

# Corporate Governance Practices and Prospects in Transition Countries: The Case of Russia, Ukraine, and Kyrgyzstan

## SHORT SUMMARY

- This is a joint project of SITE (Stockholm), CEFIR (Moscow), IET (Moscow), STCSR (Kiev), CASE-Kyrgyzstan (Bishkek), and CASE-Poland (Warsaw).
- In each round of the survey, the project teams collected unique data on ownership, corporate governance and investments for about 1000 Russian, 1100-1200 Ukrainian and 300 Kyrgyz medium- and large-size enterprises.
- The three countries feature a lot of similarities in their corporate governance practices. However, Russian firms are the worst and Ukrainian firms are the best in terms of corporate governance, with Kyrgyz firms lagging slightly behind their Ukrainian counterparts.
- There were no significant changes in corporate governance and ownership patterns in any country over the year between the two rounds.
- The main determinants of corporate governance are size, legal form, and the ownership structure. Larger firms and open joint-stock companies (OAO) practice better governance in all countries. However, the effects of ownership differ qualitatively across countries.
- We did not find any link between corporate governance and either need for investment or actual investment. This is consistent with the respondents' perception that facilitating access to capital markets is not among primary goals of corporate governance. There is a weak link between investment and the ownership structure.
- There is some evidence of the disciplining effect of the market for corporate control in Russia (takeover threats make firms improve corporate governance). There is also some evidence that takeovers lead to a more efficient reallocation of assets in Kyrgyzstan (worse performing firms are more likely to be taken over).
- The results of the project both have scientific value and can be used for policy advice. The scientific value of the results consists of improving our knowledge and understanding of functioning of institutions of corporate governance in transition economies. On the basis of our results policy recommendations for improving corporate governance practices in Russia, Ukraine and Kyrgyzstan can be developed. The main policy recommendation for all countries is to improve minority shareholder protection, legislation and legal enforcement, necessary for preventing and resolving corporate conflicts. Another important recommendation concerns developing financial markets through better regulatory oversight and more efficient infrastructure. This would make raising funds from the public more attractive, and, hence, would create more benefits from practicing good corporate governance. Methodology for measuring the quality of corporate governance that has been developed during the project can be now used to construct indices of corporate governance at both country level and firm level.

## DETAILS OF THE ANALYSIS

- Analysis of the data obtained from the surveys has shown that the three countries feature a lot of similarities in terms of firms' ownership structures, corporate governance practices and investment patterns. At the same time, there are a few important differences suggesting that country-specific factors do matter for companies' choices.
- There were *little changes* in ownership, the overall quality of corporate governance and investment patterns from 2005 to 2006. Table 7 gives an impression that in Russia the quality of corporate governance somewhat dropped over the year, but our regression analysis did not show any statistically significant decrease.
- **Ownership structure and control turnover**
  - In all three countries most companies have concentrated ownership structure, with large stakes belonging to insiders and large outside shareholders (table 2).
  - A fair number of firms changed the largest shareholder, with Russia having the highest turnover rate (table 3). As a rule these were friendly takeovers, though often they led to CEO replacements (table 4).
  - The share of management and the share of all small shareholders tend to decrease with the firm size, while the share of the largest outside shareholder and the government's share tend to increase with the firm size (figure 2).
- **Companies' perception of problems of corporate governance.**
  - Inadequacy of legislation is considered the main problem by respondents in all countries, but its importance is especially high in Ukraine. Weak minority shareholder protection is also very important in all countries, while poor quality of judicial system is considerably important only in Russia and Kyrgyzstan (table 5). These results give an idea on which aspects of the legal system reforms in each country should focus.
  - Many Russian and Ukrainian respondents are of opinion that the main problems of their national industries lie beyond corporate governance, implying that Russian and Ukrainian policymakers should devote substantial attention to other aspects of business environment as well (e.g. taxation or regulation).
- **Companies' perception of goals of corporate governance.**
  - In all countries a significant number of companies perceive corporate governance goals as complex ones that combine improvements in the internal decision-making process, their image to outsiders, and the need to comply with the legal requirements (table 6).
  - Facilitating access to capital markets is not among primary concerns, which is consistent with the data on investment (table 9) showing that a very small percentage of firms rely on public capital markets (stock and bonds) for attracting external funds.
  - Strangely, prevention and resolution of corporate conflicts is a rather rarely mentioned goal of corporate governance.
- **Corporate governance practices and their determinants.**

To keep the number of respondents in the samples large enough, an index of corporate governance (CGI) was constructed on the basis of six questions, typed in red in table 7. For additional analysis various alternative indices were tried as well.

  - Intra-country variations in the corporate governance practices are substantial (figure3). As figure 4 shows, in all three countries larger firms are more likely to adopt the norms of good governance. Open joint-stock companies (OAO) practice better governance than firms of other legal forms. (Results on size and legal form are confirmed by the regression analysis, in which we controlled for other factors).
  - Table 7 gives an impression that Ukrainian firms practice the best corporate governance, while Kyrgyz firms – the worst. However, when we control for the firm size, Kyrgyz firms become better than Russian ones, though still somewhat worse than

Ukrainian firms (figure 4). For very large firms (here we can only compare Russia and Ukraine) corporate governance quality is similar irrespective of the country.

To better analyze determinants of corporate governance, we have done regression analyses for each country separately (as well as jointly for Russian and Ukraine). Our CGI as well as various alternative indices were regressed on ownership variables, size, group affiliation, industry and control turnover variables. We tried various specifications. Representative examples of our regressions for the three countries are in tables 10a-c.

- Dispersed ownership (share of all shareholders having less than 5% of shares) positively affects corporate governance. It does not follow, however, that the effect of ownership concentration is straightforward. In Russia managers', largest outside shareholder's and government's shares have an inverted U-shape effect on corporate governance with the maximum at 30-50%, though the effect of the managerial ownership is not very strong. In Ukraine large outsider ownership has no effect, and the effect of state ownership is mainly negative and concave, while the effect of managerial ownership has an inverted U-shape, but is much more pronounced than in Russia. In Kyrgyzstan shares of all mentioned types of large shareholders (including government) have mainly either a negative (albeit nonlinear) or U-shape effect.
- These differences suggest that managers and controlling shareholders have different incentives to practice good corporate governance in the three countries. Why we observe such differences is puzzling and needs further investigation.
- Neither need for outside funds nor industry did appear to affect corporate governance.
- **Determinants of investment.**
  - Our regression analysis has shown that investments, whether overall or external, are not affected by corporate governance in either country (not reported in the appendix). This is consistent with the respondents' perception that facilitating access to financial markets is not a primary goal of corporate governance (table 6).
  - There is generally a weak link between investment and ownership structure (not reported in the appendix). In Russia, managerial ownership positively affects investment, while in Kyrgyzstan it seems to positively affect outside investment. State ownership has a negative impact on outside investment in Russia and Ukraine.
- **Efficiency of the market for corporate control.**

Our regression analysis has provided some evidence, albeit rather weak, that the market for corporate control works toward more efficient redistribution of assets and greater managers/controllers' discipline (not reported in the appendix):

  - In Russia, hostile takeover threats lead to a greater improvement of corporate governance, and, in turn, improvements in corporate governance lead to fewer takeover threats. This result suggest the presence of a discipline effect of takeovers in Russia
  - More profitable firms are less likely to be taken over in Kyrgyzstan, which provides some evidence of efficiency of the assets reallocation.

## ANNEXES

### Description of the samples.

In each of the two rounds of the surveys about 1000 Russian, 1100-1200 Ukrainian and 300 Kyrgyz medium- and large-size enterprises were surveyed. The number of firms in each round was roughly the same, and roughly 75-90% the first round respondents participated in the second round.

As a result, the teams obtained data on ownership, corporate governance and investments for the majority of the surveyed firms. Though Russian firms are somewhat bigger than Ukrainian ones and substantially bigger than Kyrgyz ones, this difference should be attributed to the natural difference in the size of companies in the countries' industries and, thus, in terms of representativeness the samples are similar.

Most of the companies are medium or large size enterprises, but not very large: less than 15% of enterprises in each country are listed. A majority of the firms are open joint-stock companies (OAO). Most firms are not parts of business groups.

Figure 1a. Sample structure of Russian and Ukrainian firms by size in 2006.

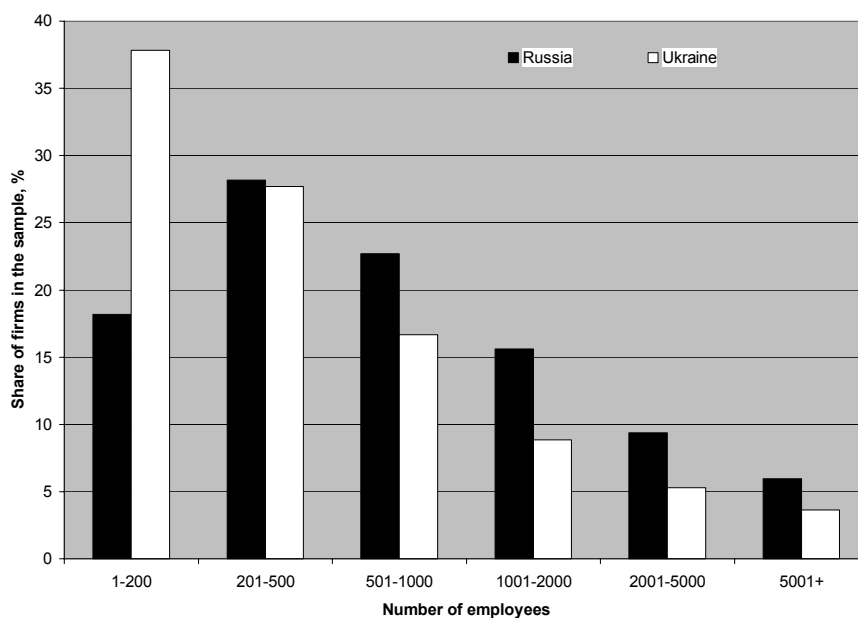
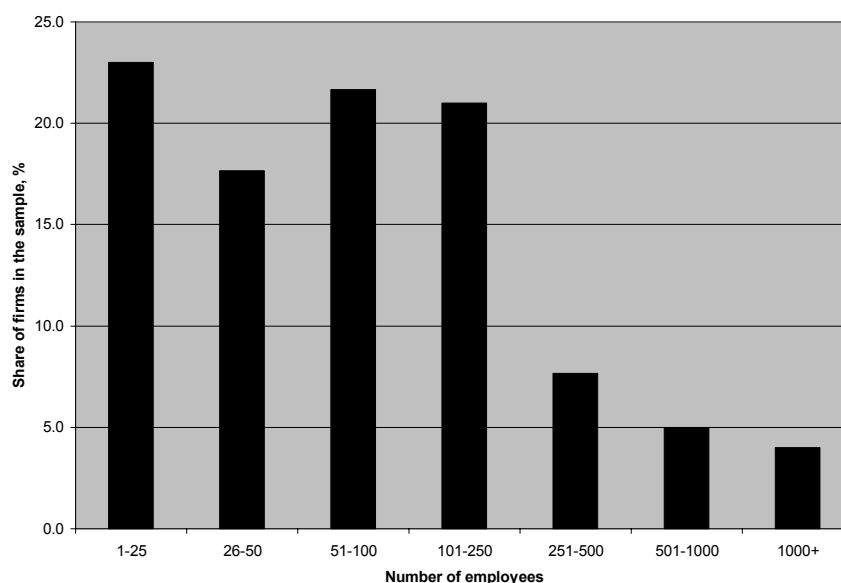


Figure 1b. Sample structure of Kyrgyz firms by size in 2006.



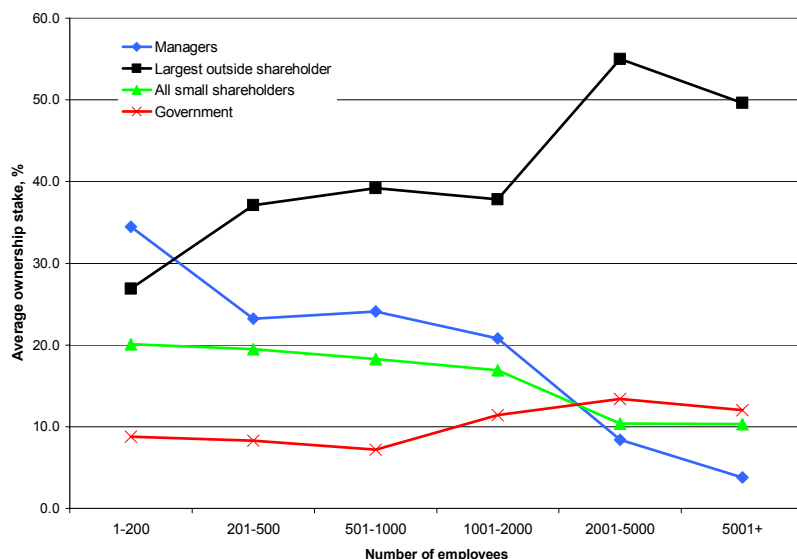
**Table 1. Firms' characteristics in 2006 (figures were similar in 2005).**

<b>Legal form</b>	As a percentage of firms for which the data were available		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Open joint-stock company (OAO)	74	69	66
Closed joint-stock company (ZAO)	24	31	11
Other	2	0	23
Number of companies	981	1103	306
<b>Is your company a part of a business group?</b>	As a percentage of respondents who answered this question		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Yes	31	18	11
No	69	82	89
Number of companies answered	981	780	306
<b>Is the company listed?</b>	As a percentage of respondents who answered this question		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Yes	7	14	9
No	93	86	91
Number of companies answered	569	710	286

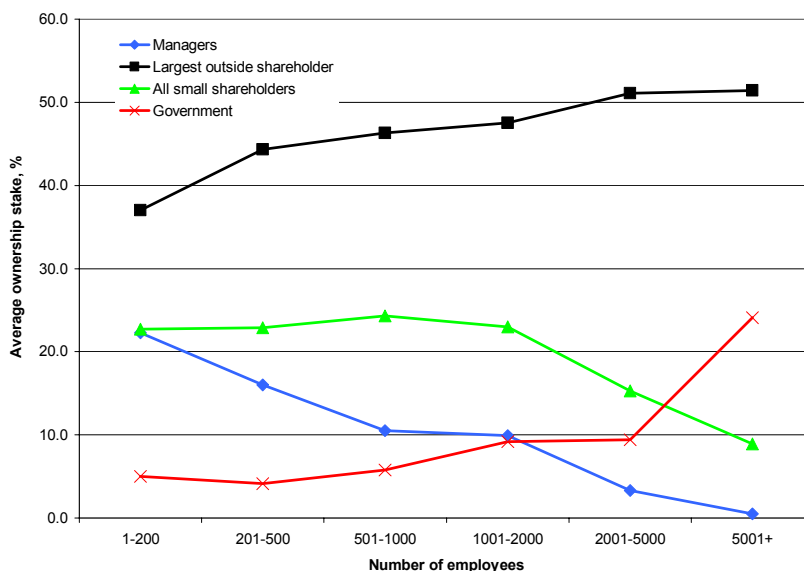
**Table 2. Ownership structure in 2006 (figures were similar in 2005).**

<b>What actual percentage of shares in your firm do you think is owned by:</b>	Mean percentage share on the sample of respondents who answered this questionnaire		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Management	22	16	34
Largest outside (non-state) shareholder	35	42	26
All small (below 5%) shareholders	16	22	20
Government	9	6	15
Number of companies answered	666	587	254
<b>What is the type of the largest outside shareholder in your company?</b>	As a percentage of respondents who answered this questionnaire		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Domestic individual	42	34	55
Domestic legal entity	56	48	25
Foreign individual	1	4	8
Foreign legal entity	4	16	12
Number of companies answered	588	551	215

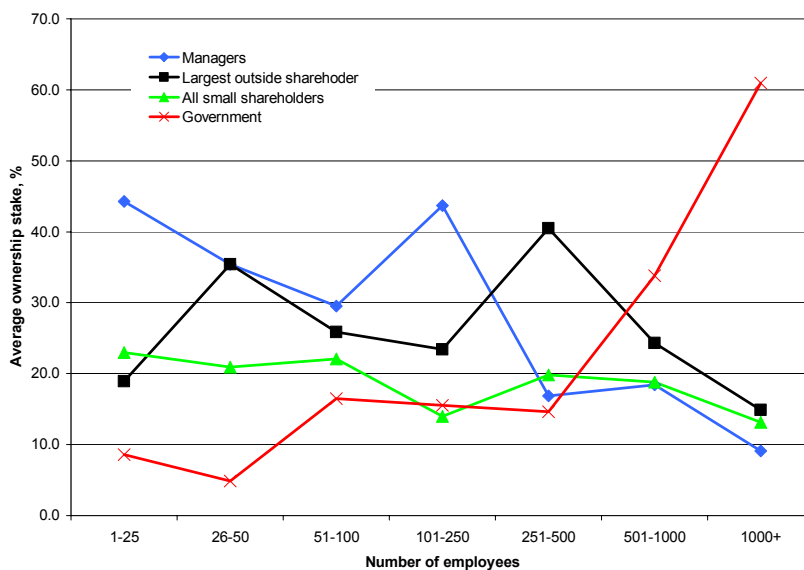
**Figure 2a. Ownership structure and firm size in 2006. Russia.**



**Figure 2b. Ownership structure and firm size in 2006. Ukraine.**



**Figure 2c. Ownership structure and firm size in 2006. Kyrgyzstan.**



**Table 3. Control turnover**

<b>Was there a change of the largest shareholder or appearance of a new large shareholder in 2004-2005?</b>	As a percentage of respondents who answered this question		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Yes	22	15	14
No	78	85	86
Number of companies answered	749	731	277

**Table 4. Hostility of changes in corporate control**

<b>Was the appearance of the new largest shareholder a result of a hostile or friendly takeover?</b>	As a percentage of companies where change of the largest shareholder occurred		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Hostile takeover	13	4	-
Friendly takeover	87	96	100
Number of companies answered	125	97	35
<b>Did the appearance of the new largest shareholder entail involvement of a court?</b>	As a percentage of companies where change of the largest shareholder occurred		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Yes	10	7	15
No	90	93	85
Number of companies answered	130	105	39
<b>Was the CEO replaced as a result of a change of the largest shareholder?</b>	As a percentage of companies where change of the largest shareholder occurred		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Yes	34	43	69
No	66	57	31
Number of companies answered	138	106	39

**Table 5. Companies' perception of the most sensitive problems of corporate governance in their country in 2006 (figures were similar in 2005)**

<b>Which corporate governance problems do you think are currently the most sensitive in Russian industry?</b>	<b>As a percentage of respondents who answered this question</b>		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
weak protection of small shareholders	37	30	41
weak protection of large shareholders	10	4	17
insufficient control over managers' operation	19	4	16
failure by companies to meet information disclosure requirements	9	2	9
inadequate competence of the members of the board of directors	14	3	15
inadequate protection of creditor rights	8	6	10
inadequacy of current legislation (laws on companies, on bankruptcies, etc.)	39	58	48
weakness of the judicial system in settling corporate disputes	25	14	26
other corporate governance problems	6	9	8
main problems of Russian/Ukrainian/Kyrgyz industry go beyond corporate governance	39	35	9
Number of companies answered	664	666	190

**Table 6. Respondents' perception of the goals of corporate governance in 2006 (figures were similar in 2005)**

<b>Which goals in your opinion corporate governance serves achieving in your company?</b>	<b>As a percentage of respondents who answered this question</b>		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Raising the effectiveness of the decision making process	66	66	62
Facilitating access to domestic and international capital markets	10	10	32
Raising company's reputation	44	25	51
Prevention and (or) resolution of corporate conflicts	14	11	16
Conducting business in compliance with the law	41	42	38
Other	2	1	2
Corporate governance does not serve achieving any goals in our company	8	8	11
Number of companies answered	672	693	199



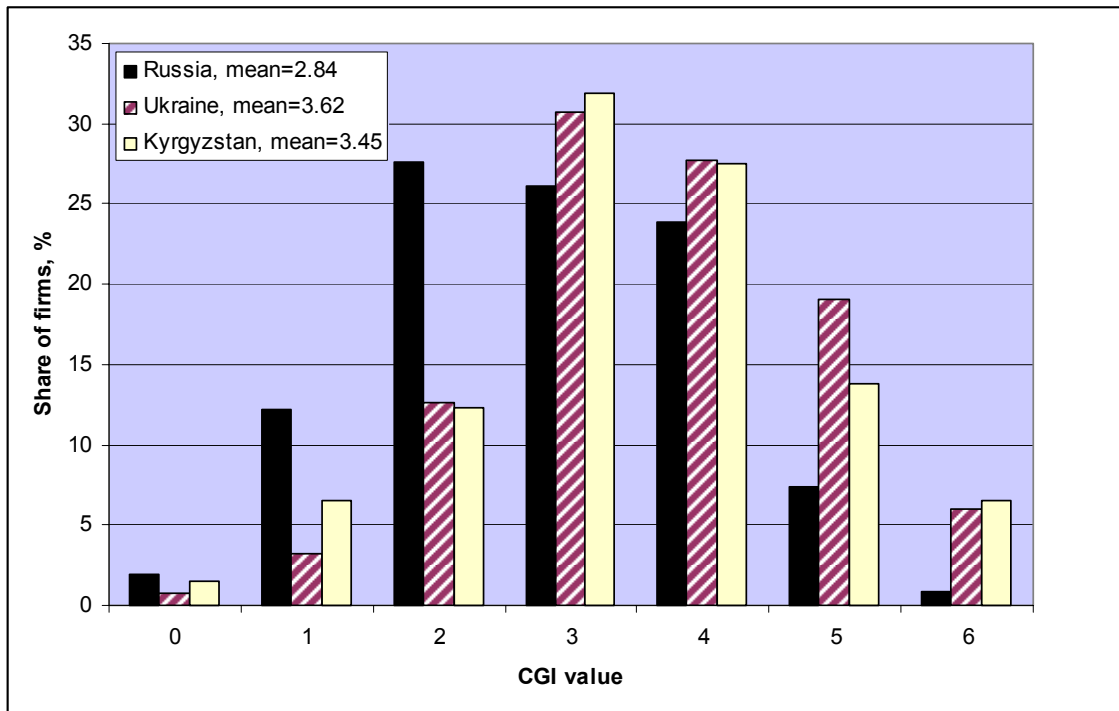
**Table 7. Corporate governance practices of companies.**

Questions in “red” were used in the creation of the Corporate Governance Index (CGI). For each question, answers that correspond to the best practice among the three countries are highlighted in yellow. Similarly, worst practices are highlighted in black. For the questions concerning board practices, calculations were made on the sample of firms that have a board directors.

Corporate Governance Practices. Shareholder rights and board structure.	Percentage of “yes” answers in the sample of respondents who answered the corresponding question					
	Russia		Ukraine		Kyrgyzstan	
	2005	2006	2005	2006	2005	2006
Do you have A SHAREHOLDERS DEPARTMENT?	40	35	36	34	17	23
Do you supply AGENDA of general shareholders meeting to all of your shareholders?	88	80	96	96	88	77
Is your shareholders’ register maintained by an INDEPENDENT REGISTRAR?	79	74	90	90	69	63
Are there INDEPENDENT DIRECTORS on the board of directors of your company?	46	43	56	55	27	25
Are there REPRESENTATIVES OF MINORITY SHAREHOLDERS on the board of directors?	29	24	61	60	49	43
Are there FORMAL COMMITTEES (audit, remuneration, nomination) on your board of directors?	9	7	16	18	5	6
Do you use INTERNATIONAL ACCOUNTING STANDARDS (US GAAP/ IAS)?	9	9	31	30	49	61
Are your annual reports audited by an INDEPENDENT AUDITOR?	93	91	95	99	71	75
Number of companies answered	562-720	654-721	667-915	534-859	252-291	281-298

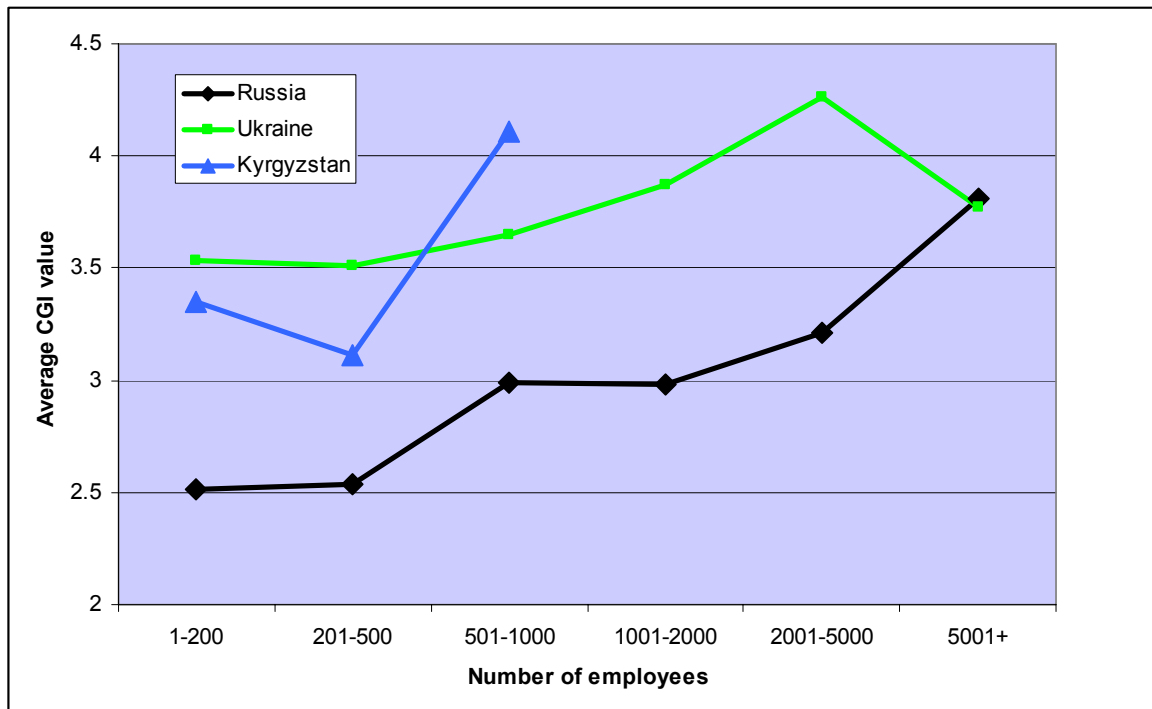
**Figure 3. Index of corporate governance (CGI) in 2006. Histograms and sample means.**

CGI is computed on the basis of six questions highlighted in red in table 7. Only firms that have a board of directors were considered for this graph. CGI takes values from 0 to 6. For each firm, a value of 1 was assigned to an answer if it was “yes” and 0 if it was “no”. The value of CGI for each firm was obtained by adding up the answers to all six questions.



**Figure 4. Index of corporate governance (CGI) as a function of firm size in 2006.**

Only firms that have a board of directors were considered for this graph.



**Table 8. State involvement in 2006 (figures were similar in 2005).**

	As a percentage of respondents who answered this question (and who have a board of directors for the second question)					
	Russia		Ukraine		Kyrgyzstan	
<b>What actual percentage of shares do you think is owned by the government?</b>	9		6		15	
Number of companies who answered this question	666		587		254	
<b>Do you have government representatives on board?</b>	yes	no	yes	no	yes	no
	29	71	8	92	14	86
Number of companies answered this question	640		674		175	

**Table 9. Investment in 2005 (figures were similar in 2005).**

<b>What were your company's investment finance sources in the past (2005) year?</b>	As a percentage of respondents who answered this question		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
There was no investment	14	30	48
Own funds	78	65	41
Bank loans	31	23	12
Owner's funds	11	5	1
Budget and non-budget funds	3	0	1
New bond issue	0	0	9
New share issue	1	2	1
Other	3	1	8
Number of companies answered	776	696	269
<b>What is the maximum interest rate at which your company would take a bank loan?</b>	As a percentage of respondents who answered this question		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
No need	32	30	37
3-6%	51	55	47
7-10%	15	12	11
11-20%	2	3	4
Number of companies answered	747	706	254
<b>Does your company plan to raise external finance for investment in the next 3 years?</b>	As a percentage of respondents who answered this question		
	<b>Russia</b>	<b>Ukraine</b>	<b>Kyrgyzstan</b>
Yes	49	37	48
No	51	63	52
Number of companies answered	645	567	237

**Table 10a. Determinants of corporate governance in Russia. OLS cross-sectional regressions using the data from both rounds.** The dependent variable is the index of corporate governance (CGI), based on the six questions. The first principle component is used instead of a simple sum. *Own\_man* is the managerial share, *own\_out* is the share of the largest outsider, *own\_state* is the share of the government, *own\_minor* is the share of all shareholders who hold below 5% of shares, *x\_sq* is the corresponding share squared. When running regressions all ownership shares were expressed as shares of 1 rather than in percentage terms. *Profitable* is a dummy variable that equals one if the firm has reported positive profit in the last year, and zero otherwise. *Group* is a group affiliation dummy. *Emplx\_y* are dummies that equal one if a number of employees in a firm lies between *x* and *y*. *OAO* is a dummy that equals one if a firm is an open joint-stock company, and zero otherwise. *y2006* is a year dummy. *Change\_own* is a dummy that equals one if a firm reported a change in the largest owners in the last year, and zero otherwise. *Hostile\_take* is a dummy that equals one if a firm reported a hostile takeover in the last year, and zero otherwise. *Friend\_take* is a similar dummy for friendly takeover. *Chown\_chdir* and *chown\_court* are similar dummies indicating if a takeover was associated with a change of CEO and court involvement respectively. \*, \*\*, \*\*\* denote statistical significance at 10%, 5%, and 1% respectively.

	(1)	(2)	(3)	(4)	(5)
	CGI_pc1	CGI_pc1	CGI_pc1	CGI_pc1	CGI_pc1
<i>own_man</i>	1.120*	1.148*	1.115*	1.023*	1.195**
<i>own_man_sq</i>	-1.021	-1.130*	-1.113	-1.070	-1.188*
<i>own_out</i>	1.686***	1.660***	1.687***	1.674***	1.761***
<i>own_out_sq</i>	-2.012***	-1.963***	-2.002***	-2.044***	-2.121***
<i>own_state</i>	2.490***	2.414***	2.402***	2.364***	2.378***
<i>own_state_sq</i>	-3.738***	-3.403***	-3.507***	-3.413***	-3.365***
<i>own_minor</i>	0.855***	0.848***	0.830***	0.767***	0.829***
<i>Profitable</i>	-0.072	-0.069	-0.078	-0.075	-0.055
<i>Group</i>	0.071	0.018	-0.008	0.026	0.034
<i>Empl200_500</i>	-0.146	-0.147	-0.144	-0.182	-0.164
<i>Empl500_1000</i>	0.353**	0.390***	0.396***	0.389***	0.371***
<i>Empl1000_2000</i>	0.444***	0.528***	0.547***	0.564***	0.527***
<i>Empl2000_5000</i>	0.878***	0.970***	1.019***	0.942***	0.946***
<i>Empl5000_</i>	0.800***	0.844***	0.933***	0.807***	0.818***
<i>OAO</i>	0.388***	0.335***	0.305**	0.303**	0.327***
<i>y2006</i>	0.116	0.100	0.094	0.117	0.097
<i>industry dummies</i>	Not significant				
<i>change_own</i>		0.070		0.099	-0.014
<i>hostile_take</i>			0.438*		
<i>chown_chdir</i>					0.211
<i>chown_court</i>				0.154	
<i>friend_take</i>			-0.041		
Constant	-1.227***	-1.213***	-1.218***	-1.127***	-1.194***
Observations	747	713	683	694	701
R-squared	0.22	0.20	0.20	0.20	0.20

**Table 10b. Determinants of corporate governance in Ukraine. OLS cross-sectional regressions using the data from both rounds.** The notation is the same as in table 10a.

	(1)	(2)	(3)	(4)	(5)
	cgind_pc1	cgind_pc1	cgind_pc1	cgind_pc1	cgind_pc1
own_man	1.554***	1.916***	1.793***	1.902***	1.910***
own_man_sq	-1.963***	-2.493***	-2.409***	-2.484***	-2.473***
own_out	0.329	0.205	0.112	0.199	0.201
own_out_sq	-0.124	0.053	0.128	0.064	0.076
own_state	1.205	0.913	0.924	0.911	0.945
own_state_sq	-2.285**	-1.846*	-1.892*	-1.843*	-1.874*
own_minor	0.658***	0.565***	0.545***	0.568***	0.582***
profitable	0.025	-0.029	-0.021	-0.027	-0.031
group	0.239*	0.210	0.196	0.196	0.199
empl200_500	0.086	0.101	0.113	0.103	0.100
empl500_1000	0.203*	0.169	0.184	0.172	0.166
empl1000_2000	0.401***	0.444***	0.485***	0.473***	0.473***
empl2000_5000	0.257	0.149	0.171	0.155	0.165
empl5000_	-0.287	-0.289	-0.273	-0.299	-0.265
OAO	0.494***	0.497***	0.484***	0.489***	0.491***
y2006	0.023	0.013	0.017	0.019	0.020
industry dummies	Mostly not significant				
change_own		-0.006		0.004	0.055
hostile_take			0.561*		
chown_chdir					-0.121
chown_court				0.152	
friend_take			-0.059		
Constant	-0.487*	-0.508*	-0.471	-0.505*	-0.521*
Observations	724	647	641	646	646
R-squared	0.15	0.15	0.16	0.15	0.15

**Table 10c. Determinants of corporate governance in Kyrgyzstan. OLS cross-sectional regressions using the data from both rounds.** The notation is the same as in table 10a, except that due to a more detailed employment data, logarithm of employment (*log\_empl*) was used instead of employment dummies. Due to the small sample size and substantial homogeneity across firms in terms of industry affiliation, industry dummies were not controlled for.

	(1)	(2)	(3)	(4)	(5)
	CGI_pc1	CGI_pc1	CGI_pc1	CGI_pc1	CGI_pc1
own_man	-2.665***	-2.725***	-2.824***	-2.666***	-2.717***
own_man_sq	2.441**	2.458**	2.579**	2.453**	2.489**
own_out	1.414	1.411	1.468	1.421	1.427
own_out_sq	-1.927**	-1.936**	-1.942**	-1.898**	-1.890**
own_state	-1.531	-1.604	-1.690	-1.627	-1.570
own_state_sq	1.074	1.057	1.253	1.203	1.022
own_minor	1.906*	1.915*	2.072*	2.000*	1.927*
profitable	0.156	0.144	0.138	0.156	0.120
group	0.168	0.184	0.212	0.185	0.204
log_empl	0.190***	0.202***	0.180***	0.188***	0.208***
OAO	0.922***	0.884***	0.935***	0.892***	0.898***
y2006	0.074	0.079	0.060	0.062	0.094
change_own		-0.100			
hostile_take			1.180***		
chown_chdir					-0.260
chown_court				0.251	
Constant	-1.698***	-1.656***	-1.646***	-1.673***	-1.707***
Observations	274	271	262	269	271
R-squared	0.26	0.27	0.27	0.27	0.27