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Corporate Governance and Ownership Structure

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A B S T R A C T

The highly concentrated ownership in the Bosnia and Herzegovina market provides a rich environment to explore corporate governance practices. The paper will assess effects that ownership structure of companies has on the level of implementation of corporate governance in companies listed on the Official market of the Banja Luka Stock Exchange. Results of implementation of the corporate governance in companies will be presented using Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance for companies which are listed on the Official market of the Banja Luka Stock Exchange. Ownership structure will be presented in three groups of owners determined by controlling owner: government, domestic and foreign owners. Paper will show correlation and effect which different owners of companies have on the level of implementation of corporate governance in these companies.

A R T I C L E I N F O

Keywords:
Corporate Governance, Ownership structure, Domestic, Foreign

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1. **INTRODUCTION** (Style: Times New Roman, 12 pt, Bold, CAPITALISED)

Corporate governance is a key element for improvement of investors' confidence, increase of competitiveness and improvement of economic growth. Corporate governance is on the top of agenda for international development as stated by James Wolfensohn (1998) that "the governance of the corporation is now as important in the world economy as the government of countries".

Good corporate governance is not possible without appropriate legal framework and quality rules, regulations and standards. Without these assumptions it is not possible to create business environment in which shareholders, especially minority shareholders, will be able to successfully and equally fulfil their rights and interests in companies in which they invested their capital.

Research problem of this paper is determining effects that ownership structure of companies has on the level of implementation of corporate governance in companies listed on the Official market of the Banja Luka Stock Exchange. For investors one of the most important aspects when making an investment decision is a level of implementation of corporate governance principles.

2. THEORETICAL BACKGROUND AND RESEARCH HYPOTHESIS

In the last few years corporate governance has become subject of the large interest in theory, as well as in practice. Parker stated that “corporate governance has commanded the highest levels of attention and debate among legislators, regulators, professions, business bodies, media and in the general community” (Parker, 2007:1). Despite existence of many different approaches and definition of corporate governance, it can be broadly defined as “basically the system by which companies are directed and controlled” (Cadbury, 1992).

Most basic and widely used definition of corporate governance is given by Sir Cadbury by whom “corporate governance is the system by which companies are directed and controlled” (Cadbury, 1992). More accurately, it is the framework by which interest of various stakeholders are balanced, or as stated by the International Financial Organization (IFC) it „concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders“(IFC, 2005). The Organisation for Economic Co-operation and Development (OECD) also defines corporate governance in its Principles of corporate governance „corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined “(OECD, 2004). There is evidence from many researches that good corporate governance system produces direct economic benefit to the company, making it more profitable and competitive. Lipman (2006) states that good corporate governance helps to prevent corporate scandals, fraud, and potential civil and criminal liability of the organization. Good corporate governance enhances image and reputation of a company and makes it more attractive to investors, suppliers, customers and other stakeholders of the company.
Recent research in this field shows that investors have a tendency to invest more in companies which have better governance systems. Bushee, Carter and Gerakos (2007), as well as Leuz, Lins and Warnock (2007) support this claim that investors exhibit preference for well-governed firms.

Merton (1987) argues that investors are more likely to invest in those companies that they know about. Results of studies of Brennan and Cao, (1997); Kang and Stulz, (1997); Covrig, Lau and Ng, (2006); and Choe, Kho and Stulz, (2005) indicate that foreign investors tend to invest primarily in those companies associated with less information asymmetry.

According to McKinsey Global Investor Opinion Survey on Corporate Governance (2002) 73% of investors say that corporate governance is equally or more important relative to financial issues (e.g., profit performance and growth potential) in evaluating which companies they will invest in. Also this Survey indicates that corporate governance does matter to investors, and that 76% of investors said that they are willing to pay a premium for a well-governed company. This indicates that investors, especially in crisis, value more companies which are well governed.

One of the central points of the corporate governance literature is the role of the ownership structure as a governance mechanism. Most of the literature deals with the relation between ownership structure and firm performance. Ownership structure is mostly viewed through ownership concentration. The debate on ownership structure and firm performance was firstly started by Berle and Means (1932). Relationship between the ownership structure and firm performance was tested by Jensen and Meckling (1976), Shleifer and Vishny (1986), Morck, Shleifer and Vishny (1988), McConnell and Servaes (1990), La Porta R, Lopez-de-Silanes F, Shleifer A, Vishny R. (1999), Thomsen and Pedersen (2000), Gedajlovic and Shapiro (1998, 2002), Demsetz and Lehn (1985), Himmelber, Hubbard, and Palia (1999), Demsetz and Villalonga (2001) as well as by many other researchers.

This paper focuses on different aspect of ownership structure dividing it into three groups of owners determined by controlling owner: government (state), domestic and foreign owners. Paper focuses on determining correlation and effect which different owners of companies have on the level of implementation of corporate governance in these companies.

To offer useful answers to the research problem and realize the study objectives, the following hypotheses were tested.

H1: There is a correlation between level of implementation of corporate governance and ownership structure.

H2: Foreign owned companies have higher level of implementation of corporate governance standards in each of seven areas of Scorecard analysis than companies which are domestic and state owned.

H3: State owned companies have lowest level of corporate governance and do not comply with best practices and principles of corporate governance.

3. RESULTS AND METHODOLOGY

3.1 Methodology

The highly concentrated ownership in the Bosnia and Herzegovina market provides a rich environment to explore corporate governance practices. The paper will assess effects that ownership structure of companies has on the level of implementation of corporate governance in companies which are listed on the Official market of the Banja Luka Stock Exchange. Results of implementation of the corporate governance in companies will be presented using Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance for companies which are listed on the Official market of the Banja Luka Stock Exchange. The research for the Scorecard analysis was done for a period of 3 years (2010, 2011 and 2012). Ownership structure will be presented in three groups of owners determined by controlling owner: government (state), domestic and foreign owners. The research data was gathered from the database of the Banja Luka Stock Exchange, the National Assembly of the Republic of Srpska, Securities Commission, companies' annual reports and WebPages. Scorecard analysis for corporate governance.

The Scorecard for the Standards of governance of Joint Stock Companies (The Banja Luka Stock Exchange 2009) was developed by the Banja Luka Stock Exchange with the assistance of the International Finance Corporation (IFC) based on the model of the Scorecard for German corporate governance (DVFA Corporate Governance Working Group 2002).

The purpose of the development of the scorecard is to facilitate the work of analysts and investors by providing a systematic and simple overview of all relevant issues with regard to good corporate governance, enable companies to easily determine the scope and quality of own corporate governance and enable comparison with other companies, industries and countries.

The structure of the Scorecard analysis contains the main criteria which are included in the standards and recommendation of best practice of corporate governance, with the relevant set of questions for each area.

The structure of the Scorecard analysis consists of seven areas:

1. Commitment to corporate governance principles;
2. Rights of shareholders;
3. Equal treatment of shareholders;
4. Role of stakeholders in governance of joint stock companies;
5. Publishing and transparency of information;
6. Role and responsibility of the boards; and
7. Audit and internal control system.

These seven areas of the Scorecard analysis are comprised of 42 questions on which every tested company should give an answer (yes, partially or no).

Conceptually, the evaluation of the implementation of the principles of corporate governance should have the score between 65% - 75%, which is possible by the implementation of mandatory principles of corporate governance defined in the Standards of Governance of Joint Stock Companies, i.e. in the legal framework of the capital market of the Bosnia and Herzegovina. Achieving the total score of 100% should be an incentive for companies to implement higher principles of corporate governance (Strenger 2002).

3.2 Results

The research for the Scorecard analysis was done for a period of 3 years (2010, 2011 and 2012) in companies which are listed on the Official market of the Banja Luka Stock Exchange. Research results are derived from more than 2.000 survey answers. Moreover, results are presented by each area of Scorecard analysis for corporate governance.

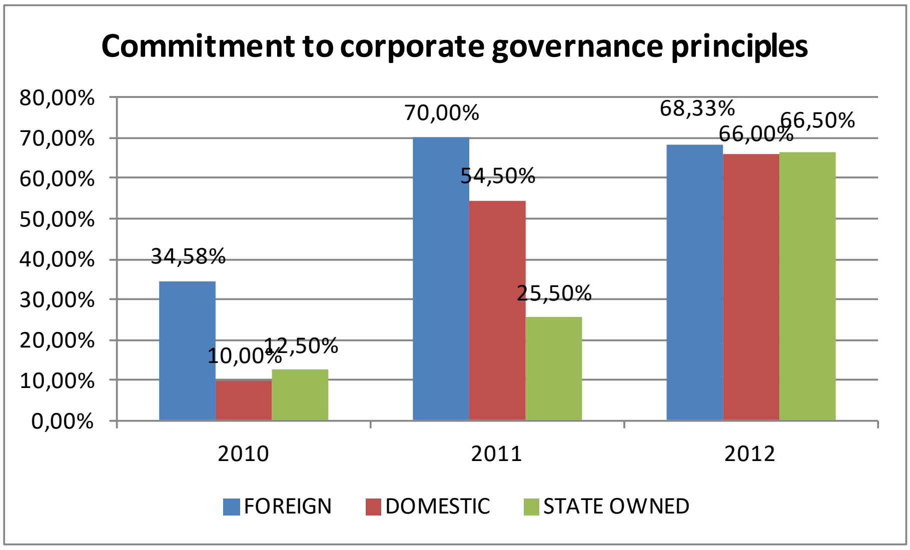

Chart 1: *Commitment to corporate governance principles*

On the Chart 1 it has been shown that foreign owned companies have been more committed to corporate governance principles and have been engaged in implementation of corporate governance systems than domestic and state owned companies. Results also indicate that domestic and state owned companies have improved its commitment to corporate governance principles over the period of three years. This is mainly due to obligation which has been put on them by new Company Law. Through further analysis it has been determined that 50% of foreign owned companies have adopted its own corporate governance codes, which are based on company specific situation, industry and market. While none of the domestic owned and state owned companies have adopted its own company specific corporate governance codes.

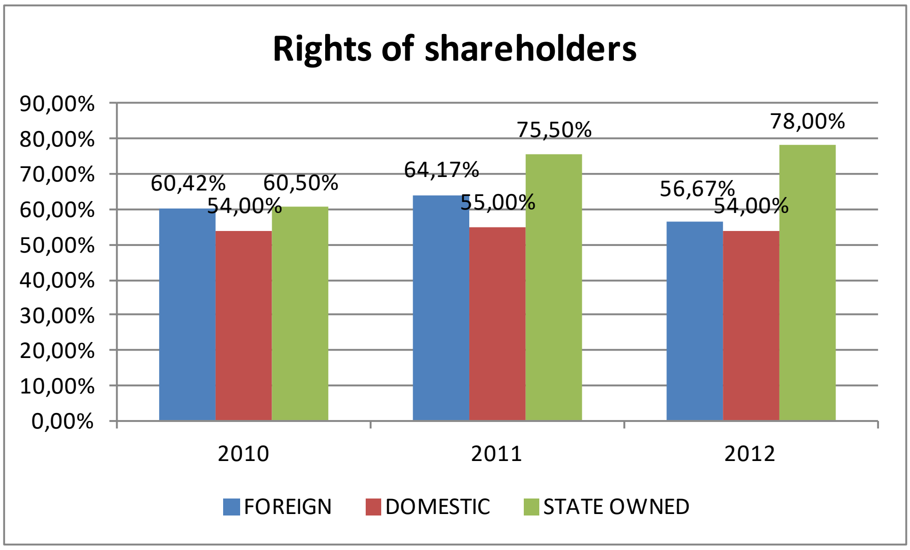

Chart 2: Rights of shareholders

On the Chart 2 it has been shown that state owned companies protect rights of shareholders more than foreign and domestic companies. Further analysis has shown that state owned companies, which have a highest score in protection of shareholders rights, have adopted documents regarding the rights of shareholders as they are required by law, but they do not comply with these rights. Furthermore, appointments of members to the Boards are not publicly announced or are publicly announced but person who would be elected is earlier known.

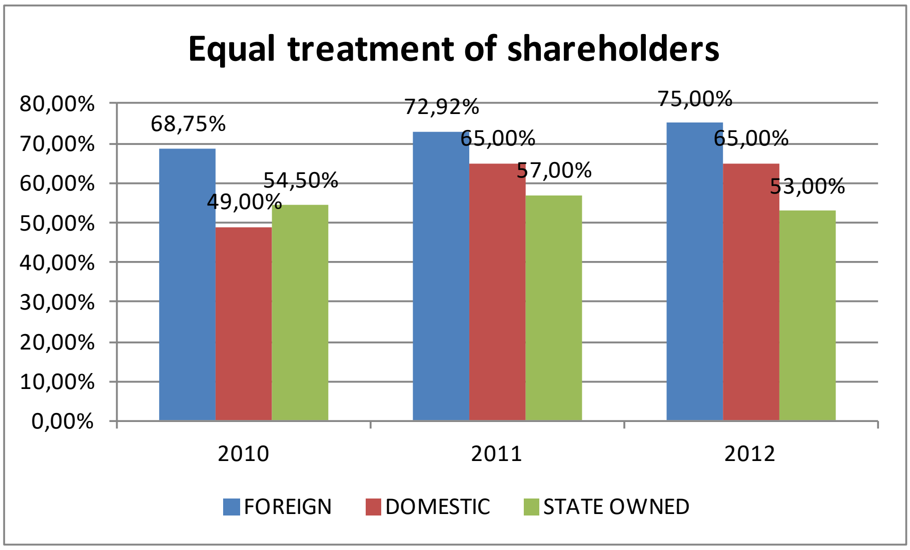

Chart 3: Equal treatment of shareholders

Results from Chart 3 have shown that foreign owned companies have highest score in equal treatment of shareholders, while state owned companies have lowest score. Furthermore, foreign owned companies have adopted procedure for protection and equal treatment of shareholders. While, domestic and state owned companies usually do not have additional internal acts and procedures which protects minority shareholders. Also, most of tested companies have not adopted internal regulations and procedures for the prevention of share trade based on insider information.

These results confirm previous point that state owned companies do not comply with their acts and do not protect rights of shareholders.

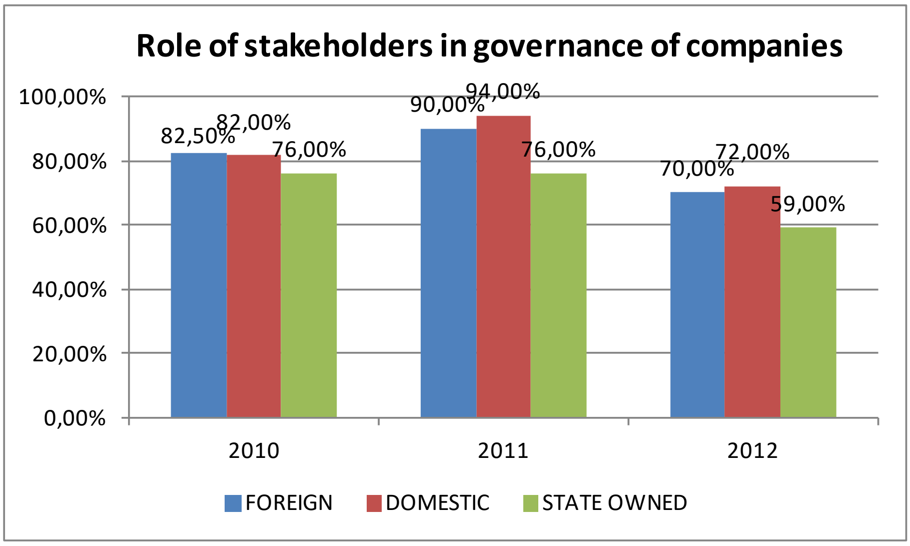

Chart 4: Role of stakeholders in governance of companies

Results from Chart 4 have shown that domestic and foreign owned companies have highest score in area of role of stakeholders in governance of companies, which indicates that they actively cooperate with stakeholders and do take into account interests of the stakeholders. State owned companies rarely cooperate with stakeholders and take into account their interests. Also, in state owned companies there are no clear procedures for disclosure of information to all stakeholders of company. Moreover, tested companies rarely have a person responsible for contact with stakeholders, or this person is not disclosed on companies' web page or annual report.

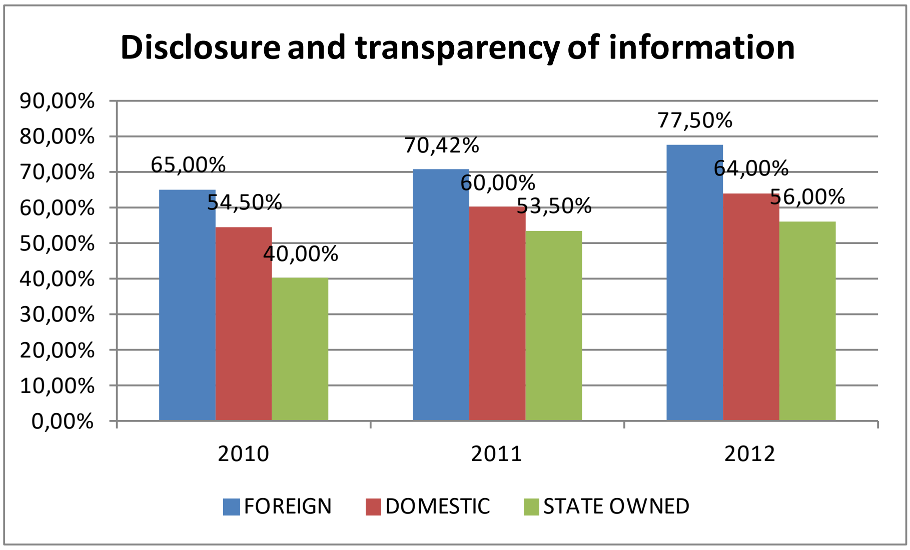

Chart 5: Disclosure and transparency of information

On the Chart 5 it has been shown that foreign owned companies have much better practice of disclosure and transparency of information than domestic and state owned companies. Majority of domestic and state owned companies do not have web-site with up to date information or information available in English. Main issue which has been detected through analysis is that companies only disclose obligatory information which are required by law and do not go further and company with best practices and requirement of OECD principles of corporate governance. Further analysis of results has snow that worst situation is with disclosure of reason why they do not comply with the Standards of Corporate Governance as this is required by these Standards if company do not comply with any standard („COMPLY OR EXPLAIN“ principle). Moreover, management board of companies rarely discusses company's compliance with the Standards of Corporate Governance.

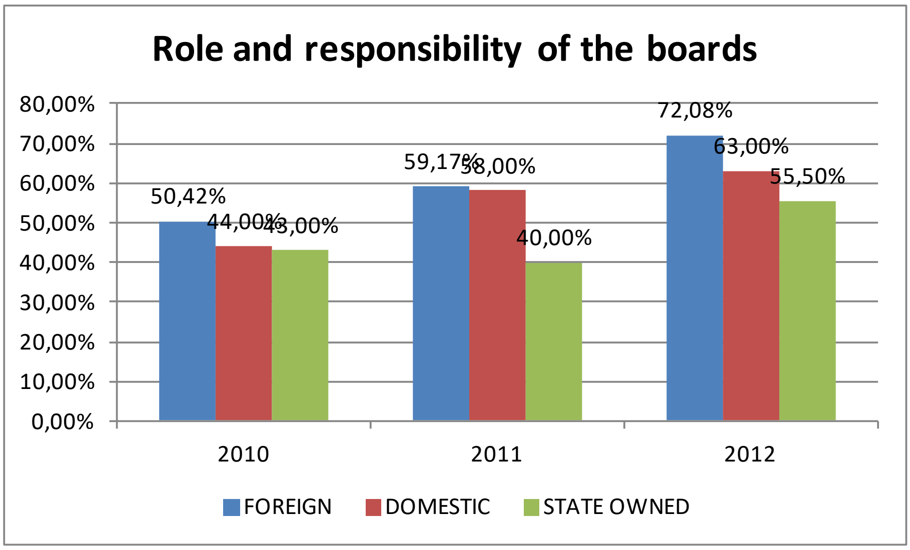

Chart 6: Role and responsibility of the boards

Chart 6 shows that foreign owned companies have highest score in role and responsibility of its boards, while state owned companies have lowest score. These results indicate that foreign owned companies' boards are more responsible in decision making and running a company. Analysis has shown that domestic owned, but mainly state owned companies do not have sufficient number of independent members. Also most of domestic and state owned companies do not have procedure dealing with conflict of interest. Most important issue in this area of analysis is that in most of tested companies board members compensation is fixed and it's not related to company's performance.

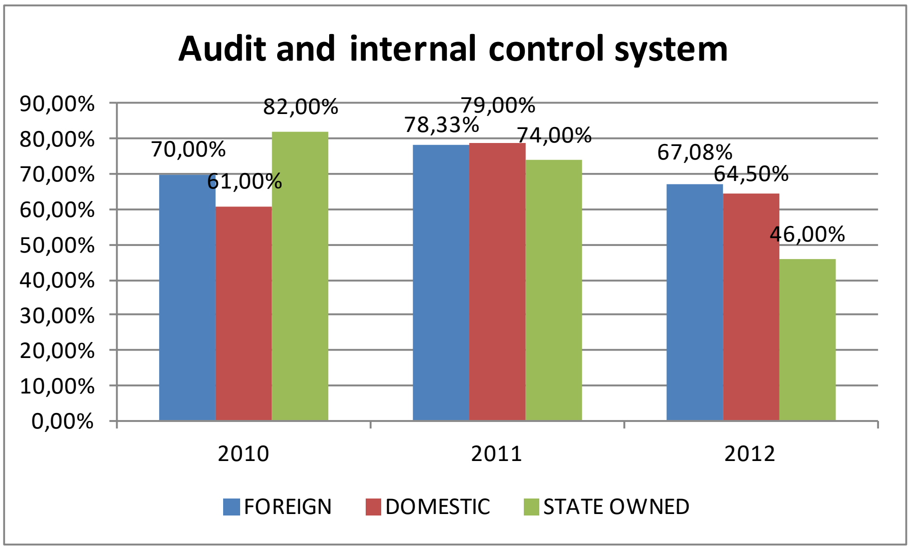

Chart 7: Audit and internal control system

Results from Chart 7 have shown that state owned companies in 2010 have highest score as they were obliged to implement audit and internal control systems. Analysis for 2011 and 2012 have shown that audit and internal control systems was not functioning in state owned companies, while foreign and domestic owned companies have kept its score at almost the same level. Main problem for all tested companies was independence of persons responsible for the internal audit and control. Furthermore, most of tested companies do not have established Risk Management. There is a place for improvement of audit and internal control systems in all three groups of companies.
paper. They should be ranked from general to specific terms.

4. DISCUSSION

Results from Chart 8 and Table 1 have shown that foreign owned companies have highest total score in Scorecard analysis and have best practice of corporate governance. This is due to origin of owners of these companies. Majority of these owners come from developed countries with good system and practices of corporate governance. Therefore, they have incorporated these practices into companies they own in the Bosnia and Herzegovina.

Most of domestic owned companies still do not have a satisfactory level of corporate governance and did not implement system of corporate governance but they do comply, to some extent, with standards and principles of corporate governance.

The worst results have state owned companies which do not have implemented system of corporate governance and do not comply with standards and principles of corporate governance. Results have shown that state owned companies only comply with minimum obligation required by law and do not go further and complay with best practices and requirement of OECD principles of corporate governance.

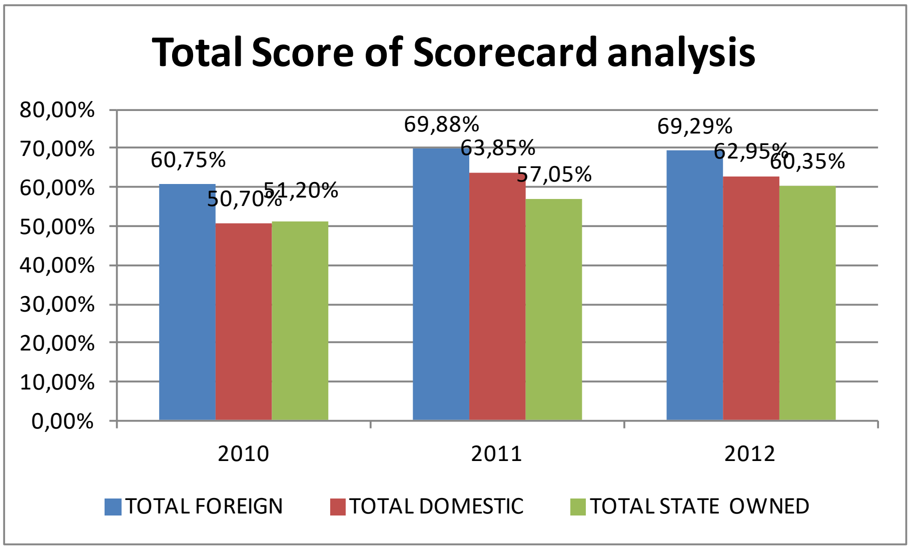

Chart 8: Total score of Scorecard analysis

	Foreign Owned	Domestic Owned	State Owned
Commitment to corporate governance principles	57,64%	43,50%	34,83%
Rights of shareholders	60,42%	54,33%	71,33%
Equal treatment of shareholders	72,22%	59,67%	54,83%
Role of stakeholders in governance of joint stock companies	80,83%	82,67%	70,33%
Disclosure and transparency of information	70,97%	59,50%	49,83%
Role and responsibility of the boards	60,56%	55,00%	46,17%
Audit and internal control system	71,81%	68,17%	67,33%
TOTAL	**66,64%**	**59,17%**	**56,20%**

Table 1: Average corporate governance score for 2010, 2011 and 2013

On average domestic owned companies have total score of 59,17%, while state owned companies have total score of 56,20% which is not on satisfactory level taking into account that companies that apply basic principles of corporate governance should have the score between 65% - 75%.

A low level of implementation and compliance with principles of corporate governance increases business risks, lowers completeness of company and increases investment risks for potential investors.

Legal and Corporate governance framework of the Bosnia and Herzegovina do not encourage companies to do more and therefore companies comply with minimum standards required by the law. Furthermore, companies see these legislations and standards only as an obligation they have to comply with because it's the law but not as way to differentiate themselves from other companies, to build company image and reputation, build investors trusts, attract new investors and raise capital at lower price.

Authors should discuss the results and how they can be interpreted in perspective of previous studies and of the working hypotheses. The findings and their implications should be discussed in the broadest context possible. Future research directions may also be highlighted.

5. CONCLUSION

Results of the Scorecard analysis of implementation of corporate governance practices and principles indicate that there is an obvious correlation and effects that ownership structure of companies has on the level of implementation of corporate governance.
Moreover, results indicate that level of voluntary governance compliance has a connection with firm ownership structure.

A low level of implementation and compliance with principles of corporate governance, in domestic but specially in state owned companies, increases business risks, lowers completeness of company and increases investment risks for potential investors.

There are many segments which should be improved in order to reach satisfactory level of corporate governance, lower business risks, attract new investors and raise capital at lower price. Most important are commitment to the corporate governance standards, rights and equal treatment of shareholders and disclosure and transparency of information.
Improvement in legal framework and companies compliance is obvious strategy which will lead to better corporate governance system, increase in investors trust and decrease in agency problem between controlling and minority shareholders as well as shareholders and managers.

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