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Corporate Governance in Eastern Europe: Case of Romania and Russian Federation

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Abstract. *Corporate governance has been well known in the last two decades for making the attraction of investors its main objective. During communism, corporate governance was absent from economical life and thus quick steps were taken by former communist countries to adopt corporate governance, Romania and the Russian Federation are two countries that realized the strategy. Eventually after the collapse of the communist bloc both countries have moved in different directions based on internal and external factors. Romania has moved toward the European Union Model, while Russia experimented with building a different model by borrowing parts from Western values and at the same time using traditional values. These perspectives are clearly differentiated in Romanian Petrom OMV and Russia's Gazprom.*

Keywords: corporate governance, Romania, Russia, OMV-Petrom, Gazprom.

JEL Classification: G34.
REL Classification: 17G.

1. Introduction

Adopting the governance model of a certain country may not be suitable for a different country. Former communist countries quickly liberated their markets and adopted capitalism without an accurate preparation and without international standards, including corporate governance standards. Although models from Western countries were adopted, this did not achieve the expected results. For example, to this day, the Bucharest Stock Exchange does not function the way it was supposed to. A lot of regulations are written in law but are not applied. Romania decided to adopt Western models, especially the Austrian model which allowed Romania to be a part of European Union in 2007. Russia, on the another hand, used Western models such as German and American models, but traditional values are heavily reflected to be a core part of Russian governance.

Governance mechanisms, accounting systems, understanding the role of stakeholders and of different committees must belong to the actual standards of the country and must be harmonized with international standards in order to enable corporate governance to achieve its objectives. Many big companies were sold after the liberalization of markets, new owners / investors brought their own visions of corporate governance, different from one of the host country. Thus, local interests caused politicians to seek the direct involvement of the state in trying to coerce these companies. For example, the Russian state was directly involved in a business conflict in the industrial town of Pikalevo in 2009, forcing the owners to respect social responsibility. However, Russian governance mechanisms, rather than helping society are only helping individuals.

2. Romanian Governance Model & Petrom-OMV

Corporate governance has taken a conceptual and legal place during the last two decades and regulations issued to structure a governance model. However, the model has been corrupted by politicians, socialists and economists. Even though capitalism has established a long time ago, the transfer to a market economy will also take time (Feleagă et al., 2011). Through communism, decisions that should benefit society are not made. Instead, the government takes advantage of society, and does not utilize natural resources. In 1995, the Bucharest Stock Exchange was founded by The National Securities Commission, but poor practices and a non-efficient banking system allowed for the generation of false financial reports (Feleagă et al., 2011).

The governments did not apply their own rules. The market was supposed to be a controlling mechanism but stakeholder responsibilities were not recognized. Romanian law issued in 2001 established the guidelines for the integrity and the transparency of financial statements, but the law completely failed because this rule is not applied. Due to this the corporate governance institution was established by the Bucharest Stock Exchange (BSE). In 2001, The OECD, along with USAID, launched a program to develop Romanian governance through setting several objectives:

A. Assessing corporate governance in Romania.
B. Providing recommendations to develop corporate governance in order to be closer to OECD standards.
C. Determine necessary governance techniques.
D. Improving governance understanding in Romania and informing international society about progresses in Romanian corporate governance.
E. Helping Romania with access to international dialogue on governance.

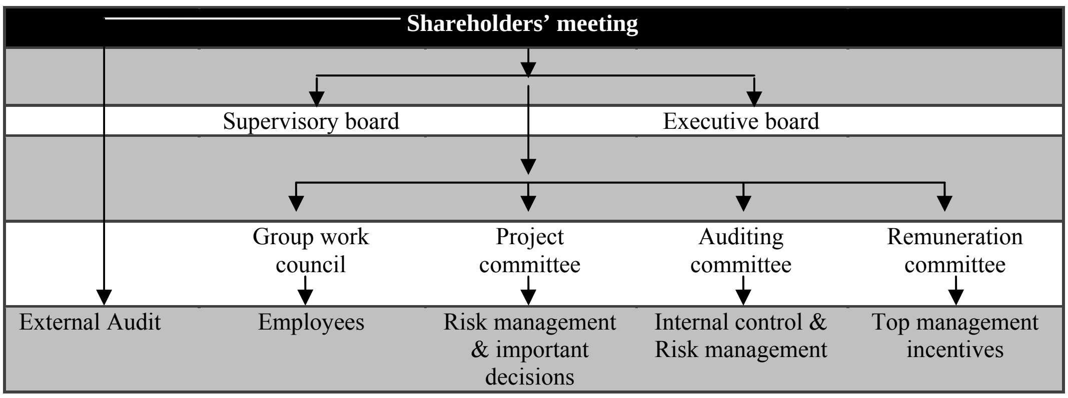
OECD principles were considered a benchmark for the Romanian corporate environment (OECD; 2001). Significant difficulties of Romanian governance were pointed out by Prof. Niculae Feleagă (2008):

- Poor analyses deal with the relationship between managers and shareholders, and with the reason of why stakeholders are scared from being involved in the decision-making process.
- Omitted conceptual framework for an effective market and social influence.
- The impact of Auditors on corporate governance is doubtful.
- Failure to change accounting systems to be accordance with international accounting systems.
- Missing effective control mechanism.
- Missing understandable, comparable and relevant financial disclosures.

The decision to apply OECD governance codes was made by the Bucharest Stock Exchange in 2008, but it came into effect only one year after. Listed companies were requested to submit a conformity declaration (Feleagă et al., 2011). A new law similar to European Union law was set to improve the performances of the executives and the board of directors. An urgent need to improve government regulations is necessary. Recent revisions of Romanian regulations provided important improvements over conditions of internal auditing and auditing committee, but the application of the requirements was complicated (Dobroţeanu et al., 2007). Romanian law describes responsibility, composition, and insures the independence of the committees by replacing internal and external auditors. Governance provisions obligate listed companies to report on a comply-or-explain principle. This code ensures the independence of auditing, nominating and remunerating committees. The responsibility of auditing committee is to aid the board of directors in order to accomplish its responsibilities regarding financial reports, risk management and internal control systems. Also, it is responsible for providing advice to the board by replacing and hiring external auditors, and to monitor the objectiveness and the independence of external auditors (Bucharest Stock Exchange; 2008).

OMV Petrom – Romania is an important company sold to Austrian group "OMV". The executive board adopts a "two-tier" governance model. The executive board is in charge of daily operations and it is monitored by the supervisory board. According to Petrom rules, which are approved by shareholders, the duties of the supervisory board must be achieved efficiently. The main duties are to supervise executive board activities, to select and replace members of the executive board, to insure that the company's activities are according to regulations, to provide activity reports at least once a year, and to represent company concerns. The members of the executive board and the supervisory board are obligated to fulfil their responsibilities and to perform in the best interest of shareholders. The ownership structure is divided between several shareholders. OMV owns 51.01 %, Romanian Ministry of Economy owns 20.64 %, Property Fund (issued by the Romanian government to compensate individuals after the revolution of 1989) owns 18.99 % and individual people own 9.36 % (OMV-Petrom, 2012). The minority of shareholders is protected through several laws. Environmental and social activities are insured by Petrom regulations, and are related to Petrom businesses. These activities are presented in a biannual performance report (OMV-Petrom, 2012).

Corporate governance structure of Petrom



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The supervisory board contains 9 members from European countries and the average age among them is 54.00 years. They have a medium education level with practical experiences in different companies (Petrom, 2013). Diversity and independence are the main factors in selecting these members. The board performance is evaluated by the results of their activities and work procedures (OMV-Petrom, 2012).

The supervising board selects the members of the executive board. The executives run daily transactions, monitor and manage the performance of the business to insure that everything is according to Romanian law and Petrom regulations. They consist of five members selected to work for four years. The chief of the board is a Romanian woman and members come from different countries such as Romania, United Kingdom and Austria. The average age of the members is 50.20 years and their education level ranges from medium to high. Some are specialized in engineering, law and economy (Petrom, 2013). The board meets on a weekly basis to exchange information and make decisions based on comprehensive approval (OMV-Petrom, 2012). The duties of the audit committee are established according to section No.92 – 4 A of the Stock Corporation Act. The committee meets six times annually dealing with annual financial statements, evaluation of auditory activities, risk management systems and procedures of internal control (OMV-Petrom, 2012). The financial statements are prepared according to international financial reporting standards and are audited by external auditors. The auditing fees of external auditors are monitored by the supervisory board. In 2012, Ernst & Young audited financial statements of OMV (OMV-Petrom, 2012). The project committee helps the executive board with complex duties and wherever it is necessary. The activities of the project committee are reported to the supervisory board. Thus, meetings are held when needed (OMV-Petrom, 2012). The remuneration committee deals with compensation for the executive board members. Employees are not represented in the remuneration committee. The main duty of the remuneration committee is to manage the executive board members (OMV-Petrom, 2012). According to the governance report of 2012, the remuneration committee met five times, and members of the executive board were invited to attend as well. PricewaterhouseCoopers LLP advised the remuneration committee to include market information, governance developments and OMV's application with employee's contracts to estimate the incentives in the short term and the long term along with advice regarding risk management and tax advisory services (OMV-Petrom, 2012). Top management remuneration is based on Austrian law. It encompasses the managers' performance, the performance-related component for the long and the short term. Also included are the company's performance, and that of other companies/competitors in the European market. Financial and non-financial measures are used to evaluate the board's performance with OMV-Petrom strategies, which are included in the remuneration policy (OMV-Petrom, 2012). Short term remunerations include basic salary, variable remuneration and non-cash incentives. Long term incentives were launched in 2009 to increase the value of the company in the long term. The interests of management are aligned with the interests of shareholders by providing them with shares in OMV. The maximum share grants for members of the executive board (as percentage of annual salary) are up to 175% for the Chairman. The Deputy Chairman receives up to 150%, and other members who have worked a minimum of the three years, between January 2012 and December 2014, receive up to 125%. The group work council represents the employees in the executive board meetings in order to exchange and discuss the information regarding plans that affect them. The risk management is organized into financial and operational forms. The risk management is divided into many branches such as: market risk, project risks, process risks, financial risks, tax risks, compliance risks, personnel risks, legal risks, regulatory and reputational risks, security, health and safety risks (Petrom, 2012).

The framework of internal control systems include:

- Internal control environment.
- Assessment of process and compliance risks.
- Risk mitigation via control activities.
- Documentation and information.
- Monitoring and auditing.

The ethical aspect of corporate law is based on principles from OMV group – Austrian law, which are in accordance with the United Nations Global Compact principles. They guide efforts toward the best corporate practices and make sure that transparency at the management level results in the confidence of stakeholders. Therefore, OMV has utilized Austrian governance law and its recommendations since 2002.

3. Russian Governance Model & Gazprom Russia

The corporate governance is characterized by an ownership structure where the majority of shareholders control the company. Also, the state plays a significant part in the management of the company. The lack of protection for the rights of shareholders, the penury of independent internal and external auditors, the lack of executive responsibility and the lack of hiring of independent directors are common characteristics in Russian governance. Due to this, there is an urgent need to develop a comprehensive governance law, which should be compulsory for companies. Recently, a new version of an old law has been issued for 2013. After the collapse of the Soviet Union, the Russian economic system adopted several steps towards a market economy. They added limited liabilities, joint-stock and close joint-stock companies to take a place, however the law requested joint-stock companies with a large number of shareholders which was not available in Russia at the time. The framework of Russian governance was structured twenty years ago and significant progress has been achieved by highlighting its weaknesses. The main challenge is to increase trust in the Russian stock market. Companies which are owned by the state and are a subject of the new governance law contribute fifty percent of the Gross domestic product. Even within privately owned businesses, the state will hold significant shares enabling it to rule the companies.

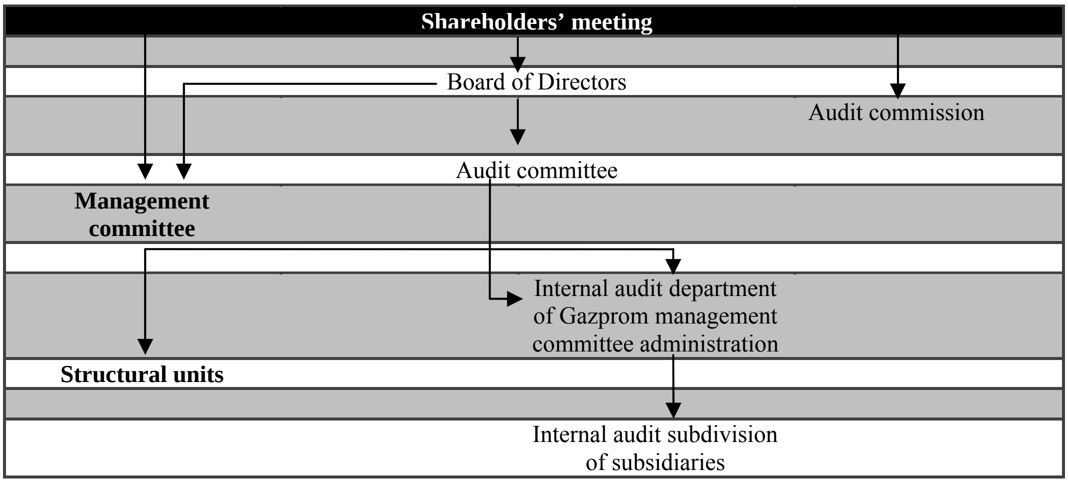
The new governance law was applied in 2013 to improve the performance of all companies. The challenge was to improve the transparency of financial statements and of the state regulations in order to strengthen relationships with investors. In addition, there was another important development taking process in the public house (Doma), which was to adopt changes in the civil law. Unsolved matters of certain conflicts were highlighted through these processes, which lead to a high hope that the new law will achieve its objectives. The OECD principles are applied to achieve positive changes in a capital market in order to attract foreign investors after improving transparency and integrity principles.

The Russian board of directors is similar to a single tier model like the American and the British boards which include executives as well as non-executives and external directors. Executives are a minority in the board of directors. Recently in Russia, the number of independent directors increased to ensure board independence. Independent directors are supposed to strengthen the trust of the stock market and the public. They are also supposed to provide advice to managers on how to improve their performance. However in Russia, the role of independent directors is not well understood and does not play a major role in the companies' performance. During the last five years, the function of internal auditing has been more common and has been an important part of company practices. Internal auditors are responsible for a fair assessment of financial statements by ensuring independence from executive officers. These statements are illegally reported (according to new law) to the general director, which nullifies the auditing concept. Also, the risk management may increase because of a poor performance of executives.

Gazprom Russia is considered an important gas supplier in Russia and neighbouring regions. The single tier model complies with generally accepted international standards and protects the rights of shareholders as well as establishes a good relationship with different groups of stakeholder. According to the reports of 2012, equity capital was divided into shares between the Russian state (50.002 %), American Depositary Receipt holders (26.955 %) and other registered entities (23.043 %). In 2005, on the other hand, the Russian state owned

50.002 %, Russian legal entities owned 29.482 %, Russian individuals owned 13.068% and non-residents owned 7.448%. These changes occurred due to the desire of adding Gazprom into the American stock market.

Corporate governance structure of Gazprom



Source: Gazprom website (2012), http://www.gazprom.com/about/management/corporate-governance/

An internal control system protects the shareholders and the investors. All procedures and objectives of the internal control system were replaced in 2012 by the board of directors. These regulations comply with Russian law and the laws of the Federal Securities Market Commission. They also comply with Gazprom regulations and international standards of internal audit and control (Gazprom, 2012). Financial reports need to be protected and prepared efficiently, fair, on time and must be completed by applying Gazprom legalizations. The external auditor is selected through an open bidding event set annually. The rules of external auditors must comply with Russian legislations. They must ensure that accounting statements are prepared according to Russian standards, and consolidated financial statements are prepared according International Financial Reports Standards (Gazprom, 2012). In 2012, the PricewaterhouseCoopers audit agency was selected. The duties of an external auditor are represented by insuring the independence of internal auditors, avoiding employees' investments in the company and monitoring individual relations between employees and top-management (Gazprom, 2013). Gazprom completely respects the Russian and the global environmental regulations in its businesses. Environmental policy is based on protecting the environment and reducing the negative influences on the atmosphere. From 2012 to 2015, a program was adopted and includes a list of investment projects and systemic measures to insure the energy security. Gazprom held a social program from 2005 to 2011 in Russia where an estimated 146 billion RUB was used to support different social activities. This money was also used to improve education, science, healthcare and cultural lifestyle. Another social program (2007-2012) used 7,8 billion RUB targeted to spiritual and physical improvements of child life, and maximizing the number of children in social activities. In 2013, Gazprom was a special sponsor of the UEFA football league to show the modern value of the new generation and respect to other cultures. The board of directors contains eleven members. Their average age is 58.81 years and they are well experienced. The majority holds a PhD in economics, philosophy and law. The minority holds a bachelor's degree in economics and graduated from aviation institution. All members have worked in different places both in public and private sectors. All members are Russian citizens and the board only has one female member. The management committee contains 17 members from Russia and their average age is 50.50 years. They are also well educated and the majority holds a PhD degree in economics and engineering. Two members graduated from the law faculty and the University of economics. All members are well experienced from different backgrounds such as state universities, governments, banking sectors, and other institutions. The main gender of the executives is masculine with two women. The auditing regulations, approved by shareholders, conduct the activities of the auditing commission (Gazprom, 2012). Objectives of the commission are to monitor operations and financial activities. Controlling the compliance of financial statements with accounting standards and insuring that these statements are disclosed to shareholders and investors are parts of these objectives. They also ensure the efficiency of asset management and reduce the risks of financial and operational activities to improve the efficiency of internal control system. The audit commission consists of 9 Russian members including 2 women. Gazprom lives by ethical codes to determine and establish respect among employees, board of directors, management committee and revision commission (Gazprom, 2012). The best practices of national and international experiences are adopted in Gazprom business behaviour and are used to develop governance laws. The issues of stakeholder relationships are reflected in Gazprom regulations. Also, the principles of the relationship between Gazprom and its employees are disclosed. The remuneration committee conducts compensations of the directors after being approved by shareholders. The short-term compensations are paid to all members of the management committee and the board of directors. Other benefits such as providing health and civil services are also mentioned in the contracts. Determining the amount of remunerations is subjected to certain regulations. For the board of directors it is divided into a basic remuneration and premium remuneration. The basic remuneration includes the main responsibilities and duties. The premium remuneration is related to additional duties (Gazprom, 2012). Risk management exercises strong and continuous efforts to improve Gazprom systems. Approved by shareholders, an action plan was set up to improve the risk management systems in 2011. For the risk management, Gazprom develops unified approaches to organize policies, methodologies and procedures. Thus recently, an interaction strategy linked to the risk management system was applied in the Gazprom group. In the meantime, several efforts have been made in order to minimize the credit risk of Gazprom in international and domestic markets.

Key Risk Factors as they are presented in the Gazprom report (2012)

Strategic and country – specific risks:
- Risks relating to global credit crunch developments.
- Risks relating to operations in European gas market.
- Risks associated with development of renewable power sources.
- Risks of state regulation in the sector.
- Risks relating to natural gas transit.
- Risks associated with entering new regions and new markets.
- Risks associated with gas production development from unconventional sources.
- Geographical and climatic risks.

Risks relating to customs, foreign currency and tax regulation:
- Risks associated with the changes in currency regulation and tax legislation in Russia.
- Risks relating to changes in rules of customs control and payments in Russia.

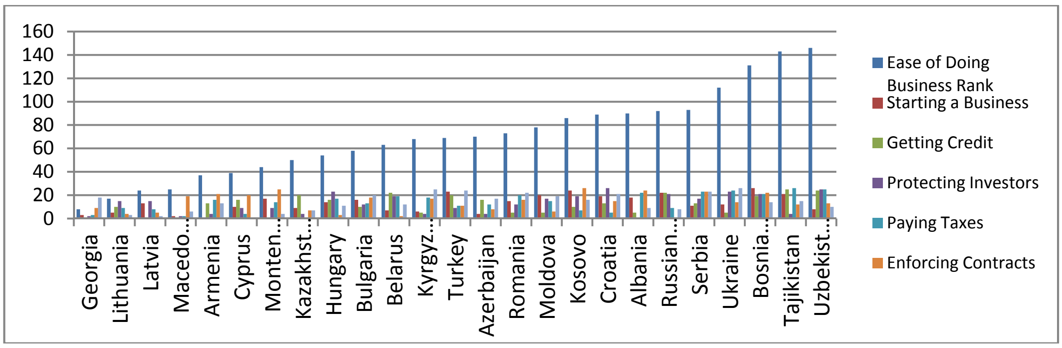
Financial risks:
- Foreign exchange risks, interest rate and inflation risks.
- Credit and liquidity risks.
- Market risks including risks associated with decrease in volumes and cost of gas sold at foreign markets.

Operating risks:
- Risks relating to non-extension of subsoil licenses.
- Cost escalation risks.
- Risks relating to exploitation of operating facilities.
- Risks associated with assessment of hydrocarbon reserves.
- Risks associated with vertical integration and diversification of operations.
- Risks relating to registration of title to real estate and land plots of OAO Gazprom.
- Environmental risks.

	Gazprom	Petrom
OECD principles	Adopted	Adopted
Governance model	Single tier model	Double tier model
BOD Members' citizens	Russia, Former USSR (that returns to fact that Gazprom were presented as a national company, recently foreign capital takes a place in order to be listed in American Stock market)	European including Romania (that returns to fact that Petrom is a member of OMV group; majority of member of OMV are from Austria, and executive board's chief is Romanian)
Education level	Majority of members of board and committees carry PhD degree in economy and law, Aviation Institute	Majority of members of board and committees carry bachelor degree in economy and law, and MBA, Mechanical Engineering.
Experiences	Professors in universities, banks, Russian government, and related companies and institutions.	Banks, consultant, and related companies and institutions, Romanian government.
Women's advancement	5 members	1 member the CEO
Ethics codes	More reflect Russian values.	More reflect European-Austrian values and U.N
State sharing percentage	55.002% (other reason; codes reflects Russian value)	20.64% hold by Romanian Ministry of Economy
Foreign sharing percentage	26.955% (American Depositary Receipt: ADR)	51.01% (OMV group)
Accounting Standards	IFRS	IFRS
Remuneration	Based on members' contracts and other health and social benefits based on members' performance.	Based on members' contracts, market and giving shares.
Independence directors	Acceptable level (state influence)	High level

4. Efficiency of these models

Romania and Russia have achieved a good progress in the field of corporate governance but additional work must be completed in the next few years to achieve a proper functioning of the governance mechanisms. Switching from a planned economy to a market economy was attempted without a well prepared plan. According to www.doingbusiness.org (the chart below) shows the ranks of businesses in Eastern Europe and some former communist countries

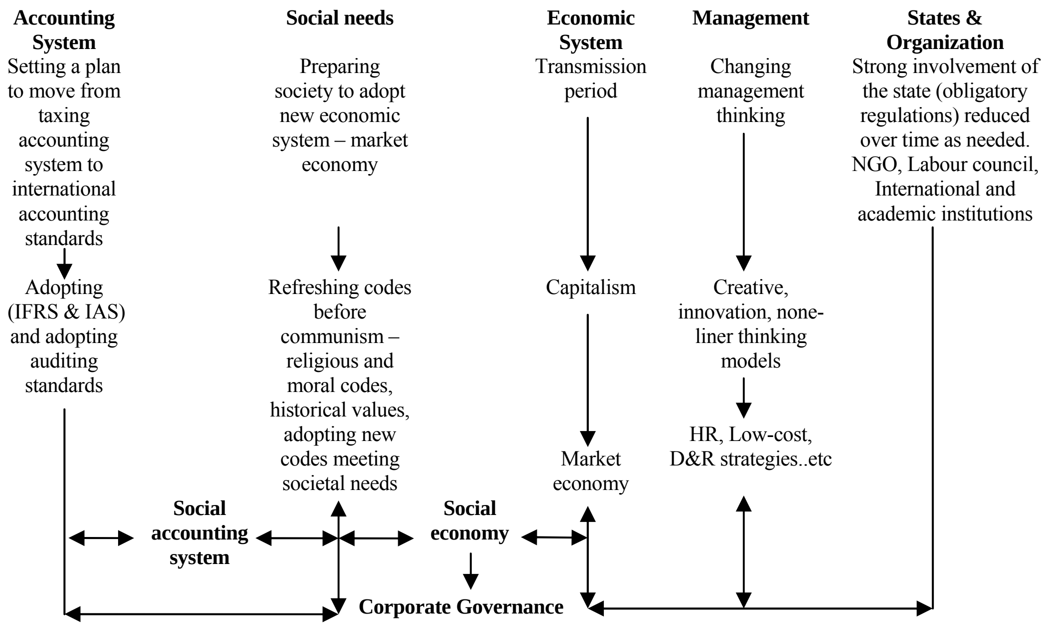


Source: doingbusiness.org/ranking excel sheet transferred to a chart by author.

Romania and Russia succeeded in attracting new investors through new governmental regulations. This enriched the national economy and rebuilt the management system based on Western models. Romania was ranked at number 15 and Russia was ranked at number 21in doing business. To its credit, Romania ranked at number 5 and Russia ranked at number 22 which confirms that the adoption of the Western model was beneficial for the economy. However, other former countries have performed even better. This change encouraged them to adopt certain models that facilitate foreign investments. The main objective of adopting OECD corporate governance principles was to facilitate companies in starting a business but huge challenges were faced which is why Romania ranked at 73 and Russia at 92. High corruption is one of these challenges. Because of missing moral and religious rules, stemming from communism, the adoption of international standards was not as effective as it should have been. In Petrom-OMV, governance law was taken from OMV Austrian law without considering Romanian cultural principles. Russia adopted the international standards to make Russian companies well known globally by keeping Russian tradition a core part of corporate governance. Protecting investors and paying taxes are linked together. Romanian investors are evading taxes and take advantage of loopholes in the regulations. In Russia the state is directly involved which leads to changes in the capital structure of the company. That explains the higher number of forced contracts in Russia than in Romania, in which Russia is ranked at No.1 and Romania is ranked at No.16. In paying taxes, Russia is ranked at No.9 and Romania is ranked at No.20. One reason for Russia's high rank is due to its accounting system, which is based on tax purposes. Politicians also have an overall impact on governance. In Russia, governance is used to increase popularity of politicians. In Romania, foreign investors are seen as a chance for the improvement of the national economy, whereas in Russia they are considered a serious threat to the independent decision making process. One of the main reasons behind the adoption of international accounting standards is the push for the globalization of the Russian economy, to gain profits from international activities and to be a tool to help control other economies. The eco-political relationship between Russia and Ukraine is an example of this. Due to the lack of communication between the groups of stakeholders and the absence of ethical programs, the implementation of a governance code is not fully effective. In Petrom's executive board, the only Romanian is the chief. All other members come from different countries causing a huge loss in translation not just in language but also in background, which can reflect the company negatively. In Gazprom, all members are Russian. However, their main objective is to benefit politicians, which also reflects the company in a negative way. These reasons may additionally affect social and national perspectives of these companies.

5. Conclusions

Many needs must be met in order to build an effective model of corporate governance, like understanding the concerns of politicians, societies, investors and other stakeholders. Due to this lack of understanding, the market economy cannot be used as a controlling mechanism. Being open to other models without considering the sensitivity of the society can cause a negative turn on the perspective of the whole country. During communism, the role of the state was strong in social and economic aspects. There was a high level of enforcement of the law and a planned economy. These principles should be re-adapted but with slight modifications. There is a need to refresh certain principles such as religious and traditional codes, which were lost during communism. That can provide a golden opportunity to utilize human and national resources. To rebuild an active corporate governance in former communist countries, the following structure can be presented:



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