

MARKET FOR EXECUTIVES IN UKRAINE: EXECUTIVE DECISION MAKING AND ITS EFFICIENCY

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Executive performance and ownership structure

Transformation of the structure of corporate ownership in Ukraine should be followed with transformation of approaches to decision making at all levels. This concerns executives, who are responsible for the day-to-day management of a company. As Berle and Means noted, to govern companies effectively, executives should avoid conflict of interests and managerial opportunism. This will facilitate reducing agency costs and improve corporate performance. From this perspective, executive nomination and monitoring play the most important role in reaching the above objective. Both these corporate control mechanisms are established by shareholders. Therefore, we suppose that the executive performance depends on the structure of corporate ownership and the type of controlling owner.

Regrettably, since the beginning the process of privatization in 1992 no research has been conducted to answer the question: "Is there a relationship between ownership structure and efficiency of decision making by executives?"

To find the answer at this question, it is very important to research the market for executives in Ukraine.

Literature review

According to our investigation, about 380 thousand executives (members of the executive board) are employed by Ukrainian joint stock companies. *Saul Estrin* and *Adam Rosevear (1999)* concluded that major executives in Ukraine behave in very opportunistic manner and provoke conflicts of interests. The degree of executive monitoring is very low. Major executives were former employees of the company, where they are presently on the executive board. This is a large contribution to an increase of the degree of managerial opportunism.

Estrin (2000) and *Kostyuk (2003)* report, that the most, widespread throughout the world, mechanisms to monitor executives are not developed in Ukraine. Particularly, this concerns such mechanisms as executive compensation, audit committees of the supervisory board, market for corporate control, bankruptcy system. The only mechanism that can be actually efficient in Ukraine to monitor executives is the meeting of shareholders, where executives will have to report to shareholders and become monitored by them. Therefore, ownership structure should play very important role in the executive monitoring.

Research methodology

To answer the above mentioned question in the field of decision making in Ukrainian joint stock companies, we conducted an investigation. Companies, having shares listed in PFTS (OTC market) were taken to research. Total number of companies is 60. The ways of conducting research: observations and questionnaires. Research was started in November 2001 and finished in March 2004.

Questionnaires were sent to members of Supervisory and Management Boards of Ukrainian enterprises, financial analysts, shareholders and stakeholders.

The following hypotheses were developed:

1. Inside executives are still dominating over the outside executives on the executive boards of Ukrainian joint stock companies.
2. Performance of inside executives in deciding agency conflicts is very weak.
3. Employee-shareholders are the least efficient in nominating and electing executives.
4. The degree of accountability and transparency of inside executives is very weak and does not meet requirements of all shareholders, despite their type.
5. All groups of shareholders are sure that outside executives are much better equipped with knowledge how to make decisions effectively than inside executives.

6. Ownership structure is the key factor in creating an efficient system of mechanisms for executive decision-making at Ukrainian joint stock companies.

Results of research

The markets for Heads of Supervisory Board and Management Board are still not developed in Ukraine. Especially, this concerns the secondary market for heads of supervisory and management boards. Outside directors and executives are not still demanded, as it could suppose, taking into account the world trends at the market, where independent outsiders are the key element of the board. The main reason of weak development of the market can be explained by still lasting process of separation of control and ownership.

Moreover, the class of professional, independent heads of supervisory boards is still under development. Should Ukraine follow international standards in the board practices, i.e. at least a half of the directors on the board should be independent, the market for directors in Ukraine would require about 160 thousand persons. It is hardly possible to happen in the nearest future, because only 6 percent of the researched Ukrainian joint stock companies wrote the term "independent director" in their internal statements, i.e. the statement on the supervisory board.

One more reason of weak development of the market for executives (heads of management boards) is very low transparency of the market and lack of well-developed procedures to be applied by the supervisory boards to nominate and elect executives². Heads of supervisory boards who are responsible for recruiting new executives, prefer to choose candidates for a post of the head of management board from those, who work in the company during a long period of time. Doing so, directors try to secure all risks, related to nomination of executives. Probably, under the weak developed secondary market for executives, directors have nothing, but nominating candidates who are insiders.

From this perspective, the secondary market for executives in Ukraine is much similar to the secondary market for executives in Japan. Executives prefer to work in a company as long as possible. The situation, when executives are fired, is considered by them as "a wrack of all hopes". Only personal relationships will allow executives to find a job in a new company. Probably, this provokes managerial entrenchment, when executives are concerned more for "keeping the chair" than for contributing to shareholder wealth.

There is no still a professional rating of executives in Ukraine. There are no companies that would evaluate the degree of professionalism of executives. Therefore, if directors want to nominate somebody from outside of the company, they will have to nominate their friends or ask their friends and colleagues for appropriate candidates. This approach is a threat to independence of directors, who become tied by friendly or even relative relationships with executives.

² In Ukraine there are almost no nominating committees on the boards in contrast to the USA board practice. A question: "Who is responsible for nominating new directors?" is still not answered in Ukraine, although countries with the best corporate governance practices have already answered and named a Chairman of the Supervisory Board to be responsible for selecting candidates to be nominated to the board. That is way the procedure of nominating new directors in Ukraine is very simple and little chaotic at the same time. Shareholders are provided an opportunity to nominate directors by themselves. But to do this, shareholders must own quite sufficient stake in the company. Every shareholder who owns shares of the company at the volume above 2 percent of shareholders equity can propose his own candidate on the supervisory board. Moreover, directors can be nominated by the supervisory and the management boards independently. The procedure of nomination requires a meeting of the board where candidates are proposed. The companies with dispersed ownership structure have a practice of nominating directors by governing corporate bodies - the supervisory and the management boards, or the audit commission. It is really hard to accumulate 2 percent of shares at Ukrainian companies under conditions of weak activity of individual, minority shareholders to nominate a director. All candidates on the board in any way must be shareholders and can not be simultaneously nominated on the management board or on the audit commission which is independent body of corporate governance.

Table 7.1. Profiles of the Heads of Supervisory and Management Boards of Ukrainian joint stock companies

Features	Heads of Supervisory Boards	Heads of Management Boards
Average age, years	51	44
Experience of executing certain duties (as a Head of Supervisory Board or head of Management Board) in other companies, years	3	10
Experience of work in the company on various posts, years	-	20
Share of Heads of the Boards who worked in the company before their appointment, %	18	90

With reference to *table 7.1* it should conclude that heads of supervisory boards in Ukraine are not experienced enough (a three year experience is the most popular) to direct the companies. Executives are much more experienced. Executives experienced a ten year work on the management boards.

It is worth of mentioning that the share of heads of the management boards who worked in the company before their appointment, increased from 86 percent in 2001 to 90 percent in 2003. This is an evidence of the lack of improvement in development of the secondary market for executives in Ukraine. The market for directors in Ukraine has the same negative trends. Thus, the share of heads of the supervisory boards, who worked in the company before their appointment increased from 6 percent in 2001 to 18 percent in 2003. This is a very negative trend, evidences that the degree of independence of directors reduces from year to year.

Besides this, heads and members of the supervisory boards in Ukraine, as a rule, experienced a work on the management board of the same company. All this contributes to an increase in the degree of entrenchment of directors and interdependence of members of the management and supervisory boards.

Results of research evidence that decisions made by heads of supervisory boards concerning recruiting executives are made in uncertainty³. To reduce uncertainty, Ukrainian companies prefer to elect directors from insiders, i.e. strongly dependent, who will further elect executives from insiders too. Under such circumstances, it is hardly possible to hope for development of the control role of directors. All these create a fruitful soil for the managerial entrenchment growth and decrease in the degree of director independence.

According to *table 7.2* it must be concluded that inside executives become more demanded in Ukraine. That is the proof of the first hypothesis, i.e. *inside executives are still dominating over the outside executives on the management boards of Ukrainian joint stock companies*. Especially, this concerns the companies where the majority of shareholders are represented by employees⁴. In contrast to shareholders-employees, foreign institutional shareholders are the most loyal to services of outside executives.

In a whole, the share of Ukrainian joint stock companies, headed by "intracorporate" executives, increased during 2001-2003 from 74 to 76 percent. The following contains a very interesting comparison.

³ Surprisingly, the management board is a step ahead of the supervisory board in successful nomination of directors. Thus, 31 percent of elected directors were nominated by the management board. Only 25 percent of directors were nominated by the supervisory board. Moreover, exactly executive board has a direct impact on the process of nomination of candidates to the supervisory board. Everybody, who is allowed to nominate candidates, should deliver an application form to executive board that is responsible for processing all these proposals and make it ready for voting at General Shareholder Meeting. Certainly, executives receive information about nominated candidates at the earliest stage and, if the candidate is not loyal to executives, have enough time to try to do something to avoid electing these candidates.

⁴ Employees became shareholders as a result of the first stage of privatization, that started in 1992 and was over by 1995. At this stage, privatization in Ukraine was very liberal. By a liberal feature of privatization is meant, that those companies, which wanted to be privatized, were privatized. Only employees could take part in privatization. No foreign institutional shareholders, both national and foreign, no outside individual investors were allowed to participate in privatization. So, the first stage was given to the will and intentions of Ukrainian companies, i.e. employees and management.

Frankly said, the State wanted employees of Ukrainian companies to take a decision whether to privatize their companies or not. The State property fund reported that about 39 percent of Ukrainian open joint stock companies (5.800 companies) were privatized by employees. Regrettably, lack of effective audit firms, capable to estimate companies' values (par value, book and market values) sufficiently distorted actual "investment" value of companies and many of them have been bought buy employees and management by very low expenses.

The share of companies where shareholders are not satisfied with qualification of "intracorporate" executives increased over the same period of time too (from 54 to 58 percent). The share of companies where shareholders are not satisfied with qualification of outside executives decreased over 2001-2003 (from 42 to 37 percent). So, the comparative performance of outside directors is higher than inside executives, but shareholders prefer to elect inside executives.

Table 7.2. *Dependence of structure of ownership and origin of executives*

	Majority of shareholders are represented by			
	Employees	Ukrainian financial-industrial groups	Foreign institutional investors	Ukrainian banks and investment companies
Share of companies headed by "intracorporate" executives, per cent	96	83	54	72
Share of companies where shareholders are not satisfied with qualification of "intracorporate" executive, per cent	70	56	38	49
Share of companies where shareholders are not satisfied with qualification of outside executives, per cent	52	34	15	41

Existing only "intracorporate" market for executives in Ukraine is a strong contributor to hampering a professional development of inside executives as soon as they climb up by corporate ladder at the top. Inside executives are inclined to entrench after they become Heads of Management Boards. About 72 per cent of responding shareholders were sure that inside executives ignore interests of shareholders and provoke a conflict of interests.

Very often professional qualification of inside executives does not meet requirements of shareholders. Thus, about 61 per cent of respondents representing shareholders, answered that they were not satisfied with the degree of qualification of inside executives. Therefore, the second hypothesis, i.e. *performance of insider executives in deciding agency conflicts is very weak*, is vital.

It should be noted that foreign institutional investors are the most efficient group of shareholders of Ukrainian joint stock companies in making a decision about recruiting executives. By the way, foreign institutional investors are efficient in recruiting both inside and outside executives.

With reference to *table 7.2*, the most inefficient decisions concerning recruiting executives are taken in the companies under control of employees⁴. This proves the third hypothesis, i.e. *employee-shareholders are the least efficient in nominating and electing executives*. Probably, the degree of knowledge of employee-shareholders of Ukrainian companies on strategic decision making, i.e. nominating and electing executives is very low. Employee-shareholders prefer to elect members of the executive board of those candidates, who work in the company at the various positions for a long time. This explains why the degree of executive monitoring is very weak when the company is controlled by employee-shareholders.

⁴ The latest trends in development of market for corporate control evidence that the State as a shareholder, leaves corporate ownership structure. This is very progressive element of development of market for corporate control in Ukraine. At the same time employees leave corporate ownership structure too. It is possible to suppose, that this is positive feature of development of market for corporate control too, taking into account that employees are not efficient in corporate governance. This supposition could be taken for conclusion, but for ways, which are used by management to force employees sell their shares. For example, if management of the company want to obtain a corporate control through buying shares, they force employees sell their shares to them. If employees refuse this "offer", they will be fired. Employees got used to store their jobs but not their ownership. Moreover, during 2001-2003, management of Ukrainian companies started to use one more mechanism to grasp corporate control – proxies voting. It is not difficult for management to force employees give proxies to management. We have accounted more than 60 cases how such mechanism works. As a rule, executives come to the General Meeting of the works council, that happens before the Annual shareholder meeting, and order employees, who are shareholders, to give proxies to management. Doing in such way, executives obtain corporate control with no costs. This is a management dictate.

According to the results of conducted research, the worst performance is shown by inside executives in the field of corporate communication policy and investor relations. The results obtained are a surprise. Inside executives, weakly equipped with required knowledge on corporate governance and pursuing their own interests through setting high compensations, have nothing but provoking and supporting asymmetry of information in relations with general public and investors including shareholders. Therefore, the fourth hypothesis, i.e. *the degree of accountability and transparency of insider executives is very weak and does not meet requirements of all shareholders, despite their type.*

Inside executives are inclined to provoke conflicts with middle-level managers who are their subordinates. They are not efficient in solving the conflicts provoked by them (see *table 7.3*).

Inside executives are inclined rather to fire middle-level managers than solve the problem through mutual discussion and decision making. So, inside executives of Ukrainian joint stock companies are mainly authoritarians.

Table 7.3. *Efficiency of "Intracorporate" executives in solving conflicts with their subordinates*

Please, assess the degree of efficiency of executives in solving conflicts with their subordinates at the company you control	Companies under control of (structure of responds in per cent)			
	Employees	Ukrainian financial-industrial groups	Foreign institutional investors	Ukrainian banks and investment companies
Strongly efficient	10	16	21	15
Efficient	21	21	33	27
Weakly efficient	60	49	40	46
Not sure	9	14	6	12
Total	100	100	100	100

Efficiency of outside executives in solving conflicts with subordinates is much higher than that performed by inside executives (see *table 7.4*). Probably outside executives perform well in solving conflicts because they are free of entrenchment. Coming at the company outside executives try to use as much their skills as possible to make appropriate decisions in transparent manner. Transparency of decision making during solving conflicts with subordinates lets outside executives create a positive image within a company.

Table 7.4. *Efficiency of outside executives in solving conflicts with their subordinates*

Please, assess the degree of efficiency of Executives in solving conflicts with their subordinates at the company you control	Companies under control of (structure of responds in per cent)			
	Employees	Ukrainian financial-industrial groups	Foreign institutional investors	Ukrainian banks and investment companies
Strongly efficient	19	31	46	35
Efficient	34	30	38	24
Weakly efficient	36	32	12	28
Not sure	11	7	4	13
Total	100	100	100	100

Therefore, the fifth hypothesis, i.e. *all groups of shareholders are sure that outside executives are much better equipped with knowledge how to make decisions effectively than inside executives*, is approved. For the first time it is a paradox when shareholders are sure that outside executives are much more efficient in decision making than inside executives but at the same time, the number of inside executives is much higher than the number of outside executives.

According to *table 7.5* the paradox can be explained by the nature of shareholders controlling a company. Thus, the higher level of knowledge on corporate governance of shareholders the higher number of outside executives in the company. The most qualified shareholders of Ukrainian joint stock companies are foreign institutional investors. The least qualified owners of Ukrainian companies are employees.

Table 7.5. *Ownership structure and origin of executives*

	Majority of shareholders is represented by			
	Employees	Ukrainian financial-industrial	Foreign institutional	Ukrainian banks and investment

		groups	investors	companies
2001				
Share of companies headed by "intracorporate" executives, per cent	96	84	79	89
2002				
Share of companies headed by "intracorporate" executives, per cent	98	81	52	76
2003				
Share of companies headed by "intracorporate" executives, per cent	96	83	54	72

So, the sixth hypothesis, i.e. *ownership structure is the key factor in creating an efficient system of mechanisms for executive decision-making at Ukrainian joint stock companies*, is approved.

The critical factor in composing the executive board

Under asymmetry of information and low level of knowledge of shareholders in the Ukraine, an ownership structure is one of the most important factors influencing efficiency of decision making by executives. Bounded rationality and managerial opportunism contribute to worsening the problem of developing the system of mechanisms for efficient decision making. Under such circumstances outside executives are more efficient than insiders in decision making. Outside executives are not characterized by bounded rationality and managerial opportunism.

From this perspective, an ownership structure plays an important role in hiring the outside executives. We concluded that the higher level of knowledge on corporate governance of shareholders the higher number of outside executives in the company. The most qualified shareholders of Ukrainian joint stock companies are foreign institutional investors. The least qualified owners of Ukrainian companies are employees.

At the same time, all groups of shareholders are sure that outside executives are much better equipped than inside executives with knowledge how to make decisions effectively. All shareholders, despite their type are sure that the degree of accountability and transparency of insider executives is very weak and does not meet requirements of all shareholders. Obviously, the critical factor in composing the executive board of outside members is ability of shareholder to behave in the way of looking for outside executives, nominating outside executives, electing outside executives and evaluating performance of outside executives. At this time, foreign institutional shareholders behave the most effectively in the manner above.

