

## CORPORATE GOVERNANCE IN ESTONIA

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### Introduction

The last dozen years Corporate Governance (CG) has become an important subject in many countries around the world. Although it has been admitted that governance models vary greatly between different countries and there is no single ideal model of governance (Mygind 1998), Turnbull (1997, 185) argues, most research into the theory and practice of corporate governance has been heavily focused on English speaking countries and the US in particular and Klijnsmit (2001, 25-26) claims that the issues in corporate governance (CG) have primarily been at the centre of attention in Anglo-Saxon countries.

The corporate governance problems as known in a market economy arose in CEE countries in connection with the privatisation of large enterprises at the beginning of the 1990s, and to a large degree even afterwards. The emerging pattern of CG is quite difficult to interpret according to the traditional Western models and varied greatly from country to country, because in the case of transition countries various institutions and the environment as a whole do not work or at least do not work fully (Tafel et al, 2006). Therefore CEE-countries represent a very good testing ground for Corporate Governance (CG) related research.

This paper studies forms of corporate governance in foreign owned companies situating in Estonia: cooperation between the owners, council and board in Estonian enterprises. The paper starts with the theoretical part followed by methodology and results of empirical study in Estonian companies.

### Theoretical background

Corporate governance has been defined as coordination mechanisms of different stakeholders to produce and distribute the output of the enterprise Mygind (1999, 2).

Babic (2003) points out, although there are considerable differences between the Anglo-American, German and Japanese corporate governance systems, they all share the luxury of defining the subject of corporate governance within the context of functioning market systems and highly developed legal institutions (and at the same time)

many developing and emerging economies lack or are only in the process of developing the most basic market institutions.

*The changes in the economic environment and related institutional and social environment occur faster in CEE countries than in other groups of countries — in countries with a developed economy and in the developing countries. Trying to develop a system of good corporate governance in these countries is made difficult by problems such as complex corporate ownership structures, vague and confusing relationships between the state and financial sectors, weak legal and judicial systems, absent or underdeveloped institutions and scarce human resource capabilities (Tafel et al, 2006).*

*Kuznetsov and Kuznetsova (2003, 244, 245) claim, that Anglo-American theory of corporate governance, which concentrates mostly on the problems of stock ownership, is not exactly adequate in a situation where the ownership structure is in rapid transition and where ownership concentration as well as increases in foreign ownership is in progress. As far as one particular context or rather its scale is concerned, the US capital market for example cannot be compared to that of a small European country.*

*Babic (2003) raises two problems at once: whether the CG system working in developed economies could be adapted to transition countries at all and whether it would be a good solution.*

Nuti (1997) has noted that depending on which country's legislation a post-socialist country was oriented on, and which privatisation schemes it used, the development of different types of corporate governance models could be observed in various countries, for example, in Poland the German type and in Russia the Anglo-American type. In reality Slovenian enterprises adopted the German model of CG (Rozman 2006). So did also Czech enterprises (Maly 2006). In German model, governance is assigned to two boards: supervisory board and the management board.

One of the key problems is the role of supervisory board in relations to the management board (Rozman 2006). Also the daily practices of CG in Estonia have been influenced by conflicts between shareholders, the supervisory boards and management

(Vaks 2006). The general agreement is, that supervisory boards should not be involved in operative and tactical decisions (Rozman 2006).

Ownership structure is determined by several enterprise and country level factors, as size of enterprise, its need for capital and specificity of capital; economic, institutional and cultural environment (Jones and Mygind 2004; Demsetz and Lehn 1985).

Board of directors is fundamentally a decision making body (Harper 2005: 7). Boards should carefully define its own objectives and make a plan for how it can best carry them out (Carter and Lorsh 2004).

The stage of a company's development dictates which roles and responsibilities should have the most attention (Conger et al 2001).

Growing burden of legal duties and responsibilities is being placed upon the shoulders of directors (Coulson-Thomas 1993).

To explore knowledge about corporate governance in different environments empirical study was conducted in Estonian enterprises.

### Empirical study in Estonian enterprises

Small-scale privatisation in Estonia began in early 1991 in Estonia. In 1992 it was decided to implement the 'Treuhand' model for accelerating the process of large-scale privatisation and a special body – the Estonian Privatization Enterprise was established (Kein & Tali, 1995, 143). Privatisation was launched in the form of international tenders giving equal access to all bidders, including foreign investors. This means that enterprises were sold to either Estonian or foreign buyers on the condition that the buyers would be able to guarantee a certain amount of investments during a fixed period of time and to maintain a certain number of jobs (Hannula 2006, 80-81).

The ownership structures of Estonian enterprises are very concentrated, whilst at the time of privatisation a market for shares did not exist and enterprises or individuals could not buy the shares of enterprises as they could in Western countries. This makes the Estonian case different from the so-called Anglo-American system, where ownership is more diffused, and also from the so-called German system, where the role of banks is very high, as the participation of institutional investors (banks and other financial institutions, including pension funds) in share trading has also been very low. It is more similar to the Italian model, as many enterprises are family-owned, but the concentration of domestic outsiders and foreign investors is also high (Hannula 2006, 81).

The aim of empirical study is to explore which forms of corporate governance exist in foreign owned companies situating in Estonia 2007.

The questionnaire used for the research was originally composed by German researcher Thomas Steger and it has already been carried out in East Germany. The questionnaire has been applied for Estonian conditions and survey was carried out by

Estonian Business School (EBS) in cooperation with Estonian Institute for Future Studies.

The companies were randomly selected by Estonian Statistics Bureau. Survey was done in January-February 2007 in 373 companies in Estonia. Respondents rate was 31,4%, this means we got valid responses back from 117 companies. In this sample 55 of companies were foreign owned and 62 domestic. 40 companies had more than 100 employees and are considered as big in this paper and 77 had from 50 to 99 employees and are considered as medium.

## Results

### General characteristics

Most of enterprises were established in the middle of the 1990s (75%), only 25% were already operating before 1991, during the Soviet era. Only 10 companies, all foreign owned, were listed companies. On the basis of turnover, medium-sized enterprises had an average turnover of 8,5 million euros in 2006. Large enterprises had 4 times more turnover (33,3 million euros). One third of all enterprises experienced a rapid increase in turnover in the last 5 years (33,3%), 50,4% evaluated the increase in their turnover as being moderate, in 12% turnover was stable and in 3,5% turnover decreased.

The comparison in Figure 1 indicates that domestic firms have experienced a more rapid increase in turnover.

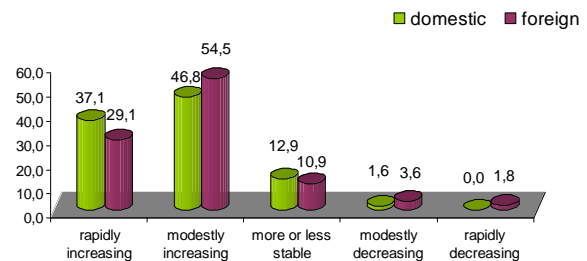
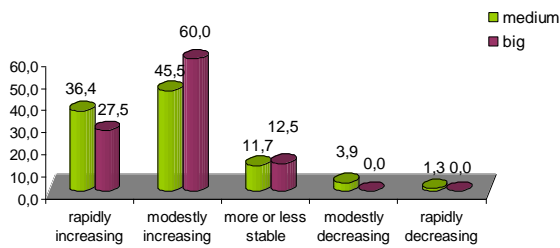


Figure 1. Turnover increases during last 5 years on the basis of ownership (%)

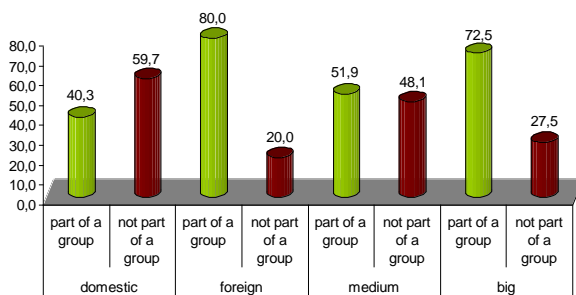
Rapid increases in turnover took place more often in medium-sized compared to large enterprises (Figure 2).



**Figure 2.** Turnover increases in the last 5 years on the basis of company size (%)

Ownership data indicates that in one third of all domestic companies, the company belongs 100% to the CEO or top management team and their closest family.

According to the data in Figure 3 about being part of a larger group, 4 out of 5 foreign enterprises belong to a larger corporation or conglomerate.



**Figure 3.** Belonging to larger concerns (%)

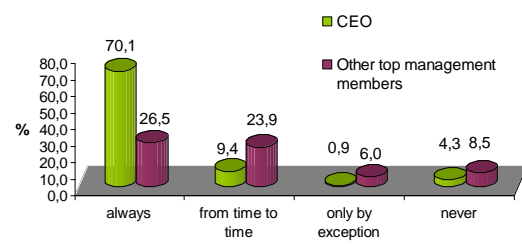
### Top Management

In most firms, the top manager is also the CEO. Most top management teams have 1 or 2 members (38,5% and 22,2% respectively), 14,5% had 3 members and 10,3%, 4 members. Finally, 23% of the members of the top management were female.

The average tenure for CEOs is 7 years. Only 8% of CEOs were remunerated with stock options.

Most top management teams meet 1 or 2 times per month, on average 1.5 times per month. Only 14% of companies change their external auditor regularly. The average time between each change is 4 years. The top management has to report to the supervisory board on average 4 times per year.

CEO of company or other top management members attend meetings of the supervisory board quite often (Figure 4). There is difference between CEO and other members of top management team. If company has CEO and managing director, CEO participates on board meetings only in 29% of companies.



**Figure 4.** How often the CEO and other members of the top management attend supervisory board meetings (%)

### Supervisory Board

As much as 44% of enterprises have 3 members that possess voting power on the supervisory board. Only 13% of the members of boards were female and 11% were elected by employees. In foreign firms most of the board members are foreign.

On the basis of background, 37% of supervisory board members are also a CEO or similar top executive in other companies, 10% are a CEO or similar top executive in the same firm, 9% are blue-collar workers in the company and 7% are state representatives. *The members of boards of directors are also members of boards in other firms in 48% of cases, but 65% of board members had no business ties to the firm. Only in 13% of companies are there family ties between the CEO and the supervisory board members.* The average that the present chairperson has held his/her position was 6 years. Before becoming CEO the same person was a top manager in the same firm in 20% of companies.

Board meetings take place on average 4 times per year. Quite often, formal board decisions are made outside board meetings (e.g. via phone meetings, e-mails, fax, etc). Only in 15% of cases do extraordinary preparatory meetings (e.g. of the supervisory board members elected by shareholders and by employees) take place before the ordinary board meeting. In 11% of cases the supervisory board formed a special *committee* for dealing with issues such as *compensation or remuneration* for members of the top management team, strategy, finances, issues connected with purchasing raw materials, investments, evaluating assets and changing top managers. The *job descriptions* for top manager positions are confirmed by 58% of CEOs. In 45% of cases, the board regularly evaluates the performance of the top management team. In 33%, no such evaluation takes place. A self-evaluation by the supervisory board was carried out in only 15% of companies.

Only 15% had rules for compensating the work of the board members. In 35%, their work was compensated and in 49% it was not compensated.

Compensating the work of board members (%)  
 There were several types of conflicts in the supervisory board (Figure 5).

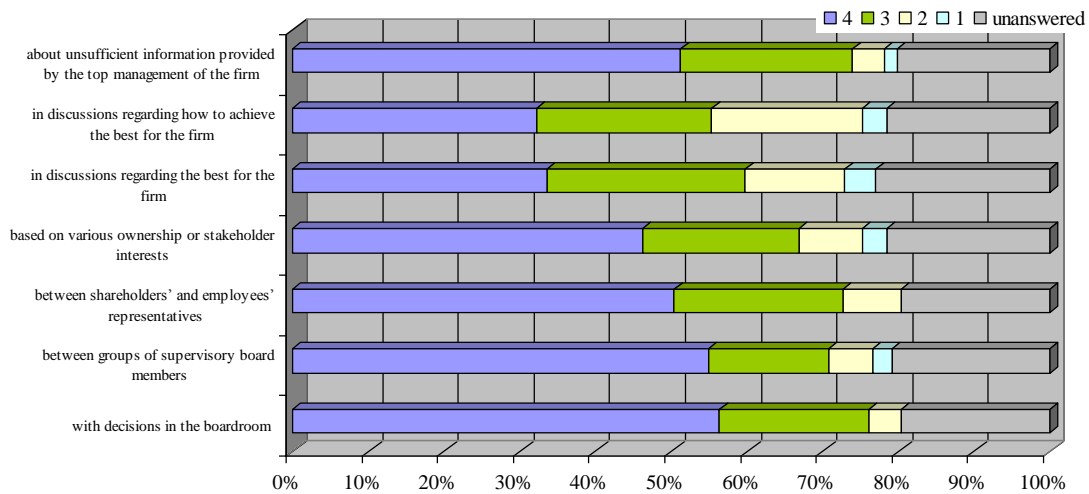
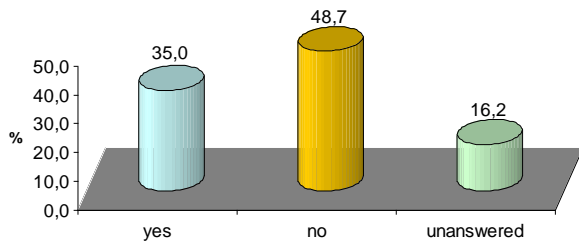


Figure 5. Types of conflicts in the supervisory board 1 = yes and 4 = no.

According to these results, conflicts arise most often in discussions about what is best for the firm, and second, in discussions about how to achieve the best for the firm.

Figure 6 indicates the contribution made by the supervisory board to different issues. Most attention was paid to the firm's business results, next came business decisions and then replacing the top management.

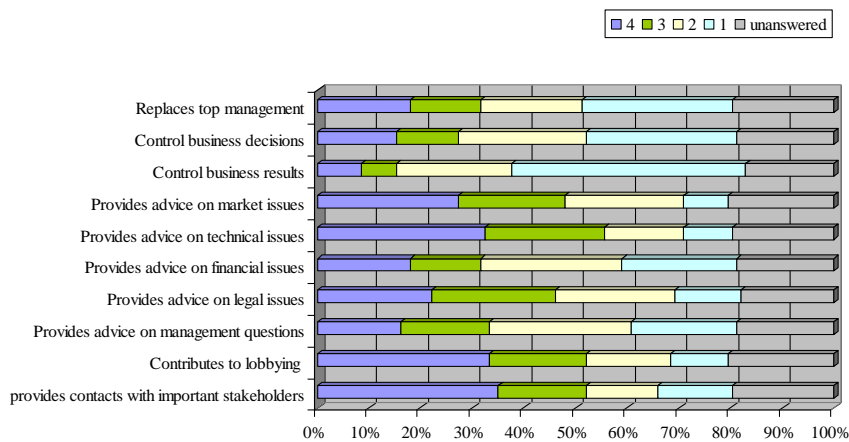


Figure 6. Contributions by the supervisory board to different issues 1 = significant contribution and 4 = does not deal with this

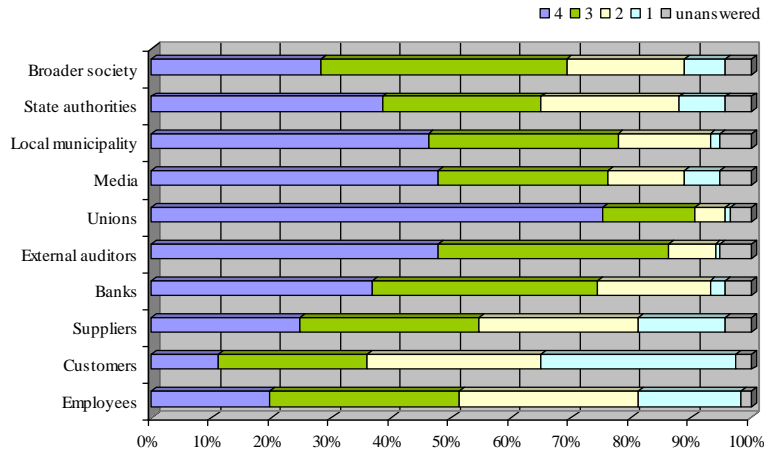
There were statistically significant correlations at level 0,01 between all areas the board deals with.

**Stakeholders**

There were three topics connected with stakeholders: which stakeholders influence the company's corporate governance, has **the company signed an agreement with trade unions** and does the company have a relationship with suppliers of debt capital.

Figure 7 indicates the influence that stakeholders have on the company's corporate governance.

The most influential stakeholders are the customers (33%) followed by employees and suppliers. The influence of banks, the media and local municipalities are all at a similar level. Trade unions and external auditors have the lowest influence. Only 15% of organizations have signed agreements with trade unions.



**Figure 7.** Stakeholder influence on company corporate governance 1 = significant influence and 4 = no influence

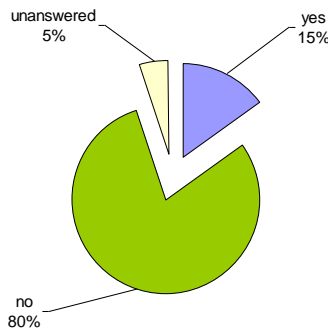
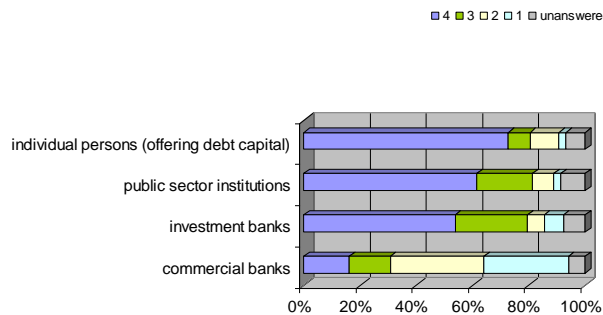


Figure 8 indicates the relationship with suppliers of debt capital. The strongest ties are with commercial banks (30% had very strong ties). The second strongest ties are with investment banks.



**Figure 8.** Relationship with suppliers of debt capital 1 = very strong relationship 4 = no relationship

## Conclusions

Current study was the first attempt to study corporate governance in Estonian companies by using quantitative methods. Results indicate, that the average number of members in supervisory boards and top management boards is low. Near half of supervisory boards have 3 members and most top management teams consist from 1 or 2 members.

According to current study management boards meet 1 or 2 times per month. Board meetings in Estonian companies take place on average 4 times per year. Stiles and Taylor (2002) have found, that the role of the board has indeed far more potential for active involvement in the running of organization than they actually use. It is also true in Estonian companies. The small number of members of both boards rises the question, do Estonian companies really need two boards.

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