



DEVELOPMENT OF CORPORATE GOVERNANCE IN LATVIA SINCE 1992

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Development of Corporate Governance in Latvia since 1992

Abstract

Corporate governance processes and their evaluation in Latvia recurrently become hot issues of the agenda of mass media and whole society. Yet, there are no research carried out on legislation processes and corporate policy influence on economy development. Most often the evaluation of separate elements of these processes are at culmination during the pre-election campaigns, when both politicians and experts in political marketing set down to drafting, arranging and carrying out effective political campaigns, which aim at arousing common standpoints in the society to ensure a successful election outcome for particular politicians or parties.

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1. Introduction

When studying the development of public policy in Latvia, starting with the moment democracy was formed and started to develop along with the development of corporate policy and corresponding communication processes in 1990th, one should take into account the preconditions of how a democratic state is formed, as well as consider the necessity for approximation economic priorities between politically, socially and economically active subjects. Yet, these principles were not defined as a priority of public administration processes. However, along with the changes characterizing the intensity of political life in Latvia, and subjects' political experience as well as their possibility to collaborate in public administration, a greater attention is paid to how socially and economically active subjects and groupings influence the pace of state development.

It is essential to be aware of the experience other economically developed countries have when exchanging viewpoints, developing legislation processes as well as corporate policy traditions and entrepreneurs ethical principles. These should be taken into account when doing the analysis of present political experience in Latvia: should it refer to social dialogue of corporate governance when introducing social, political or economic priorities or promoting socially responsible entrepreneurs in country's development.

Corporate governance is perceived as dealing with "problems that result from the separation of ownership and control."¹ From this perspective, corporate governance in Latvia focuses on: internal structure and rules of the board of directors; creation of independent audit committees; rules for disclosure of information to shareholders and creditors; and control of management.

A recent academic discussion began with the following quote: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." So the main worries could be identified:

¹ Sullivan J.D., "Building Sound Corporate Governance, Center for International Private Enterprise, U.S. Chamber of Commerce, Cartagena, Colombia, 17.11.2004.

1. How do the suppliers of finance get managers to return some of the profits to them?
2. How do they make sure that managers do not steal the capital they supply or invest it in bad projects?
3. How do suppliers of finance control managers?

Assessing the Causes and Effects of Corporate Restructuring in the 1980s, hypothesized that a sustained rise in real interest rates reduced investment opportunities; "restructuring was largely fuelled by the conflict among managers, financial institutions, and shareholders over whose interests should take precedence. But the model of ownership and control is rethinking corporate governance for the 21st century like attempting resolution of this conflict by proposing "maximizing total wealth creation by the firm." The key to wealth maximization is to be found in providing ownership-like incentives to "those who control critical, specialized inputs and to align the interests of these critical stakeholders with the interests of outsiders.

Corporate governance is the body of "rules of the game" by which companies are managed internally and supervised by boards of directors, in order to protect the interests and financial stake of shareholders. And just as good government requires transparency so that the people can effectively judge whether their interests are being served, corporations must also act in a democratic and transparent manner so that their owners can make educated decisions about their investments. Therefore corporate governance issues have been faced in the Latvian economy. Further, national business community are learning and re-learning the lesson that there is no substitute for getting the basic business and management systems in place in order to be competitive internationally and to attract investment.

As a result, the World Bank, the Organization of Economic Cooperation and Development, most of the regional development banks, and the various national development agencies have either launched or expanded programs in this area since 1998. In Latvia since 1998, similarly, business-related organizations appeared like – employers and industry organizations, stock exchange etc.

2. Privatisation processes as an early barometer of corporate governance

It is perhaps not surprising that the countries that rushed into large-scale privatisation, have experience of large corporate governance failures including asset stripping and fraud. Today, however, Latvia has to come to grips with the need to substantially improve corporate governance standards and practices.

The drive to rapidly privatise the entire business structure of the post-communist economies began to increase interest in corporate governance as a development topic. As a start, state owned firms had to be corporative, i.e. converted from a governmental type structure to a corporate form. The whole body of commercial law had to be put into place including bankruptcy, laws on property, accounting systems, and a host of other rules of the game. Unfortunately, only few individuals had any experience as members of a board of directors.

Privatisation was crucial experience for the future perspectives of country's development. As the gap between executive compensation and corporate performance drove the demand for change in Latvia, the roots of what is now recognized as corporate governance type issues can be found in the drive for privatisation that grew in the 90-s. Clearly, creating a sound corporate structure should have been central to the success of privatisation both from the point of view of the government seeking to sell the firm and from the point of view of the potential investors. In fact, some of the most telling failures in the early privatisation experiences can be traced back to a lack of sound regulatory structures that allowed unwise business practices.

One of the most scandalised processes was bankruptcy of Banka Baltija since 1995, because of visible lack in adopting standards for transparency and dealing with investors and creditors. That could be a major benefit for all helping to prevent systemic banking crises. Taking the serious steps to adopt bankruptcy procedures could help to ensure with methods for dealing with business failures that are fair to all stakeholders, including customers, employees as well as owners and creditors. We have learned that without adequate bankruptcy procedures, especially enforcement

systems, there is little to prevent insiders from stripping the remaining value out of an insolvent firm to their own benefit.

The lack of adequate institutions and poor legislation system in Latvia has resulted in several highly publicized cases involving allegations of asset stripping, management manipulation, and fraud. The Latvian privatization program has demonstrated the weakness of the voucher method in the absence of sound corporate governance mechanisms since it resulted in a lack of corporate restructuring and a consequent decline in competitiveness.

What these examples have in common is that they all involve the basic rules of the economy and the relationship between these rules and the way companies are governed. Transparency or full disclosure of financial and key performance information was needed. Procedures for bankruptcy did not cover conflicts of interest involving boards of directors, managers, minority shareholders and society. Property rights, precise activities to prevent corruption or adventurism were ignored.

3. Ways to improve corporate governance in Latvia

Each of these issues poses grave challenges for both the functioning of a Latvian market economy and a democratic society. Solving corporate governance problems such as those listed above involves going beyond a narrow view of how owners and managers of capital interrelate. In Latvian economy, the standard definition should be supplemented by placing it in context as follows:

1. Corporate governance system in Latvia depends upon a set of institutions (laws, regulations, contracts, and norms) that create self-governing firms as the central element of a competitive market economy.
2. These institutions ensure that the internal corporate government procedures adopted by the firms are enforced and that management is responsible to owners (shareholders) and other stakeholders.
3. The key point in this definition is that the public and private sectors have to work together to develop a set of rules that are binding on all and which establish the ways in which companies have to govern themselves.

From this point of view, company's policies and practices adhere to applicable national and local laws, and corporate governance in Latvia tends to focus on a simple model presented by Centre for International Private Enterprises (CIPE):

1. Shareholders elect directors who represent them.
2. Directors vote on key matters and adopt the majority decision.
3. Decisions are made in a transparent manner so that shareholders and others can hold directors accountable.
4. The company adopts accounting standards to generate the information necessary for directors, investors and other stakeholders to make decisions².

Transit economy of Latvia has made fundamental changes in the relationship between citizens and the state in order to create free market economy. However, building a market economy requires a complete overhaul of legal norms to allow for innovation and initiative rather than predefining areas of allowable activity. That is why corporate governance should be thought of as a mechanism for creating self-governing organizations, is equally important to emphasize that a market economy is not simply the absence of governmental intervention.

To develop the own corporate governance culture, it is vital to avoid simply copying other countries systems or asking foreign experts to write model laws. If the foreign donor community often pushes this type of approach, it should be resisted.

Through Central and Eastern Europe a network of extremely capable policy research institutes have been formed to gain followers. Many of these centres have been formed with the backing of the business leadership and are in a position to devise, adapt and advocate for systems that will be appropriate to the status of each country. In the process, not only will the resulting policy reforms advance better systems of corporate governance, they will point to the need for other reforms. Unfortunately, such research institutes are not influential and successful in Latvia.

The need for adoption of modern management systems including areas such as quality management, strategic planning, innovations and social dialogue will become more apparent in the process. It's up to the policy research centres, the national business associations, and others in civil society to work with governments to craft the

² www.cipe.org

best national systems. Business leader's advices business community to incorporate corporate governance into ISO standards.

How often has it been said that, the government should get out of the way and let the market function, still that idea is a myth. Government is absolutely essential in setting up the framework of a Latvian economy. Without rules and structures of a binding nature anarchy results. Hence there is more need for corporate governance procedures in this type of economy than in one where shareholding is relatively concentrated. Financial market liberalization increased privatization, and the growing use of funded systems to support pensions is driving Latvian economies toward more explicit and more comprehensive rules on corporate governance. In short, globalization is forcing convergence of different systems into a more open and internationally accepted set of standards.

4. Common standards

Just as good government requires transparency so that the people can effectively judge whether their interests are being served, corporations must also act in a democratic and transparent manner so that their owners can make educated decisions about their investments. Business organizations would be willing to work with TQM or other international quality models as ISO in developing corporate governance standards that would promote adoption of best management practices in corporations worldwide. The business leaders also called for regional and country-specific awards that recognize companies that adhere to sound corporate governance practices. Another consideration in the debate over corporate governance systems is the risk that individual firms face. Unless a company is able to build the kinds of governance mechanisms that attract capital and technology they run the risk of simply becoming suppliers and vendors to the global multinationals.

Particularly firm specific human capital, is growing in importance in relation to ownership based governance is likely to reduce the corrupting influence of unaccountable power on government. At the same time, by transforming corporations into more democratic institutions, institutional investors can unleash the wealth-generating capacity of "human capital" which is based in the skills and knowledge of corporate employees.

Common ethical standards have appeared on industry or branch level to improve the entrepreneurial climate and fair competitiveness in Latvia. Ethical codes should appear to present the maturity of the strongest industries understanding the developmental opportunities to co-operate in European associations' level, and it can be seen as an opportunity to create global partnerships.

5. General Manager as a key aspect for successful corporate governance

One way to sum up the concept of corporate governance is to look at it from the perspective of the corporate director. Increasingly directors are being held liable for their actions or inaction. What does a director need to be able to function and have a balanced view of the firm? Following is the minimum essential information:

1. Operating systems, balance sheets and cash flow statements comparing current period and year-to-date performance to target improvement vs. previous year.
2. Management comments about current performance explaining the deviations from the targeted performance and revise performance targets for the remainder of the year.
3. Information on the company's market share.
4. Minutes of management committee meetings.
5. Financial analysts' reports for the company and its major competitors.
6. Employee attitude surveys. Customer preference surveys.
7. Key media articles on the company, its major competitors, and industry trends³.

The list not only sums up the key responsibilities of a board by showing the kinds of information that a board should review and disclose. These concerns reinforce the argument that corporate governance reflects the underlying systems of law and regulation. Most importantly, without sound and accurate accounting systems, how could the director function? The list also points up that good corporate governance will bring with it modern management systems.

³ Sullivan J.D., "Corporate Governance: Transparency Between Government and Business", Center for International Private Enterprise, www.cipe.org

The business participants explored corporate governance reforms by examining the impact on four sets of constituencies: general public, media, business community and government and policy makers. The executives developed the list of specific initiatives that businesses and business organizations can undertake with each constituency.

For example education is beneficial for all to help elevate the status of corporate governance in the national business agenda. Therefore, initiations of educational and training programs with target groups (employers and industry organizations) that promote good corporate governance are needed. As well as encouragement for companies to promote positive interaction between suppliers and consumers, formulate transparent guidelines for transactions, offer recourse for consumer complaints and establish mechanisms to receive complaints and feedback.

NGO assistance could establish third-party monitoring and evaluation systems on corporate governance, and foster collaboration among firms, business associations and consumer groups. It is a great opportunity to promote good corporate citizenship and social responsibility among firms and standards of fairness in interaction with the public, and organize periodic reviews and information exchanges with businesspeople both nationally and internationally to ensure continued relevance of standards and possible adoption of new ideas.

Business community faces an increased percentage of independent directors on corporate boards initially to one-third and eventually to 50 percent. Disclose information on directors including remuneration, family relationships and business relationships that may also constitute conflict of interest. And proposals for legislators to hold directors legally responsible for failure appeared to discharge fiduciary responsibility, taking into account differences in liabilities between executive and non-executive directors consistent with national legislation.

As vitally important aspect has been faced obstacles, that responsibility for company management should be placed in the hands of professional and experienced executives, establish clear management policies and make these known to employees and shareholders, and afterwards to establish audit committee consisting of at least three independent directors that reports directly to the Board (internal auditors also should report directly to the boards), as well as annual reports should be published

containing extensive information on firm's financial condition, ownership structure and corporate governance standards.

The role of legislators and government is visible as they have legitimate power to incorporate corporate governance into the International Standards Organization system, adopt a grading system utilizing corporate governance principles to help business evaluate the efficiency of government agencies and encourage the evaluation and review of current laws, rules and regulations to improve the quality of existing legislation and simplify administration.

Only nowadays understanding has reached need for the national government to sign-on to the anti-corruption convention of the Organization of Economic Cooperation and Development (OECD)⁴. So, recommend that governments adopt simplified, clearly defined, transparent, and time-limited systems for any government processes concerning corporate governance.

By way of improving the entrepreneurship friendly environment and affecting the corporate policy, the role and place of social dialogue in Latvian society has been strengthened. The evidence of this is the tax policy promoting the development of entrepreneurship and other laws so important for Latvia's future, to name just two: *Law of Labour* and *Law of Labour Protection*, worked out in cooperation with international organizations (especially with EU and World Trade Organization (WTO)) and passed by Latvian government. Entrepreneurs, in turn, have acknowledged their readiness to undertake the liabilities of an EU member state, especially those regarding the employment, labour relations and labour protection, thus demonstrating the Employer's, including the State as an Employer, attitude towards the most significant value – the man.

By adopting the long-term Strategy of Latvia's Macroeconomic Development and by according to it implementing, for example, National Employment Schedule Plan or National Innovation Programme⁵ which provides the implementation of new technologies, promotion of efficiency and the performance of labour relations Latvian entrepreneurs are given the possibility to conquer new positions in word market and

⁴ www.oecd.gov

⁵ www.liaa.gov.lv/eng/inner/business_environment/gzdgsgsdg/

rise competitiveness. This is also to guarantee Latvia's social and economic growth, social peace and stability.

6. Shared responsibility and commitment of public and private sectors in monitoring the corporate governance

Considering the apparent achievements in Latvian economy as well as the pace of economy growth one should admit that legislation processes meet the incompetence of lawmakers as well as their unwillingness to listen to organized entrepreneurs bodies and adopt entrepreneurs' friendly resolutions. As a result of this the lawmakers produce but statutes of a low quality and entrepreneurs become passive. Circumstances like these are in no favour of economic growth as well as an obstacle to social peace.

Corporate policy issue in frames of public administration became more acute as life in general turned politicised and more and more people were involved in political processes. Entrepreneurs were striving to develop and modernize their enterprises having close cooperation with the consumers, clients, share holders, partners and society in general, in order to learn and satisfy their needs by way of constantly producing products and services with added value. Thus, promoting not only entrepreneurship itself, the outcome and its reputation, but improving also public prosperity.

At the same time, corporate policy foresees the use of updated equipment and technologies, and most effective management methods, thus stimulating the overview of different development stages of Latvian corporate policy in terms of the following criteria:

- development of the contemporary products and services meeting the needs of customers and clients;
- promotion of public health protection by introducing environment friendly technologies and raw materials;
- promotion of stable export potential by propagating and spreading a product or service, thus fastening the enterprise position among other leading international enterprises.

By tracing topical political issues in Latvia and by getting acquainted with written resources one can offer the most effective pattern how to develop qualitative legislation processes, promote the development of corporate performance and propagate business ethics.

Comparing the present situation in Latvia as a transit country and analysing qualitative as well as quantitative research data there possibly will arise suggestions and solutions how to improve the legislation processes and social dialogue by involving the interested parties in developing country's economically significant issues.

It is important to involve more and more entrepreneurs in cultivating corporate policy and stimulating the elaboration of socially relevant decisions, thus promoting the standards of business ethics and entrepreneurs' reputation. Unfortunately Latvian media focuses and deals with statements producing that Latvian society is not yet mature for democratic traditions when handling social, political and economic issues. Negative attitude towards open exchange of opinions, intolerance towards diverse opinions and historically refined world wide traditions of lobbyism perceived with prejudice and neglect are just few examples to name.

During professional activities have experienced entrepreneurs' interaction and implementation of corporate policy in legislation processes by both contacting the governmental organizations straight as well as via nongovernmental organizations. Thus, interaction analysis of legislation processes and corporate performance is possible based on the draft of a concrete law with the moment the issue is on agenda till the moment of its publication and evaluation of the changes it brings along.

The research should comprise legislation and identification processes of corporate policy in public awareness. Promotion of public relations and communication technologies, improvement of legislation processes as well as propaganda of corporate policy altogether forms a contemporary comprehensive pattern of political cognition. Changing nature of the political life in Latvia proves how easy it comes to loose the sense of reality and limit when analysing the interaction and regularities of political and economic processes. Often, when working at public administration issues, it is problematic for politicians to keep balance between their personal and ideological victories and defeats. They rather run to extremes. Also public mind is rarely objective:

rather the cooperation between entrepreneurs and politicians is often seen hyperbolic, either denouncing or under-evaluating.

These are issues that may cause significant academic discussions, analysing the interaction of Latvian political and economic processes and their reflection in choice of corporate policy and public relations strategies. Stable grounds must be found to develop on democratic traditions based understanding about the political life in Latvia and the necessity for improvement of surroundings quality in public administration and entrepreneurship.

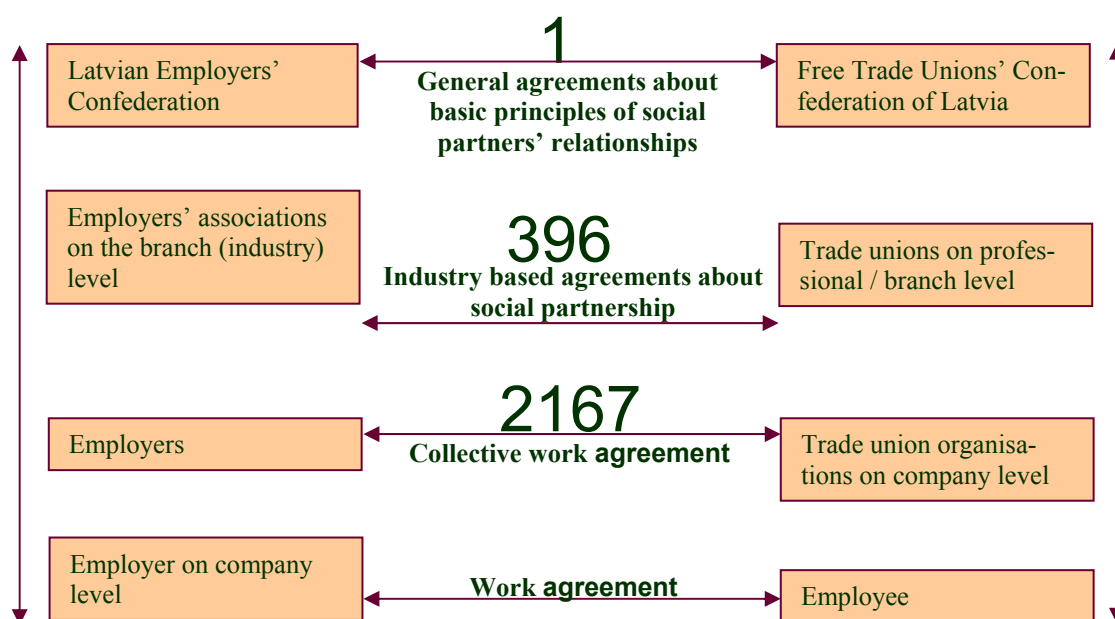
Signed contracts between trade unions and employers, association's branches and trade unions etc. is another quantitative indicator of corporate governance quality and social dialogue development. The above-mentioned statistics show quantitative data that further on may be analysed qualitatively by studying carefully the efficiency and features of organizations' activities.

7. Role of social dialogue

Both Latvian and EU institutions, where social partners work, serve as a bridge between government and society. The strength of this bridge depends on our social partners' ability to formulate and express their opinion in Latvia and in EU institutions, as well as on the Government's wish to listen to this opinion. It depends on whether the Government will realize that social partners is a support resource rich of knowledge and practical experience to address any socio-economic issues.

Transparent and good governance enhances effectiveness of entrepreneurship and employment development by observing interests of the public at large to promote strengthening and development of organizations and enterprises, it provides the growth of employers, the development of enterprise culture and creation of favourable social conditions. The chart bellow shows the status quo of the current situation in bipartite social dialogue, where we can see sound development of agreements concluded on industry level and collective agreements.

Chart 1: Number of set agreements at different levels at the beginning of Year 2002.



Source of information: the Latvian Employers' Confederation 2003

Both state and entrepreneurs have shown their interest in state proposed targets that includes limited illegal employment and increase of state budget income; rationalizing of state administration expenses; prevention of tax increase and other compulsory payments; proper use of the rights declared in *Law on Employees Organizations and Associations*⁶; increase of impact regarding the drafting and passing of legislation and resolutions; broadening of international contacts⁷.

Governmental organizations' intentions promoting public cooperation in legislation processes or just the contrary, their absence, is a crucial precondition in shaping the settings in favour of entrepreneurship, as well as in promoting social welfare. Only by studying the performance of separate ministries, committees, councils and experts' one can judge about the development of social dialogue or the other way round – about the atavisms of totalitarian regime.

⁶ <http://www.lddk.lv/index.php?pid=112>

⁷ <http://www.ilo.org/public/english/dialogue/actemp/papers/1998/srstripa.htm#CE>, C. The Role of Employers and Their Organizations

Entrepreneurs joining in non-governmental organizations show their maturity. Being aware of advantages it brings: promotion of competitiveness on regional as well as global scale and qualitative output that satisfied employees will provide. By way of preserving the common values and securing good labour conditions entrepreneurs are ready to undertake the apparent burden, thus providing a civilized society growth.

Based on legislative and socially responsible initiatives, entrepreneurs have done the survey of state budget programme and handed in proposals for rationalizing of expenses. Particular attention was paid to the programmes affecting issues concerning the labour market, such as, professional education, regional development, promotion of infrastructure, including health protection and repair of public roads. Part of the proposals have already been taken into account and changes made in legislation and resolutions. Yet, it is possible that course of events like this have caused public suspicion and origin of myths about lobby practice in Latvia.

Nevertheless, the non-governmental organizations in Latvia share a growing role and reputation on international scale. "Social dumping"; internal enterprise performance and entrepreneurs' role improvement; efficiency of entrepreneurship; evolution of employment, as well as trilateral advisory mechanism are fields of serious effort in future Latvia where present obstacles and problems should find reasonable solutions.

When integrating the corporate governance policy in strategic public relations and communication objectives it is essential to collect the recognition and evaluation of enterprises' owners, shareholders, clients, employees and the whole society in general. To obtain this, continuous improvements concerning entrepreneurship's surroundings, professional health of people involved and safety in all spheres of entrepreneurs activities by involving the above-mentioned subjects should be carried out, thus improving the system of economy.

By doing the analysis of quantitative and qualitative research data we reach the possibility to evaluate the maturity of both: the most significant spheres of influence and interaction, as well as the involved parties under the process of power division. Latvia's situation, based on public administration analysis, is important to evalu-

ate National Tripartite Co-operation Council, results of its activities harmonizing legislation and improving business environment.

Chart 2 shows the organizational model of National Tripartite Co-operation Council⁸ and the principal issues and priorities to be solved. Seven representatives - experts representing government, employers and trade unions take part in this Council.

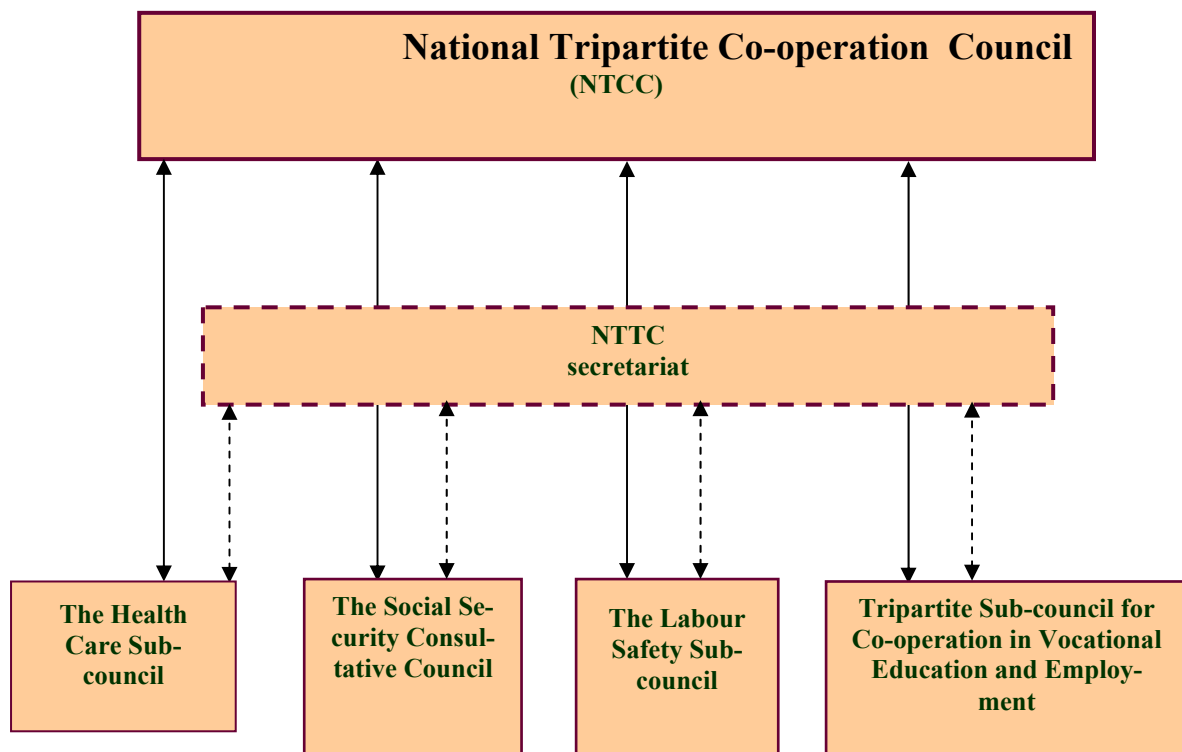


Chart 2

Separate case studies that help defining the involved parties' understanding of social responsibility, their attitude towards the country, the society and the environment should be carried out within qualitative research. For example, the environment protection has lately become a topical issue, yet there are few companies ready to see that their corporate policy according to corresponding legislation standards comprises the following issues:

1. Determine such aims and assignments which prove their effort in environment, health and labour protection;

⁸ <http://www.lddk.lv/index.php?pid=113>

2. Meet all binding statutes, instructions, standards and requirements of all interested parties;
3. Explain and propagate health and labour protective corporate performance, promote employees cooperation and personal responsibility, thus providing labour friendly environment, free of accidents and illnesses;
4. Develop and utilize resource preserving labour methods; diminish production or service waste by recycling them thus promoting materials and energy saving processes;
5. Pay particular attention to employees' education and understanding of environment, professional health and labour safety;
6. Explain company's environment, professional health and labour safety policies to employees and society;
7. Involve the society and other interested parties in solving the environment issues.

Social research methods offer to use several case studies of qualitative research. To approve the hypothesis that qualitative legislation processes, based on application of underlying principles of social dialogue and social responsibility within corporate policy, are the basis for economic development, it is necessary to carry out all: Snapshot Case Study, Longitudinal Case Study and Pre-Post Case Study, which then should be summarized in a kind of Comparative Case Study, thus presenting a wide spectra of anybody's interests and their application possibilities in legislation processes and corporate policy communication within a broader range of society members.

8. Summary

Corporate governance processes and their evaluation in Latvia recurrently become hot issues of the agenda of mass media and whole society. Yet, there are no research carried out on legislation processes and corporate policy influence on economy development. Most often the evaluation of separate elements of these processes are at culmination during the pre-election campaigns, when both politicians and experts in political marketing set down to drafting, arranging and carrying out effective political campaigns, which aim at arousing common standpoints in the society to ensure a successful election outcome for particular politicians or parties.

No doubt that many economic issues differ by their impact on the society, as well as differ the society understanding about the meaning and impact of a particular issue. That is why the issues concerning economy development are broader examined and analysed by professionals and the involved parties: both drafting and approximation of the laws, passing and implementing them, as well as considering the impact legislation has.

As the research is closely connected with topical political issues it is also possible to get to know the observations and conclusions of scientists. Scientists and experts in abroad analyse one or more political processes and factors affecting them. However, by learning these arguments it is not possible to get one common image about legislation processes, their typology or classification by any definite measures. Also one must conclude that there are no similar academic observations made in Latvia or be there but fragmentary and analysing the above mentioned issues alongside with other.

Political processes and corporate governance evaluation most often can be traced in periodicals, yet not always objective. Media deals with these issues by presenting the corresponding media opinion or policy. Journalists are often no professionals and / or incompetent in political, social and economic issues they present.

At present more broad and periodical research is done by EU institutions that based on definite criteria carry out evaluations of political maturity and economic

growth of separate and particularly of candidate countries. Yet, these evaluations lack academic approach and theoretical framework.

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