have such kind of experts in their structures. Moreover, about 52 per cent of supervisory boards have two experts in sales.

It is worth of mentioning that the Ukraine supervisory boards need a more balanced structure with an application to the professional skills of the members of the supervisory boards.



**Figure 4.** Professional expertise of the members of the supervisory boards in Ukraine

The main reason of such disbalanced supervisory board in Ukraine from the point of view of the professional qualifications of its members is the business customs. Thus, a huge part of the members of supervisory board in Ukraine have a corporate origin, i.e. before coming to the supervisory board they were executives. Executive practices in Ukraine are still based on the traditional professional qualifications mainly manufacturing and sales. Those qualifications are the heritage of the socialist planned economy. Departmental structure of Ukrainian joint stock companies is still constructed around those two functional elements of the company activity. Therefore, an initiative in the company with a relation to the corporate strategy development and execution belongs to manufacturing and sales executives. From this perspective the supervisory board is constructed by the same principle that has a socialist economy origin when a company exists only to manufacture and sell something. Financial stability of the socialist companies has been guaranteed and

reinforced by the state authorities. Rights of the employees were secured by the state too. That heritage makes the demand for audit, financial and compensation professional qualifications among the heads of supervisory board quite low. Members of supervisory boards in Ukraine should learn how to develop and maintain a system of internal control with required checks and balances.

Women membership on the supervisory boards of joint-stock companies in Ukraine is very low. The share of women on the supervisory boards is equal only to 0,8 per cent. There are some explanations of such situation. First of all, women are still not considered by the shareholders as the reliable and strong representatives of the shareholder interests. Secondly, men are trusted by the employees much more than women. Thirdly, mentality of the Ukrainian men is very resistant to the thought that women can be an equal part of their team.

*Experience* of the supervisory board members in Ukraine is quite poor. Only 24 per cent of members

of supervisory boards have a five and more year experience as supervisory board members. 63 per cent of members of supervisory board have a three and more year experience. The most negative is the fact that this poor experience is the experience with the company where the member of supervisory board works. Therefore, a multi-corporate experience is still not developed in Ukraine. A way out for the Ukraine supervisory boards could be in employing foreign directors who could come to Ukraine with their rich experience and knowledge to share both these values to the Ukraine supervisory board members. At the end of 2005 the share of the foreign members at the supervisory boards in Ukraine was equal only to 0,3 per cent. The reason is double.

First of all the director remuneration in Ukraine is much lower than abroad. Thus, the German, French, Italian and any European director would ask for remuneration at USD50-60 thousand a year. The UK director would ask for remuneration at USD60-70 thousand. The USA director would ask for remuneration at USD90-100 thousand. Ukrainian directors are rewarded with an amount at USD700-750 a year!!! Therefore the material incentives in the boardroom of Ukrainian company are very weak. In comparison to the people who are controlled by the supervisory board, i.e. the management board members, the remuneration of the member of supervisory board in Ukraine is as 1/25 to the remuneration of the management board members. Thus, in Germany this ratio is equal to 1/15, in France – 1/16, in UK – 1/18, in the USA – 1/19 (Mercer Delta, 2005). As for Ukraine, the lowest ration is observed at the banking. It is equal to 1/36. The lowest ratio is documented for the machine-building industry. The ratio is equal to 1/21. But it is not because the high level of the supervisory board member remuneration. It is because of the low level of the remuneration of the management board members. The second reason of the weak demand of the Ukraine companies for the foreign directors is their very narrow and specific knowledge. As a rule, foreign directors are very difficult to integrate themselves into the system of an adequate decision making by the directors in Ukraine. Moreover the foreign directors are difficult to get used to the weakly developed strategic role of the Ukraine supervisory boards.

*Employees on the supervisory boards.* Under circumstances of a weak development of the secondary market for the supervisory board members a quite large share of the supervisory board members combine the work in the company with a membership in the supervisory board of the same company. As it is required by the Ukraine legislation it is prohibited to combine the memberships in the supervisory and management boards. But the way out for Ukraine joint stock companies is through electing at the supervisory board those persons who are employed as the middle-level managers, heads of

departments who are not members of the management board and audit commission.

During the years 2000-2005 the trends toward the electing at the supervisory board people employed simultaneously at the company slightly entrenched. Thus, in 2005 there were 38 per cent of the supervisory board members who were employed by the same companies. At the beginning of the year 2000 about 35 per cent of the supervisory board members in Ukraine were simultaneously employed by the same companies. It is very interesting to note that so named "intracorporate" supervisory board members are proposed as candidates at the supervisory board members basically by employee shareholders or by the management board.

In the first case employee shareholders try to compensate their weak efficiency in the knowledge of how to select the outside supervisory board members with their personal contacts with the "intracorporate" supervisory board candidates.

In the second case there is a threat of establishing the entrenchment net in the company. Under the entrenchment net the corporate executives have a chance to control the supervisory board members. At the same time, the supervisory board members are forced by the executives to distort the corporate information to be supplied to the shareholders and make the executive entrenchment not visible to the shareholders and society at all.

It is very difficult to evaluate the degree of threat to the best corporate governance principles when noting the following numbers. Thus, about 82 per cent of companies where the "intracorporate" supervisory board members were proposed by the management board experienced a conflict of interests. Their opponents, i.e. outside supervisory board members were much more effective in preventing the conflict of interests. Thus, 24 per cent of the companies with the majority of the outside members on the supervisory board experienced the conflict of interests. Other negative effect of the intracorporate supervisory boards is about the best standards of corporate governance. Thus, the intracorporate supervisory boards have much less audit, executive compensation and shareholders committees than those companies with the outside supervisory board members. Work of the intracorporate supervisory board turns into the rubber stamping. Advisory, strategic and control roles of the board are not executed.

From the point of view of the efficient work and entrenchment there is a strong doubt about the reasonability to elect managers of the company at the supervisory board. Conflict of interest should come quickly. Such kinds of managers as a rule are headed and commanded by the management board members as the company charter orders. From another view, the same managers are the supervisory board members who can supervise the management board more strictly. This could be a very strong reason and a very fruitful soil for the conflicts of interests. The

slogan "You order me but I supervise you" makes this situation clear. This situation could exist even if the intracorporate supervisory board members are proposed by the outside shareholders, not executives or employees. Intracorporate supervisory board members never try to act as the promoters of the company interests and philosophy to the society. About 92 per cent of the intracorporate supervisory board members never tried to take part in conferences, seminars, press-conferences and say something to the mass-media about the company. They are not "a company brand promoters". From this perspective it will be quite problematic to maintain an effective stakeholder policy by the supervisory board. Probably it is a right time to start a new concept of the corporate board development in Ukraine from the point of view of the board composition. Under the new concept the supervisory board should be composed of the outside, independent professionals. The supervisory board in Ukraine in a whole should be composed of the professionals of the various spheres of expertise, including audit and executive compensation to make the fulfillment of the control role of the supervisory board possible.

## Conclusion

Despite the formal attributiveness of the board model in Ukraine to the Continental type of governance structure an average number of members of supervisory boards at Ukrainian joint stock companies is only about 8-10. By this feature, the Ukraine's board practices are closer to Anglo-Saxon model than to German model of corporate governance. Corporate ownership concentration and type of controlling owner are still the main factors influencing the board size in Ukraine. Thus, the higher degree of concentration of ownership the fewer members are on the board. Companies, where controlling block of shares (50 percent + 1 share) belongs to one owner, have boards with 5-6 members, representing exclusively interests of the controlling shareholder. Companies with dispersed ownership have, as a rule, more than 12 members on the board. At such companies directors perform mainly the role of control. They are not strategists and advisors. The reason for so large size of the board is so named "trade-union democracy". It is labeled with the following principle in the board practices: "The more the better". Number of members on the board of companies owned by employee shareholders reaches 15-16 persons. The most remarkable criteria of the supervisory board composition are type of shareholder representation, the age of directors, professional skills diversification. There is no dominative position of any shareholder on the supervisory board of Ukrainian companies in a whole. Thus, 42 per cent of members of the supervisory boards in Ukraine

represent interests of large institutional shareholders. Employee shareholders have 28 per cent of members of the supervisory boards. Executive shareholders have about 17 per cent of the supervisory board representatives. The lowest number of the board sits belongs to the state (about 11 per cent of the members of the supervisory board) and outside individual minority shareholders (2 per cent).

The supervisory board members at Ukrainian companies have the strong links with the company in the past as executives. Thus, about 74 per cent of members of the supervisory boards in Ukraine worked as executives of the same company at least during a year for the last ten years. This makes the negative impact on the independence of the members of the supervisory boards. From this side, the market for outside directors is still not developed in Ukraine.

Professional skills of directors are not well-balanced on the board. Thus, about a third part of the supervisory boards in Ukraine have no opportunities to develop the best practices within the audit and finance committees. The most pessimistic situation concerns such expertise as executive compensation. 78 per cent of Ukrainian supervisory boards have no members experienced in executive compensation development and monitoring. This gives a way ahead for executives to manipulate with financial results and, as a result, with their compensation, i.e. the threat for overcompensation grows remarkably.

The most popular expertise, represented by the members of the supervisory boards in Ukraine is commerce (sales). All 100 per cent of the supervisory boards in Ukraine have such kind of experts in their structures. Moreover, about 52 per cent of supervisory boards have two experts in sales.

All these findings lead to a final conclusion that the Ukraine board model develops in a unique, inefficient way. The main evidence of weak perspective of such development is a strong attention of the companies to the intracorporate market for directors, i.e. directors-former executives of the same company. Under such circumstances the problem of the director dependence should hardly be overcome in the nearest future.

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