ARGUMENTA OECONOMICA
No 2 (21) 2008
PL ISSN 1233-5835

*Dariusz Klonowski**

CORPORATE GOVERNANCE AND THE VENTURE CAPITAL PROCESS IN EMERGING MARKETS: EVIDENCE FROM POLAND

This article examines the perceived corporate governance problems within the venture capital investment process. Evidence is provided to demonstrate that venture capitalists in Poland address their corporate governance concerns in a sequential or hierarchical manner. Venture capitalists first focus on addressing issues related to financial control and accountability (during the screening stage). Secondly, they address conflict of interest concerns (during the deal agreement stage). Once these two major corporate governance concerns are addressed, venture capitalists move to focus on corporate governance enhancement (during the monitoring stage), and, finally, on value maximization (during the divestment stage). 99 questionnaires were sent out to investment officers from thirty three venture capital funds operating in Poland, yielding the response rate of 56 percent.

Keywords: venture, capital, corporate, governance, Poland

INTRODUCTION

Financial scandals in the U.S (WorldCom, Enron, Tyco) and in Europe (Maxwell, Marconi, Parmelat) have re-ignited discussions on corporate governance (Deakin and Konzelmann, 2004; Montagnon, 2004). Public debates, legal proceedings, and investor outrage spurred government involvement in this matter (Deakin and Konzelmann, 2004). Legislators in different countries have focused on introducing corporate and stock exchange regulations aimed at adopting a set of commonly accepted corporate conduct standards for the equitable treatment of shareholders, the establishment of accountability and control over directors and management, and improved transparency in financial reporting. In 2001, for example, the U.S. Congress enacted the *Sarbanes-Oxley Act,* which introduced new measures into federal securities and corporate laws. The Act was "designed to protect investors by improving the accuracy and reliability of corporate disclosure". While the *Act* is broad and general, it provides useful guidelines

* Department of Business Administration, Brandon University, Canada

related to off-balance-sheet disclosure of liabilities, security analysts' conflict of interest, timing of bonus payments to corporate executives, and more. U.K. legislators followed a similar route. They amended the *Combined Code* (fully called *The Combined Code: Principles of Good Governance and Code of Best Practice*) containing the corporate governance principles and code provision applicable to the U.K. publicly listed companies. These amendments incorporate the recommendations of the Higgins report (on non-executive directors) and Smith report (on audit committees). Similar initiatives have also been undertaken in other countries. For the review of academic literature on corporate governance in international markets see Solomon, Lin, Norton, and Solomon (2003), Demirag and Serter (2003), Keenan (2004), and Melis (2004). Even though these codes and regulations go a long way towards identifying problems and proposing corporate conduct, some academic literature argues against a regulation-based approach in favour of establishing best market practices based on principles (Montagnon, 2004; Keenan, 2004; Pitelis and Clarke, 2004; Dawson, 2004). Such a principle-based approach has been successfully implemented in the field of accounting.

The venture capitalists operating in Poland face some unique challenges in their investment activities. Firstly, they have to deal with a complex legal infrastructure. Many local venture capitalists confirm that the legal environment in Poland is not suitable for venture capital investment purposes. The Polish legal system does not allow for the types of investor protections normally existent in Western markets. Secondly, the Polish accounting system, while it has improved in the last decade to be in line with European Union directives, is not fully comparable to the Western accounting standards. The accounting firms invited by venture capitalists to review investee firms' financial statements often have to restate them to adhere to generally accepted accounting principles (GAAP) or international accounting standards (IAS). Thirdly, local venture capitalists have to deal with corporate governance issues.

The objective of this paper is to analyze the perceived corporate governance concerns in the context of the venture capital investment process. Specifically, the paper analyzes the importance of various corporate governance concerns as venture capitalists progress their transactions towards completion. The framework of the project is the Polish venture capital industry. The paper is organized in the following way. Section 1 provides a brief description of the relevant literature in the area of corporate governance and venture capital investment process. Section 2 describes

research methodology while section 3 focuses on the discussion of actual results. Section 4 provides concluding remarks.

1. LITERATURE REVIEW

1.1. Corporate Governance

While the role of corporate governance has evolved over the years and even varies from firm to firm, it can be generally classified into four main functions: financial control and accountability (Melis, 2004; Keenan, 2004; Solomon, Lin, Norton, and Solomon, 2003), conflict of interest resolution (Korn/Ferry International, 1998; Schlup, 2003; Daily and Dalton, 2003; Demski, 2003), corporate performance enhancement (Henke, 1986; Hampel, 1998; Demb and Neubauer, 1992; Van den Berghe and Levrau, 2002; Scherrer, 2003; Nadler, 2004), and shareholder value maximization (Pearce and Zahra, 1991; Scherrer, 2003). It is likely that these corporate governance functions will further evolve over time, as shareholders learn to effectively deal with the current concerns as well as any new concerns that may emerge (i.e. detecting corporate fraud).

Financial control and accountability is an essential function in corporate governance (Solomon, Lin, Norton, and Solomon, 2003; Melis, 2004; Keenan, 2004). This function is often fulfilled by the appointment of an external financial auditing firm that generally provides reassurance to the management, the board of directors, and shareholders about the company's financial performance (Keenan, 2004). These activities are termed as financial statement audits. The audits are achieved by evaluating a company's internal system of controls in order to determine its reliability, thereby providing a reasonable assurance to shareholders that audited financial reports will reflect the company's actual financial standing. Audits, however, have other functions as well. Compliance audits focus on determining whether the company's managers are following certain procedures, by-laws, or provisions outlined by various corporate documents, regulations, or contracts (i.e. Articles of Association, provision of the loan agreements). Operational audits review the company's internal procedures to evaluate the company's internal operational efficiencies. Lastly, comprehensive audits include a comprehensive review of the company's financial performance, including all of the aspects mentioned above. Sinnet (2004) argues that the purpose of auditing should be to detect corporate

fraud. Montagnon (2004) suggests that control and accountability should be able to prematurely identify and reduce the risk of a crisis instead of responding after the fact. In venture capital investments, venture capitalists rely on financial control and accountability for a variety of decisions. They monitor the company's financial performance against the forecasted budget and quickly respond to any underperformance. Venture capitalists understand that their success in achieving a profitable exit is connected with the quality of the financial data provided to a strategic investor at the time of a trade sale or listing on the publicly quoted exchange. Venture capitalists also use the financial control function to verify whether entrepreneurs and management adhere to the terms of legal agreements. Lastly, financial control is used for awarding management bonuses, stock option programs, and, occasionally, adjusting the level of ownership between shareholders.

Conflicts of interest within corporations are well documented in the academic literature. Conflict of interest arises when a stakeholder's actions or intentions have the potential to benefit personal interest at the expense of shareholders (Demski, 2003). Shleifer and Vishny (1997), Bushman and Smith (2001), and Daily and Dalton (2003) focus on issues related to conflict of interest in the corporate boardroom and note that poor corporate oversight and lack of a director's independence from management were the chief reasons for the largest corporate governance failures. Korn/Ferry International (1998) and Schlup (2003) confirm the existence of the dual CEO-Chairman role in the majority of international companies and outline the key types of conflicts in such settings. These studies note that if the board's primary roles are to effectively monitor management on behalf of shareholders and protect shareholders' interest, the dual CEO-Chairman role is not conducive to proper governance. The agency and asymmetry problems, as well as the incongruency of goals and objectives, arise as financial risks vested with shareholders, while operating risks lay within management. This gives rise to distinctly different circumstances for shareholders and managers during a time of bankruptcy or company liquidation; "shareholders lose while managers just do not win". Kostyuk (2003), Sung Wook (2003), and Devlin (2003) provide insights into corporate governance models in the international setting, confirm the existence of inherent conflict of interest in all countries, and offer some insights into dealing with these problems. Resolving multiple conflicts of interest within entrepreneurial firms is a prerequisite for a successful venture capital investment. Venture capitalists regularly encounter conflicts of interest in the transactions they enter into (Gladstone and Gladstone, 2004).

They understand that unless they resolve these critical issues, their ability to realize full value from their investment may be jeopardized, and the distribution of economic value may not be in accordance with the agreed deal.

Hampel (1998), Van den Berghe and Levrau (2002), Scherrer (2003), and Nadler (2004) argue that corporate governance is more than a mechanism for resolving the problems of financial control and conflict of interest; it also puts focus on corporate performance enhancement through the directors' impact on strategic decision-making. The academic literature on the actual involvement of directors and their effectiveness in strategic decision-making, however, is inconclusive and has evolved over time. The early studies by Mace (1971), Norburn and Grinyer (1974), and Pahl and Winkler (1974) suggested that the boards did not get actively involved in strategic decisions. Exceptions included a period of crises management, during which directors were likely to get involved in daily decision-making on a hands-on basis (Mace, 1971). Later studies by Pearce and Zahra (1991), Conference Board (1993 and 1995), Ferlier, Ashburner, and Fitzgerald (1994), and Stiles (2001), confirmed that directors are primarily involved in crafting a business strategy, while the overseeing of a company's strategic direction is the board's main task. Such an involvement could take a variety of forms, including occasional active counseling to the CEO (Lorsch and MacIver, 1989), continuous involvement and participation (Demb and Neubauer, 1992), unintended but helpful assistance to management (Henke, 1986), or crises management (Mace, 1971). In the study by Nadler (2004), the author offers a framework for building an effective board of directors and raises the importance of the shareholders' conscious decision to formulate the board with respect to type, nature, and composition. Furthermore, he distinguishes among the five types of board models and argues that directors should more actively participate in corporate affairs. In the context of venture capital, active involvement of venture capitalists is a must. Active interaction between venture capitalists, entrepreneurs, and management is a pre-requisite for the proper development and implementation of strategy. Even though research studies pertaining to the value added approach by venture capitalists offer conflicting conclusions, it is likely that venture capitalists are undoubtedly more active in their participation than other types of investors. Venture capitalists regularly participate in decision making with respect to key personnel, budget approvals, and strategic plan development. Their role is often clearly defined in the shareholders' agreement.

The concepts of performance enhancement and company prosperity are inherently connected with value maximization and realization. A well-implemented strategy can translate into a significant increase in sales and profitability, thereby leading to a higher business valuation and value to shareholders (Pearce and Zahra, 1991). Pearce and Zahra (1991) found that active participation from the board of directors is likely to be associated with a superior level of financial performance (as measured by earnings per share). Scherrer (2003) argues that directors need to be more involved in strategic decision making processes to ensure corporate governance compliance and strong market performance. For venture capitalists, the implementation of well-developed business strategies translates into value creation. Venture capitalists also engage in "corporate grooming" activities prior to divestment. These may include simplifying the legal and corporate structure, negotiating strategic relationships (which would be perceived to increase the value of the company in the future), and resolving any technical and environmental challenges that were previously un-addressed. Venture capitalists also occasionally employ external consultants to affect divestment.

1.2. Venture Capital Process

The stages of the venture capital process have been described in a number of studies (Sweeting, 1991; Bygrave and Timmons, 1992; Fried and Hisrich, 1994; Bruno and Tyebjee, 1994). The key elements of this process that relate to corporate governance are screening, deal agreements, monitoring, and divestment.

Screening. Venture capitalists commonly receive many business proposals (Manigart et al, 1997). Ultimately, it is only 1-2% of these received proposals that venture capitalists decide to invest in (Silver, 1985). In order to filter out the majority of proposals and meet investment objectives, venture capitalists use a process known as screening. The first stage of the screening process sees venture capitalists eliminate the proposals that are unable to meet the investment criteria, have been previously unsuccessful in certain sectors, and seem generally unpromising. Significant amounts of proposals are rejected during the course of this (sometimes short) initial review (Zopounidis, 1994; Dixon, 1989). The second stage of the process sees the remaining proposals more heavily scrutinized. Information included in the provided documents is confirmed and financial forecasts are investigated (Plummer, 1987). The company's key employees, customers, suppliers, and creditors are also consulted, while external advisors assess the

legal, financial, technical, and environmental issues. Though the general objective of this due diligence process is to gain a thorough understanding of all business aspects, the focus of this internal and external investigation can vary from deal to deal (Silver, 1985; Dixon, 1994). The venture capitalist's professional judgment is paramount to the overall screening process. Only through years of experience – in both day-to-day business operation and the venture capital industry itself – can these decision making abilities be developed (Carter & Van Auken, 1994; Silver, 1985).

Deal Agreement. If due diligence does not identify any major areas of concern, venture capitalists proceed to negotiate a deal. The academic literature relating to venture capital contracting is significant. Sahlman (1990), Gompers (1997), Black and Gilson (1998), and Kirilenko (2001) focus on the degree of control exercised by venture capitalists and confirm that venture capitalists enjoy a disproportionately large degree of control. Kaplan and Stromberg (2003) provide a comprehensive description of the basic rights found in venture capital contracts and confirm that venture capitalists adjust these rights. Cash flow rights relate to the claim that shareholders and management may have on the company's equity. Board rights refer to the shareholders' right to approve key corporate decisions that relate to the company's strategies, implementation plans, stock options programs, employment, and termination of key personnel. Voting rights refer to the voting thresholds, defined in percentage terms, of the total equity necessary to affect corporate decision making. Liquidation rights refer to the preference of claims on the company's equity by venture capitalists, entrepreneurs, shareholders, management, and other parties. Kaplan and Stromberg (2003) also describe the other control rights that are often written into legal contracts, such as automatic conversion rights (allowing venture capitalists to convert their various types or classes of shares into common equity upon certain circumstances), anti-dilution protections (protecting venture capitalists against the dilutive effects of next-round financing at low valuations), vesting clauses (providing incentives to entrepreneurs or management to increase their ownership in the company's equity over time by meeting specific operational milestones), and non-compete clauses (protecting the company against any adverse effects caused as a result of entrepreneurs starting a competing business). Chan, Siegel, and Thakor (1990) describe the salient features of venture capital contracting, including the entrepreneurs' inability to walk away from the business.

Monitoring. Four aspects of venture capital investment make it necessary for venture capitalists to be active investors: asymmetry of information, an extended period of illiquidity, high entrepreneurial and business risks in companies, and the inability to predict future problems in business. These aspects are problematic for a number of reasons. Any asymmetry of information that venture capitalists are faced with throughout the investment process can cause significant agency risks, and an extended period of illiquidity can result in a questionable exit scenario or returns. The high entrepreneurial and business risks associated with the companies in which venture capitalists invest are equally problematic. Finally, venture capitalists, like entrepreneurs and management, are unable to predict the future of a business. In order to reflect current market conditions and changes in business opportunity, business plans, operational goals, and shareholder agreements need to be revisited and sometimes revised after the initial deal is closed. Venture capitalists, in addition to providing a wide range of other services, become active in this process of monitoring, and govern their portfolio companies once a deal is finalized and capital is flowing into the company (Sadler, 1993; Bellas, 1993). While venture capitalist participation in a portfolio company will vary from deal to deal, their involvement is generally greatest in new ventures (Sapienza, 1992; Elango, Fried, Hisrich, and Polonchek, 1995; Barry, 1994; Sweeting, 1997).

Divestment. Achieving an exit, or divestment, is a major element of venture capital investment. Divestment is driven by a venture capitalist's need to generate a profit for their capital provider(s). This process can be achieved through two common routes: a public offering (IPO) or a trade sale to a strategic investor or investors. Regardless, each exit route has a different implication for both venture capitalists and entrepreneurs (Rind, 1997). A public offering is often the preferred exit route, as it generally results in the highest possible valuation for a company (Andrews, 1995; Lim, 1990). Companies favour this route because it preserves the independence of both the company and the entrepreneurs, in addition to providing the company with continued access to capital. Public offerings, however, may not end venture capitalist involvement in portfolio companies, as regulators or underwriters can prevent venture capitalists from disposing of their shares at the time of an IPO. This has prompted Lerner (1994) to conclude that venture capitalists remain actively involved with portfolio companies after an IPO until the company's shares are sold. Private sales offer different consequences. Venture

capitalists consider a private sale to a strategic investor more attractive, as this route will almost immediately end their involvement with a firm (Rind, 1997). Entrepreneurs and management, though, discourage private sales, as the possibility of a larger company merging with or acquiring the company may diminish their operational independence. Also, strategic investors tend to favor only the companies with a dominant share in growing markets. To conclude, advantages and disadvantages are inherent to different exit routes depending on the perspective involved. For a discussion of other types of divestment, see Rind (1997).

2. DATA AND METHODOLOGY

The primary objective of this research paper was to address the relationship between the venture capital process and various corporate governance concerns. Specifically, the study aimed to understand the relationship between four main functions of corporate governance (financial control and accountability, conflict of interest resolution, corporate performance enhancement, and shareholder value maximization) and four stages of the venture capital investment process (screening, deal agreements, monitoring, and divestment). A single main hypothesis guided the design of methodological approach. It related to the analysis of the importance of various corporate governance concerns as venture capitalists navigate their transactions from completion to an exit. Specifically, the research related to the classification or grouping of corporate governance concerns in the context of the venture capital process. Previous academic research covering Central and Eastern Europe indicates that venture capitalists are mostly concerned with financial accountability and control, management, and operating controls (Filatotchev et al., 1996; Karsai et al., 1998; Bliss, 1999; Wright et al., 1999; Allchorne, 2004). The nonacademic literature focusing on the region has also noted other corporate governance concerns (Lewis, 2000; Molo and Bielonka, 2002; Skarzinskaiste, 2003; Sormani, 2003; Lawday, 2005). The personal use of company assets, the appointment of nonqualified family members to senior management positions, and the multiple roles of entrepreneurs within their companies are among the key corporate governance problems. The academic research also provides evidence that investors and shareholders focus on different issues throughout different stages of a company’s life cycle (Black and Gilson, 1998; Keenan, 2004; Melis, 2004; Daily and Dalton, 2005). Therefore, it was conjectured

that the same corporate governance concerns are unlikely to be addressed by venture capitalists at each stage of the venture capital process. The main hypothesis was stated in the null form:

Hypothesis: Different corporate governance concerns are addressed at various stages of the venture capital process.

The sampling frame for the study included about 185 investment officers employed in thirty three venture capital funds operating in Poland. The target population of venture capital funds was derived from the local venture capital association, Polish Private Equity Associations. To ensure completeness of the target population, other relevant data sources were researched (e.g. local newspapers, Book of Lists). The objective of the research was to solicit responses from the entire universe of venture capital funds operating in Poland. Three questionnaires were sent to each venture capital fund to randomly selected investment officers employed at these funds. It was assumed that while the response in the demographic section received from the same venture capital fund were expected to be the same, the responses related to the importance of the specific corporate governance problems at each stage of the venture capital process were likely to be different, reflecting diverse background of investment officers working in the same fund. It was also assumed that investment officers developed deal specialization in their respective venture capital funds in terms of industrial sectors or types of deals (e.g. private sector versus privatizations). Such specializations were likely to result in different perceptions of corporate governance problems. 99 questionnaires were sent out to 33 venture capital funds, yielding a response rate of 56 percent.

A mail questionnaire was sent in a personally addressed envelope with a covering letter and a freepost envelope for return. The questionnaire was designed in two sections totaling 3 pages. The interview questions drew from the analysis of the existing literature review. The questionnaire was piloted by four venture capitalists and three local academics focusing on venture capital. A five-point Likert scale was used to gauge the importance (to each venture capitalist) of 20 listed problems relating to corporate governance functions (where 1 denoted “very unimportant” and 5 denoted “very important”). These specific corporate governance categories were considered in relation to each stage of the

venture capital process. Table 1 presents the relative areas from each of the four functions of corporate governance.

Table 1

The relative problems in four functions of corporate governance

1. Financial control and accountability related to external financial audits and reviews, regulatory compliance, quality of internal financial reporting, adherence to shareholders' agreements and company statutes, variance analysis (budgeted versus actual performance);
2. Conflict of interest related to separation of CEO and chairman role, family-based management appointments, entrepreneurs' personal use of corporate assets, performance-based allocation of stock options and bonuses, and importance of shareholders' agreement and company statutes;
3. Corporate performance enhancement related to strategy development or modification, oversight of strategy implementation, acquisition or merger assistance, operational controls and monitoring activities, development of business plan;
4. Value maximization related to development of exit strategy, evaluation of exit alternatives, engaging in company's grooming activities, exit execution, and usage of external consultants.

Source: own definition

3. RESULTS AND DISCUSSION

Table 2 presents the average responses of venture capitalists related to various corporate governance concerns, as well as their relative ranking across all corporate governance categories based on quantitative data analysis.

Table 2

The average responses of venture capitalists related to various corporate governance concerns and stages of the venture capital process

	Screening		Deal Agreement		Monitoring		Divestment	
	Average	**Rank**	**Average**	**Rank**	**Average**	**Rank**	**Average**	**Rank**
Financial control and accountability								
External financial audits and reviews	4.21	1	4.07	3	3.68	7	4.01	3
Regulatory compliance	3.91	6	3.76	9	3.25	11	3.91	7
Quality of internal financial reporting	4.18	2	4.01	5	3.87	5	3.97	5
Adherence to shareholders' agreements and company statutes	3.86	8	3.58	13	3.18	13	3.41	15
Variance analysis (budgeted versus actual financial performance)	3.60	10	2.95	16	3.67	8	3.73	12
Conflict of interest resolution								
Separation of CEO and Chairman roles	3.48	11	3.63	11	3.08	17	2.98	20
Family-based management appointments	3.25	15	3.97	7	2.94	18	3.27	17
Entrepreneurs' personal use of corporate assets	4.12	3	4.15	1	3.25	10	3.35	16
Performance-based allocation of stock options and bonuses	3.90	7	4.13	2	3.11	15	3.74	11
Importance of shareholders' agreements and company statutes	4.07	4	4.06	4	3.09	16	3.89	8
Corporate performance enhancement								
Strategy development or modification	3.96	5	3.98	6	4.04	2	3.56	14
Oversight of strategy implementation	3.28	14	2.66	18	3.37	9	3.87	9
Acquisition or merger assistance	3.39	13	3.04	15	3.91	4	3.01	19
Operational controls and monitoring devices	3.44	12	3.67	10	3.19	12	3.81	10
Development of business plan	3.09	17	3.21	14	4.11	1	3.18	18
Value maximization								
Development of exit strategy	3.18	16	3.65	12	3.81	6	3.70	13
Evaluation of exit alternatives	3.69	9	3.78	8	3.98	3	4.01	4
Engaging in company's grooming activities	3.07	18	2.54	19	3.16	14	4.08	1
Exit execution	2.67	19	2.67	17	2.91	20	4.04	2
Usage of external consultants	2.54	20	2.49	20	2.93	19	3.96	6

Source: own calculations

3.1. Screening

The five most important corporate governance problems in the screening stage of the venture capital process are presented in Table 3.

Table 3

Five most important corporate governance problems in the screening stage

	Average	Rank
• External financial audits and reviews	4.21	1
• Quality of internal financial reporting	4.18	2
• Entrepreneur's personal use of corporate assets	4.12	3
• Importance of shareholders' agreement and company statutes	4.07	4
• Strategy development or modification	3.96	5

Source: own calculations

Active interaction between entrepreneurs and venture capitalists begins in the initial screening process. The involvement of Polish venture capitalists reflects the nature of the Polish entrepreneurship. Polish entrepreneurs are generally unprepared to receive venture capital financing. Entrepreneurs confuse venture capital with debt instruments and believe that venture capital financing requires repayment at the end of the holding period. Key areas of project attractiveness for venture capitalists are management and track record, product, strategy, competitive position, sales growth opportunities, profitability, and financial returns. The most problematic areas for venture capitalists relate to financial reporting and control. The accounting and financial functions are generally neglected, as personnel in these departments are understaffed and poorly qualified. It is not surprising, therefore, that the area of financial analysis is addressed in priority. At this stage, both sides make a decision on the format of financial disclosure during the due diligence process and future reporting. Entrepreneurs and venture capitalists also agree to employ accountants, who audit the company's books and issue an auditors' report (average score = 4.21; rank = 1). The financial audits performed in the future are used to confirm management spending in comparison to the budget, related-party transactions, and adherence to certain provisions in the articles of association and shareholders' agreements. Discussions with venture capitalists confirm that they rarely proceed with the deal unless they are able to effectively address issues related to financial disclosure. They also do not proceed unless they are satisfied with the quality of financial reporting (average score = 4.18; rank =

2), even if due diligence results in a positive assessment of the company and the preliminary agreement on deal terms look promising.

Private Polish companies have multiple areas where conflicts of interest are likely to arise. The most common areas relate to using the company's assets and financial resources for private use (average score = 4.12; rank = 3). Polish entrepreneurs visiting the accounting departments and making undocumented cash withdrawals is common. They also use barter transactions to leverage a company's assets in exchange for cash or non-cash benefits. These off-balance-sheet transactions are difficult for venture capitalists to identify and address. Discussions with venture capitalists confirm that entrepreneurial habits are difficult to change and often continue after deals have been completed. Venture capitalists have learned to cope with such circumstances in two ways. Firstly, they may appoint their own financial director to examine the financial functions for the entire company. This is usually done without objection from entrepreneurs, as they are usually aware of weaknesses in the finance area. Secondly, as a part of the annual financial audit, the company's auditors are specifically instructed to investigate behavioural patterns, confirm entrepreneurial compliance with the terms of the shareholders' agreement and the company's articles of association or statutes, and subsequently report their findings to all board members. Also, entrepreneurs often hold various posts in management and the board. With no clear guidelines for remuneration or stock option programs, entrepreneurs are able to distribute cash and ownership according to their own wishes. Another common problem relates to unqualified family members holding senior management positions. There are numerous instances where family members appear on the payroll without actually providing any services to the company. These conflicts of interest are often outlined by venture capitalists early in the process when they discuss their standard clauses of shareholder agreements and statutes (average score = 4.07; rank = 4).

The interaction between venture capitalists and entrepreneurs forces a broad consideration of the company's strategic development (average score = 3.96; rank = 5). This, in turn, leads to the identification of key business risks and milestones that need to be achieved in order to reach a successful exit. The process also identifies personnel needs, mainly in the areas of finance, accounting, and marketing. Entrepreneurs commonly do not have a business plan when they enter into discussions with venture capitalists. Under these circumstances, venture capitalists take two possible courses of action. Firstly, they may recommend that the entrepreneurs retain an external

advisor who will assist them in preparing a business plan. The advisors may later be used by entrepreneurs to help them navigate the complexities of the venture capital process. Secondly, venture capitalists may decide to help the entrepreneurs develop a business plan. This approach, while time consuming to venture capitalists, prevents entrepreneurs or their advisors from "shopping the deal" to competing venture capitalists. Hence, venture capitalists choose the second alternative if they deem that the deal has many attractive commercial features, consequently increasing the chances of completing the deal by guarding it from other venture capitalists. The process of developing a business plan for entrepreneurs is done through an interview, during which entrepreneurs provide input data and venture capitalists focus on the mechanics of preparing financial forecasts. The key is to have entrepreneurs and management buy into the modeled financial forecasts and assume full ownership of the numbers.

3.2. Deal Agreement

The five most important corporate governance problems in the deal agreement stage of the venture capital process are presented in Table 4.

Table 4

Five most important corporate governance problems in the deal agreement stage

	Average	Rank
• Entrepreneur's personal use of corporate assets	4.15	1
• Performance-based allocation of stock options and bonuses	4.13	2
• External financial audits and reviews	4.07	3
• Importance of shareholders' agreement and company statutes	4.06	4
• Quality of internal financial reporting	4.01	5

Source: own calculations

Venture capitalists and entrepreneurs discuss deal terms early in the investment process. This has numerous implications for both sides. Firstly, deal terms, normally negotiated with entrepreneurs during the later stages of the investment process, are discussed much earlier. These terms are subsequently captured in the form of a detailed letter of intent. This is beneficial for entrepreneurs and venture capitalists. For entrepreneurs, the process allows them to make an intuitive decision as to whether venture capital is an appropriate method to secure additional financing now or in the future compared to other sources of financing. For venture capitalists, it allows them to decide whether or not they will be involved with a particular

company. While there are commercial factors that influence the decision to proceed with the investment project, venture capitalists try to assess the probability of the project being completed. This is an important area of assessment, since the risk of not completing the project is normally regarded as above average, mainly due to potentially unsuccessful negotiations or the tender approach used by many entrepreneurs. Engaging in early discussions over deal terms with entrepreneurs is a valuable investment for venture capitalists since they can potentially save significant human and financial resources otherwise unnecessarily dedicated to a project that has minimal or no chance at completion. Also, early discussions of serious matters test the personal "chemistry" between entrepreneurs and venture capitalists and serve as a proxy for the quality of interaction between the two sides in difficult circumstances (which are likely to arise in the future).

The commercial terms of the deal are summarized in a detailed document called *Terms Sheet*, *Letter of Intent* or *Head of Terms*. This document includes, among other things, deal pricing; the level of shareholder protection (especially when venture capitalists are minority shareholders); budget and strategic decision approval procedures; standard rights (i.e. pre-emptive rights, rights of first refusal); and exit mechanisms. The head of terms is subsequently translated into formal legal documentation, including the articles of association, shareholders' agreements, subscription agreements, and other ancillary legal documentation. At this stage, entrepreneurs often realize that they need to make some key decisions pertaining to the way they should operate their business in the future. The key discussion points relate to the stoppage of an entrepreneur's personal use of corporate assets (average score = 4.15; rank = 1) and the establishment of proper schemes for stock allocation and bonus systems (average score = 4.13; rank = 2). The latter area is particularly important since entrepreneurs and venture capitalists make key personnel decisions and develop management remuneration systems, which would ultimately dilute the percentage of shareholding for entrepreneurs and venture capitalists. Naturally, the importance of a sound shareholders' agreement and company statutes is a priority as well (average score = 4.06; rank = 4).

Discussions continue to center around financial control, accountability, and, specifically, external financial audits and reviews (average score = 4.07; rank = 3) and quality of internal reporting (average score = 4.01; rank = 5). At this stage in the process, venture capitalists often receive information from external consultants (i.e. investigative accountants or lawyers) and often use this information as the basis for price renegotiations. The two sides

also formalize a business plan while discussions of corporate performance and exit arrangements continue. These issues now become more important, as the issues related to financial control and conflict of interest are resolved or the process ends if the parties are unable to reach an agreement.

3.3. Monitoring

The five most important corporate governance problems in the monitoring stage of the venture capital process are presented in Table 5.

Table 5

Five most important corporate governance problems in the monitoring stage

	Average	Rank
• Development of business plan	4.11	1
• Strategy development or modification	4.04	2
• Evaluation of exit alternatives	3.98	3
• Acquisition or merger assistance	3.91	4
• Quality of internal financial reporting	3.87	5

Source: own calculations

Once the issues relating to financial control and conflict of interest are resolved at the end of the deal agreement phase, these issues become less critical. Many venture capitalists consider the monitoring function to be a time consuming period for venture capitalists and entrepreneurs and that it is rarely limited to quarterly meetings. Due to new, unforeseen business expansion opportunities, management often engages in the revision or development of new business plans (average score = 4.11; rank = 1) shortly after deal completion. They also pursue other opportunities, and these become the most pressing issues for the board. This often leads to the establishment of new financial projections, new operational priorities, and personnel requirements. All these activities are captured in the company's modified strategy (average score = 4.04; rank = 2). Venture capitalists confirm that they often participate in industry consolidation opportunities, where venture capital backed companies acquire or merge with other businesses in the industry (average score = 3.91; rank = 4). Venture capitalists play a pivotal role here, as entrepreneurs are inexperienced in this area. Companies often seek expansion opportunities in the other countries of Eastern Europe, especially in the Czech Republic and Hungary. According to venture capitalists, these pan-East European expansion efforts often lead to better business valuations from strategic investors and public markets.

Surprisingly, traditional operational controls and monitoring activities are not listed as key areas of concern by venture capitalists during the monitoring stage. Venture capitalists confirm that, through their active interaction with companies during the course of mergers or acquisitions and business plan revisions and development, they feel "on top of the numbers". However, they regularly receive formal monthly or quarterly reporting requirements, including management commentaries and audited financial statements, to engage in formal approvals of managerial and shareholder actions and other activities anticipated in the shareholders' agreement and articles of association or statutes. Some of the monitoring measures are developed by venture capitalists while the investment is in progress, and may not have been anticipated earlier in the process (i.e. corporate spending limits).

Discussions of strategic alternatives often force an evaluation of exit alternatives (average score = 3.98; rank = 3). Discussions with venture capitalists confirm that they try to build their portfolio companies as close as possible to target a specific group of buyers. They generally study the many facets of these potential buyers, including their market entry strategies, business focus, expansion plans, offered prices, and potential timing.

3.4. Divestment

The five most important corporate governance problems in the divestment stage of the venture capital process are presented in Table 6.

Table 6

Five most important corporate governance problems in the divestment stage

	Average	Rank
• Engaging in company's "grooming" activities	4.08	1
• Exit execution	4.04	2
• External financial audits and reviews	4.01	3
• Evaluation of exit alternatives	4.01	4
• Quality of internal reporting	3.97	5

Source: own calculations

The achievement of divestments often occurs earlier than initially anticipated. Venture capitalists and entrepreneurs spend a considerable amount of time evaluating exit opportunities and alternatives (average score = 4.01; rank = 4). The highest priority is given to the company's "grooming" activities, which prepare for divestment (average score = 4.08; rank = 1).

This process includes making changes to the company's articles of association, removing any off-balance sheet liabilities, resolving any outstanding legal problems or lawsuits, and reducing costs with an aim to enhance profitability (positively impacting business valuation). Venture capitalists also take a hands-on approach in the disposal of their stake by directly negotiating with buyers (average score = 4.04; rank = 2).

The issues related to financial control and accountability continue to be important for companies, as these issues are critical to the due diligence investigations performed by strategic investors and in listing companies on stock exchanges. Venture capitalists focus on external financial audits (average score = 4.01; rank = 3) and aim to achieve unqualified financial audits for their portfolio companies. They also attempt to feed potential investors with reliable financial data prior to acquisition or listing through high quality and timely financial reports (average score = 3.97; rank = 5). This process would assist in their divestment.

4. CONCLUSIONS

Evidence from the discussions demonstrates that many venture capitalists believe that Polish entrepreneurial firms have to be well governed. This is reflected in the fact that venture capital-entrepreneur agreements are heavily regulated, often above the levels found in Western countries. Venture capitalists rely on detailed procedures written into key legal documents to address issues relating to corporate governance, namely financial control and accountability, conflict of interest, corporate performance enhancement, and shareholder value maximization. Venture capitalists feel that they need this level of protection to affect the appropriate legal and operational controls that ultimately lead to a successful exit. Luckily, entrepreneurs do not object to rigorous corporate government measures and believe that their entrepreneurial companies benefit from written corporate governance regulations. In turn, these principles are introduced into the companies that entrepreneurs merge with or acquire. Research confirms that there is an unwritten set of standards for corporate governance in the Polish venture capital industry that outlines minimal corporate governance standards for venture capital deals. Rarely would local venture capitalists violate these principles in order to close a deal in a competitive situation.

Research also confirms that local venture capitalists address the issues related to corporate governance in a sequential or hierarchical manner.

Different corporate governance priorities occupy venture capitalists during different stages of the investment process. Each stage of the process has its central corporate governance theme. While other corporate governance functions are also addressed during these stages, they are complimentary functions to this main corporate governance theme. Venture capitalists begin by addressing issues related to financial control and accountability. This is critical for venture capitalists, as proper financial reporting that is timely and accurate is important for monitoring the company's actual financial performance. It is also pivotal that accountants audit financial data on a regular basis. More important, financial reporting is critical during the time of divestment. Focus on this area occupies a significant portion of venture capitalists' time early in the investment process, mainly in the initial screening stage. Secondly, the issues related to conflict of interest seem to be the next priority in the initial screening and deal agreement stages of the investment process. Polish entrepreneurial companies are filled with multiple conflicts of interest and it is critical for venture capitalists to effectively resolve them and entrench proper procedures into managerial and entrepreneurial behaviour. The third stage of the process, occurring once the deal moves into the monitoring phase, involves venture capitalist focus on corporate performance enhancement through business plan revision and implementation. Lastly, venture capitalists dedicate their efforts to achieve a successful exit. At this stage, shareholder value is the key focal point.

REFERENCES

Allchorne, T., *Assessing CEE private equity post accession*, "European Venture Capital Journal", June, pp. 48-53, 2004.

Andrews, K.R., *Initial public offerings: the experience of eight Canadian growth companies*, Ottawa: Conference Board of Canada, 1995.

Barry, C., *New direction in research on venture capital finance*, "Financial Management", Vol. 23, Issue 3, pp. 3-15, 1994.

Bellas, R.C., *The value of relationships with venture capitalists*, "Healthcare Financial Management", Issue February, pp. 63-64, 1993.

Bruno, A., Tyebjee, T., *The entrepreneurs' search for capital*, "Journal of Business Venturing", Vol. 1, Issue 1, pp. 61-64, 1985.

Black, B.S., Gilson, R.J., *Venture capital and the structure of capital markets: Banks versus stock markets*, "Journal of Financial Economics", Vol. 47, pp. 243-277, 1998.

Bliss, R. *A venture capital model for transitioning economies: The case of Poland*, "Venture Capital", Vol. 1, Issue 3, pp. 241-257, 1999.

Bushman, R., Smith, A., *Financial accounting information and corporate governance*, "Journal of Accounting and Economics", Vol. 58, Issue 1, pp. 237-333, 2001.

Bygrave, W., Timmons, J., *Venture capital at the crossroads*, Harvard Business School Press, Boston, 1992.

Carter, R.B., Van Auken, H.E., *Venture capital firms' preferences for projects in particular stages of development*, "Journal of Small Business Management", Vol. 32, Issue 1, pp. 60-73, 1994.

Chan, Y., Siegel, D., Thakor, A.V., *Learning, corporate control and performance requirements in venture capital contracts*, "International Economic Review", Vol. 31, Issue 2, pp. 365-381, 1990.

Conference Board, *Corporate Boards and Corporate Governance*, New York, 1993.

Conference Board, *Corporate Boards and Corporate Governance*, New York, 1995.

Daily, C.M., Dalton, D.R., *Conflicts of interest: a corporate governance pitfall*, "Journal of Business Strategy", Vol. 24, Issue 4, pp. 7-8, 2003.

Dawson, S., *Balancing self-interest and altruism: corporate governance alone is not enough*, "Corporate Governance", Vol. 12, Issue 2, pp. 130-133, 2004.

Deakin, S., Konzelmann, S. J., *Learning from Enron*, "Corporate Governance", Vol. 12, Issue 2, pp. 134-142, 2004.

Demb, A., Neubauer, F.F., *The Corporate Board*, Oxford University Press, New York, 1992.

Demski, J., *Corporate conflict of interest*, "Journal of Economic Perspectives", Vol. 17, Issue 2, pp. 51-73, 2003.

Demirag, I., Serter, M., *Ownership patterns and control in Turkish listed companies*, "Corporate Governance", Vol. 11, Issue 1, pp. 40-51, 2003.

Devlin, D., *EU toughens audit standards*, "International Tax Reviews", Vol. 14, Issue 6, p. 7, 2003.

Dixon, R., *Venture capitalists and investment appraisal*, "National Westminister Bank Quarterly Review", Issue November, pp. 2-21, 1989.

Elango, B., Fried, V., Hisrich, R., Polonchek, A., *How venture capital firms differ*, "Journal of Business Venturing", Vol. 10, Issue 2, pp. 157-179, 1995.

Ferlier, E.F., Ashburner, L., Fitzgerald, L., *The non-executive director and the board – some evidence from the NHS*, Center for Corporate Strategy and Change, University of Warwick, 1994.

Filatotchev, I., Hoskinsson, R., Buck, T., Wright, M., *Corporate restructuring in Russian privatizations: Implications for U.S. investors*, "California Management Review", Vol. 38, Issue 2, pp. 87-105, 1996.

Fried, V., Hisrich, R., *Towards a model of venture capital investment decision-making, financial management*, "Financial Management", Vol. 23, Issue 2, pp. 28-37, 1994.

Gladstone, D., Gladstone, L., *Venture Capital Investing: The Complete Handbook for Investing in Private Businesses for Outstanding Profits*, Upper Saddle River, New Jersey: Pearson Education, 2002.

Gompers, J., *Ownership and control in entrepreneurial firms: An examination of convertible securities in venture capital investments*, Working paper, Harvard University, 1997.

Hampel, E., *Committee on Corporate Governance*, Final Report, 1998.

Henke, J.W., *Involving the directors in strategic planning*, "Journal of Business Strategy", Vol. 7, Issue 2, pp. 87-95, 1986.

Kaplan, S.N., Stromberg, P., *Financial contracting theory meets the real world: An empirical analysis of venture capital contracts*, "Review of Economic Studies", Vol. 70, pp. 281-315, 2003.

Karsai, J., Wright, M., Dudzinski, Z., Morovic, J., *Screening and valuing venture capital investments: Evidence from Hungary, Poland, and Slovakia*, "Entrepreneurship and Regional Development", Vol. 10, issue 2, pp. 203-224, 1998.

Keenan, J., *Corporate Governance in UK/USA Boardrooms*, "Corporate Governance", Vol. 12, Issue 2, pp. 172-176, 2004.

Kirilenko, A., *Valuation and control in venture finance*, "Journal of Finance", Vol. 56, Issue 2, pp. 565-587, 2001.

Korn/Ferry International, *Board of Directors*, Twentieth Annual Study, 1998.

Kostyuk, A., *Board Practices: An international review*, "Corporate Ownership & Control", Vol. 1, Issue 1, pp. 102-111, 2003.

Lawday, D., *Monopoly money*, "Economist", November 18, pp. 22-24, 2005.

Lerner, J., *Venture capitalists and the oversight of private firms*, Unpublished working paper, Harvard University, 1994.

Lewis, P., *The penny drops*, "Business Eastern Europe", August 14, pp. 4-6, 2000

Lim, J.Y., (1990) *Initial public offerings: the role of venture capitalists*: Charlottesville: Institute of Chartered Financial Analysts.

Lorsch, J.W., MacIver, E., *Pawns or Potentates: The Reality of America's Corporate Boards*, Harvard Graduate School of Business Administration, Boston, MA, 1989.

Mace, M.L., *Directors: Myth and Reality*, Harvard University Graduate School of Business Administration, Boston, MA, 1971.

Manigart, S., Wright, M., Robbie, K., Desbrieres, P., De Wale, K., *Venture capitalists' appraisal of investment projects: An empirical European study*, "Entrepreneurship Theory and Practice", Vol. 21, Issue 4, pp. 29-42, 1997.

Melis, A., *On the role of the board of statutory auditors in Italian listed companies*, "Corporate Governance", Vol. 12, Issue 1, pp. 74-84, 2004.

Molo, M., Bielonka, M., *Venture capital*, "Rzeczpospolita", Issue 189, p. 3, 2002.

Montagnon, P., *The governance challenge for investors*, "Corporate Governance", Vol. 12, Issue 2, pp. 180-183, 2004.

Nadler, D., *Building Better Boards*, "Harvard Business Review", Vol. 82, Issue 5, pp. 102-111, 2004.

Norburn, D., Grinyer, P., *Directors without direction*, "Journal of General Management", Vol. 1, Issue 2, pp. 30-39, 1974.

Pahl, R.E., Winkler, J.T., *The economic elite: theory and practice, in Stanworth P.J. and Giddens* A. (ed), "Elites and Power in British Society", Cambridge University Press, Cambridge, 1974.

Pearce, J.A., Zahra, S.A., *The relative power of CEOs and boards of directors: association of corporate performance*, "Strategic Management Journal", Vol. 12, Issue 2, pp. 135-153, 1991.

Pitelis, C., Clarke, T., *Valuing Corporate Governance: an introduction*, "Corporate Governance", Vol. 12, Issue 2, pp. 125-133, 2004.

Plummer, J.L., *QED report on venture capital financing analysis*, Palo Alto: California: QED Research, 1987.

Rind, K.R., *Profitable exiting: forming strategic partnerships, IPOs, sale backs, mergers and other mechanisms*, Atlanta: Venture Capital Institute Conference, 1997.

Sadtler, D.R., *How venture capitalists add value*, "Journal of General Management", Vol. 1, Issue 1, pp. 1-16, 1993.

Sahlman, W., *The structure and governance of venture-capital organizations*, "Journal of Financial Economics", Vol. 27, pp. 473-521, 1990.

Sapienza, H., *When do venture capitalists add value*, "Journal of Business Venturing", Vol. 7, pp. 9-27, 1992.

Scherrer, P.S., *Directors' responsibilities and participation in the strategic decision making process*, "Corporate Governance: The International Journal of Effective Board Performance", Vol. 3, Issue 1, pp. 86-91, 2003.

Schlup, R., *Hotel management agreements: Balancing the interests of owners and operators*, "Journal of Retail and Leisure Property", Vol. 3, Issue 4, pp. 331-342, 2003.

Shleifer, A. and Vishny, R., *A survey of corporate governance*, "Journal of Finance", Vol. 52, Issue 2, pp. 737-783, 1997.

Silver, D.A., *Venture Capital: the Complete Guide for Investors*, Wiley and Sons, 1985.

Sinnet, W. M., *Detecting fraud – will the new rules help*, "Financial Executive", Vol. 20, Issue 2, pp. 63-65, 2004.

Skarzinskaiste, A., *Risky at best*, "Business Eastern Europe", July 14, pp. 7, 2003.

Solomon, J. F., Lin, S.W., Norton, S. D., Solomon, A., *Corporate governance in Taiwan: empirical evidence from Taiwanese company directors*, "Corporate Governance", Vol. 10, Issue 3, pp. 235-248, 2003.

Sormani, A., *Central and Eastern Europe: The accession years*, "European Venture Capital Journal", July/August, pp. 63-71, 2003.

Stiles, P., *The impact of the board on strategy: an empirical examination*, "Journal of Management Studies", Vol. 38, Issue 5, pp. 627- 650, 2001.

Sung Wook, J., *Corporate governance and firm profitability: evidence from Koreas before the economic crises*, "Journal of Financial Economics", Vol. 68, Issue 2, pp. 287-323, 2003.

Sweeting, R., *UK venture capital funds and the funding of new technology based businesses: Process and relationships*, "Journal of Management Studies", Vol. 28, pp. 601-622, 1991.

Wright, M., Karsai, J., Dudzinski, Z., Morovic, J., *Transition and active investors: Venture capital in Hungary, Poland, and Slovakia*, "Post-Communist Economies", Vol. 11, Issue 1, pp. 6-38, 1999.

Van den Berghe, L.A.A., Levrau, A., *The Role of Venture Capitalists as Monitor of the Company: a corporate governance perspective*, Corporate Governance, Vol. 10, Issue 3, pp. 124-135, 2002.

Zopounidis, C., *Venture capital modeling: Evaluation criteria for the appraisal of investments*, "The Financier" Vol. 139, pp. 54-64, 1994.

Received: September 2007, revised: February 2008