CORPORATE GOVERNANCE IN KOSOVA 1

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INSTITUTI PER HULUMTIME ZHVILLIMORE
INSTITUTE FOR DEVELOPMENT RESEARCH

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Improving the Corporate Governance Framework and Transparency in Publicly Owned Enterprises in Kosova

This report is part of the project: **Improving the Corporate Governance Framework and Transparency in Publicly Owned Enterprises in Kosova,** supported by CIPE (Centre for International Private Enterprise), Washington D.C.

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PREFACE

In the post-war period, Public Services in Kosova have been the most criticized sectors by the civil society, first of all for their low quality services, high prices, bad, inefficient and not transparent governance. Efforts undertaken to improve the situation in this sector have not been satisfactory.

The project "Improving the Corporate Governance Framework and transparency in Publicly Owned enterprises in Kosova", implemented by the Riinvest Institute and supported by the Center for International Private Enterprise (CIPE), Washington D.C. and KEK has mainly focused on improving the governance of these enterprises.

The improving of the corporate governance system of publicly owned enterprises in the light of the OECD Guidelines (2005), the raising of public awareness of the importance of good corporate governance, the improving of the public finance management and improving of transparency in publicly owned enterprises in Kosova are considered as key issues to offer high quality services for the citizens.

Through the publishing of the research report, which is the end result of the project, we aim at offering the readers a research source on the situation at publicly owned enterprises, problems related to the management and transparency, and through recommendations we aim at inducing the establishment of advanced relations of understanding and cooperation between the customers and the boards of the publicly owned enterprises.

The research report is one of the main project activities. The research findings and recommendations have been discussed at the conference held on September 22, 2006. The President of Kosova, Mr. **Fatmir Sejdiu,** contributed at this conference with a letter, unable to participate, as he was on a visit abroad. Mr. Andrew Wilson, **CIPE** Senior Program Officer for Central Europe and Eurasia attended the conference and addressed the participants with a speech on the importance of good corporate governance. These contributions have been included in the research report.

Riinvest would like to thank CIPE and KEK for supporting the project, **Sharon Hester**, Head of USAID Economic Growth Office, and **Jermyn Brooks,** Member of the Board of Directors, Transparency International, for their contribution at the conference. We would like to thank Professor Iraj Hashi, Staffordshire University, UK, too, for his contribution to the research report.

Fatmir Sejdiu
President of Kosova

Greeting Letter for the Conference Participants

Dear participants of the Conference,
Ladies and Gentlemen,

Thank you for inviting me to participate in your conference, and for the opportunity to be with you today. I have the pleasure that in this way to greet your Conference and activities of your project dedicated to such important field, such as improvement of corporative governance and the transparency in public enterprises in Kosova.

In addition to the progress for empowering public enterprises that will offer qualitative services for citizens, economy and social services, we face many problems in this field:

- Quantity and quality of public services aren't satisfactory, incomplete competences and often with conflict elements in managing them
- Relationship between public enterprises and Institutions of Kosova are not built yet; Parliament of Kosova has lack of proper information for current situation, problems, and the work of these companies
- Kosova's Budget instead of benefiting from these companies, funds some of their operations and because of its limits and other problems that faces, represents huge burdain
- Relationship with consumers, citizens and businesses is not built properly; therefore problems with payments of bills exist

All these problems should be addressed and solved in order to ensure development of these strategic sectors, to improve the ability of our economy to develop and improve the life of citizens. Greeting your work, please let me congratulate on cooperation between Riinvest and Center for International Private Enterprise (CIPE) from Washington, for making possible this project and the commitment of CIPE in Kosova since 1997, and also American Government that through this Agency and many others is contributing for Kosova.

Thank You

PhD. Fatmir Sejdiu, President of Kosova

Andrew Wilson,
CIPE, Senior Program Manager for Eastern Europe and Euroasia

Good morning and thank you for the opportunity to speak with you this morning at this important event which we at CIPE see as an important milestone in Kosovar efforts to develop better and more responsive institutions.

Today you are going to hear from a wide variety of experts on the corporate governance challenges facing Kosova's state-owned sector. So when I was asked what type of contribution I could make to today's events I responded that I would like to explore the linkages between effective corporate governance and economic and democratic development. Today I hope to offer you a new perspective on corporate governance that seldom gets attention but we at CIPE believe deserves greater attention, and in doing so I hope I can assist in providing a broader strategic vision for the importance of the findings that are discussed today.

Let me begin by explaining why CIPE has been interested in issues of corporate governance. Many of you know CIPE as an organization that promotes economic reform around the world, but I would wager that only a few of you know that our actual mission is to promote democracy around the world through private sector development and the reform of market institutions. We therefore look at corporate governance through a slightly different lens than other groups, we see corporate governance as a critical element of a reform strategy that works to protect property rights, improve efficiency, and increase the quality of both state and non-state institutions that watch and govern the economy.

Before I touch on this broader impact of good corporate governance institutions, let me begin with the better-known economic argument for corporate governance. For the purposes of this discussion let us define corporate governance as how companies deal fairly with problems that result from the separation of ownership and effective control. This can include actions such as:

1) building a structure and rules to govern a company board of directors.
2) Creating independent audit committees made up of the enterprise's board members
3) Ensuring disclosure of all relevant information to shareholders and creditors, including business risk analyses; and
4) Controlling management

Why is this important? Well, studies are starting to make a pretty clear case that good corporate governance enhances bottom-line performance, as well as shareholder value. It turns out the improved internal controls and accounting systems required for good reporting, make firms more efficient, and the heightened emphasis on risk management in boards provides for greater accountability and oversight in management decision-making. Furthermore studies indicate that in countries where the rule of law is weak, good corporate governance practices that serve as a guarantor of stewardship and respect for property rights add even a greater value to shares traded.

Corporate governance promotion has become a global movement and as such a wide ranging set of standards, codes and evaluation criteria have emerged. In the search for global capital to grow economies, money is increasingly flowing to places where it is better protected by corporate governance. Economies reliant on the old practices of casino capitalism where a lack of guarantees and protections turn investment into a bet will find it harder to attract good long-term investment. This combination of global capital movement, the creation of internationally recognized standards, and the high profile corporate governance failures in the United States, South Asia, and lately in Europe have provided for a "perfect storm" of corporate governance reform. Countries and companies that fail to address corporate governance shortcomings run the risk of being left behind in the global race for capital. James Wolfenson when he was head of the World Bank said it best a few years back when he stated "The governance of the company is becoming as important as the governance of the state".

Which is a good point to discuss how all of this, and in particular corporate governance within SOE's is important to the democratic development of a state.

When we at CIPE first started focusing on corporate governance issues many years ago the OECD had just completed a first draft of a list of principles to guide companies in implementing good governance, they grouped their guidelines around four basic principles:

Fairness
Accountability
Responsibility
Trust

I would posit here that the linkages between good corporate governance and democratic development are a two-way relationship for both the company and the state. If one looks at the four principles, they are indeed four sets of values that are sacred in successful democracies and that by bringing these principles into the life in our companies we are indeed bringing the values and standards of democracy into how companies make decisions, treat stakeholders and behave in the broader community.

Well governed companies are in a position to treat shareholders equitably, thereby increasing confidence in market reforms. Well governed companies possess the internal controls, the ethical standards, and risk management principles that help fight corruption. Well governed companies become good corporate citizens, and in this day of corporate social responsibility, the link between good governance and responsibility becomes critical.
In the other direction good corporate governance also can improve the quality of government. Corporate governance requires a host of well-functioning institutions to support its implementation this means

- Securities and exchange commissions to protect against shareholder abuse
- Courts that function well
- Improved protection of property rights
- Improved accounting standards that assist in revenue collection and fight informal activity

In the case of SOE's corporate governance not only can improve the performance and responsiveness of enterprises, but also requires that government become a more effective owner, brining greater accountability both from company directors but for politicians as well who must ultimately answer for their stewardship of state resources. Corruption can be reduced and better services provided through effective controls and accountability.

I hope that what I've said here can help convince you of the important role the corporate governance can and should play in the future development of Kosovo. This is not a passing trend in economic development, global competitiveness means that corporate governance is here to stay as a business practice, the challenge for you gathered here today is not whether or not you should implement better standards of corporate governance, but WHEN?

EXECUTIVE SUMMARY

This Research Report[1] is one of the key activities of the project "Improving the Corporate Governance Framework and Transparency in Publicly Owned Enterprises in Kosova", which is being implemented by Riinvest Institute with the support of CIPE (Washington D.C.). The project was focused on: (a) improving the corporate governance system in Publicly Owned Enterprises (POEs) in the light of the newly published OECD Guidelines on the Corporate Governance of State Owned Enterprises (2005); (b) increasing public awareness of the importance of good corporate governance for improving the efficiency and competitiveness of POEs and for improvement in public finances; and (c) enhancing the transparency of POEs' technical and financial operations and the accountability of their management structures to all stakeholders (the Kosova Government, customers and the society at large).

With the establishment of the Kosovo Trust Agency (KTA) by UNMIK Regulation No. 12/2002 and the passing of the Regulation on its operational policy, KTA was given full control over the enterprise sector of the economy which was made up of over 400 'socially-owned' and a small number of larger 'publicly owned' enterprises. The so-called 'socially owned' enterprises were to be privatized, using a 'spin-off' method, or liquidated. The 'publicly owned enterprises', however, were explicitly excluded from privatisation and were to be retained in the KTA portfolio to undergo a process of restructuring and reform under the KTA supervision.

Until recently, and despite the large scale technical and financial support from the international donor community, the performance of these companies has been very poor and, in the case of the energy sector, it has resulted in a serious drain on the very scarce public resources. The transfer of control to KTA has not changed the situation significantly. There are many factors contributing to the poor performance of these companies: macroeconomic, legal, institutional, and microeconomic. Some of these factors are exogenous to POEs (the general macroeconomic conditions, unresolved political status, legal and institutional developments, obsolete equipment, subsidy policy, etc.) while others are internal and specific to the companies themselves. One of the most important of the internal factors has been the weak corporate governance framework which manifests itself in low efficiency, poor revenue collection record, absence of transparency and

[1] The authors of this research report are: Professor Iraj Hashi, Staffordshire University, UK, Mrika Kotorri, Senior Researcher, Riinvest, and Salvador Elmazi, Ministry of Energy and Mining.

accountability, the unclear roles and competencies of different stakeholders, and the multiple agency relationships – UNMIK, KTA, the Government, ministries, Board of Directors of POEs, management of POEs, employees and customer groups. Again, until recently, there was no systematic arrangement for POEs to report their activities and their technical and financial situation to any of the Kosovar institutions such as the Parliament or any of the stakeholders such as employees or customers (KTA being an exception).

In 2004 KTA embarked on the process of 'corporatisation' as the first stage of reform. Companies under consideration have been converted to joint stock companies with 100% of shares held by KTA. These companies, which have been historically organised as vertically integrated entities, need to be vertically separated, initially on a financial basis but eventually as separate companies in line with current thinking on the restructuring of utilities in EU countries.[2] The reform and restructuring of publicly owned enterprises have to address the problem of corporate governance and bring the corporate governance framework into line with international standards, especially those established by the OECD for state owned enterprises. A good corporate governance framework ensures that a company has an effective board system, a well defined relationship between the board and management, with the obligations and duties of the management are clearly identified, the interests of shareholders (including minority shareholders), investors and creditors are protected, and the broad interest of other stakeholders are taken into account. It also sends the right signal to potential investors (especially foreign investors) and lenders that their investment, or loan, is safe in the company and, therefore, facilitates the company's access to external finance.

Against this background, the OECD developed its Guidelines on the corporate governance of state-owned companies, designed to supplement the OECD Principles of Corporate Governance (OECD, 2005). The main elements of these Guidelines are:

I. ***Ensuring an effective regulatory framework.*** The government should establish an effective regulatory framework to ensure competitive behaviour by POEs.
II. ***State as an effective owner***. The state should act as an informed and active owner and establish a clear and consistent ownership policy.
III. ***Equitable treatment of all shareholders.*** The state and POEs should recognize the rights of all shareholders and in accordance with the OECD Principles of Corporate Governance ensure their equitable treatment.

[2] For a detailed discussion of the restructuring and reform of utilities, see the proceedings of the Privatisation of SOEs and Reform of Utilities in Kosova, Research Report and International Conference, 2002.

IV. ***Relations with other stakeholders.*** The state ownership policy should fully recognise the state-owned enterprises' responsibilities towards all stakeholders.

V. ***Transparency and disclosure.*** POEs should observe high standards of transparency in accordance with the OECD Principles of Corporate Governance.

VI. ***Responsibilities of the Boards.*** The boards of state-owned enterprises should have the necessary authority and competencies to carry out their function of strategic guidance and monitoring of management and be held accountable for their actions.

Using interviews with members of the management teams, supervisory boards, government officials in relevant ministries and the regulatory offices, the research team investigated the nature of the corporate governance system in POEs and the challenges of improving this framework in line with the OECD Guidelines. The financial statements of the largest POEs (KEK and PTK), highlighting the consistently profitable PTK and consistently loss making KEK were also examined.

From the analysis of the performance of PTK and KEK, we can conclude that PTK has continuously recorded a good performance. However, PTK's profitability is to a large extent due to its monopoly position and the relative ease of collecting revenue for its services. Given the weaknesses in its corporate governance systems, it is possible to improve its performance even further. KEK, on the other hand, has always struggled with the losses incurred and those accumulated because of the differences in invoicing and bill payment for the electricity produced and sold.

Finally, public opinion surveys were used to demonstrate the attitude of citizens towards POEs and how these attitudes have changed over time. Among public services, KEK is considered to be the worst performer. However, in 2006 compared to the year 2003, improvements have been recorded in the level of customers' satisfaction with the service quality of both PTK and KEK. Customers do not support the ABC regime, implemented by KEK, and suggest finding alternatives in order to induce customers to pay their electricity bill. The majority of customers perceive that both KEK and PTK are involved in corrupt practices. Again, KEK is in a worse position.

On the basis of the investigation by the research team, the following policy recommendations are offered to the PISG, the Assembly of Kosova and UNMIK.

POLICY RECOMMENDATIONS

1. **Code of Practice on Corporate Governance**. The Governmental Institutions should develop a Code of Practice on Corporate Governance for POEs, based on the OECD Guidelines on the Corporate Governance of State Owned Enterprises (2005) and require the POEs to report on their compliance with this Code in their Annual Reports and explain the reasons for non-compliance.

2. **Raising Awareness of Corporate Governance amongst Stakeholders.** It is necessary to improve and enhance the awareness of PISG, POEs, the citizens and the media of the importance of modern corporate governance not only for improving the performance of companies, but also for increasing the attractiveness of POEs to investors and reducing further budget subsidies.

3. **State as an Effective and Informed Owner.** The government, in consultation with the Parliament, should develop a clear ownership policy towards POEs for the medium term which emphasises the urgency of the restructuring of POEs and clarifies its intentions regarding the eventual evolution of their ownership. The state should commit itself to the eventual privatisation, or partial privatisation, of most parts of the restructured POEs. At the same time, the state should also develop a medium term strategy for each POE and require the boards of POEs to work towards the realisation of this strategy.

   The government should also decide on whether it should concentrate the ownership and management of all POEs in one institution or decentralise it to relevant ministries. Although on the basis of the experience of other transition economies it seems preferable to keep POEs within the ministries, the advantages and disadvantages of these alternatives should be explored further before a final decision is made.

4. **Responsibility for POEs.** With the gradual transfer of government competencies to PISG and the developing status negotiations, it is recommended that the responsibility for POEs be transferred to PISG in order for these companies to be managed with one voice and on the basis of one coherent and consistent strategy. In the meantime, before such transfer, PISG should engage in the operations of POEs more actively. POEs should keep the government and related governmental institutions informed of their financial and technical operations by providing them with detailed annual reports.

5. ***The Management Structure of POEs***. It is essential to establish a management structure in POEs which is unambiguous and clear to all stakeholders. Although the law lays down a unitary board structure for POEs, with a Board of Directors as the main decision making body of the company (after the assembly of shareholders), the by-laws of POEs provide for a so-called 'supervisory board' as a body without any decision making power which advises the 'government' on issues related to each POE. This is an unsatisfactory structure and the cause of much confusion, particularly because the term 'supervisory board' is a well-established title for the main decision making body of the two-tier board system. It is therefore recommended that the so-called 'supervisory boards' should be abolished. The government should be able to obtain information on the operation of POEs through its representatives on the Board of Directors.

   Furthermore, in addition to the Board of Directors and 'supervisory board', some POEs have also established a 'management board' or 'executive board' consisting of the top management personnel of the company. This is also a source of confusion and should be avoided.

   There is a general feeling amongst the project experts that the two-tier board system, with a supervisory board and a management board, may be a structure more suitable to POEs in Kosova. It is therefore recommended that the PISG and UNMIK investigate the possibility of amending the Regulation on POEs after consultation with stakeholders.

6. **The Board System.** In addition to the above, the roles and responsibilities of the present Board of Directors should be clarified to ensure that:

   a) There are clear relations and division of functions between the Board of Directors and the management personnel (whether organised in a board or not) in a consistent manner (especially the full membership of the CEO in the Board).
   b) There are clear criteria (in terms of experience and qualifications) for the appointment of members of the Board; with at least 1/2 of the board members to be elected/appointed as independent experts free from political influence.
   c) The Board of Directors of POEs should be responsible for selecting the top management, evaluating their performance annually, and linking their remuneration to targets based on business performance.
   d) In line with the OECD Guidelines, employees should have one representative on the Board of Directors of POEs.

e) The Boards should have committees such as internal audit, nominations and remuneration, and procurement committees reporting to it directly. The authority of the internal audit committee should be strengthened.
f) The activity of the boards reflect customers' interests.

7. Transparency and Disclosure. POEs should observe a strict policy on transparency and disclosure on the basis of the OECD Guidelines (2005) and the European Commission's Transparency Directive (2004). In particular, they should:

a) Make their annual financial and other company reports publicly available(based on International Accounting Standards), with free access for all interested parties, on a timely basis, together with all material information, the auditor's reports and comments, any risk assessment report, etc. The minimum content of the financial report should be in accordance with the Transparency Directive (2004).
b) Establish a clear policy on the disclosure of related party transactions and conflicts of interest.
c) Disclose the remuneration and benefits (i.e., the total cost to the company) of board members and the top few managers (members of the management or executive board).
d) Advance transparency practices in the procurement process.
e) Establish good and honest communication practices with customers, citizens and the media, undertake customer satisfaction surveys, and endeavour to improve the present poor image amongst the citizens.

8. There is a general need for a Company Law to regulate the operation of different types of companies in Kosova as the UNMIK Regulation on Business Organisations is no longer suitable for the present stage of the development of Kosova's economy. A new Company Law should allocate a special chapter to the operation and governance of POEs.

1. INTRODUCTION

This report presented at the Conference organized on September 22, 2006, represents the concluding activity within the project "Improving the Corporate Governance Framework and Transparency in Publicly Owned Enterprises in Kosova", financed jointly by the Center for International Private Enterprise (CIPE), Washington, and the Electricity Corporation of Kosova (KEK j.s.c.). This project is the first effort in Kosova to address the challenge of promoting modern corporate governance principles by engaging all of the main stakeholders – public companies, the Government, customers and the civil society – in a debate on the present corporate governance arrangements in publicly owned enterprises and how they can be improved. The overall aims of the project were:

- To improve the corporate governance system in Publicly Owned Enterprises (POEs) in Kosova in the light of the newly published OECD Guidelines on the Corporate Governance of State Owned Enterprises (2005).
- To raise public awareness of the importance of good corporate governance for improving the efficiency and competitiveness of POEs and for improvement in public finances.
- To enhance the transparency of POEs' technical and financial operations and the accountability of their management structures to all stakeholders (the Kosova Government, customers and the society at large).

In conducting this project, the research team studied the development of POEs in Kosova under the UNMIK (and KTA) administration, focusing on their governance structure, accountability and transparency, and compared these with the requirements under the OECD Guidelines on the Corporate Governance of State Owned Enterprises (2005) and other guidelines and principles developed by various international organizations such as the Transparency International.[3] The research team conducted 15 interviews with directors, members of the management and supervisory boards of KEK and PTK and the Prishtina International Airport (PIA j.s.c.), officials at the energy and telecommunications regulators – ERO and TRO, and representatives of KTA during the period February-March 2006.

[3] See, e.g., Transparency International and Social Accountability International, Business Principles for Countering Bribery, http://www.transparency.org /building_coalitions/private_sector/business_principles.html, (December 2002), and the UN's Principles of Global Compact, urged on world business leaders by the UN Secretary General in the World Economic Forum in Davos, 31 January 1999 (http://www.un.org/Depts/ptd/global.htm).

A semi-structured questionnaire was completed during and after these interviews. The interviews aimed at identifying the precise structure of governance, the board system, the appointment of board members and their competencies, the influence of those who act on behalf of the owners of the company (KTA or the PISG), the accountability of the management and boards, the transparency of the companies' operations, and their relationship with other stakeholders. Based on the abovementioned and with the aim to raise awareness and improve the knowledge of the main stakeholders, the public and civil society about the importance of OECD Guidelines on the Corporate Governance of SOEs, the interim report "Improving the Corporate Governance Framework in Publicly Owned Enterprises in Kosova" was prepared and presented at a two-day seminar held on 18-19 April, 2006. A second interim report was prepared based on the semi-structured interviews and the analysis of the development of POEs focusing on the importance of operational and financial transparency of POEs and their contribution to the development of anticorruption policies. This report was presented at the seminar "Transparency and Corporate Governance at POEs" held on June 22. 2006. Among other project activities, a one-day debate on "The Electric Bill Payment: KEK-Customers Relations" was held on June 12, 2006. The aim of this debate was to raise awareness and improve the dialogue level of sound corporate governance, June 12, 2006.

In compiling this Research Report, the project team has integrated both interim reports and has also analyzed the financial development of POEs and costumers' perceptions on the quality of public services. Despite several attempts the project team was not allowed access to the financial reports of POEs, so that use had to be made of he auditors' reports, albeit for the last 2 or 3 years only (the previous years' accounts and those of 2005 were simply not obtainable). These reports have been analyzed with a view to obtaining a fuller picture of the financial development of the companies.

In terms of the position of other stakeholders, we considered the state of public opinion about the two most important POEs (in the energy and telecommunication sectors), obtained through surveys undertaken for the UNDP's Early Warning Reports and the UNDP's Kosova Mosaic 2003 and 2006. The views of other stakeholders (PISG and employees) were also collected through discussions with government officials and trade union organisations.

The international experiences, from both developed economies and transition economies, and numerous Guidelines and Principles were also studied in order to assess the present state of affairs POEs and propose improvements in the system and the legal framework for corporate governance in Kosova.

This Research Report is structured as follows. Chapter two follows this introduction and deals with theoretical background on corporate governance, OECD principles, and experiences in transition and recent developments. Chapter three focuses on analysing the current situation of corporate governance at POEs, their financial performance and challenges for implementation of OECD principles. Chapter four presents the result of surveys on costumer satisfaction with the services provided by POEs.

We would like to thank CIPE and KEK for supporting this project and closely cooperating with the team during its implementation. We would also like to thank Transparency International (TI) and its experts Mr. Jermyn P. Brooks, Director Transparency International and Mr. Boris Divjak, Board of Directors Transparency International as well as OECD and its expert Mr. Alexander Karpf, Corporate Affairs Division, OECD for their presentations for the seminars organized within this project. The views expressed in the Report are those of the Riinvest Institute and do not necessarily reflect the opinions of other parties involved in the project.

2. CORPORATE GOVERNANCE IN PUBLICLY OWNED ENTERPRISES: Theoretical Background, OECD Principles and recent developments

Corporate governance refers to the structures and mechanisms by which a company is governed: its governance bodies, the rights and responsibilities of these bodies, the treatment of shareholders and creditors, and the relationships between the management and different stakeholders. A good corporate governance framework ensures that a company has an effective board system, the relationship between the board and the management are well defined, the obligations and duties of the management are clearly identified, the interests of shareholders (including minority shareholders), investors and creditors are protected, and the broad interest of other stakeholders are taken into account. It also sends the right signal to potential investors (especially foreign investors) and lenders that their investment, or loan, is safe in the company and, therefore, facilitates the company's access to external finance.

Although the importance of corporate governance mechanisms has been brought to the forefront of debate amongst economists, lawyers, finance specialists and policy makers as a result of a number of financial scandals in the last decade, economists have been concerned with the issue for a much longer period – since 1932 when the concept of 'separation of ownership and control' was developed both theoretically and empirically.[4] The problem of governance arises because, in joint stock companies, there is a separation of ownership and control: managers make decisions on the allocation of resources of companies which may not be in the best interest of their shareholders. A company's owners hire the managers to run their business but because they delegate the decision making process to these hired managers, they are not (and cannot be) consulted about every decision that managers make. Furthermore, their ability to monitor the managers is very limited as they are dispersed and individual shareholders cannot bear the cost of monitoring which benefits all shareholders (there is incentive for free riding). Therefore, there is always the possibility that managers may make decisions in their own interest and not in the interest of owners and creditors of the company.

With the growth of joint stock companies in the 20th Century and their dominant position in developed market economies, the separation of ownership and control also gained greater significance and attracted the increasing attention in the microeconomics and financial economics

[4] This is the date of the publication of the seminal work, *The Modern Corporation and Private Property*, by A. Berle and G. Means.

literature. It was later extended to the concept of 'principal-agent problem' or 'agency cost' by a number of economists, who argued that under conditions of uncertainty and asymmetric information the principle (shareholders or lenders) can not link the performance of the company with the efforts of their agent (the management team) and may be subject to the opportunistic behaviour by the agents.[5] It is, of course, possible for shareholders to reduce the problem of managerial opportunism by increasing their ownership stake in the company. In this case, the large shareholders will have the incentive to monitor the managers more carefully, ensuring that their interests are not ignored.[6]

2.1. Can the market mechanism prevent corporate governance problems?

For many years, some economists argued that the cost of the separation of ownership and control is not large (especially in comparison to the benefits of the joint stock form of organisation) and that the market mechanism itself ensures that managers' interest and shareholders' interest are aligned. If managers pursue their own interest at the expense of shareholders, their self-serving actions will be detected by the company boards, or the managerial labour market or the financial markets. Firstly, the company board may take appropriate action to prevent opportunistic managers to damage shareholders' interests. Second, managers are concerned about their reputation on the managerial labour market and will refrain from actions which may damage their reputation. Finally, the financial markets may identify the under-performing managers and their company will become the subject of takeovers and managers' jobs will be threatened.

However, it soon became clear to economists and law makers that these mechanisms are, at best, imperfect and, at worst, ineffective and illusory. The existence of uncertainty and incomplete information by the relevant stakeholders mean that it is not possible to link the poor performance of a firm to its managers' efforts. Boards proved to be less than perfect in monitoring the managers and their performance. Managerial remuneration packages, and contracts, attracted much attention, especially when it became clear that even when company managers were dismissed for poor performance, they left the company with huge so-called 'golden hand-shakes' (more on this later). Following the pressure from the public, the media and professional organisations, and a number of important enquiries (e.g., Cadbury, 1995, in the U.K.), financial market regulators and stock exchanges around the world began to institute new voluntary or compulsory codes of practice to prevent the

[5] See, for example, Fama and Jensen (1983); Jensen (1986) and Jensen and Meckling (1976), among others.

[6] See, for example, Shleifer and Vishny (1988).

company management from misusing the shareholders' trust and engaging in self-benefiting activities. OECD and other organisations of professionals involved in financial markets also developed their guidelines for good corporate governance.[7] Furthermore, given that many large companies in most countries of the world are state owned or publicly owned, it soon became obvious that the problem of corporate governance applies equally to these companies too and the OECD Principles should also be applied to, and be observed by, these companies.

2.2. Models of corporate governance

There are several models of corporate governance in place in different countries around the world and in recent years there has been some convergence between these models. This convergence is reflected in the codes of good practice put forward by various international institutions and organisations. The convergence is also manifested in similarities of the main features of different models of corporate governance such as the rights of shareholders, including the minority owners, responsibilities of boards, the presence of independent members on boards, the relegation of decisions on remuneration and nominations of board members to separate committees, and the disclosure requirements imposed on companies.

On the one hand, there is the Anglo-American model, involving diffused ownership structures, supported by well developed financial markets, together with elaborate and enforceable rules and regulations, including bankruptcy laws, protecting the interest of shareholders, investors and creditors. In this model, joint stock companies have a one-tier board system – a 'Board of Director', elected by shareholders, which is in charge of the company's long term strategic development. The Board then nominates the CEO and other top management personnel who implement the Board's plans and run the company's day-to-day affairs. The Board represents the owners and exercises oversight on the managers; it should be aware that it may be dominated by the management who controls vital information on the financial and overall performance position of the company and who also influence the nomination of Board members. In the last decade, therefore, there has been a move to encourage companies to appoint independent, or outside (non-executive), directors to their boards in order to ensure that boards act in the best interest of the company as a whole and not that of the large shareholders who influence their appointment. The function of these independent directors is to exercise oversight and monitoring over

[7] For example, the OECD Principles of Corporate Governance, the International Corporate Governance Network Statement on Corporate Governance Principles, the European Association of Securities Dealers Principles and Recommendations. See, OECD (1999) and (2002), Cadbury (2002) and ICGN (1998).

the executive directors and ensure that the shareholders' interests (especially minority shareholders) are protected. It has also been recognised that the chairman of the board should not act simultaneously as the CEO of the company and the board chairman and that these two offices should be separated.

On the other hand, there is the German model, also in place in many EU countries, in which joint stock companies are governed by a two-tier board system comprising of a 'Supervisory Board' elected by owners and a 'Management Board', nominated or elected by the supervisory board and confirmed by the annual general meeting of shareholders.[8] There is a separation of functions between the two boards with the former being in charge of the broader strategic issues and also exercising oversight and monitoring over the latter, and the latter in charge of the day to day affairs of the company. In this model, joint stock companies usually have concentrated ownership, often by families, groups of associates, or other companies with banks and financial institutions playing a major role as financiers. Thus, while in the UK, the proportion of the stock exchange companies controlled by a majority shareholder is less than 3%, in Austria, Denmark and Germany, about two-thirds of listed companies have a controlling shareholder.[9] In these countries, financial markets are not very deep or are underdeveloped and/or the legal protection of shareholders and investors is not as strong as in the Anglo-American model.[10] By concentrating their ownership stakes, the owners ensure that they can exercise control over managers and ensure that their interest is protected. Of course, in these conditions, the protection of minority shareholders becomes the focus of corporate governance debate.[11]

Of course apart from the two stylised models, other configurations can also be observed in different countries – in many, e.g., we observe the single-tier (unitary) board and concentrated (instead of dispersed) ownership in many continental countries and developing economies or that many company laws allow the company to choose a unitary or two-tier board on whether it . But as far as the developed market economies of the OECD are concerned, countries generally fall into one of the two models.

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[8] The names of these boards may be slightly different in different countries but their function remains the same (e.g., instead of the supervisory board, there is a Board of Administration in Romania and a Board of Directors in Russia and in some Kosovar POEs).

[9] See Barca and Becht (2001).

[10] Thus, the stock market capitalisation (main and parallel markets) as a percentage of GDP is much higher in the U.K. (185% in 2000) than in the countries mentioned above (16% in Austria, 69% in Denmark, and 68% in Germany). Of course, the depth of stock market is also strongly related to the legal system of these countries and the degree of protection afforded to shareholders. See Barca and Becht (2001) for the depth of stock markets and La Porta, et al. (1997) for the relevance of the legal origin.

[11] See, e.g., LaPorta, et al. (1998) and (1999).

In transition economies, the ownership structure of enterprises has been evolving in the past fifteen years, largely through the privatisation process but also through the establishment of new firms. The initial post-privatisation ownership, especially when mass privatisation was implemented, was considered transitory, a temporary position in which the initial owners will sell their shares to those who can use these shares more effectively, from the 'less efficient' to 'more efficient' owners. In these countries, three important aspects of the corporate governance system should be highlighted. Firstly, most of the Central and East European countries have adopted the German two-tier board system.[12] Of course, the adoption of the two-tier system, in itself, does not ensure effective corporate governance – the regulations governing the operation of these boards and their competencies are even more important. Secondly, with underdeveloped financial markets, poor legal framework and weak law enforcement, there is broad agreement that dispersed ownership structures, often resulting from mass privatisation schemes, have not been not conducive to good corporate governance. The more concentrated ownership structures (where owners of companies can exercise more direct and better monitoring of the managers) are more seen as more appropriate for good corporate governance.[13] Indeed, the experience of many of these countries shows that there is already a noticeable trend towards concentrated ownership.[14] Third, effective corporate governance can facilitate one of the most urgently needed processes of the transition period, the restructuring process, because unlike the transitory owners and managers, the newly emerging owners have the interest and the incentive to pursue the restructuring process.

2.3. OECD Principles of Corporate Governance

In response to the concerns raised by shareholders, investors, stock markets and practices in member countries, OECD published its Principles of Corporate Governance in 1999 as a set of voluntary guidelines for private joint stock listed on a stock exchange to bench mark the practice in different companies. Following the OECD Principles, the International Corporate Governance Network, the European Association of Securities Dealers and the European Shareholders Group also produced their guidelines and statements which built on and extended the OECD Principles in one or other directions. The objective of the OECD Principles was to improve companies' performance,

[12] In some countries like Bulgaria and Macedonia, companies can choose between the one-tier or two-tier board systems while in Kosova, UNMIK regulations specify only the one-tier system. The proposed accomplished the incorporation of POEs involves a unitary board structure, the Board of Directors, although the bylaws of incorporated POEs require the establishment of the Supervisory Boards, too, which in fact have no real authority in the functioning of POEs.
[13] See, e.g., Shleifer and Vishny (1997).
[14] See, e.g., Berglof and Pajuste (2003) and Grosfeld and Hashi (2003).

competitiveness and/or access to capital. The five principles of the OECD code are:[15]

I. ***Protect shareholders' rights.*** This covers the process of participation in decision making (being informed of the annual general meeting in time and being able to participate in the process with minimum effort and cost), the right to information on the company's financial and technical performance, and the right to protection from controlling shareholders.

II. ***Equitable treatment of all shareholders, including minority and foreign shareholders.*** This would require the company to take appropriate measure to protect minority shareholders, including establishing clear rules for decisions subject to qualified majority.

III. ***Recognise the rights of stakeholders as established by law.*** This would encourage active cooperation between corporations and stakeholders (employees, customers, the government, and the community) in creating wealth, jobs, and sustainability of financially sound enterprises.

IV. ***Disclosure of timely and accurate information.*** This would ensure that all relevant material regarding the corporation, including the financial situation, performance, ownership and governance of the company are disclosed to shareholders at no cost.

V. ***Effective board system for the strategic guidance of the company and effective monitoring of management.*** This would require the company to have an effective board structure (whether unitary or two-tiered) accountable to the company and the shareholders, independent of managers and large shareholders, and able to exercise effective oversight over the management.

2.4. More recent developments in the corporate governance debate

After the Enron and Worldcom scandals, and the failure of what were previously regarded as sufficient safeguards against managerial opportunism and theft, the authorities worldwide embarked on developing policies designed to prevent the repeat of Enron and other scandals. Following extensive debate about the role of different corporate governance mechanisms, the role of boards, auditors, financial analysts and media, related party transactions and the nature of disclosure were highlighted as areas requiring additional new legal safeguards. In the

[15] For a detailed discussion of the five OECD Principles, see OECD (1999) and Weil, Gotshal and Manges (2002); for a discussion of other codes, see the latter.

U.S., the Congress passed the Sarbanes-Oxley Act; the New York Stock Exchange (NYSE) imposed new requirements on listed companies; the EU developed its own Transparency Directive; and many academics, commentators and professional organisations also put forward their recommendations.[16]

The Sarbanes-Oxley Act (July 2002) aimed at increasing the responsibility of the management and reducing the chance of collusion between the management and auditors.[17] It increased the penalty for CEOs and CFOs for willingly providing false information[18]; imposed more stringent disclosure rules[19]; and made it easier for the company staff with the knowledge of misconduct to come forward and disclose wrong doings. It also established a new professional body, the public chartered accountants oversight board, to monitor the accounting/auditing firms. NYSE imposed additional requirements on its companies. It required them to have majority independent directors on their boards and a nominations and a remuneration committee entirely made up of independent board members.

The issue of executive pay packages, which has always been highlighted as the single most obvious indication of managerial opportunism, was eventually considered by the US Securities and Exchange Commission. Earlier this year (17 January), in an attempt to curb the managers' ability to grant themselves lucrative pay packages at shareholders' expense, the Commission decided on expanded disclosure rules on executive pay arrangements in order to force companies to disclose the true value of executive compensation for shareholders.[20] Although this was seen as an

[16] For a detailed survey of corporate governance, especially the recent developments, see Becht, et al. (2005).

[17] It is now illegal for accounting firms to be both auditors and consultants of a company; the appointing of auditors is no longer made by the CFO but by the audit committee made up entirely of independent board members; the lead partner of the audit firm is required to change every five years;

[18] CEOs and CFOs must now sign the public accounts on the earnings of companies and they face prison sentence for wrong reporting; they must pay back any bonuses received on the basis of false reporting of performance; they can no longer borrow money from the company repayable in company shares- widely practiced in Enron.

[19] The 'off balance sheet' items which were used extensively by Enron and are not uncommon in many other companies are prohibited now.

[20] The issue of executive pay and its relation to managerial performance has been a major focus of attention in the corporate governance literature since the pioneering work by Baker, et al. (1988) and Jensen and Murphy (1990). The view that managers use their position to extract remuneration packages (pay, bonuses, options, pension plans and retirement or departure arrangements) which have no relation to their performance has gained much support in recent years (see, e.g., Bebchuk, et al., 2002 and Bebchuk and Fried, 2004), thus prompting the SEC into action. Although companies have, for a long time, been required to disclose the pay package of their executives, the practice has been far from satisfactory. While the compensation package has been disclosed, it has been quite difficult to calculate the money value of the full compensation package in each year of executives' service. Furthermore, the departure package of top executives is generally not disclosed to shareholders until the executives actually depart (a problem which has still not been resolved).

important step, some observers considered it insufficient, asking for the disclosure to go much further.[21]

In the EU, the Commission issued the Transparency Directive 2004/109/EC in December 2004, to cover companies listed on official exchanges in the Union. All member states are required to transpose the Directive into their own laws, and to designate an authority (e.g., Securities Trading Commission in Germany) to implement the Directive and enforce its provisions. The Directive is particularly concerned about the disclosure of changes in the ownership and voting rights, the minimum content of yearly and half yearly reports, and the related party transactions. The acquisition or disposal of voting rights by a shareholder going beyond the set threshold levels (5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%) must be disclosed to the competent authority by the company. Major related party transactions must be disclosed in half yearly financial report (and an explanation if such transactions have taken place). The Directive also requires the company to provide information on its financial situation in yearly and half-yearly reports (comparative balance sheet and profit and loss statement, notes, etc) in accordance with the International Accounting Standards principles, the annual audit statement, material events which may affect the company's financial position, changes in contingent liabilities and assets, together with a statement made by the CEO, testifying to the accuracy of financial information on assets, liabilities, financial position and profit and loss position of the company, and describing, amongst other things, the principal risks and uncertainties faced by the company. The information companies are required to disclose must be made available in an accessible form and free of charge, and disseminated to the public.

2.5. OECD Principles of Corporate Governance in State-Owned Enterprises[22]

State-owned enterprises play a major role in most countries of the world – often the dominant role in utilities, telecommunication, transport, etc. In many OECD countries, state-owned enterprises still account for a significant share of output and employment. According to the OECD Guidelines the term "state owned enterprises" refers to enterprises where the state has significant control, through full, majority, or significant minority ownership. In many developing countries, these enterprises constitute the dominant sector of the economy in terms of both output and employment. The operation of state-owned enterprises can therefore have a major influence on the economic efficiency and competitiveness of the country as a whole. State-owned enterprises are

[21] See Lucian Bebchuk's 'How Much Does the Boss Make', *Wall Street Journal* 18 January 2006 and 'Beyond Disclosure', *Forbes*, 19 January 2006.

[22] Although the phrase 'state-owned enterprises' is commonly abbreviated as 'SOEs', we avoid this abbreviation in order to avoid confusing this type of enterprise with 'socially owned enterprises' which are common in Kosovo and are also abbreviated as 'SOEs'.

often monopolies or have a natural monopoly element, and are not subject to two major disciplinary mechanisms of the market system, i.e., the bankruptcy and takeover mechanisms. Furthermore, unlike private companies where the principal-agent relationship is straight forward, in state-owned enterprises, the relationship is one of multiple agency, with the ultimate principles (the society) far removed from the scene. In private companies, owners are close to the management and can display their dissatisfaction of the company by either selling their shares or by attending the general meeting of shareholders and try to dismiss inefficient managers. But in state-owned companies owners can neither sell their shares (indeed they have no legal entitlement to the company or its shares) nor can they try to dismiss the managers. State-owned enterprises are often the subject of politically motivated excessive government interference and rent seeking behaviour. Therefore, it is even more important that appropriate mechanisms are developed to enable these companies to run as closely as possible to private companies in a competitive environment.

Given the above considerations, following the publication of the OECD Principles, it was recognised that corporate governance principles are equally (if not more) applicable and necessary for the efficient operation of state-owned companies. Any improvement in the performance of these companies would benefit not only the economy as a whole but also the operation of private sector companies. Against this background, the OECD developed its Guidelines on the corporate governance of state-owned companies, designed to supplement the OECD Principles of Corporate Governance (OECD, 2005). The main elements of these Guidelines are:

I. ***Ensuring an effective regulatory framework.*** The legal and regulatory framework for state-owned enterprises should ensure a level-playing field in markets where state-owned enterprises and private sector companies compete in order to avoid market distortions. The framework should build on, and be fully compatible with, the OECD Principles of Corporate Governance.

II. ***State as an effective owner***. The state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of state-owned enterprises is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness.

III. ***Equitable treatment of all shareholders.*** The state and state-owned enterprises should recognize the rights of all shareholders and in accordance with the OECD Principles of Corporate Governance ensure their equitable treatment and equal access to corporate information.

IV. ***Relations with other stakeholders.*** The state ownership policy should fully recognise the state-owned enterprises' responsibilities towards stakeholders and request that they report on their relations with stakeholders.

V. ***Transparency and disclosure.*** State-owned enterprises should observe high standards of transparency in accordance with the OECD Principles of Corporate Governance.

VI. ***Responsibilities of the Boards.*** The boards of state-owned enterprises should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.

Principle I recognises the fact that many state-owned enterprises are monopolies, with a possible 'natural monopoly' element such as networks, transmission system, etc. and that their pricing procedure has to be regulated by an independent agency. In Kosova, the regulation of the electricity and telecommunication industries is delegated to the Energy Regulatory Office and the Telecommunications Regulatory Office. Of course, these Offices are still not in full control of the pricing process and the regulation of companies in their sphere of activity. There is much room for improvement in this area but these are not issues of direct concern with the present project and, therefore, we shall not discuss this aspect in detail in this Report. This Principle also ensures that the state's ownership role is separate from its regulatory role.

Principle II requires the state to use its ownership rights to ensure that the company is run effectively, efficiently and in a transparent manner, and not treated favourably in comparison with its private sector competitors. The state should appoint members of the company board on the basis of their professional qualifications and merits, leave the management of the company in their hand, and hold them accountable for their actions. Unlike dispersed shareholders of a private joint stock company, the state holds all (or in some cases the majority) of the enterprise's shares and should have the incentive and the ability to monitor the management and hold it accountable. But it is crucial that the state does not interfere in the running of these companies or tries to use them as instruments of industrial policy. When the state has ownership rights in several companies, it is advisable that its ownership rights in all companies are exercised by one ministry so that a consistent ownership policy can be pursued in all companies. In transition economies, where the reform process will eventually lead to the privatisation of all state-owned companies, ministries of finance or economy could be the body which manages the ownership rights of the state in all companies for a temporary period.

Principle III is particularly relevant to companies which are not fully state-owned and, in addition to the state, there are also other shareholders. In these companies, the state may be the dominant or controlling shareholder but the rights of other shareholders to participation in decision making and to information have to be recognised. The Principle refers to the OECD Principles which requires special provisions in the company's corporate governance framework to protect the rights of minority and foreign shareholders have to be included. Given that the publicly owned companies in Kosova are now fully controlled by the KTA, and that KTA holds 100% of shares of those already incorporated, this Principle is not particularly relevant to Kosova POEs at present. However, as the reform of POEs proceeds and the shares held by KTA are gradually sold to outside investors, the issue of the rights of new owners would become important and may, indeed, influence the speed of the transfer to private owners.

Principle IV highlights the importance of the company's stakeholders (other than owners), in particular its employees, customers, suppliers and the community. Given that state-owned companies are often large companies and engaged in the production of public services, their relation with their stakeholders are particularly important. This Principle requires state-owned companies to have regular communication with its stakeholders about its long term plans and strategies as these may have important implications for employees or for the local community.

Principle V is fundamental to the operation of all companies in a market economy and even more so in countries without a developed financial system and media. Correct and timely disclosure of information is essential for investors, banks and financial institutions on which companies rely for their expansion and growth. The accuracy of financial information must be ensured by means of annual auditing (both internal and external) using international accounting and auditing standards, in the same manner as it is expected of private companies. Because of their size and importance, state-owned companies play a major role in all economies and their procurement and related party transactions must be completely transparent. Conflicts of interest arising from their operations must be avoided, or declared. Similarly, the full remuneration of the management and board members should be fully and clearly declared. The corporate governance framework should require state-owned companies to have clear policies on declaring potential risks from their operations and the impact on any of their stakeholders. Similarly, any subsidies from the state, direct or indirect, should be declared.

Principle VI identifies the roles and responsibilities of the company's board(s) and their relationship with the state (the owner). Most importantly, members of the board of directors (in the unitary board system) or the supervisory board (in the two-tier board system) must be appointed on the basis of their professional abilities so that they can lead the company[23], they should have a clear mandate from the state about the objectives they should pursue, they should act in the best interest of the company, and they should be held accountable for their performance – which must be reviewed on an annual basis. They should be directly involved in the appointment, and dismissal, of the company's CEO. The number of directorships of board members must be limited and the boards must meet on a regular basis. Boards are responsible for the strategic guidance of the company and for monitoring of the management. In line with the practice of private companies, boards should appoint specialised audit, nominations and remuneration committees to ensure that the company's financial situation is correctly represented to the owners and the public, that management is remunerated appropriately, and the board can carry out its functions independently. The board should include a number of non-executive directors, not appointed by the state, who would act independently of the owners and in the interest of the company. These members should be from the private sector with relevant experience and their expertise should complement those of other board members.

2.6. Experience of other transition economies

Over the past fifteen years, all transition economies have tried to adopt modern CG codes, similar to those of the Continental Europe. But the undeveloped, or underdeveloped, legal institutions and financial markets have hampered this process in many of them, particularly those in the South Eastern Europe. On paper, there has been much progress but there is a big gap between laws on books and laws in practice.[24] The enforcement of the new laws and regulations is far from satisfactory, a feature that has a direct effect on the availability of external finance and the willingness of investors to provide new or additional capital for the firm. The progress has also been very uneven with the most impressive changes having taken place in the eight countries which joined the EU in 2004, and least progress made in Central Asia, the Caucuses and the SEE region. In terms of the present discussion on the responsibilities of the boards and transparency and disclosure (Principles V and VI of the previous section), it is useful to review the current situation in selected transition economies.[25] Table 1 summarises some of the characteristics of the boards and disclosure requirement in selected transition countries in 2003 (i.e., in their pre-accession phase for the new EU member states).

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[23] The Code of Best Practice of the Warsaw Stock Exchange specifically requires that board members should have relevant *education* and related professional or practical *experience*. This is aimed at reducing the appointment of directors on the basis of their political and personal relations.

[24] For a detailed discussion of the state of corporate governance in South East Europe, see OECD (2003).

[25] For a detailed comparison of the corporate governance framework in selected transition economies, see Hashi (2003).

Table 1. Boards, Disclosure and Transparency in Selected Transition Economies (2003)

Country	Independent members on boards	Representatives of employees on boards	Independent auditors	Financial reporting Requirement for quoted companies	Threshold for disclosure of ownership stakes	Disclosure of managerial ownership and Remuneration	Tenure of general director (years)
Albania	No	No	Yes	N/A	None	No	3
Bosnia-Herzegovina	No	No	Yes	Half yearly	None	No	4
Bulgaria	No[a]	No	Yes	Quarterly	5%	No	3
Croatia	No	No[d]	Yes	Quarterly	10%[f]	Partial[h]	5
Macedonia	No	No	Yes	Quarterly	10%	No	6
Romania	No	No	Yes	Half yearly	5%	No	4
Russia	No[b]	No	Yes	Quarterly	5%	Yes	5
Hungary	No	Yes[e]	Yes	Half yearly	25%	No	5
Czech Rep	No	Yes	Yes	Half yearly	5%[g]	Partial[i]	5
Poland	No[c]	No	Yes	Quarterly	5%	Yes	5
Slovenia	No	Yes	Yes	Annually	5%	Partial[i]	8

Notes:

[a] Except for public companies where 1/3 of the supervisory board must be independent.

[b] Although the presence of independent members on boards is not a requirement at present, the notion of independent directors exists in the legislation for adoption of related parties transactions. The Code of Corporate Conduct also *recommends* that 25% of board members or at least 3 members should be independent. The practice is limited to some of the biggest companies only and is largely formalistic.

[c] The Code of Best Practices in Publicly Listed companies, however, *recommends* that 50% of board members should be independent (for Treasury owned companies, however, the law requires that 3/5 of the board members should be independent).

[d] In major state owned companies, one member of the supervisory board must be an employee of the company.

[e] In companies with more than 200 employees, 1/3 of the supervisory board is elected by employees.

[f] The company has to disclose the 10 largest shareholder but not their individual holdings.

[g] Any outsider can find out the identity of shareholders once they reach the 10% threshold.

[h] Remuneration of board members and the disclosure of their contracts are required for firms listed on the Stock Exchange.

[i] Only the total salary bill is disclosed.

Source: Hashi (2003)

Boards: As mentioned earlier, most countries have adopted the two-tier board system but there are no independent directors on the supervisory boards (or board of directors) in any of the selected countries. Employees are usually not represented on the supervisory boards of companies except in the Czech Republic and Slovenia and to some extent in Hungary. The presence of employees on company boards is in line with Principle IV above, and can play an important role in not only involving this important group of stakeholders in the decision making process, but also using their inside knowledge of the company to improve the monitoring of the management. This is particularly important in transition countries where there are no independent shareholders on boards. In Poland and Russia, e.g., although there is no requirement for employees to be represented on company boards, the practice is very common, especially in most large companies.[26]

Disclosure: In all countries under consideration, joint stock companies are required by law to have external auditors to monitor their accounts and to publish their financial information on a quarterly or half-yearly basis. The responsibility for providing such information lies ultimately with company boards. Companies listed on the stock exchange are required to publish more detailed accounts more frequently. Companies are legally required not only to declare the ownership stakes of board members but also to identity the firm's large shareholders and any owner reaching a threshold ownership level. The disclosure of information about beneficial owners of a company is recognised in all countries studied, with most of them now having a threshold of 5% (and other higher levels). However, in some countries such as Russia, the effectiveness of this provision is reduced by the fact that some beneficial owners are simply classified as 'off shore companies' with the true identity of their owners unknown. Furthermore, there is anecdotal evidence about the existence of cross ownership and pyramid holdings which also hide the true identity of beneficial owners (see Berglof and Pajuste, 2003 for examples).

In terms of the disclosure of information about the ownership stakes and the remuneration of the company's management, only in Poland and Russia, companies are required to disclose such information and remuneration. Most countries, including some new EU members, however, still maintain a veil of secrecy on this information and, at best, provide partial information (such as the aggregate value of managerial remuneration and shareholding).

The chief executives of companies in transition economies still enjoy a great deal of power. Their term of office is usually very long, between 3 to 8 years (mostly 5), which is much longer than that in EU countries –

[26] In Poland, employees are legally represented on the supervisory boards of companies which were commercialised for the purpose of privatisation in the early 1990s (but are still by Treasury-owned companies).

the Cadbury Committee recommended contracts of 1 to 2 years for chief executives in the U.K. (Cadbury, 2002).

Major shortcomings: In transition economies, the corporate governance framework in general, and that of the state-owned enterprises in particular, need major improvements in two areas. Firstly, the composition and membership of the boards and their competency and responsibilities need to be clarified in such a manner as to ensure that the right people are appointed to the board, they can undertake their jobs competently and exercise oversight on the management, ensure the protection of the interests of companies and their owners (the state), and are held accountable for their actions.

Secondly, the disclosure and transparency requirements should be tightened. In particular, a minimum amount of information on financial and ownership structure of the company, especially on the contingent assets, liabilities and risks, related party transactions, conflicts of interest, and on the management remuneration package must be provided on a regular basis. The role of independent auditors must be strengthened and the use of international accounting standards emphasised.

But, most importantly, transition economies need to improve their law enforcement and the rule of law. They need to implement and enforce their existing corporate governance regulations, however inadequate they may be, in order to establish the necessary confidence amongst shareholders, investors and lenders. At the same time, they should aspire to improve the framework in line with practices in other countries.

3. CORPORATE GOVERNANCE OF POEs IN KOSOVA AND CHALLENGES FOR IMPLEMENTATION OF OECD GUIDELINES

3.1. Publicly Owned Enterprises in Kosova

The origin of the 'publicly owned enterprise' (POE), as a legal form of organisation, should be traced to the days of former Yugoslavia. This legal form was different from the 'socially owned enterprise' form which was the most common form of organisation in the Yugoslav system of social ownership and self-management. Publicly owned enterprises relied very heavily on public resources (subsidies) from the government (at Federal, Republican and/or Provincial levels) because of the large initial investment and the high cost of replacement of their assets, and also because they produced 'public services' which in general was priced below the average cost of production. In comparison with the ordinary 'socially owned' companies which operated on the basis of self-management with little involvement of the government, the 'society' (or the government institutions at various levels) had greater interest and involvement in these companies and the employees' self-management rights were less extensive. Although there was no confusion about the legal form and the nature of ownership of these enterprise under the Yugoslav system of social ownership and self-management, UNMIK was unable to define their ownership in any of its Regulations and also unable to elaborate a solution for their eventual privatisation. Consequently, it decided to abolish the old self-management institutions and rights of employees in these companies and put them under the control of KTA until the question of ownership is resolved at a later date, possibly at the time of the resolution of the status question. In the meantime, KTA will manage these companies and oversee their reform and restructuring.

While KTA is not the legal owner of publicly owned enterprises, it acts as the *de facto* owner and enjoys all the rights and responsibilities enjoyed by any owner. It appoints most of members of the boards of these companies, changes their status, holds their shares, approves or rejects their investment plans through the BoD and, finally, receives the profit of these companies (if there is any).[27] Indeed this is the position of 'state owned companies' in other countries – the government acts on behalf of the owners (which, ultimately, are the citizens of the country). For this reason, publicly owned enterprises in Kosova are similar to state owned enterprises in other market economies and therefore can be the subject

[27] Strangely though, the bulk of subsidies to the energy sector flows from the Kosovo Consolidated Budget managed by the PISG, which does not enjoy any ownership right whatsoever.

of the OECD Guidelines on the Corporate Governance of State Owned Enterprises (2005).

The 'publicly owned enterprises' in Kosova, consist of utilities, rail transport, airport terminal and a few smaller companies providing water and sewerage services mostly at the municipal level. The energy and telecommunication companies are the largest employers in Kosova, with only KEK JSC itself employing around 8000 employees. They have a strong influence on the operation of other sectors of the economy as providers of crucial inputs. They also impact the welfare of the citizens in a direct manner. Any improvement in their performance will therefore have a direct and strong effect on the economy and society.

3.2. The importance of the corporate governance framework in POEs

The corporate governance framework refers to the set of rules by which companies are managed in the interest of their owners, investors and other stakeholders; the mechanisms by which owners monitor the work of management; and the systems which clearly define the responsibilities of the management bodies of the company particularly in terms of transparency and accountability. The failure to implement an effective corporate governance framework, i.e., the absence of effective control and monitoring and the lack of accountability, has been one of the main causes of the poor performance of POEs, with serious adverse consequences for the efficiency and competitiveness of Kosova's economy. A good corporate governance framework provides assurance to owners, potential investors and lenders that their interests in the company are protected, and facilitates the company's access to external finance. The absence of good corporate governance discourages investors, especially foreign investors, and in this way slows down further evolution of ownership and contributes to the stagnation of the economy.

While most of the corporate governance literature and policy discussion papers, written by national or international organizations, are concerned with private joint stock companies, the underlying principles are equally applicable to publicly owned companies. Indeed, the OECD Guidelines on Corporate Governance of State-Owned Enterprises (April, 2005) is a clear recognition of the fact that the corporate governance of public companies is equally important for efficiency, competitiveness and economic growth. In POEs, the owners (i.e., the citizens) are in a much weaker position and the management has a much greater degree of discretion than in privately owned firms. The stakeholders of POEs include not only financiers and creditors but also the employees, the citizens, the government, and the customers of the company. There is, therefore, a serious possibility of lack of accountability and the company not being run in the interest of its owners and creditors. POEs may suffer equally from politically motivated interventions by the state or from a passive un-interested government. Moreover, in general, POEs do not operate in a competitive market but are generally monopolies. The government, therefore, finds itself playing several (sometimes contradictory) roles, representing the interests of different groups of stakeholders such as the owners, consumers and tax payers while also being ultimately responsible for the regulation of the monopoly.

The adoption of a modern corporate governance framework, in line with the OECD Guidelines on Corporate Governance of State Owned Enterprises (April 2005), which are based on the OECD Principles for Corporate Governance (OECD, 2004), is one of the most fundamental issues facing the Kosova governments (and reforming governments in all transition economies). With a weak system of property rights and rule of law, and generally poor institutional set up, an effective corporate governance framework is essential if publicly owned enterprises are to be able to attract investors (especially foreign investors) which are necessary for their restructuring and modernization.

There are many benefits deriving from the implementation of best practices of corporate governance, such as those deriving from OECD Guidelines. Empirical evidence suggests that good corporate governance increases the efficiency of capital allocation within and across firms, reduces the cost of capital for issuers, helps broaden access to capital, reduces vulnerability to crises, fosters savings provisions, and renders corruption more difficult. The implementation of the OECD Guidelines may help ensure the positive contribution of POEs to a country's overall economic efficiency and competitiveness, as POEs represent a substantial part of GDP, employment and market capitalization, and in addition, their performance is of great importance to broad segments of the population and to other parts of the business sector. Consequently, the governance of POEs will be critical to ensure their positive contribution to a country's overall economic efficiency and competitiveness. To support this argument, the OECD experience has also shown that good corporate governance of SOEs is an important prerequisite for economically effective privatization, since it will make the enterprises more attractive to prospective buyers and enhance their valuation.

Kosova is at a crucial juncture in her transition to a democratic market economy now. The 'final status negotiations' have started and, given the positive attitude of the international community and the massive pressure from the public, it is expected that they would lead to independence. It is therefore even more important that the Kosova Government lays the foundations of its policies on POEs (as with other important areas) on a sound and efficient basis as soon as possible. The continuation of the present situation in POEs would entail poor and inefficient performance, increasing levels of subsidies, lack of accountability and rising levels of corruption. This may divert resources from other urgent needs or lead to additional taxation to fund the POEs. However, the present situation can be changed by adopting appropriate policy measures in the area of corporate governance, particularly implementing the OECD Guidelines. This would not only improve the efficiency and competitiveness of these companies, it would also contribute to improvements in other sectors of the economy, reduce the level of subsidies and lead to an improvement in public finance, reduce the pressure for tax increases and make resources available to improve other essential functions of the government. It will also prepare these companies for eventual privatization – which is one of the strategic goals of the Kosova Government.

3.3. The role of Kosova Trust Agency (KTA) in corporate governance of POEs

On June 13, 2002, the United Nations Interim Administration Mission in Kosova (UNMIK) issued Regulation no. 12, on the establishment of the Kosova Trust Agency (KTA). Through this Regulation, the KTA was entrusted to administer the Socially and Publicly Owned Enterprises in Kosova. The administrative authority of the KTA, as set forth in the Regulation 2002/12, includes any action that the KTA considers appropriate to preserve and enhance the value, viability or governance of enterprises. The Kosovar POEs employ around 14,000 people, with the Korporata Energjetike e Kosovës Sh.A. (Kosova Energy Corporation J.S.C.) alone employing around 8,000 employees.

3.4. Incorporation or Corporatisation of POEs

In 2004, the KTA initiated a major incorporation programme to transform POEs into modern corporations with clearly defined entities, corporate governance, and audit structures. This process also included a meticulous assessment, review and appraisal of all existing assets/liabilities, operations, contracts and cadastre and other official records and management structures, as well as a wide range of other legal, commercial and financial matters. Incorporation in Kosova was a two steps process: the first step was the transformation of existing POEs into Holding J.S.C (Parent Company), followed by the 'Spin-Off' stage, involving the creation of several NewCos (Operating Companies) responsible for a specific segment or part of the operation of the old company as a wholly owned subsidiary in the form of a joint stock company.

The purpose of such an exercise was to ensure that everything is properly and correctly documented, recorded and registered, that assets and contracts are identified and transferred to the right entities, cadastre records and other registrations are updated or recorded in the correct name. The process would allow the vertical separation of the integrated company into separate entities – a procedure necessary in the process of reforming the utilities. However, the Government must establish a clear strategy on further restructuring after the incorporation of POEs. Furthermore, the Government must also decide about two further issues: (a) how it wishes to deal with its ownership rights in all POEs and choose between the two alternatives of keeping its ownership rights (shareholding) in all POEs in one institution as it is now under the KTA's stewardship, or decentralise it to relevant ministries; and (b) how to proceed with the eventual partial or full privatisation of POEs. However, this ownership policy must be arrived at through consultation and close collaboration with all relevant stakeholders such as with the PISG and the Parliament.

Following incorporation and in cooperation with PISG and UNMIK institutions, the KTA established and appointed the Board of Directors (BoD) in eight POEs as the highest governing body in these companies. The BoDs of POEs consist of members from KTA, PISG and UNMIK, which supervise the management of POEs, direct the strategic planning and vote on major issues affecting the POEs (see the POEs board membership on the KTA's website www.kta-kosovo.org). This way of organizing the incorporation process was dictated by the current legislation in force - the UNMIK Regulation on Business Organizations, particularly the part on the functioning of corporations (joint stock companies). However, this Regulation does not make any distinction between private and state/public enterprises. Taking into consideration that public firms operate under specific regimes (e.g. public service obligation and regulated tariffs), there is a need to distinguish through legislation between the organizations of private and state/public joint stock companies.

3.5. The implementation of OECD Guidelines in Kosovar POEs

One of the most relevant issues is to assess the extent to which the OECD Guidelines are implemented in Kosovar POEs. The KTA, after the launch of this project, has produced a Code of Corporate Governance for POEs, which, essentially, is a sub-set of OECD Guidelines on Corporate Governance of State Owned Enterprises. To date, neither the KTA, nor the POEs themselves, have reported their compliance with this Code.

<u>With regard to the Legal and Regulatory issues,</u> the current system of POEs consists of the following framework: the KTA, Kosova Government ministries, POEs, and regulators. The results of interviews that have been conducted at earlier stages of the project have suggested that the regulators are established by law to be independent but in reality they cannot be fully independent because of financing. In this regard, the law anticipates own revenues of regulators from the issue of licensing fees.

Because regulators in the current circumstances depend on Kosova Budget financing, they have limited space for independence. Due to multi agency relationship in Kosova (the interfering of the reserved powers by UNMIK in the competencies of Provisional Institutions of Self Government in Kosova), there are many conflicting interests between regulators, ministries, and the KTA. Another important issue is that the regulators do not collaborate sufficiently with the government institutions and the enterprises, which limits their effectiveness. To overcome this situation, some form of coordination of activities between the respective ministries and regulators is essential.

With regard to *pricing*, they are under the regulatory regime. The regulatory authorities issue licenses to the operators of services, as well as regulate their pricing policy. Prices are set through collaboration between the regulator and the company on the cost recovery basis and the enhancement of efficiency. The companies propose their tariffs, which in turn are considered and approved by their respective regulatory bodies. Although the prices are set to be cost recovery, they assume sufficient and satisfactory cash collection in order to maintain business activities and reinvest in future activities. However, many of POEs face difficulties with cash collection such as cases with KEK JSC and many other municipal public utility companies. As a result of very poor cash collection, among others, companies face serious problems, resulting in massive losses. Furthermore, they face many difficulties in using the court system to pursue the non-paying customers and to resolve disputes. These are due partly to the weak law enforcement system and insufficient administrative capacity of courts, and partly to the inability of the company to prepare their submissions to courts properly. It should be noted that due to different character of services different enterprises face different problems. For example, PTK JSC finds it easier to deal with non-paying customers as it can switch them off individually from the operation centre, but this is not possible for KEK JSC which has to disconnect non-payers individually at their apartments or houses. However, both the PTK and KEK face difficulties to take their claims to courts as the courts are overloaded and their decisions are not enforced easily. On one hand, KEK JSC has for example stated that there are 400 cases sent to courts per month and there is a stock of 40,000 cases outstanding. On the other hand, the municipal court in Prishtina states that they have received very few cases from KEK, if any. Because of difficulties faced by courts, it was suggested to establish a special court to deal only with non-paying electricity customers.

With regard to *capital market financing, POEs* have the right, especially after incorporation, to raise capital in the financial markets. However, if they do it they must do it through a very complicated and slow system of the KTA. Yet, due to the unresolved status of Kosova and because the ownership issue of public enterprises is not clear, enterprises face difficulties finding sources of finance. In addition to this, some POEs such

as KEK, it is impossible to raise capital in the financial markets due to poor financial situation and inability to sustain on commercial grounds.
In relation to providing *liabilities' guarantees*, it is certain that the government does not provide automatic guarantees for the liabilities of POEs. However, certain POEs, such as KEK JSC, which produces an essential service for citizens, cannot be allowed to go bankrupt. Hence, the government has had to support the company with financial resources from the budget and cover its poor financial and technical performance over the last years. According to government officials, this sum is around 440 million Euros, including the projections for 2007. Or, the government has offered its help regarding the necessity for the Prishtina International Airport JSC to get the certificate for international operations.

With regard to the *Role of State* - With the incorporation process POEs have become joint stock companies with all shares issued to the KTA under its custody and with the core businesses of enterprises divided (unbundled) into several units, with the non- core business activities of enterprises being sold to private companies or being liquidated. In formal aspect the government (PISG and UNMIK/KTA) exercise their influence over the public companies through the mechanism of Board of Directors, which is a supervisory body monitoring the management of enterprises. Both institutions have their representatives on the BoD and in this regard they take active part in nominating the members of BoD. However, the central question remains which institution has control on the decisions taken at the BoDs of POEs. The results of interviews show that the PISG members have little influence over the decisions taken at the BoDs and that the UNMIK and/or the KTA representatives have the decisive influence. This is due to the fact that the PISG part in the Board, without exception, always present a minority on the BoD compared to UNMIK/KTA part of the BoD.

The response from the interviews has been mixed regarding whether or not the government institutions have a clear strategy about POEs. For example, on the one hand, the government has prepared the medium term strategy for the energy sector, but on the other hand, to date, there has been no close collaboration between the government on one side and KEK and heating companies on the other to implement the energy strategy.

The responses from interviews also make it clear that the government has not had a strategy for the telecommunication sector, either. Moreover, it neither had inside information on the document on incorporation prepared by the British company, nor it has participated in discussions. Only the Telecommunications Regulatory Agency participated in discussions.

In general, the management of POEs have a great deal of freedom to lead the day to day business affairs. However, there were cases where the management could not do things for the benefit of their enterprise because of political interference. Regarding the criteria for the nomination of the BoD members, the results of interviews are mixed. On the one hand, there are responses that there are official criteria for the nomination of board members, but they are little respected, and on the other hand, that there are no criteria to nominate board members. In addition, some of interviews suggested that board members have actually been nominated on political party basis and that there are no such things as criteria for nomination. One thing is sure that none of BoD members are part of regulatory authorities. Respective ministries have legal authority to design sectoral policies and strategies as well as creating laws in respective fields. In addition, the respective ministry appoints a number of members to the BoD.

With regard to *Role of Stakeholders*, as was mentioned earlier, POEs operate in a very complex legal environment. On one hand, you have the KTA, which is in charge of ownership control and has majority of votes in the highest governing body of POEs, the BoD. On the other hand, there are PISG institutions that legitimately require greater influence on the functioning of POEs. In most of POEs, almost without exclusion, the PISG representatives in the BoD present a minority, with voting rights, but without voting influence. Respective ministries have the legal authority to design sectoral policies and strategies as well as propose new laws in their respective fields. There also the customers and/or citizens that are served by POEs. They are not represented in the governing bodies of POEs, same as with employees, which represent one of main company stakeholders, except in the so-called "supervisory boards" of POEs- which are non-decision making bodies and are established to being PISG closer to corporations and to inform them better in regard to the functioning of public corporations. However, until now, based on interviews and other project activities, the supervisory boards of POEs have not been functioning.

POEs communicate with the public through the media conferences and press releases that are organized by their offices for public relations. In addition, they write articles in newspapers to inform the public about their functioning. With regard to investors, most of contacts with potential investors are done through the contacts of management with potential strategic partners who may be in the future the investors in company.

<u>Transparency and disclosure</u> – The annual reports of POEs are prepared by management and approved by BoDs. The aggregate reports contain the statement of external auditing. The information from the internal

audit reports are not disclosed without the approval of the BoD.[28] However, corporations have not prepared a functional system of disclosure of information, e.g. their annual reports are meant to be publicly available, but their websites are poorly maintained and in most cases reports are not available. Despite financial reporting, there are no adequate treatment of various other issues that might be important for corporate governance and interesting for the public and other stakeholders such as remuneration policies, voting structure, political and other risks including economic and environmental. The lack of transparency in the functioning of various elements of the system leaves room for speculation by the media and the public and generates mistrust in the system of governance. In addition, in those enterprises where it is said that the remuneration is linked to the performance of the management, the public is not informed whether the targets are reached.

With regard to auditing, most of POEs have their internal audit offices, or are in the process of establishing them. However, their role is not understood as it should be. Where they exist, they report to the Managing Director (or Chief Executive Officer – CEO) or to the management as a group, and not to the BoD. With regard to external auditing, POEs are audited by international specialized companies (e.g., Deloitte & Touché, KPMG, etc.). The external audit reports are submitted to the BoD. Statements of external auditors are included in the financial reports of POEs. Most of POEs have separate accounts for grants and subsidies. The accounts are also audited separately. However, in those companies where this was not done so, and it was required by donor due to the high amount of grant, the accounts for grants then were audited on separate basis from other accounts.

There is no clear and uniform system of management remuneration in POEs. In most of enterprises, the remuneration of management is decided by the BoD, except KEK, where the remuneration of management has been decided directly by the KTA, based on the management contract between the KTA and the Irish company ESBI International. Based on this management contract, it is this Irish company that manages KEK.

The public procurement law in force is also binding on POEs. It covers in detail most of the procedures required and is designed to eliminate or reduce the potential for fraud and corruption. However, the procurement law is designed for public institutions and as such presents a barrier to business development and commercial enterprises. Public procurement rules are not supportive to organizations that are business oriented due

[28] At the time of writing this report, there were available in the PTK website, the annual reports for 2003 and 2004. The KTA website has the audited reports of POEs for only 2003 and 2004.

to the rigidity of procedures causing many delays in business functioning. This is the essence of why POEs consider this Law as a barrier and ask for its modification to allow more flexibility for POEs with regard to procurement practices.

Responsibilities of the board **–** The *post-incorporation legal requirements with regard to board responsibilities -* According to the incorporation documents, the Board of Directors of POEs may be composed of no fewer than three (3) members. However, in practice, these boards are made up of six members: 3 nominated by PISG, 2 by KTA and 1 by UNMIK." The members of Board of Directors shall be elected for a term of one year and may be re-elected for an unlimited number of one-year terms. The members of the Board of Directors shall serve at the pleasure of the shareholders and may be removed at any time with or without cause by the General Meeting of the shareholders (in this case the KTA, as it is the sole shareholder of all POEs). Directors may be elected from the ranks of the Company's shareholders and employees, as well as from the ranks of other persons outside the Company. At least one third of the directors shall not be employees of the Company. To be eligible for election as a director, a person shall have at least five (5) years of relevant business experience or shall have been a public accountant or a member of other relevant professions for at least five (5) years.

With regard to the company’s officers, the company should have the Managing Director (MD), the Chief Financial Officer (CFO), and the Secretary. The Board of Directors may elect other officers, whose duties shall be specified in the resolutions electing them. Officers may be elected from the ranks of the Company's shareholders and employees, as well as from the ranks of other persons outside the Company. Subject to incorporation documents, the Board of Directors shall designate the duties of the officers. The MD is the chief executive officer of the Company and reports to the Board of Directors. The day-to-day activities of the Company are conducted under the management and supervision of the MD in accordance with the charter and by-laws of the Company and the resolutions of the Board of Directors. The MD shall submit to the Board of Directors a proposal regarding the internal organization of the Company. The MD shall have the authority to hire and dismiss the officers and staff of the Company and to delegate such authority to other officers and staff members.

According to their bylaws, the companies must have their advisory committees. The Company shall have an Audit, Finance and Insurance Committee. The Company may have the following additional Advisory Committees: (i) Corporate Governance and Compliance Committee, and (ii) Human Resources and Compensation Committee. The Advisory Committees shall provide advisory services to the Board of Directors and, when requested, to the General Meeting of Shareholders, and have oversight functions with respect to the operations of the Company, in their respective areas. The Advisory Committees shall report, during each General Meeting of shareholders, on their activities since the previous General Meeting.

According to incorporation bylaws, the Company shall also have a Supervisory Board consisting of five members. Three of the members shall be nominated for appointment by the PISG, one member shall be nominated for appointment by the KTA and one member shall be nominated for appointment by the Union of Independent Trade Unions of Kosovo.

Current situation with regard to board responsibilities

Although the incorporation documents specify corporate governance issues and mandate the one-tier board system, in reality, the situation with POEs is different. Given that in some POEs (such as the Prishtina International Airport J.S.C. and PTK), the Managing Directors (MD) are full BoD members with voting right while in others (such as in KEK J.S.C), the MD is not a full member of the BoD, we can conclude that no uniform board system has been implemented. It is not quite clear whether the board system in POEs is a unitary board system (where the same board, the board of directors, accomplishes both the management and oversight or monitoring function), or a two-tier system, where the management and monitoring functions are accomplished by strictly separated boards, the supervisory and the management/ executive board. In fact, the PISG are more inclined towards the two-tier board system, with strict separation of functions between the supervisory and management functions.

The PISG representatives usually include 2 of the most senior members of the Government). However, the Boards are controlled by the KTA through the voting system. The MD usually sides with KTA and therefore the majority of votes in the Boards belong to the KTA/UNMIK, hence the PISG representatives on BoDs feel that they have little influence over the decisions made by the BoD, as in all BoDs the PISG members represent a minority. The management of corporation prepares the strategy, and the Board approves it. The Board is also involved in monitoring the implementation of the strategy and reviewing the progress on regular basis. The Boards have their monthly meetings where they discuss the achievements in terms of implementing the strategy. The BoD (controlled by the KTA/UNMIK) nominates and hires the management. With regard to evaluation of work of management and their performance, the results of interviews are often mixed. Some of the answers suggest that the work of management is rarely evaluated by the BoD, while others provide more positive answers to this question.

The incorporation documents foresee the establishment of supervisory boards of POEs which have two functions: to exercise oversight functions and act as a liaison with the PISG. In practice, however, supervisory boards do not function along these lines. Most importantly they do not have any legal power over the Board of Directors. Their 'oversight' function is purely nominal and there is no formal mechanism to enforce their decisions. Given this and their negligible role, it seems that supervisory boards were set up as an attempt to have a counterbalance to the BoD and also to appease the PISG. Yet, the system is, formally and in practice, a one-tier system with the BoD as the only decision-making body and the supervisory board as an 'advisory' body with no power. Indeed, to our knowledge, supervisory boards have not yet been established in any POE.

In practice, different POEs have established different committees (such for procurement, remuneration, ethics, and other types of committees) only on an ad hoc basis, excluding the audit committees that are established on permanent basis. In those enterprises where a certain committee exists, the heads of those committees are not independent as they should be.

3.6. The financial situation of POEs

This section focuses on the analysis of the auditors' reports 2003 and 2004[29] for PTK and KEK. According to these reports both the PTK and KEK management have departed from International Accounting Standards in several respects in preparing their financial reports. In addition to elaborating the non-compliances of the financial statements, the performance of PTK and KEK will be presented with regard to profitability, efficiency, and liquidity. Using data from the three last years, ratios will be calculated to give a deeper insight into the past performance and the current strengths of the companies.

Based on income statements the PTK operating profit has recorded an increase of 30% during the 2002-2004 period. A similar pattern has been recorded by profit for the year, too. Yet, there are several issues that are worth mentioning with regard to PTK profits. If PTK had recognized prepaid mobile revenues upon sale of scratch cards for the year ended 31 December 2004, profit for the year would have increased by 1,756,000 EUR.

The situation at KEK is totally different. The loss from operations has increased by about 27.5% from 2003 to 2004. In addition, the total loss

[29] Despite several attempts the project team was not allowed access to the financial reports of PTK and KEK, except to the published 2003 and 2004 financial reports of PTK. Hence, the analysis was conducted using the respective independent auditors' reports.

has increased by about 0.5% from 2003 to 2004. The difference between the loss from operations and the loss for the year is complemented by grants and net financial incomes.

Table 2: PTK and KEK profit 2002-2004 (in thousand Euros)

	2002	2003	2004
PTK			
Operating profit	38,844	50,747	59,036
Profit for the year	30,739	39,287	47,778
KEK			
Loss from operations		93,092	118,735
Loss for the year	27,616	39,776	39,990

Source: KTA website, Independent Auditors' Reports 2003 and 2004, PTK and KEK

It is worth stressing that the accumulated losses at KEK reached the value of 443,455,000 EUR by the end of 2004. As a result the percentage increase in accumulated losses from 2002 to 2004 is 9.4%.

The performance of PTK could be evaluated through the calculation of the return on sales (ROS) and return on total assets (ROTA). The ROS shows that there has been an improvement in PTK's ability to increase the profit margin. Furthermore, to consider changes in the assets used for creating profits, the asset turnover was calculated. The figures show that asset turnover has declined continuously. Yet, the increase in the profit margin has cancelled out the decrease in asset turnover and thus resulted in an increase in return on capital employed (ROCE) from 2002 to 2003. In 2004, however, the increase in the profit margin was not high enough to offset the decrease in asset turnover, which resulted in a decrease in the return on capital employed (see table below), implying that more assets had to be used to achieve the profit margin.

Table 3: PTK profitability ratios 2002-2004[30]

PTK	2002	2003	2004
ROS	34.96 (%)	43.85 (%)	49.13 (%)
Asset turnover	0.63 (times)	0.57 (times)	0.49 (times)
ROCE (ROS x Asset turnover)	22.31 (%)	25.01 (%)	24.51 (%)

Source: KTA website, Independent Auditors' Reports 2003 and 2004, PTK

PTK revenue sources consist among others of prepaid mobile revenues, fixed line revenues, income from public phone booths, postal revenues, internet service revenues. In this regard, too, PTK has recorded a continual increase. In relative terms the increase in this item during the

[30] Given that KEK has continuously incurred losses, it was unnecessary to calculate these ratios for it.

2002-2004 period was 14.7%. Mobile phone revenues present the major source of revenues making up more than 60% of revenues each year. The share of this component has increased each year, from 62% in 2002 to 68% in 2004.

The situation at KEK is again problematic; revenues have continuously decreased during the 2002-2004 period. The relative decrease during 2003-2004 was 0.6%, while the relative decrease from 2002[31] to 2004 was 16.8%. Revenues from sale of electricity comprise the invoiced value of electricity supplied. There are three types of consumers: consumers connected at 10 kV, 35 kV, and 0.4 kV, industrial consumers connected at 110 kV, and households. The largest portion of revenues comes from selling electricity to households which increased by 0.6% from 2003 to 2004.

According to the independent auditors' report 2003 and 2004 for PTK, the system of internal controls has had serious weaknesses. This causes problems in terms of verifying the completeness of fixed line income for the respective years. Moreover, the Monaco Telecom is in charge of billing and collecting revenue from incoming call revenue to the VALA 900 mobile network, and again there is no control system for the billing and collection of this revenue. Another issue worth mentioning is the new agreement[32] between PTK and Monaco Telecomm International (MTI), based on which PTK is no longer obliged to pay 18% of its total revenues and to take the risk of collecting revenues from international calls. Furthermore, PTK will be allowed access to the financial information of MTI. This agreement is considered to increase revenues by 25 million EUR.

Table 4: PTK Revenues 2002-2004 (in thousand Euros)

	2002	**2003**	**2004**
PTK			
Revenues	111,991	118,802	128,483
Mobile phone revenues	69,648	75,013	86,812
KEK			
Revenues	130,189	108,939	108,224

Source: KTA website, Independent Auditors' Reports 2003 and 2004, PTK

Regarding PTK, year-to-year increases are evident also in total assets. Within this category the increase is attributed to the relatively sharp increase of 85% in current assets during the 2002-2004 period. On the

[31] The grants are presented in 2002/2003 audit report as revenues, contrary to 2003/2004 audit report where grants are deducted from loss from operations in order to get the data for net loss for the year.

[32] "The new agreement, €25 million more for PTK", Koha Ditore, August 1, 2006.

other hand, the value of fixed assets has recorded a slight year-to-year decrease of about 3.7%. Contrary to PTK, during the period 2002-2004, the value of total assets at KEK has decreased continuously, from 427,071,000 EUR in 2002 to 421,673,000 EUR in 2003 and 402,341,000 EUR in 2004. In relative terms the value of total assets at KEK decreased by 5.8% during the 2002-2004 period. Considering the components of assets, this decrease is a result of the decrease in both. In calculating depreciation both PTK and KEK use the straight line method. KEK uses the following rates: buildings (2%-5%), production equipment and machinery (7%-10%), motor vehicles and office equipment by 15%), computers (20%). Trade and other receivables, which represent the most part of current assets are recognized and carried out at original invoice. PTK, on the other hand, in 2003 calculated depreciation on the old inflated historical cost figures without considering the revaluation of assets, and thus departing from International Accounting Standards.

Table 5: PTK and KEK assets 2002 - 2004 (in thousand Euros)

	2002	2003	2004
PTK			
Total assets	175,510	207,779	257,515
Fixed assets	75,445	74,337	72,628
Current assets	100,065	133,442	184,887
KEK			
Total assets	427,071	421,673	402,341
Fixed assets	374,479	363,721	351,737
Current assets		57,952	50,604

Source: KTA website, Independent Auditors' Reports 2003 and 2004, PTK and KEK

Grants received by KEK have recorded a continuous increase in the 2002-2004 period and amounted to 24,460,000 EUR in 2002, while in 2003 they amounted to 53,238,000 EUR and 78,660,000 EUR in 2004. The increase from 2003 to 2004 gives a percentage increase of 47.7%, while the relative increase during the 2002-2004 period was 221%. Most of the grants were used for importing electricity and for repairs and maintenance. Notes to the financial statements show that the total electricity purchases have increased from 17,932,000 EUR in 2003 to 26,006,000 EUR in 2004. KEK has not entered into any hedging transactions to cover its exposure to price movements arising from the purchases of energy.

From the audit reports of PTK and KEK one can conclude that both enterprises have had continuous departures from International Accounting Standards. Further analysis of these reports shows that PTK has continuously been profitable, while KEK has found itself in enormous losses during the reporting period. Both profit figures of PTK are supportive of its good financial situation and of a positive trend in this regard. A continuously positive trend has been recorded by the revenue figures as well. The financial situation at KEK, on the other hand, is different. KEK has continuously incurred losses. Moreover, the difference between the loss from operations and the loss for the year has been complemented by grants and net financial income. The revenue figure, too, has also declined over the reporting period. The PTK ratio analysis further confirms the profitability of the company. Given the poor performance of KEK in terms of profitability, no ratio analysis was conducted. Nevertheless, the difference in the performance of the two companies mainly lies in PTK's relative ease of collecting revenue for its services. Given the weaknesses in its corporate governance systems, it is possible to improve its performance even further.

4. CUSTOMERS' SATISFACTION WITH PUBLIC SERVICES

To get a clearer picture of how customers perceive the quality of public services, an analysis of customers' perception on public services was performed using data from the Kosova Mosaic. This is a report published by UNDP which is based on a survey with a sample of 6,000 respondents from across Kosova. Moreover, the analysis also made use of the Early Warning Reports #10, #12 and #13 published by UNDP in cooperation with USAID. Table 6 shows the level of customer satisfaction with various POEs.

Table 6. Level of satisfaction with public services (% of respondents)

	RTK	PTK	KEK	Water Supply	Sanitation	Local roads infrastructure
Very dissatisfied	19.8	13.9	44.5	11.8	20.2	26.4
Dissatisfied	21.6	30.8	32.7	20.4	37	40.6
Satisfied	49.3	50.1	19.4	55.1	47.3	29.6
Very satisfied	9.3	5.2	3.4	12.7	3.7	3.4

Source: EWR #10, EWR #11, EWR #12

There are variations in levels of satisfaction among different public services. Table X shows that power supply (KEK) was given the lowest rating in terms of satisfaction with public services, while water supply showed the highest satisfaction ratings. Hence, power supply is considered to be one of the worst performers among public services. In comparison to KEK, PTK is better satisfying the customer needs. Yet, when pooling the percentage of respondents "very dissatisfied" and "dissatisfied", PTK is rated fifth among the different public services. Consequently, according to customer perceptions PTK is rather an average performer.

The overall picture of satisfaction with KEK and PTK is reconfirmed by the results of the Kosova Mosaic 2006. According to the index of satisfaction with public services (Kosova Mosaic 2006)[33] KEK has recorded the lowest rating, becoming thus the worst performer. Again, PTK, manages to satisfy a greater proportion of customers. Although both service record improvements during the 2003-2006 period, PTK gets a higher positive rating, while KEK manages to just decrease the negative rating, but not cross the border to the positive level of satisfaction. These are shown in Table 7.

[33] Index of satisfaction with public services – in the range from (-100) "very dissatisfied" to (+100) "very satisfied"

Table 7. Index of satisfaction with public services

	2003	2006
Hospitals	33	16
Public Health	30	21
Management of Primary and Secondary Schools	37	27
Garbage Collection	-7	-2
Consistency of Water Supply	10	16
Sewage and Sanitation	-15	0
KEK	-65	-3
PTK	15	24
Urban and Rural Planning and Land Use	-3	-4
Social Services	-15	-23
Pensions	-31	-36
Procedures for Tax Payment	-13	-1

Source: Kosova Mosaic 2006

Given that this Research Report focuses on KEK and PTK, an in-depth analysis of the performance of these two POEs will be conducted separately in order to identify the trend in the level of satisfaction.

Table 8. Level of satisfaction with the Performance of PTK (percentage of respondents)

	Q2	Q3	Q4
Very dissatisfied	15.4	15.7	13.9
Dissatisfied	32.80	37	30.8
Satisfied	46.90	44.6	50.1
Very satisfied	4.90	2.7	5.2

Source: EWR #10, EWR #11, EWR #12

Regarding PTK, the majority of respondents perceived its performance as satisfactory. Yet, a large part of respondents are dissatisfied, while a considerable percentage of them are "very dissatisfied". The trend in the level of satisfaction has recorded a positive change from Q3 to Q4 where the share of "dissatisfied" and "very dissatisfied" customers has decreased, thus contributing to the share of those who perceive the performance of PTK as "satisfactory" and "very satisfactory".

Table 9. How satisfied are you with the performance of KEK (percentage of respondents)

	Q2	Q3	Q4
Very dissatisfied	24.1	39.6	44.5
Dissatisfied	37.2	40	32.7
Satisfied	37.4	18.7	19.4
Very satisfied	1.3	1.7	3.4

Source: EWR #10, EWR #11,EWR #12

The above table shows that the majority of customers were either "very dissatisfied" or "dissatisfied" with the power supply service. Yet, there are variations in the level of satisfaction from quarter to quarter. The share of "very dissatisfied" customers increases continuously, while the share of "dissatisfied" customers increases from Q2 to Q3, and decreases from Q3 to Q4. Furthermore, the large decrease in the share of "satisfied" customers, from Q2 to Q3, and the slight increase in the share of customers perceiving power supply services as very satisfactory are striking. When analyzing these changes in more detail it can be concluded that the better ratings are due to the improvement of the power supply situation during Q4. These opinions are presented in Table 5.

Table 10. Is the ABC regime fair? (percentage of respondents)

	Q4
Fair and improves the payment level	19.6
Unfair and deteriorate payment level	20.8
It is necessary to search for other solutions	35.7
No opinion about this issue	16
No answer	7.9

Source: EWR #10, EWR #11, EWR #12

Last year, KEK started the implementation of the ABC regime, which implies that customers under the A category have 24 hour power supply, those under category B have 5 hours power supply and 1 hour no power supply, and category C has 4 hours supply and 2 or more hours no supply. Whether this regime is fair and conducive to paying the electricity bill can be best understood through customers' responses. In this vein, there are variations as to the reasons why they do not pay their electricity bill. More than 57% of respondents find the regime to be unfair and that alternative solutions should be considered, while app. 20 % of customers consider it to be fair and 16% of them have not yet build an opinion on the issue. Given that around 57% of respondents do not support the regime, it can be induced that KEK should search for alternatives in order to induce payment.

Table 11. Reasons for not paying the electricity bill (percentage of respondents)

	Q3	Q4
No fear of penalty	4.4	4
Dissatisfaction with KEK services	18.3	15.6
Financial inability to pay	67.3	75.6
Why pay when it is free	1.8	2.7
Other	1.6	2.1

Source: EWR #10, EWR #11, EWR #12

As a result of the low performance of KEK, a considerable share of customers decides not to pay the electric bill. However, based on the opinion poll the dissatisfaction with the performance of KEK is the second biggest reason, with the financial situation being the most important reason for not paying the electric bill.

In general, transition societies are plagued by corruption. Kosova does not make an exception in this respect. Corruption is analyzed in the EWR reports in terms of customers' opinion about the presence and the extent of the presence of corruption in different public services and utilities.

Table 12. Does corruption exist and to what extent is it present in PTK (percentage of respondents)

	Q2	Q3	Q4
It is not present at all	15.5	9.5	9.6
Present in a small scale	18.4	22.3	21.8
Present in a medium scale	27.4	31.6	31.5
Present in a large scale	38.8	36.6	37.2

Source: EWR #10, EWR #11, EWR #12

The majority of customers, app. 85%, share the opinion that corruption exists in PTK among which almost 40% are convinced that corruption is present in a large scale. Furthermore, the share of customers, who share the opinion that corruption exists in a large scale in PTK, has increased during Q4, while at the same time the share of those believing that corruption is not present has decreased during the same quarter.

Table 13. Does corruption exist and to what extent is it present in KEK (percentage of respondents)

	Q2	Q3	Q4
It is not present at all	8.4	4.6	4.5
Present in a small scale	15	12	10.4
Present in a medium scale	26.1	27.2	24.5
Present in a large scale	50.5	56.3	60.6

Source: EWR #10, EWR #11, EWR #12

Albeit customers have declared that corruption is present both in KEK and PTK, the situation in KEK is perceived to be worse compared to that in PTK. In the case of KEK, the share of customers that are of the opinion that corruption is present makes up 95% of respondents. A difference between PTK and KEK is obvious also with regard to the share of customers declaring that corruption is present in a large scale. This group is bigger and makes up 60% of respondents. Moreover, the share of this group has increased continuously during 2005.

Table 14. What are the sources on which you base your opinion about corruption (percentage of respondents)

	Q4
Personal experience	14.9
Talks with relatives and friends	35
Information through media	48.7
Other	1.4

Source: EWR #10, EWR #11, EWR #12

The main sources of information about corruption are information from the media and talks with relatives and friends. Yet, the share of respondents declaring that their opinions were formed by personal experience is also pretty high: app. 14%.

In general, customers perceive the quality of public services to be poor. In comparison with PTK, the level of dissatisfaction with the performance of KEK is higher. Yet, "Kosova Mosaic 2006" reports a positive trend of customers' satisfaction with public services, both PTK and KEK, in 2006 compared to 2003. The ABC regime implemented by KEK with the aim of inducing customers to pay their electricity bills was considered to be unfair. Customers would like to see KEK consider new ways of inducing customers to pay their electricity bill. Furthermore, the majority of customers conceive corruption to be an issue both at PTK and KEK. The percentage is higher in the case of KEK.

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