Corporate Governance Practices in Bosnia and Herzegovina

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Abstract

The purpose of this paper is to present the state of corporate governance in Bosnia and Herzegovina, to determine the degree of its principle applications, and to emphasize the importance of good corporate governance practices for transition economies, such as Bosnia and Herzegovina. Corporate governance, by its simplest definition, presents a system of management and control over the company. Good corporate governance practice is important for the investment climate, because it provides greater security for investors and shareholders and leads to sustainable long-term economic development. Because of the reorganization of the still present economic system, developing countries are faced with many problems related to the implementation of corporate governance, such as insufficient use of existing legislation, underdeveloped capital markets and insufficient bussiness transparency of the company. Foreign investors do not wish to invest in companies that do not apply the principles of corporate governance and studies have shown that for making investment decisions, the application of good corporate governance practices plays an important role. The problems Bosnia and Herzegovina is facing are still a lack of business transparency of company operations, as well as the insufficient protection of minor shareholders. At the end of this paper certain guidelines are given in order to improve practices of corporate governance in Bosnia and Herzegovina, and also the importance of their application to the company and the country itself is highlighted.

Keywords: corporate governance, transition economies, economic development, principles, business transparency

1. Definition of Corporate Governance

The term of corporate governance is far more complex than thought of at first, and implies not only the way in which a company is governed, but a full range of internal and external relations, as well as legal regulations. According to the definition of the OECD (Organization for Economic Cooperation and Development), corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. With good corporate governance practice, values as justice, responsibility and transparency of business are promoted. In economic societies in which a clear separation exists between ownership and governance, conflicts of interest appear amongst interested participants in the process of corporate governance, the influence of institutional investors, stockholders, creditors, the administration, and employees. It is necessary that all of these relationships be regulated in the aim of the successful running of the company.

According to who has the crucial position and role as concerns the relationships in a company, that is, which interest groups affect decision-making, and in which way do these interest groups participate in corporate governance, we differentiate between two types of corporate governance:

- The open corporate governance system
- The closed corporate governance system

The open system of corporate governance is called also the market, outsider, and Anglo American system of corporate governance, and is characteristic for corporations in the countries of the USA, Great Britain, Australia, and New Zealand. In the open system of corporate governance the supervision of management and the company is not in the hands of any influential interest group, while the main role falls to the capital market and the actions of the investors who invest in it. Managers have a key role in governing the company.

The closed system of corporate governance is also called the internal (insider) and the European system of corporate governance, and is characteristic for the countries of Europe as well as for countries which have harmonized their corporate governance principles with OECD recommendations which refer to corporate governance. A closed system of corporate governance is often used in countries with a poorly developed capital market and a concentrated ownership structure. It is characteristic of this system for a group of stockholders to hold a large percentage of the total number of stocks, that is, they are the owners of a significant package of stocks, and in this way actively govern the company. In this system, the capital market has a secondary meaning as opposed to the open system of corporate governance.

Bosnia and Herzegovina is closer to a closed system of corporate governance, considering its poorly developed capital market, but also due to the other characteristics of the closed system of corporate governance.

2. Corporate governance in developing and transition economies

Developing countries are still reorganizing their economic systems, so that they face numerous problems tied to the application of corporate governance, such as the insufficient application of existing legal regulations, lack of personnel for corporate governance, an undeveloped capital market, the still great presence of the state in company ownership, as well as other problems which impede upon the application of corporate governance principles. Good corporate governance practice is extremely important for countries in transition, and has influence on the optimization and growth of the country's economy. A lack of corporate governance practice leads to a negative investment climate, negatively influences the capital market, and impedes upon the further economic growth of the country. Good corporate governance leads towards long-term, sustainable survival of an economy. Developing countries need new, fresh capital and due to higher risk, foreign investors do not wish to invest in companies who do not apply the principles of corporate governance, which reduces the chances of the flow of direct foreign investments.

33McKinsey's study has shown that foreign investors are ready to invest 30% more of their resources into shares of companies from Eastern Europe with good corporate governance practice, while 40% of investors stated that corporate governance is a more important factor in deciding whether they will invest in a company in Eastern Europe than growth potential or profit. It is important that a company itself realize that corporate governance improves its economy's competitiveness on the international market. A company with a good corporate governance practice is a transparent and responsible company and as such has greater chances for access to international sources of financing.

3. OECD principles of Corporate Governance

OECD principles (Organization for Economic Cooperation and Development) were adopted in the year 1999 and revised in 2004, and they represent elements of good corporate governance and contain recommendations for policy makers, law regulation makers, investors, and companies for OECD countries, as well as in countries outside of the OECD. The principles represent non-binding standards, good customs and instructions for use, and may be adjusted to specific conditions in certain countries. The principles help companies in defining their own corporate governance practices. OECD principles cover six key areas of action: 1) construction of the frame of corporate governance, 2) rights of shareholders and key ownership functions, 3) equal treatment of shareholders, 4) the role of interest groups in corporate governance, 5) publishing of data and transparency, and 6) the board's responsibility.

In the aim of promoting the application of OECD principles of corporate governance in countries which are not OECD members, such as Bosnia and Herzegovina, regional round tables were held, in collaboration with the World Bank, in which the policies of corporate governance were discussed. In the year 2002, the Regional Round Table result was the White Paper document - a recommendation on corporate governance in southeastern Europe, which was officially adopted in Sarajevo in the year 2003. White Paper provides a list of practical recommendations, guidelines, and suggestions to policy creators, stock markets, companies, and others who have interest in the application of good corporate governance practices, and helps SEE countries in the promotion of corporate governance practices. This document is primarily focused on companies whose stocks are publically traded, but can also be applied to companies whose stocks are not listed on the stock market. OECD principles as well as recommendations within White Paper help in the development of national codex of corporate governance. One such codex is the corporate governance Codex for companies listed on the Sarajevo Stock Exchange (SASE) which represents a group of the best company leadership practices in the world, adapted to a transitional market such as Bosnia and Herzegovina. The codex includes the following areas: transparency in business, relationships with investors and interest carriers, assemblies, the supervisory board, the administration, auditing and mechanisms of internal control, as well as social responsibility. Accepting the corporate governance codex is a requirement for companies in quotation (A list companies), while the application of the codex is not required of the companies listed and included on the free

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market. A company which has accepted the corporate governance codex is obliged to abide by the provisions of the codex, and if it is unable to implement certain provisions, it is obliged to, within the questionnaire, which is a constituent part of the codex, state why it is not implementing the enclosed recommendations. In this way, investors can decide whether they wish to invest in a certain company on the Sarajevo Stock Exchange. In 2011 also Banja Luka Stock Exchange has adopted the Standards of Corporate Governance with the aim to improve corporate governance practices in companies which are listed on this stock exchange.

4. Corporate governance practices in Bosnia and Herzegovina

In order to analyze the application of corporate governance principles in Bosnia and Herzegovina, the World Bank, for the first time in the year 2006, made a Report on the Observance of Standards and the Codes (ROSC). An analysis of the following adherence to OECD principles was conducted:

Table 1. OECD Principles

Section I: Ensuring the basis for an effective corporate governance framework
Principles: Overall corporate governance framework; Legal framework enforceable/ transparent; Clear division of regulatory responsibilities; and Regulatory authority, integrity, resources
Section II: The right of shareholders and key ownership functions
Principles: Basic shareholder rights; Rights to part. in fundamental decisions, Shareholders GMS (general meeting shareholders) rights; Disproportionate control disclosure; Control arrangements allowed to function; Exercise of ownership rights facilitated; and Shareholders allowed to consult each other
Section III: Equitable treatment of shareholders
Principles: All shareholders should be treated equally; Prohibit insider trading; and Board/Managers disclose interests
Section IV: Role of stakeholders in corporate governance
Principles: Legal rights of stakeholders respected; Stakeholder redress; Performance-enhancing mechanisms, Stakeholder disclosure; Whistleblower protection; and Creditor rights law and enforcement
Section V: Disclosure and transparency
Principles: Disclosure standards; Standards of accounting & audit; Independent audit annually; External auditors should be accountable; Fair & timely dissemination; and Research conflicts of interests
Section VI: Responsibilities of the board
Principles: Acts with due diligence, care; Treat all shareholders fairly; Apply high ethical standards; The board should fulfill certain key functions, Exercise objective judgment, and Access to information

To adhere to certain principles, the assigned grades were "*observed*", "*largely observed*", "*partially observed*", "*materially not observed*" and "*not observed*". The results of the study are represented in the following table:

Table 2. Frequency of Each Category – Compliance with Corporate Governance Principles

	Principles	**%**
Observed	0	0
Largely observed	4	12,5
Partially observed	22	68,8
Materially not observed	6	18,7
Not observed	0	0
Total	32	100 %

For adhering to the majority of principles, Bosnia and Herzegovina received the grade "*partially observed*". For adhering to the principles of the basic stockholders right, the shareholders GMS rights, the principle stakeholder redress, and the creditor rights law and enforcement, B&H received a poorer grade, namely "*largely observed*". The grade "*materially not observed*", B&H received for not adhering to the following principles: the rights of shareholders to participate in fundamental decisions, Board/Managers disclosure of interests, stakeholder disclosure, whistleblower protection, disclosure standards and acting with due diligence, care. In no case did Bosnia and Herzegovina receive the grades "*observed*" or "*not observed*".

4.1. Application of Corporate Governance Principles by companies in Federation of BiH

In 2011 the independent consulting firm SEE Business Solutions d.o.o. Sarajevo has conducted an analysis of the application of corporate governance principles by companies in Federation of Bosnia and Herzegovina. The study processed 55 joint stock companies. The results according to the analyzed areas were the following:

The Management and Supervisory board: in more than 50 % of the analyzed companies the supervisory board consists of only 3 members and only 11% of companies board members are independent, while 38 % members are either stockholders or employees in the company. In 38 companies the compensations for supervisory board members are fixed, and 12 companies don't pay compensation to the board members. Only 8 companies have formed Commissions of the Supervisory/Management board.

Control environment: of the 55 analyzed companies, 43 have established a system of internal control, while the position of internal auditor exists in 28 companies. 31 companies have established a risk management system.

Publications: in 23 companies financial reports are available on the web site, which is less then 50% of analyzed companies. Independent auditor's reports can be found at only 21 web sites. Regarding the publishing of transaction with concerned parties and information on materially significant events, 28 companies publish these information.

Stockholders' rights and protection: payment of dividends in the past 3 years did only 10 companies, while 45 companies did not pay their dividends. On 38 % companies web sites the information about the general assemblies can not be found. Of the 55 of analyzed companies, 41 companies stated that they formally incorporate social responsibility through internal documents.

Based on recommendations given in the OECD report from year 2006 and accordance to the newest researches, we can single out some key courses for corporate governance development in Bosnia and Herzegovina:

- The companies should strengthen the supervisory board, increase the number of members, insist upon the independence of members, form commissions for the naming of supervisory board members, as well as define compensation policy for the members of the supervisory board
- It is necessary for more companies to organize their own control environment in accordance with their own level of risk exposure and to manage risk more intensively
- According to OECD principles, companies should publish all significant information such as financial and business company results, the goals of the company, the ownership structure, data on board members and their compensations, as well as their corporate governance policies
- Greater the protection of interests of minor shareholders. Shareholders very often do not have at their disposal important information on the business of the company and this impedes upon their security
- The access to relevant information has to be simple and timely, and the publishing of data on transactions of connected parties should be strengthened.

This research has shown that joint stockholder companies in the Federation of Bosnia and Herzegovina, and the situation being similar in companies in the smaller Bosnian and Herzegovina entity, the Republika Srpska, have not attained significant improvement in the past few years. The reason for the stated problem can be in the misunderstanding of corporate governance principles and the importance of incorporating good corporate governance practices.

5. Conclusion

Good corporate governance practice decreases the risk for investors, increases the performance of the company, improves access to capital markets, increases transparency and social responsibility in business. Since the goal of Bosnia and Herzegovina is to get closer to the European Union, companies will have to incorporate corporate governance principles in their business transactions if they wish to be competitive on the international market.

Spreading good corporate governance practice implies recognizing the significance and the usefulness of corporate governance for the company as well as for the country itself. Corporate governance is important, for the country, the companies, as well as for society as a whole. Corporate governance leads to the achievement of social wealth, increases competitiveness on the international capital market, leads towards a positive investment climate, and to the long-term development of the economy. Good corporate governance practice contributes to the greater transparency of business, better supervision of the company, and therefore its better reputation. For the aim of further promotion of corporate governance, special care should be taken of the greater promotion of good corporate governance practice, greater protection of the interests of minor shareholders, strengthening the role of the supervisory board, greater compliance of entity laws, as well as greater transparency in company's business transactions.

In the past years, corporate governance gained more importance, and many studies have shown that the application of good corporate governance practices leads to the greater value of the company and a smaller risk of financing.

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