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THE IMPORTANCE OF STRENGTHENING THE ROLE OF THE BOARDS OF DIRECTORS IN STATE-OWNED ENTERPRISES IN SERBIA*

Značaj jačanja uloge borodova direktora
u državnim preduzećima u Srbiji

Abstract

As in many other countries, state-owned companies in Serbia are generally characterized by poor performances, non-transparent operations, corruption scandals and lack of accountability. Since the state sector has a high share in the overall Serbian economy, it seriously undermines the competitiveness of the whole economy. Some research has shown that by enhancing corporate governance of these enterprises comparable results can be achieved as in the case of their privatization. Recently Board of Directors has become the only potentially active mechanism of corporate governance in Serbian state-owned companies, so this study was focused on making recommendations for strengthening the role of the Board of Directors. We gave two sets of recommendations: recommendations for the setting up of effective Boards of Directors and recommendations for improving the efficiency of such boards. Prior to that, we briefly analyzed the current situation of corporate governance legislation and practice in Serbian state-owned enterprises.

Key words: *state-owned enterprises, corporate governance, Board of Directors, competitiveness, company performances*

Sažetak

Kao što je slučaj u mnogim zemljama, državna preduzeća u Srbiji odlikuju loše performanse, netransparentno poslovanje, korupcijski skandali i nedostatak odgovornosti. S obzirom da ima visoko učešće u celokupnoj spskoj ekonomiji, državni sektor značajno podrija konkurentnost celokupne privrede. Neka istraživanja pokazuju da se unapređenjem korporativnog upravljanja ovih preduzeća mogu postići rezultati koji su uporedivi sa rezultatima koji se mogu ostvariti njihovom privatizacijom. Bordovi direktora, od nedavno, predstavljaju jedini aktivni mehanizam korporativnog upravljanja u državnim preduzećima u Srbiji, usled čega je ova studija fokusirana na davanje preporuka za jačanje uloge Bordova direktora. Dali smo dva seta preporuka: preporuke za uspostavljanje efikasnog borda direktora i preporuke za unapređenje efikasnosti bordova direktora. Pre toga, detaljno je analizirana tekuća regulativa i praksa korporativnog upravljanja u državnim preduzećima u Srbiji.

Ključne reči: *državna preduzeća, korporativno upravljanje, Bord direktora, konkurentnost, performanse preduzeća*

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Introduction

State-Owned Enterprises (SOEs)¹ in many countries are dominant in utilities and infrastructure industries whose performance is of great importance to population and to all industries within the country. Almost the whole sector of public utility companies in Serbia has remained in state ownership, including the most important companies in the field of energy, transport, telecommunications, etc.

The study of Serbian SOEs in the context of improving competitiveness is important for at least two global reasons: the size of the sector in the overall national economy and the extent of problems that these companies face. In reference to the first, although there are no reliable data, in Serbia there are 715 state and local public enterprises², with a workforce of about 150,000 employees, which accounts for 8.5% of total employment in Serbia. Some analyses also show that SOEs participate in the total income of the Serbian economy with more than 14 percent. Problems that these companies face are numerous and some of them are: low profitability and losses (current and cumulative), high debt (state is acting as guarantor for a large portion of these loans), surplus employees, etc. Despite these facts many of Serbian SOEs provide rather high wages relative to average wages in the country - in 2010 up to 38.4% higher than the average in Serbia (43.8% in 2009).³ Cumulative losses of SOEs constitute 18,5% of the total losses in economy and 71% of SOEs yearly revenues. The biggest losers "EPS" and "Železnice" partake in 80% of the accumulated losses of SOEs (42.9% and 37.1%).⁴ Taxpayers in Serbia "were punished" for SOEs in another way, too: according to the government's report on state aid (adopted in November 2008) in the period 2003 to 2006, the state spent around 2.5 billion EUR, while very little is known of how this assistance was to be meaningful, and where exactly has it been awarded. State aid ranges from 2.5 to 4% of GDP, while in the European Union up to 1.5% of

GDP is considered normal⁵. Finally, the media frequently bring some new information related to the corruption scandals, loss of property, and employment for political, friendly and relative lines in SOEs, etc.

The causes of problems of Serbian SOEs are numerous and multifaceted, but certainly one of the most important causes is the fact that they lacked adequate corporate governance. Literature and practice of corporate governance has revealed several important mechanisms of corporate governance, but almost none of these mechanisms are active and effective when it comes to Serbian SOEs. This observation applies in full when it comes to the *market for corporate control* and *bankruptcy procedures*, since the domestic SOEs are completely protected from these important mechanisms that prevent the destruction of value and discipline of inefficient and wasteful oriented managers. Our opinion is not much different in relation to other important mechanisms of corporate governance: the possibilities of disciplining SOEs managers through penalties provided by *compensation systems* that link performance and wages and risk to be removed by either *internal* or *external managerial labour market* are minimal. Absurdly, even the Board of Directors has no power to dismiss inefficient managers. So, practically the only existing mechanism of corporate governance does not function properly.

The Board of Directors stands at the heart of many systems and structures encompassing the whole of corporate governance. The European Commission stresses that Boards of Directors have a vital part to play in the development of responsible companies (EC, 2011). On this track Fama (1980) argues that Board of Directors is the central internal control mechanism for monitoring managers. Empowering and improving the quality of board is particularly important if other mechanisms of corporate governance do not work or work poorly, as is the case with the Serbian SOEs. Therefore, this article is dedicated to strengthening the role of the Board of Directors as a thoroughly fundamental step in improving corporate governance of SOEs. Good governance of SOEs is crucial in order to ensure their positive contribution to efficiency and competitiveness of the country. Also,

1 Term "SOEs" refers to enterprises where the state has significant control, through full, majority, or significant minority ownership.

2 National Bank of Serbia (2011).

3 According to Current Economic Trends 7-8 (Ministry of Finance) companies "Transnafta", "JAT" and "Srbijavode" have wages 2.6, 2.5 and 1.9 times larger than average wages, respectively.

4 Ibid.

5 NALED, web site.

corporate governance has direct impact on privatization effects because it makes the enterprises much more or less attractive to prospective investors.

Specific features of corporate governance of SOEs

Unlike the companies in the private sector, the SOEs are not usually primarily focused on profit and are not the means for creating wealth for investors. SOEs, particularly those that operate in areas of strategic importance, generally have social objective - providing services under the market prices to make them available to all citizens and development objective - encouraging the development of certain regions or industries. Multiple objectives arise either because they are determined by legislation or because a number of ministries are in a position to influence SOEs functioning. It is obvious that these political objectives may be in some conflict with the “business paradigm”.

SOEs also face some specific governance challenges different from the companies in private sector. A dilution of accountability is one of them because of the fact that the accountability for the performance of SOEs involves a long chain of agents, such as management, Board of Directors, ministries, the government, etc. These authorities may use SOEs to achieve their short-term political goals at the cost of both efficiency and longer-term objectives.

The main differences in corporate governance between private and public enterprises are given in the following table.

Much of literature about corporate governance is based on the Agency theory view. However, as can be seen in the previous table, one of the important specifics of SOEs is a *double agency relationship* - one between the citizens (principal) and the government (agent), and another between the government (principal) and the managers of SOEs (agent) (see Figure 1).

Figure 1: SOE double agency relationships

Partially adapted from Talosaga, Heatley, Howell (2011)

Table 1: Differences in governance between private and public sector enterprises

	Private companies	SOEs
<i>Objectives</i>	<ul style="list-style-type: none"> • Clear focus on profit or value maximization 	<ul style="list-style-type: none"> • Pursue commercial and non-commercial objectives • Objectives influenced by national politics • Boundaries vague
<i>Agency issues</i>	<ul style="list-style-type: none"> • Single agency: concerned about self-interested behaviour of managers 	<ul style="list-style-type: none"> • Double agency: concerned about self-interested behaviour of managers and politicians/ bureaucrats
<i>Compensation</i>	<ul style="list-style-type: none"> • Strong work motivations driven by job security and opportunity for financial rewards • Easy to remove or reassign employees 	<ul style="list-style-type: none"> • Standardized pay and limited opportunities for extra rewards for effort • Difficult to provide feedback on performance • Difficult to remove or reassign employees
<i>Transparency</i>	<ul style="list-style-type: none"> • High level of disclosure (for listed companies) 	<ul style="list-style-type: none"> • Low level of disclosure

Adapted from Wong, S. C. Y. (2004) and Rondinelli (2008)

Citizens have no direct interaction with SOE managers in the capacity of owners. Since citizens are not able to significantly exercise the ownership interests of shareholders, most control mechanisms have been delegated to the ministers. Agency relationship between citizens and ministers is much weaker than second agency relationship. Citizens have slight direct control of ministers' activities and lack strong incentives to analyse and monitor their performance. The only way that citizens can influence an SOE is indirectly by voting for a different government (Talosaga, Heatley, Howell, 2011).

As previously mentioned, SOEs are often protected from two major threats that are essential for the control over the management in private companies, such as takeover and bankruptcy; an SOE generally cannot have its Board of Directors changed via a takeover or proxy contest, and most cannot go bankrupt. The absence of potential takeovers and proxy contests reduces the incentives of board members and managers to maximize the value of the company, and the lack of bankruptcy can introduce a *soft budget constraint*, which reduces pressure to contain costs (World Bank, 2006, p.4). These constraints are "soft" because another institution will pay the shortfall for mismanagement of the SOE, that is, state is more likely to bail out a mismanaged SOE. Managers of the SOE do not fear the negative consequences of bad mistakes and, moreover, expect this sort of external financial assistance as something completely normal.

In many countries managers in even SOEs with enormous losses are less likely to be fired by the Board of Directors, because the board is simply not assigned with the legitimacy or formal power to do so. Moreover, Boards of Directors frequently are not provided with any role in the selection of CEO and senior management and may also encounter difficulties in monitoring management. Finally, in many instances SOE boards are not granted full responsibility and the authority necessary for strategic guidance and control over disclosure. If there is a strong link between the management and Ministry or government, management will tend to report to the government directly and thereby avoid the board. SOE Boards of Directors may see their roles and responsibilities encroached from two ends; by the government and by the management. In

developing countries SOEs are characterized by frequent political interference from the government. The ministries and government may be tempted to become too involved in strategic issues, although it is their responsibility to define the overall objectives of the company, particularly since the difference between defining objectives and setting strategies can be rather unclear (OECD, 2005).

Whereas the government, as the shareholder of SOEs, has a legitimate right to influence SOEs, the scope and extent of influence in practice has been excessive and calls for some limitations. Namely, appropriate roles for the government include setting objectives and performance targets, appointing directors, monitoring the performance of the enterprise and its Board of Directors. Aside from these intervention rights – which need to be clearly spelled out and publicly disclosed – the remaining authority should sit with a professional Board of Directors and management (Vagliasindi, 2008).

Board members may feel to have a reduced liability, particularly those nominated by the government. Protecting the interests of ministers is an implicit task of SOE Boards of Directors that is often in collision with efficiency requirements. Even where targets of performance were set, inadequate explanations for shortfalls in performance are not questioned.

Unlike private companies where formal procedural rules for Board of Directors member selection and evaluation process are generally well developed, in SOEs little attention has been paid to these important areas of corporate governance. Too often, SOE boards are populated with people chosen for their political allegiance rather than business acumen Vagliasindi (2008).

Curent regulation of SOEs Boards of Directors in Serbia

Governance of Serbian SOEs is regulated by Law on Public Enterprises and Performing Activities of General Interest (Official Gazette RS, 25/00, 25/02, 107/05, 108/05). Serbian model of SOEs Board of Directors is two-tier, but comparing it with EU countries company laws are somehow specific. The main advantage of two-tier Board of Directors model mentioned in the literature is increased independence and

better monitoring of management. However, in Serbia there is no increased more independence as members of Board of Directors as well as of Supervisory board are appointed by the state (e.g. the republic, city, or municipality). Additional overseeing is also questionable since according to Serbian law Supervisory board is not entitled to nominate and revoke Board of Directors as in almost all EU countries' company laws. Thus, that body does not justify its existence, while an increasing the number of qualified people need to carry out corporate governance. In our circumstances this can be an issue because building competent and well-functioning SOE boards is more difficult in emerging markets, not least because there are fewer qualified individuals available to serve as directors (Coombes, Wong, 2004). According to our insight, the number of members of the Serbian SOEs boards range from 8 to 11, while the Supervisory boards consist of 3 to 5 members. So the total number of people in both tiers is 11-15. The literature shows that smaller Boards of Directors are more effective than large boards and are accompanied by high firm value (Jensen, 1993, Bennedsen et al. 2008).

Structure of the Board of Directors is not prescribed by Law; it is left to be determined by the corporate statutes. The number of employees' representatives in Board of Directors is not regulated by law.⁶ Employees may also be appointed in the Supervisory board. Law does not require inclusion of independent directors on the board. It is well documented that independent directors monitor management more in shareholder interests than to the inside directors (Fama 1980, Jensen, 1993). More recently, Dahya et al. (2008) find a positive relationship between Board of Directors independence and operating performance.

The Law does not require possession of any specific knowledge, skills or different expertise for members of the Board of Directors, as for state representatives and for employees' representatives. Also, the process of nomination and election is not regulated. The OECD SIGMA Assessment for Serbia disclosed that the appointment of directors and members of the management board of the most significant public enterprises often reaches the spotlight of public

controversy. Tensions usually rise between political parties as they struggle to ensure that their "people" are appointed, since public enterprise top management is not appointed in public competition procedures, but according to political party interests (OECD, 2011, p.27).

Neither Board of Directors nor Supervisory board of Serbian SOEs have power to hire, fire and set the compensations of the executive director or staff head and other key employees. CEO is appointed and dismissed by the state. In domestic SOEs, Boards of Directors are not entrusted with the full range of board responsibilities and can therefore be overruled by senior management and ownership by the entities themselves. In such circumstances it sometimes seems that the CEO controls the Board of Directors rather than the other way round. The power to hire and fire the CEO and determine the terms of his or her employment should reside with the board. This is one of the board's most important functions and key to effectiveness for private companies. Empirical study of Canadian government enterprises where the chief executive was appointed by the government shows that many CEOs did not feel accountable to the Board of Directors (Vagliasindi, 2008).

Recommendations for setting effective SOEs Board of Directors

Improving the governance of SOEs requires more effective and powerful Boards of Directors. It is important that SOEs have strong Boards of Directors that can act in the interest of the company and effectively monitor management without excessive political interference. In order to achieve that, it will be necessary to ensure the competency of SOE boards, enhance their independence and improve the way they function. Board empowerment must be facilitated by the government. Our policy recommendations emerge from the review of the literature and are mainly based on OECD Guidelines on Corporate Governance of Government-Owned Enterprises (OECD, 2005).

The Government must regulate the following issues related to SOEs Boards of Directors' setting: 1) clarifying the role and responsibility of Board of Directors, including fiduciary responsibilities and monitoring of CEO and

⁶ In practice this number is usually 3, except, for example "Vojvodinašume" where Board of Directors has 5 employees' representatives.

senior management, 2) determining the structure and necessary competencies of board members by law, 3) strengthening the process of selection and appointment of board, through transparent, structured and skill based nomination process, 4) undertaking board training, 5) evaluating board performances, 6) setting compensations.

First, the Boards of Directors of SOEs should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management (OECD, 2005). An independent director in a SOEs board should not only be independent of the executive management, but also independent of the government and the political parties. SOE Boards of Directors should not react to policy requirements until they are officially approved by the Parliament or particular procedures. The government should respect independence of SOE boards and allow them to exercise their duty of care. An independence of board members means that they should not be guided by political or some other concerns when exercising their duties. Board of Directors must be professional, not political.

The Boards of Directors of SOEs should be assigned a clear tenure and ultimate responsibility for the company's performance. The responsibilities of SOE boards should be articulated in relevant legislation, regulations, the government ownership policy and the company charters. The collective and individual liability of board members should be clearly declared.

Many times directors are removed before completion of their terms without any form of explanation. In order to avoid frequent changes in boards correlated with changes of government and to provide their stability it is recommended to define the minimum tenure of directors, for example at 3 years.

Second, we recommend one-tier model of Board of Directors with several specialized committees. Board structure and number of board committees should be mandated by law. Since experience indicates that smaller Boards of Directors are effective we suggest limiting the number of board members from 7 to 9. The state should reduce the number of political appointments on SOE boards and increase the number of directors who have previous business experience that would be useful in

running a company (Sokol, 2009). Composition of Board of Directors should be as follows: a) at least one-third of the directors should be non-executive directors appointed through open competitive process, b) at least one-third of the directors should be elected from SOEs employees, 3) remaining directors on the board would be selected by the government.

SOE boards have to set up specialised committees, particularly in areas of audit, risk management, compensation and public procurement. To achieve the enhancement of the Board of Directors skills, information and independence, the committees should be composed of one board member and two experts from among the employees. Specialised board committees should have written terms of reference that define their duties. They should report to the full board and the minutes of their meetings should be circulated to all board members. Audit committee and Board of Directors should take responsibilities that had previously belonged to Supervisory board.

Third, establishing the transparent and structured nomination process with clearly defined criteria, such as competency, is the best way to minimize political interference, increase Board of Director's independence and professionalism. Moreover, setting up structured nomination processes allows government to perform this selection task even with limited administrative capacity. The process of nomination and selections of board members should be prescribed by the law. It should be clear that they should not act as individual representatives of the constituencies that appointed them; their duty is to act in the best interests of the company as a whole. A central requirement to enhance the objectivity of SOE boards is to nominate a sufficient number of competent non-executive board members who are capable of independent judgment. Board of Directors should have the relevant mix of competencies and experience aligned with the company's activity and long term strategy. Their expertise could also include qualifications related to the SOE's specific objectives.

Disqualification conditions and situations of conflict of interest should be carefully appraised and guidance provided about how to handle and resolve them. In particular, this implies that government representatives should neither

take part in regulatory decisions concerning the same SOE nor have any specific obligations or restrictions that would prevent them from acting in the company's interest (Dewan, 2006, p.194). All potential conflicts of interests concerning any member of the Board of Directors should be reported to the board, which is in charge of managing these issues and disclosing this information.

As regards to non-executive directors selected through public vacancy announcement quality of the search process could be enhanced if nomination committee uses services of professional employment agencies. These practices would help in enlarging the pool of qualified candidates for SOE boards, particularly in terms of private sector expertise and international experience.

Employees' representatives in the Board of Directors and the committees would be elected in accordance with a structured process of nominations that would be prescribed by the SOE statute. Members of the senior management team cannot be appointed to the board or to specialized committees.

Related to nomination of state representatives, nomination committees can be set up outside the Board of Directors structure, helping to focus the search for good candidates and in structuring further the nomination process. Nomination committee should include representatives of ministries concerned with particular SOE business. It could also be useful if government maintain a database of qualified candidates. Good example is Poland Ministry of State Treasury that has database which includes 35,000 names for 5,000 positions as of 2005 (Vagliasindi, 2008). When the process has been completed, nominations are to be disclosed publicly.

Fourth, training should be organized in order to inform SOE board members of their responsibilities and liabilities. Such induction training enhances board of Directors professionalism. It could include the following areas: board procedures, board responsibilities and relationship with the government and Ministries concerned. If necessary, subsequent trainings should also include lectures on corporate finance, management, business plans, accounting, restructuring, marketing, state aid for enterprises, etc.

Fifth, special government unit in charge for SOEs monitoring must actively oversee Boards of Directors on an on-going basis. Procedures and mechanisms to evaluate and maintain the effectiveness of board performance and independence should be developed. The appraisal of Board of Directors performance is crucial for demonstrating accountability and creating public trust. It is necessary to observe the involvement of the individual board member in order to provide members with the opportunity of improving their own effectiveness. Assessment must also include examination of board as a whole, its processes and performances.

Sixth, the government should ensure that compensation schemes for board members promote the long term interest of the SOE and attract and stimulate qualified professionals. There is a strong trend of bringing the remuneration of board members of SOEs closer to private sector practices. Compensation plans should contain penalties for directors that breach their fiduciary duties.

Recommendations for improving the efficiency of the Board of Directors

Professional, responsible, competitive and trained Board of Directors can initiate major changes in the SOEs operations. Empirical results reported in Aivazian, Ge, Qiu (2005) point out that, even without privatization, corporate governance reform is potentially an effective way of improving the performance of SOEs; such reforms represent a policy alternative for countries seeking to improve SOE performance short of privatization. Furthermore, Omran (2004) indicates that privatization is not necessarily a good way to improve SOEs operations because privatized Egyptian SOEs do not exhibit significant improvement in their performance relative to non-privatized ones.

In order to carry out their role, SOE Boards of Directors should actively: 1) formulate, monitor and review corporate strategy, within the framework of the overall corporate objectives, 2) establish appropriate performance measurement system, assess and follow management performances, and develop effective compensation plan for senior management tied to performances, 3) monitor

the disclosure and communication processes, 4) establish practice of self-evaluation. It is, however, crucial that, 5) the Board of Directors ensures the practice of internal auditing and 6) a proper overseeing of the risk management processes.

First, it is not simple to find a right measure of government involvement in management of SOEs. It is certain that the government should not be involved in the day-to-day management. The government could provide strategic guidelines and a course of action, and it should be formally determined and publicly disclosed in which areas and types of decisions the government is competent to give instructions. Managerial and business autonomy to SOEs should not be viewed as autonomy to the CEO of the SOEs. It implies autonomy of the Board of Directors in taking decisions and ultimate accountability for managing SOEs efficiently and effectively to achieve objectives as mandated by the government, which rests with its Board of Directors.

Second, the key function of SOE Boards of Directors should be the appointment and dismissal of CEOs.⁷ It is difficult for SOE boards to completely exercise their monitoring function and feel responsible for SOEs' performance without this authority. Rules and procedures for nominating and appointing the CEO should be transparent and appointments should be based on professional criteria. SOE Boards of Directors should carry out their functions of monitoring management and strategic guidance, subject to the objectives set by the government. It follows from their obligation to assess and follow management performance that the SOE boards should also have a decisive influence over the compensation of the CEO. To this end SOEs board must establish appropriate performance measurement system. They should ensure that the CEO's compensation is tied to performance and properly disclosed.

The government should suspend the practice of periodical review of the performance of SOEs because it is a waste of government resources as it duplicates an activity that is the responsibility of the Board of Directors. CEO could not directly interact with the government through this

process, above the board. Consequently, this cruelly restrains the independence and authority of the Board of Directors to control and monitor the management and dilutes the accountability of the board.

Third, SOEs should be particularly careful and must improve transparency by disclosing financial and non-financial information. This implies that members of SOE Board of Directors are responsible that financial statements appropriately and fairly present the operations and financial condition of the SOE in all material aspects. With regards to compensation of board members and senior management, it is viewed as good practice to carry this out on an individual basis. To underline the board's responsibilities, a Directors' Report should be provided along with the financial statements and submitted to the external auditors. The Directors' Report should contain information and comments on the organisation, financial performance, material risk factors, significant events, and relations with stakeholders.

Fourth SOE Boards of Directors should perform an annual self-evaluation to assess their performance. A systematic evaluation process is a necessary tool in enhancing SOE board professionalism, because it emphasizes the responsibilities and duties of the board and its members. It is also helpful in identifying required competencies and board member profiles. Finally, it is a useful incentive for individual board members to devote sufficient time and effort to their duties as board members. The evaluation should examine both, the overall Board of Directors performance and the effectiveness and contribution of individual board members. The evaluations could also be instrumental in developing effective and appropriate induction and training programmes for new and existing SOE board members.

Fifth, large SOEs should develop efficient internal audit procedures and establish an internal audit function that is monitored by the Board of Directors and the audit committee. To enhance their independence and authority, the internal auditors should work on behalf of and report not to management but directly to the Board of Directors and its audit committee. Their reporting is vital for the board's ability to evaluate actual company operations

⁷ In some cases, this might be done in concurrence or consultation with the government.

and performances. Consultation between external and internal auditors should be encouraged. Finally, it is also recommended as good practice that an internal control report is included in the annual reports, describing the internal control structure and procedures for financial reporting.

Sixth, the Board of Directors and the government must bear in mind that elimination of risk is not the objective of risk management. The result of successful risk management does not imply absence of risk, but understanding the risk factors and their control, as well as adequate and comprehensive communication of all relevant information on risks to the senior management and Board of Directors. Effective implementation of risk management approach involves consideration of an organization as a whole, and not focusing just on lower organizational units such as business units, product lines and the like. Prior compliance to the strategy with the defined risk appetite and the existing organizational and information infrastructure for risk management is an important prerequisite for successful risk management. In terms of corporate governance bodies which should handle risk, it has long been thought that the Audit Committee should focus on internal control and that monitoring risk management process should be transferred to a new body - the Risk management committee comprising of non-executive independent directors exclusively, who possess the sophisticated knowledge and the necessary business experience in this field.

Finally, the Board of Directors of SOEs should also develop, implement and communicate compliance to programs for *internal codes of ethics*. These codes of ethics should apply to the company and its subsidiaries. This is in the long term interest of any company as a means to make it credible and trustworthy in its day-to-day operations and with respect to its longer term commitments. In the case of SOEs, there may be more pressures to deviate from high ethical standards given the interaction of business considerations with political and public policy ones. The code should contain guidance on procurement processes, specific mechanisms for protecting and encouraging stakeholders, particularly employees, to report on illegal

or unethical conduct by SOE managers. These codes of ethics should also indicate how confidential information passed on to the government from these board members should be handled. SOE Boards of Directors could grant employees or their representatives a confidential direct access to someone independent on the board, or to an ombudsman within the company (OECD, 2005).

Conclusion

Although state ownership of enterprises has declined in recent decades, SOEs and similar entities continue to account for a significant part of the economy in many countries including Serbia. Improving the governance of SOEs can bring many advantages for the SOEs as well as for entire economy. Better corporate governance can enhance productivity and contribute to the government's financial position, allow greater reinvestment and improve overall economic performance both directly and by reallocating resources within the government sector and across the economy as a whole. Also, better corporate governance in the government sector can create a model for and increase pressure on the private sector to improve its own governance (World Bank, 2006).

Empowering SOE Boards of Directors can minimize political interference with SOEs. The government cannot take part directly in the day-to-day management of the SOEs like the controlling group of shareholders in private companies, because political and bureaucratic interference has adverse impact on SOE's performance. The government should award full autonomy and independence to the Board of Directors. The government should not have excessive representation, through government officials in the Board of Directors, but should appoint professionals in their place with relevant mix of competencies and experience in accordance with the company's activity and long-term strategy.

The current domestic regulation of corporate governance in SOEs is far away from good practice. Lack of regulation has to be eliminated through clear legislative guidelines defining: the role and responsibility of the Board of Directors, its structure and competencies required

for members, a structured and transparent process of selection and appointment to the board, and transparent and incentive compensation schemes. The important role is played by board training and evaluation processes. Once professional, responsible, competitive and trained Board of Directors is set, it can initiate major changes in SOE operations. In order to achieve its goals, board must work continuously on the formulation and monitoring of corporate strategy, building adequate performance measurement systems that will serve to monitor and assess the performance of managers, and this assessment will be used to adjust managers' compensation. Finally, appointment and dismissal of the CEO and senior management decisions rights has to be left to the Board of Directors. Throughout this process Board of Directors must not forget the internal audit, risk management, as well as questions of disclosures, transparency of operations and code of ethics.

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