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CORPORATE GOVERNANCE: STATE AND TRENDS IN THE REGION – A REGULATORY APPROACH

Korporativno upravljanje – stanje i tendencije u regionu (regulativni pristup)

Abstract

Stability of the financial system depends on its ability to respond to the demands of the time in which it has to exercise its functions. If these functions are not fully implemented in the laws and regulations governing the financial system of a country, it is understandable that there is a need to align the legislation and system with the current needs and requirements of the financial markets. In everyday life changes are becoming increasingly normal and commonplace. The need for change has become one of the biggest challenges facing the modern strategic management of the company. Looking at the macro level, due to varying success in coping with the coming changes, a relative position of individual countries is changing, as well as their industrial base, wealth, and power.

In our circumstances, where the companies are in the process of transition, various transformation processes are gaining importance given that in many companies, in the past, the very scope and structure of businesses were jeopardized and that the quality of their performance has been below a minimally acceptable level over a longer period of time. Therefore, it is clear that if they are to successfully cope with the competition, they must first empower themselves to meet modern standards of business. The contemporary review of corporate governance cannot be undertaken without the consideration of important events and relationships that the practice of developed countries has crystallized, such as the rule of law, institutional development, contractual relationships within corporation, protection of property rights, managerial discretion, and the agency problem. The study of corporate governance requires a multidisciplinary approach, involving finance, social sciences, political science and strategic management. Corporate governance system refers to the entirety of laws, effective institutions, professional chambers and business ethics. In emerging markets many of these links are absent, which makes the establishment of a stable corporate governance system

even more difficult due to the weaknesses of public governance. Effective corporate governance is based on the accountability of corporate management which should act in the best interest of shareholders and other stakeholders interested in the success of corporations. It basically derives from elementary rules of property rights protection and is a prerequisite for the integrity of market institutions.

Key words: *corporate governance, market, competitiveness, institutions, public sector auditing*

Sažetak

Postojanost jednog finansijskog sistema zavisi od sposobnosti tog sistema da odgovori zahtevima vremena u kome treba da ostvaruje svoje funkcije. Ukoliko ove funkcije nisu u potpunosti implementirane u zakonima i drugim propisima kojima se uređuje finansijski sistem jedne zemlje, razumljivo je da postoji potreba da takvi propisi i takav sistem budu usklađeni sa aktuelnim zahtevima i potrebama finansijskog tržišta. I u svakodnevnom životu promene sve više postaju normalna i uobičajena stvar. Potreba za promenom postaje jedan od najvećih izazova sa kojim se susreće strategijski menadžment savremene kompanije. Posmatrano na makro planu, zahvaljujući različitoj uspešnosti u suočavanju sa nastupajućim promenama, preuređuje se relativni položaj pojedinih zemalja, njihova industrijska osnova, bogatstvo i moć.

U našim uslovima, gde se kompanije nalaze u procesu tranzicije, različiti transformacioni procesi dobijaju na značaju imajući u vidu da su u velikom broju preduzeća, u prethodnom periodu, ugroženi obim i struktura delatnosti, te da je kvalitet njihovih poslovnih performansi u dužem vremenskom periodu ispod nekog minimalno prihvatljivog nivoa. Stoga je jasno da se one da bi se uspešno nosile sa konkurencijom najpre moraju osposobiti da odgovore savremenim standardima poslovanja.

Savremeni pregled korporativnog upravljanja nije moguće sprovesti bez razmatranja važnih pojava i odnosa koje je iskristalisala praksa razvijenih zemalja. To su vladavina prava, institucionalna razvijenost, ugovorno definisanje odnosa u korporaciji, zaštita vlasničkih prava, diskrecija menadžera i agencijski problem. Istraživanje korporativnog upravljanja zahteva multidisciplinarni naučni pristup koji obuhvata finansije, društvene nauke, političke nauke i strategijsko upravljanje. Pri čemu, sistem korporativnog upravljanja predstavlja celinu koju čine zakoni, kvalitetne institucije, profesionalna udruženja i etičnost poslovanja. Međutim, u zemljama u tranziciji mnoge od ovih karika nedostaju, pa je pokušaj postavljanja stabilnog sistema korporativnog upravljanja suočen s teškoćama zbog slabog javnog upravljanja. Kvalitetno korporativno upravljanje obezbeđuju odgovorne upravljačke strukture uz uvažavanje interesa akcionara i svih zainteresovanih subjekata za uspešno poslovanje korporacija. Ono je u osnovi izvedeno iz elementarnih pravila zaštite svojine i predstavlja preduslov integriteta tržišnih institucija.

Ključne reči: *korporativno upravljanje, tržište, konkurentnost, institucije, revizija javnog sektora*

Introduction

Effective corporate governance contributes to building trust and confidence in the company's operations, providing an easier access to external sources of financing, and increasing the credibility of the company vis-à-vis investors, employees, and other stakeholders.

This is especially important for publicly traded companies, because by entering the financial markets, a corporation is required to disclose information about the listed capital in a way that its prospectus becomes publicly available to a large number of investors (diversification of information). On the other hand, investors also diversify their portfolio in order to reduce a specific (unsystematic) risk of investments. Thus, the capital market is the intersection of demands for diversification, by which participants aim to provide the best possible option for their activities while assuming lower risk. However, the process of diversification cannot, in spite of internationally defined standards and rules of conduct, by itself provide the safest and most secure realization of interests of all participants, but can only reduce the risk of the least favorable outcome of events. For the foregoing reasons, it was established a mechanism of relations and criteria within corporations that define the need for compliance with legal, ethical rules and standards of conduct, which helps the management structures of the company to run

business in line with defined principles of corporate governance and investors to invest based on the evaluation and assessment of experiential and expert-defined criteria of business organizations.

The quality of institutions is an important component in the effective functioning of markets. Market activities involve the interaction of people, they exist to reduce the risk of uncertainty arising due to incomplete information about behavior of other individuals. Institutions can act through a number of channels: reduce informational asymmetries channeling information on market conditions, products and participants; reduce risk by defining and implementing property rights and contracts; restrict the activities of politicians and various interest groups, making them responsible citizens. Therefore, institutions exercise an important influence on economic activity. In addition, strong financial institutions are the foundation of successful capital markets and, ultimately, wealth creation and a healthy economy. A lack of effective financial institutions has disastrous impact on the economy and social costs of countries.

Research studies of numerous authors have undoubtedly confirmed the importance of institutions for the functioning of all spheres of a socio-economic system and can be classified according to:

- Degree of formality,
- Different levels of the hierarchy, and
- The area of analysis.

As regards the degree of formality, there are different formal and informal institutions. Formal rules are supported by written and unwritten rules of conduct. Formal rules and constraints stem from the Constitution, laws, property rights, contracts, statutes, regulations and decrees of implementation. Informal institutions often facilitate transactions and may be of much greater importance in poor countries, where formal institutions are underdeveloped. Informal rules are traditions, customs, cultural values, modifications of formal rules and socially sanctioned forms of behavior.

Institutions at different levels of the hierarchy are interconnected, whereby there is interaction between the different levels. At the first level there are institutions that are related to the social structure of the society, such as

social norms, customs and traditions. At the second level there are institutions that establish the rules of conduct and define the property rights and judicial system of the country. Institutions at the third level are associated with the management, while the fourth level institutions are related to the mechanisms of resource allocation, such as controlling the flow of capital, trade liberalization, and the implementation system of social security.

Economic institutions are the rules that define the production, the processes of allocation and distribution of products and services, including the market. Political institutions include variables that ensure elections, electoral rules, type of political system, party system and determine the political stability of a country. Legal institutions define and enforce property rights and legal sources. Social institutions cover the rules of health, education, social security, and the security of regulating relations among economic participants in general.

Institutional infrastructure

The notion of institutions could be represented by several elements, such as formal and informal rules of behavior, ways and means of implementing these rules, procedures for conflict mediation, sanctions in case of violation of rules, and organizational support of market transactions. Institutions [4, p. 13] may be more or less developed depending on the quality of these various features. They may create a favorable environment or destroy incentives for individuals to engage in the production, trade, and investment. Besides, institutions may encourage investment in research and development, and provide a basis for economic progress.

Institutions of corporate governance can be defined as the rules governing the control of company resources. They include traditional corporate governance mechanisms, institutions of markets for goods and services (the regulators responsible for competition), labor market institutions, capital market institutions, financial intermediaries, and the judiciary.

The aforementioned set of institutions affects growth and development in a country [6, p. 48] by creating conditions for the inflow of investments, integration into

international trade flows, capital increase, greater political stability, more efficient ethnic conflict management, and implementation of other policies. The system of corporate governance in a country embodies formal and informal rules of behavior, enforced practice and mechanisms of the law, both public and private, which interact and act as an efficient tool of control of corporation (“corporate insiders”) on the one hand, and of all other actors that might be interested to invest in a corporation, on the other. It is widely accepted that the companies that are well managed and whose shares are actively traded can attract more investment inflows from investors, who do not have a significant role in the control, at significantly lower costs than the ones that are poorly managed. The reason lies in the fact that potential investors require a higher risk premium when investing in companies that are poorly managed. This enables the efficient allocation of resources in the economy.

Entitlement to dividend could be seen as a legal substitute for the weaknesses of other types of protection of small shareholders. The countries with the “common law” systems provide shareholders with the strongest legal protection, while the countries with French “civil law” system grant the weakest legal protection to investors.

Economic performance of companies depends on the mechanisms of corporate governance, i.e. the legal protection of shareholders, ownership structure, identity of large owners, decisions that can be made at the general meeting of shareholders, corporate organizational structure, composition of management and supervisory boards, management participation in equity, competitive position and financial policy of a company. Legal stability of a country and institutional development are the preconditions for the right functioning of corporate governance and capital market. In the context of transition, it is necessary to ensure the compatibility between the model of privatization and regulation of capital markets [16, p. 31] which, with an effective practice of investor protection in place, leads to the development of capital markets, lower cost of capital, as well as to the growth and development of privatized companies. There are also monitoring costs incurred by the principal, the agent’s spending limit, and residual losses. The cost of the principal due to the monitoring does not

include only the costs of monitoring and evaluation of agent's behavior, but also the cost of the entire effort of the principal put in the control of the way in which the agent manages corporate resources, compensation policies, policy enforcement, and other activities. The divergence between the interests of the principal and those of the agent occurs when monitoring costs increase due to the need to limit unnecessary costs of the agent.

Namely, the agent will be paid to use the funds (to limit the costs) if he can guarantee that he will not take any action that may be harmful to the principal. Residual losses are actually lost potential benefits because it is not feasible to provide a perfect incentive in the circumstances where it is impossible to observe the activities of agents. The owners of corporations use different mechanisms of control or management in order to limit the discretion of managers. The economic literature identifies internal and external control mechanisms of corporate governance.

(1) Internal mechanisms are networked in the organization and distribution of corporate power and relate to ownership structure as well as management/executives structure.

(2) In addition to internal, there are stronger external influences that can motivate managers to act in the interests of shareholders. These are external mechanisms [25, p. 150] monitoring the capital markets and legal and institutional system of a country. Market competition, for example, leads to the elimination from the market (bankruptcy) of the companies whose managers do not operate in the interests of corporation. These managers lose their jobs. Discretionary behavior of managers will be limited by the action of an active market for corporate control. If managers start to act discretionary, the company's stock price will fall, which will lead to takeover of the company and thus to the replacement of inefficient management. Consequently, while managers can maintain a considerable autonomy in day-to-day operations of the company [22, p. 13], the stock market restricts their behavior. If the equity of the firm is concentrated in the hands of a few investors, each will have sufficient private incentives to invest in information gathering and monitoring of management. In addition, a large percentage share in equity opens up the possibility for increasing control over management

through two mechanisms: voting rights, and certain rules and competent regulatory body able to adequately interpret and enforce legal rules. *Regulation is efficient way to protect property rights.* While the costs of signing these contracts are equal to zero, individuals do not need the law because they will always have an interest to negotiate. However, the literature provides a clear framework for thinking about contracts, which raises many important issues such as international corporate governance and privatization. However, the real question is how to enable the private sector to enter into effective contracts in an easier manner. This can be achieved only by clear legal rules that will become a support to capital and other markets [20, p. 17]. *Strong legislation is an important prerequisite for good corporate governance.* Effective institutions reduce transaction costs, introducing the idea of the firm as a legal form that consists of the sets of contractual relationships between individuals, aimed at minimizing the agency costs incurring as a result of conflicting interests of shareholders and managers. Principals (shareholders) are taking risks, transferring the right to decide to agents. However, shareholders have complete freedom to sell their shares without any obligations to other owners, which results in more effective management control (there is competition within the firm and out of it). This situation is actually a justification for hostile takeovers, or "market for corporate control". The importance of this approach is that before them it was impossible to see a fundamental difference between corporate governance and management based on common agreements. Agency theory deals with the role of ex ante incentive alignment mechanisms in reducing agency costs incurring due to moral hazard problem and the possibility of preventive action. *Quality of institutions is an important component of efficient markets.* Market activities include human interaction; they exist to reduce the risk of uncertainty that is caused by incomplete information about behavior of other individuals. Institutions can operate through numerous channels: reduce information asymmetry channeling information on market conditions, products and participants, reduce the risk by defining and implementation of property rights and contracts, limiting the activities of politicians and various interest groups, making them responsible citizens. Therefore, institutions

[14, p. 31] exert a significant influence on economic activity. In addition, strong financial institutions are the foundation of successful capital markets, and ultimately create wealth and a healthy economy. The absence of effective institutions has a disastrous financial impact on the economy and the social costs of countries. The institutions of corporate governance can be defined as the rules governing control of corporate resources [26, p. 43]. They include traditional mechanisms of corporate governance, markets for goods and services (regulators responsible for competition), labor market institutions, capital market institutions, financial intermediaries and the judiciary.

Such a set of institutions affects the growth and development in a country, while creating conditions for attracting private investment, integration into international trade flows, capital increase, lower level of political instability, more efficient ethnic conflict management, and implementation of other policies. System of corporate governance in a country consists of formal and informal rules of conduct, adopted practices and implementation mechanisms, whether private or public, which mutually interact and enable the control of corporations (“corporate insiders”) on the one hand, and all others who may invest, on the other.

However, many authors conclude that empirical findings depend on selected research methodology. At the same time, they emphasize that the theory of corporate

governance is underdeveloped. The existing theory of corporate governance is a collection of partial hypotheses that individually express the variables. There is little debate on how to operate a wider set of interaction mechanisms that would be relevant variables for two-way causality, and how the balance of an optimal set of corporate governance mechanisms could look like. Corporate governance mechanisms are presented in Table 1.

Regional cooperation and harmonization of national legislation

The process of harmonization [23, pp. 123-141] with the EU *acquis* must include the following steps:

1. Defining the areas of the EU legislation and the list of EU regulations with which it is possible to harmonize national legislation;
2. Making a list of relevant domestic legislation;
3. Determining the degree of compliance of existing national legislation with the EU as set out in the first phase;
4. Designation of competent authorities for enacting new or amending existing national regulations whose inconsistency are detected in the previous phase;
5. Prioritization, dynamics, and other issues related to harmonization;
6. Preparing harmonized domestic legislation, including the translation of the *acquis communautaire*.

Table 1: List of corporate governance mechanisms

CORPORATE GOVERNANCE MECHANISM	
INTERNAL MECHANISMS	EXTERNAL MECHANISMS
<p>1. <i>Shareholders</i></p> <ul style="list-style-type: none"> • The concentration of ownership; • Insider ownership; • Role of large blockholders; • Issue of protection of minority shareholders; • Struggle for representation, type of the owner, shareholder activism, lawsuits and litigation. 	<p>1. <i>Regulatory framework</i></p> <ul style="list-style-type: none"> • Legal and institutional system of the country; • Stock Exchange; • Securities Commission; • Legal framework, judicial system, public sector.
<p>2. <i>The Board of Directors</i></p> <ul style="list-style-type: none"> • Board structure (one-tier or two-tier board); • Activity board; • Board independence; • Board size. 	<p>2. <i>Market supply of corporate output</i></p> <ul style="list-style-type: none"> • The market for corporate control; • Labor market; • Competition on the markets, hostile takeover, the threat of bankruptcy.
<p>3. <i>Management</i></p> <ul style="list-style-type: none"> • Building a manager’s reputation; • Fiduciary duty of manager; • Manager market; • Internal competition of managers; • System of compensation. 	<p>3. <i>Other external mechanisms</i></p> <ul style="list-style-type: none"> • Market intermediaries (brokers and investment advisers); • Business associations; • International institutions; • Media and social control; • Rating agencies.

Source: [3], [5], [22], [19]

In some countries outside the EU was made, or is in progress, the voluntary harmonization of national legislation with the EU. This process is characterized by the following factors:

- Optional character,
- Harmonization goals,
- Partiality,
- Fragmentation, and
- Gradual path.

Harmonization of the legislation of Member States relating to the integration of the domestic economy into the EU common market can be made by taking a positive and negative approach that are also referred as “positive and negative harmonization”. The realization of positive integration consists in adopting the EU rules that are applicable in a uniform manner across all Member States. At the level of the common state, these pertain to regulations/ordinances. As regulations have direct effect or immediate applicability, their uniform application leads not only to compliance, but also to full compliance. Hence, in the theoretical sense regulations are not considered as a means of harmonizing the legislation of Member States, but rather as a means of standardization, and with the application do not transform into harmonized national legislation, but remain unified supranational regulations.

The theoretical literature cites the following methods of harmonization: harmonization by establishing uniform rules at the EU level, full harmonization, optional harmonization, partial harmonization, minimum harmonization, alternative harmonization, mutual recognition of regulations, compliance checks through the recognition of the right of verification by other Member States and the harmonization of standards.

Economic development after the creation of the EU is characterized by two processes that occur simultaneously:

- Harmonization of the national legislation of EU Member States, and
- Creation of specific business entities.

The process of harmonization of national legislation in the field of business activities is conceived as the process of creating legal norms in line with the EU legislation. Harmonization of national legal norms related to business activities has been carried out in two directions:

- The countries have an obligation to apply harmonized regulations within their territory,
- Non-EU countries can voluntarily apply the regulations.

Harmonization of national legislation in the EU Member States is realized through the adoption of legal regulations enacted by the EU authorities, such as the Directive on Capital, Directive on Structure of Joint Stock Company, Merger Directive, and other directives. Harmonization of national legislation with the EU has been taking place gradually, and it is still underway and depends on the existing legal, economic, and overall social infrastructure.

Harmonization [24, pp. 357-368] of national legislation with EU regulations is aimed at improving the chances of a country to become a member or to speed up the integration process. Harmonization of national legal regulations with the EU *acquis (acquis communautaire)* is a precondition for joining the European Union. It is a complex and lengthy process, which requires not only of the adoption of new laws and amendments to old laws, but also their enforcement. These imply the education of regulatory bodies, modernization of the judicial system, and provision of adequate information to the public, and especially to business community, public administration, and the judiciary. The speed of legal harmonization depends upon the speed of the entire European integration.

Lately it has become evident that the state is seriously engaged in creating more favorable loan terms and conditions for the companies. The processes of registration and creating records of real estate are in progress and the Business Registers Agency has established the Register of Pledges. It is expected that, as was the case in some countries in transition, these initiatives will help companies to get easier access to bank loans.

The European Union has adopted the Financial Services Action Plan, which is aimed at creating a single financial market and, in this respect, points to two priorities: a) adoption of the Directive on taxation of savings income in the form of interest payments, and b) change in the adopted (1997) Code of Conduct for Business Taxation. Other proposals include: improvement of the Prospectus Directive on issuing securities or other investment services, updating the accounting regulations

of financial institutions, adoption of the Directive on cross-border use of collateral, the Agreement on the merger of financial institutions, Investment Funds Directive and Pension Funds Directive.

In the retail banking there is a need to adopt directive which would regulate the “distance selling” of financial services, to improve the system of information on mortgage loans and form the opinion of the EU Commission on the e-commerce in financial services.

One of the most important laws that Serbia doesn't have yet is the Antimonopoly Law, or the Law which stipulates antimonopoly behavior of businesses and individuals in our market. We believe that its enactment would prevent further monopolization in the Serbian economy, which is already at its peak, but none of the authorities has thus far decided to publicly disclose the facts and propose solutions.

In the area of prudential supervision of operations it is important to adopt the Directive on the winding-up of banks and insurance companies, on the treatment of “electronic money”, as well as to amend Anti Money Laundering Directive and Rules on the supervision of financial conglomerates.

Regulatory regime on foreign capital flows is based on a set of rules. The most important are: Law on Foreign Investment, Law on the Market of Securities and Other Financial Instruments, Insurance Law, Law on Credit Relations with Foreign Countries, Foreign Exchange Law, Law on Payment Transactions, and Law on Investment Funds. Regulatory regime on foreign capital flows is complemented by a number of other regulations, such as the Law on the National Bank of Serbia, Law on Banks and Other Financial Organizations, Insurance Law, and the like. After more than a decade of transition process, Serbia has largely succeeded in introducing the key legal and economic institutions of the market economy. Current efforts to improve corporate governance practices make an essential aspect of the transition process, as they are directed toward the crystallization of the legal and regulatory framework, building of trust vis-à-vis domestic and foreign investors, and strengthening of financial markets and banking system.

Practices of corporate governance are of crucial importance in the banking sector. It is well known that banks operate on the basis of allocation of excess savings of the population toward the most profitable activities of companies. The problem in the functioning of banks in transition economies arises from the lack of objective information and adequate monitoring due to loose mechanisms of corporate governance. If banks decide to give the loans to companies, then risk premium is attached to interest rates, which causes their astronomical increase. Such high interest rates significantly stifle business activity. What increases the risk for the banks is undefined ownership interests in the area of real estate and, as a consequence, problematic collaterals, but also slow collections of accounts receivables from the companies in bankruptcy. The entry of foreign banking competition has not led to a significant decrease in interest rates, but has established a great deal of discipline through the introduction of hard budget constraint due to the threat of bankruptcy.

Joint stock companies that are under control or significant influence of the state often delay the process of restructuring and the introduction of new corporate governance practices. These businesses are suffering from the lack of transparency of important transactions, which is often associated with a breach of the rules on conflict of interest and protection of competition. Finally, a main problem for these companies is a weak system of accounting and auditing, which in the past allows the outflow of large amounts of funds in the accounts of companies' related parties.

However, regardless of advanced legislation, the inefficient enforcement of existing regulations is a major flaw of the Serbian economy. There are many reasons, but the most glaring one is the absence of trained and experienced judges in the area of the company law. We should not ignore the problem of corruption. The Commercial Court, which deals with commercial disputes, is considered as one of the most untransparent and most corrupt institutions in the country. According to several international institutions and non-governmental organizations dealing with the investigation of corruption, Serbia is ranked among the most corrupt countries in the Balkans. According to reports by Freedom House, score for the last several years showed

a high presence of corruption, and most importantly, it was somehow worse than the average score for the Balkans region, which is known for its weak institutions and high corruption (see Table 2).

Table 2: Ratings of corruption in Serbia and the average score for the Balkan region

Year	2007	2008	2009	2010
Score for Serbia	5.25	5.20	5.00	5.10
Average for Balkan region	5.04	4.86	4.97	4.93

Source: Transparency International

In addition to corporate law, there are two areas that are also important for the regulation of corporate governance: regulation on European Company (*Societas Europaea*) and financial services regulation, as well as voluntary regulation – in the EU countries there are a number of codes of corporate governance adopted by various institutions, professional bodies, and voluntary associations¹.

We will present the analysis of the state of corporate governance in Serbia by using the structure of the OECD Principles of Corporate Governance [20]. The analysis is conducted for the four distinct areas:

1. Transparency and disclosure,
2. Rights and equal treatment of shareholders,
3. The role of other stakeholders in corporate governance, and
4. The responsibility of the Board of Directors and its members.

Clarity and openness are perhaps the weakest point of corporate governance in Serbia, despite the high level of legal requirements in this area. Namely, the Law on Business Companies, the Law on Securities and Other Financial Instruments, regulations of financial markets regulators (Central Registry, the Securities Commission of the Republic of Serbia and Belgrade Stock Exchange) very precisely describe the content of the financial statements, and the time and place of their presentation. In addition, the Law on Business Companies (Article 290, Paragraph 4) provides that the Annual General Assembly of Shareholders decides on the adoption of the company's annual financial

statements including reports of the board of directors, auditors, and supervisory board.

Stock exchange listing requirements prescribe that companies should update any information relevant to transactions of their shares and disclose it on the corporate website. Also, companies may send via e-mail important notice to all interested stakeholders. It is necessary to make visible information such as ownership structure, list of board members including a brief biography for each member, collective remuneration and individual compensation packages of board members, relevant reports and proposals for the shareholders' meeting.

Annual reports of companies should be more thorough, some countries even have separate annual reports on corporate governance. It is necessary to increase the internal pressure on the company's management to provide accurate and relevant information and clarification regarding projections, financial data, key risks, and important transactions.

The market for corporate control

There are different activities that could be associated with the market for corporate control and they cannot be easily classified. Many different strategies can be divided into offensive and defensive. Offensive strategies are oriented toward takeovers of other companies, while defensive strategies are based on anti-takeover measures. The offensive strategies are focused on three types of activities. Acquisitions and the combining of companies or mergers where there is a voluntary association of two or more companies through arrangements and agreements between managers and owners of interested companies. The essence of a hostile takeover is that one company buys on the stock exchange the shares of another company against the will of its owners. This kind of acquisition can be conducted in several ways. One of the most common approaches is through a tender offer where the acquiring company makes a public offer at a fixed price above the current market price. Thereby it attempts to acquire a controlling stake and take real control over targeted company. Proxy fight is a mechanism whereby the minority group in the General

¹ The European Commission believes that there is a high degree of convergence between the national corporate governance codes and practices, and that there is no need for a single European code.

Assembly is trying to win the votes of other shareholders in order to take control.

The capital market is an important external disciplinary mechanism of managerial behavior. The market price is formed based on all available information on corporation and it reflects the results of the corporation's operations and management performance. So when the management runs the company's operations inefficiently, the share price decreases, since the information about fading performance encourages existing shareholders to sell their shares and seek investments that will generate a higher return. In this way, the owners of the corporation actually vote on the quality of management (management corporation) [1, p. 21], and through buying or selling of shares express their confidence or distrust in the future performance of the corporation.

The market for corporate control should be allowed to function in an efficient and transparent manner [22, pp. 7-11]. This means that all the rules and procedures governing the acquisition of corporate control in the capital market should be transparent, as well as share prices, so that shareholders could agree to sell shares in the time of offer, not after the completion of the takeover process when it is possible to sell the shares at higher price. This kind of acquisition requires the developed money market in which the attacker can collect large sums of money for the action of hostile takeovers. Moreover, the board of directors and management of the company often have at their disposal a number of different techniques of defense against a hostile takeover, which are carried out mostly at the expense of shareholders' assets. Also, lobbies representing managers often succeed in getting legal restrictions. The market for corporate control is the main mechanism of reducing agency costs in the outsider system of corporate governance.

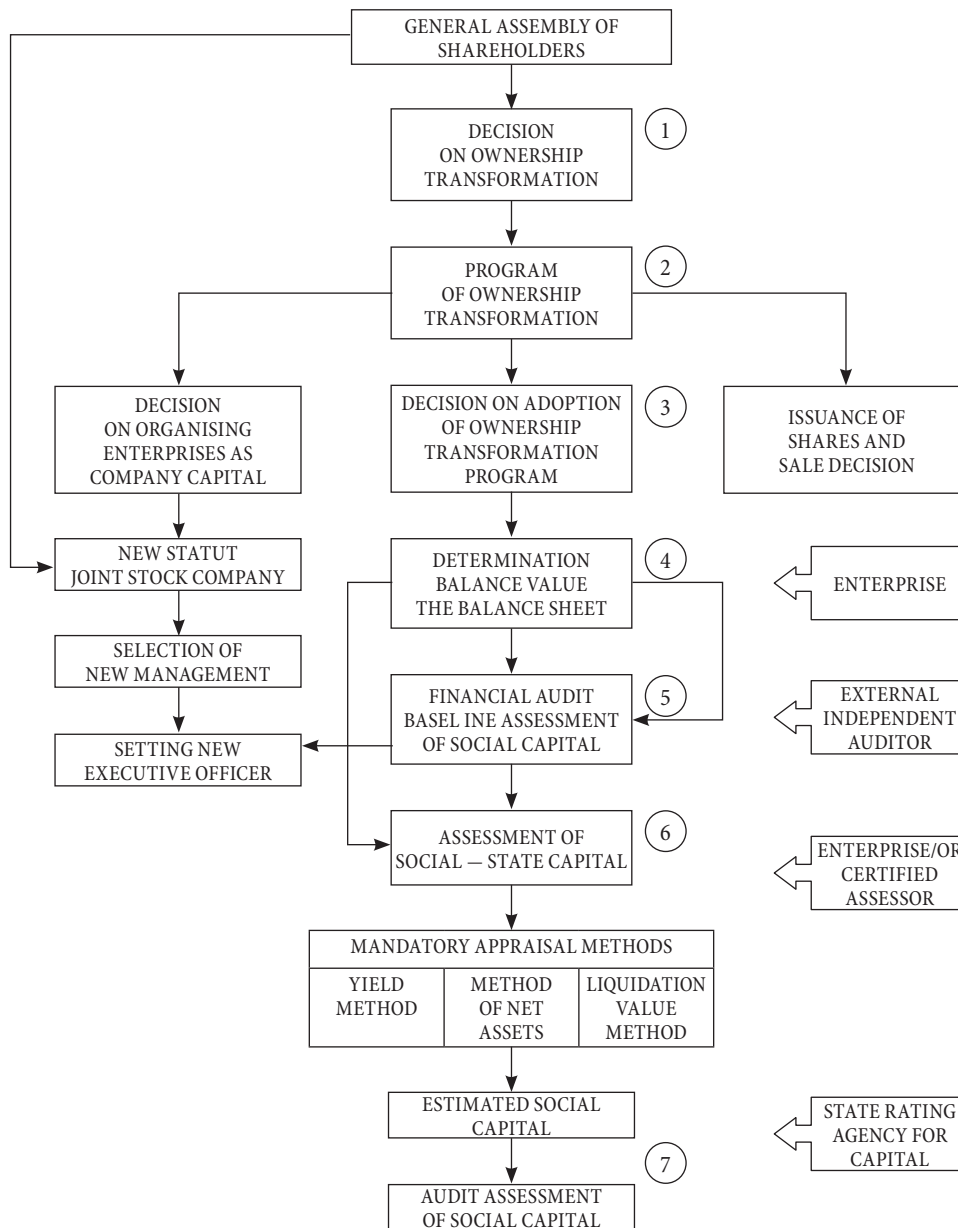
If managers demonstrate discretionary behavior (i.e. pursue their own interests and not those of the principal) the company's share price will fall and the company will become the target of a hostile takeover. In order to take control of such a company, by purchasing shares the attacker (acquirer) actually buys two types of rights: the majority of cash flows rights and control rights. However, hostile takeover usually leads only to temporary

concentration of cash flow rights and control rights in the acquired company. Following the replacement of inefficient management, the acquirer can resell a part of cash flows rights, because the ownership concentration requires additional costs. In this case, the acquirer will achieve a higher selling price if, in addition to cash flows rights, they also sell control rights in the firm. This means that, according to the dispersion strategy, after replacing inefficient management and temporary concentration, hostile takeover would again lead to dispersed control. The market for a hostile takeover functions as a threat to inefficient management because the attacker does not indemnify the inefficient management, but instead takes control of the corporation, paying to shareholders the value of company. The process of a hostile takeover is very costly due to high transaction costs associated with the resistance pressures, which reduces the tendency of potential attackers to take over. Self-interest activities of managers are determined by all of these inefficiencies. Thus, the management could accurately determine the level of inefficiency of their engagement in favor of shareholders (that would provide personal benefits), which equals the amount of takeover costs borne by the attacker. In this manner, managers maximize current private benefits without the threat of takeover as long as the attacker becomes able to make a profit from the takeover.

Another important prerequisite for efficient markets [7, pp. 232-258] for hostile takeover is high standards of information disclosure, which enable the efficient evaluation of share prices and activation of the market for a hostile takeover once the attacker spots inefficient management and sets goals that can be achieved through a hostile takeover. The decline in the cost of capital is the primary goal of corporate governance. The market for corporate control has contributed to the survival of the corporations, despite restrictions imposed by investment, finance, and management decisions on the payment of dividends.

Market competitiveness of the products (i.e. output) of corporations affects their positioning, and directly leads to the failure (bankruptcy) of companies that are unable to meet the market demand. Therefore, many studies have relied on sales growth in a given time period to measure the success of the corporation. Besides, the

Figure 1: Process chart of ownership transformation



Source: Author

competition in the product market acts an important factor in imposing discipline to managers that show poor performance, although the time frame for the assessment of this mechanism is very lengthy.

Therefore, the promotion of competition in the product market provides long-term solution. The impact of this mechanism in ensuring discipline of corporate governance depends on the government’s activities to improve the competitive environment in the country, which would create the conditions for the strong competition in the product market to act as a disciplining mechanism that reduces agency costs. Ability to repay debt and credit rating

according to rating institutions that evaluate the credit worthiness of corporations give investors strong signal about the quality of corporate governance. The best-known agencies that offer this information are Moody’s and S&P. While investing in international capital markets, many investors are guided by the estimates of these agencies.

World-renowned rating agencies publish a variety of indicators that measure the quality of corporate governance. The indicators are mostly based on similar characteristics and determinants of corporate governance. Since the end of 2002, Standard & Poor’s has published Corporate Governance Score (CGS), which assesses the

policies and practices of corporate governance and provides information on the achievement of the financial interests of stakeholders of the company, focusing on the interests of shareholders. Aggregate CGS is calculated based on the synthesis of the OECD guidelines and other international codes and guidelines for good corporate governance and four individual components (ownership structure, rights and relationships among financial stakeholders, financial transparency with disclosure, and board structure) [10, pp. 16-19]. Corporate governance is defined as a system that includes the interactions between the company's management, board of directors and financial stakeholders (shareholders and creditors). This approach primarily focuses on the financial dimensions of corporate governance, and leaves out non-financial stakeholders. CGS indicator consists of four areas: (1) Ownership structure; (2) The rights and relationships of financial stakeholders; (3) Financial transparency and information disclosure; (4) The structure and functioning of the Board. Aggregate CGS ranges from CGS-1 (the lowest value) to CGS-10 (the highest value). This analysis relates to the risk management in companies and does not consider the legal, regulatory and market systems of individual countries. It is assumed that the S&P CGS is comparable on a global basis, because it reflects current management practices of companies, laws, market conditions, etc.

An important external mechanism of corporate governance is a constant threat of bankruptcy of the corporation, which puts pressure on the managers of corporations to do business responsibly. The threat of bankruptcy arises if managers choose the wrong business policy (most frequently transfer control to creditors) and is considered as one of the main external mechanisms of corporate governance.

Concentration of ownership (see Figure 1) is generally analyzed according to two different contexts: whether the cash flow and voting rights are identical or voting rights exceed cash flow rights. The second scenario, in which voting rights exceed cash flow rights, poses a serious problem typical of developing and less developed countries. No management system solves this problem efficiently. It seems that market surveillance is not effective and that the solutions depend on the law on

business companies, domestic and international product markets and improvement of international capital flows. How does the concentration of ownership affect corporate governance? In low-income countries and underdeveloped institutional environment there is a tendency toward highly concentrated ownership. Large firms that are controlled by management and owned by different groups of small shareholders are the exception rather than the rule. There is a link between ownership structure and the quality of institutions, where the ownership concentration aspires to become a substitute for weak legal protection. Concentrated ownership allows investors easier access to information, control of operations, and provides assurance that the resources will be used in their interest. In countries with higher income levels and stronger legal protection of shareholders ownership is more dispersed. However, this is not the case in all developed countries. The major advantage of highly concentrated ownership is the motivation of shareholders to monitor the management of the company. However, with concentrated ownership, problems occur between different types of investors and minority and majority shareholders. For example, a study of firms in the East Asian economies found that the market accords higher value to the companies whose controlling shareholders have a higher share in equity. With higher equity share, the controlling shareholder wealth is more directly linked to the performance of the company. Comparative analyzes also provide evidence that investors are willing to pay more for the assets when, in addition to controlling shareholders, there is better legal protection. Legal protection makes it easier for companies to access external finance for investment projects. The potential negative effects of concentrated ownership can be reduced by introducing competition in the market and providing an exit strategy for the companies with negative performance.

In both of the described systems of corporate governance shareholders gain the right that consists of two parts. First, the investor is entitled to the profit generated from the rise of the company's share price, or cash flow right. Second, the shareholder has the right to control the business, which is achieved through voting rights (control rights). The level of concentration of these two types of

rights among shareholders points to significant differences between the two systems of corporate governance. In countries with outsider system of corporate governance (AS), dispersed ownership is dominant ownership structure in most companies. This dispersion refers to the rights of the owners to the company's cash flow (cash-flow rights) and the right of management control (control rights). In these countries, the rule "one share, one vote" is dominating principle, which is used in corporate governance as an instrument of the distribution of control rights among shareholders.

Management responsibility in the public sector

Monitoring of the management responsibility system in the public sector is the basis for an independent auditing of the public sector, whether it entails external or internal audit. The management responsibility system in the public sector rests on the accountability of state officials in organizing legally-based, regular and timely collection of public revenues, as well as on an adequate and legally-established disposal of public funds. The public sector accountability is monitored and controlled through the budget adopted in line with legal requirements and appropriate budgetary accounting systems and records that contain the systematized information on all budget revenues and public expenditures.

The main instruments of the management accountability control in the public sector are financial statements that are prepared and presented periodically and annually in accordance with the legal requirements and under authority [2, p. 31] of the Parliament of the Republic of Serbia, the Assembly of the Autonomous Province of Vojvodina, assemblies of cities and municipalities, assemblies of public funds, and other state and public agencies and organizations.

The State Audit Institution (SAI), an independent body of the Government, on behalf of the National Assembly of the Republic of Serbia checks the accuracy and reliability of submitted financial statements and notifies the National Assembly and other Assemblies of the degree of competence in the presentation of financial reports.

The responsibility of agencies and organizations in the public sector is under greater scrutiny than the responsibility that is required in the private sector. There are a number of reasons for this, most of which are based on the fact that the regular and timely collection of taxes and other public revenues is in the public interest, not in the interest of individuals. On the other hand, the ministries and other state bodies provide services that are intended for the population as a whole, not individuals. The users of public services cannot go elsewhere and buy the same service if they consider not having obtained the right value for their money, so it is necessary to establish the accountability mechanisms for public service providers which will ensure the right regulation and spending of public funds. Public sector organizations that offer direct services to individuals, such as water supply or electricity distribution, are usually monopolistic organizations that do not give consumers more choice, although a portion of their financial resources comes from tax payers through appropriate subsidies from the budgets of municipalities. In these circumstances, although the ultimate responsibility should be, and most often is, toward consumers, in practice it is usually directed to the Assembly of the Republic of Serbia, the Assembly of the Autonomous Province of Vojvodina, assemblies of cities and municipalities, depending of relevant legal jurisdictions.

The function of state auditor in the process of evaluating accountability in the public sector is performed by an independent audit agency [12, p. 7]. There is a significant difference in evaluating the responsibility of managers (officials) in the public sector depending on whether it is based on external or internal auditing [18, pp. 27-31]. The reports of an external, independent state audit agency are directed towards political bodies outside the organization, while internal audit in the public sector should serve as a tool of the company's management. Therefore, external audit will be conducted by the SAI that is completely independent of the Government and ministries and represents the Assembly in carrying out an independent review of financial statements prepared and presented by individual ministries. External Auditor is responsible to the Assembly.

According to international standards of the public sector auditing, the internal auditor of the public sector is an integral part of the ministries, public administration bodies, public funds or public companies, and acts as a representative of minister, provincial secretary, mayor, and the management of public funds or public companies. The internal auditors in the public sector should be held accountable for their work to the minister, provincial secretary, mayor, chairman of the board of public fund, chairman of the board of health care institution, or chairman of the board of directors of a public company.

Specifics of public procurement contracts

National investment plans and programs are very important in every country, and especially in the countries in transition. The nature and scope of investment in individual development projects require the provision of all necessary funds from relevant sources, such as budgets, domestic and international loans, donations and other funding sources.

Determined and approved investment programs are implemented by signing a series of contracts between the state, state agencies or other organizations designated by the state, with a corresponding credit institutions, i.e. banks in the country and abroad, as well as between the state, public funds or organizations designated by the state (for example, the Development Fund and the like) and program administrators, service providers and other suppliers of material goods. Then, there are agreements between the state or the representatives of the appointed government bodies and construction supervisors who on behalf of investors oversee and control the execution of contracted projects and other contracts related to intermediary and similar services. As a rule, development plans and programs have long-term character, so they are divided into shorter intervals to facilitate their effective monitoring, registration, analysis, and verification. In the implementation of “state” or investment contracts, i.e. the contracts which are related to the realization of investment plans, there are frequent setbacks due to inefficiency, budget overruns, financial losses, fraud, theft or damage

to inadequately secured equipment or works, and various other financial frauds, corruption, etc.

The audit of public contracts (government, investment, etc.) is a very important area in the public sector auditing [8, pp. 7-9]. The main objective of the audit of public contracts is the prevention of possible losses, damages and any other potential illegal use of approved funds [21, pp. 9-14]. An audit of public contracts begins with the audit of investment programs and legally-established funds and sources of finance for the project, then continues with the monitoring of all stages following the conclusion of the contract, certain stages during the implementation, to the completion and handover of the project. It is not enough simply to examine payment orders and check their accuracy and balance in the accounting documents. Large expenditures during the implementation of investment contracts, various technical aspects and the like, determine the choice of the audit approach based on the evaluation of the entire system in order to detect whether all the provisions of a public contract are duly executed, in the most cost-effective, effective and efficient way. Audit approach based on the evaluation of the entire system and assessment of the fairness in public procurement processes involves three main phases:

1. Phase preceding the contracting phase,
2. Contracting phase, and
3. Phase after the execution of contract.

Approach to auditing of all types of contracts related to the procurement of services, construction of buildings, and other projects is universal no matter of the fact that it takes place in different organizations, with different technologies and other individual specifics. This approach should include the following:

- Determining the adequacy of budget items relating to specific contracts and ensuring the conditions for sufficient provision of necessary financial resources for their implementation;
- Review of the compliance with established policies and procedures related to the implementation of public procurement contracts and general rules regarding the construction of buildings and other investment ventures;

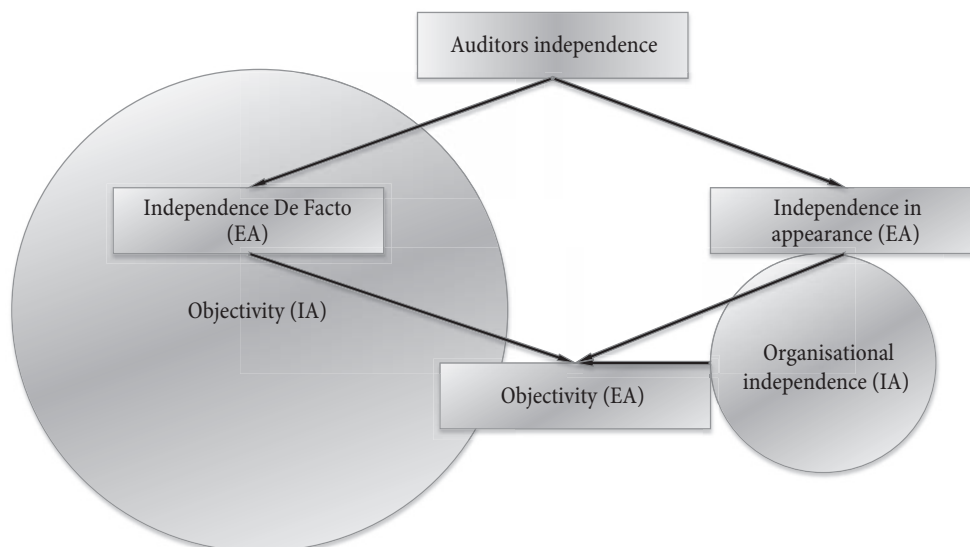
- Monitoring the functioning of the internal control system based on a continual revision of the implementation of contract (keeping construction records and building log, the system of licenses required for the approval of procurement, payments from the project budget);
- Checking the timeliness and accuracy of information on the implementation of contract;
- Controlling the effectiveness of the accounting system in the area of registration of used resources, including all employees on the project;
- Following up the activities of engaged consultants, supervisors and other service providers involved in the project;
- Detection of losses, overdrafts, and other inefficiencies in the work, to enable the realization of project within planned time frame and costs.

The existence of large state budget deficit, which characterized the first decade of the 21st century, indicates a lack of effectiveness in the monitoring of public finance. Consequences of the weaker independence and objectivity of external state auditors, as well as internal auditors, in the public sector have led to an increase in irregularities in the management and deployment of public funds by the direct and indirect budget users, irrational use of public assets, all-present phenomenon of corruption, misappropriation of public property and other criminal activities. The practice that particularly contributed

to this outcome is an uncontrolled increase in the administration in the public sector, through doubled and tripled functions, which logically caused uncontrollably large budget deficits, and thus strengthened the resistance to regular public monitoring and development of auditing in the public sector. There has been a long-standing resistance of the state administration in the Republic of Serbia to a serious independent control of public finance, starting with deliberate delay in the establishment of an independent state audit institution, then the impeding of the employment of a sufficient number of qualified auditors (the SAI has only 5 independent state auditors), to the opposition to providing the SAI with an adequate office space and other material conditions for the effective control of public finance.

Since the adoption of the Law on State Audit Institution in 2005, the first modest report on the partial audit of a part of the final accounts of the budget of the Republic of Serbian was publicly presented as late as at the end of 2009, for the first year of the audit (2008). The parliamentary debate on this auditor’s report, with a numerous qualifications, began in early 2010 and was not completed within a reasonable time according to the international standards and guidelines for the public sector auditing, which calls for an additional attention of the general public. Analysis of the development stage of the public sector auditing in Serbia points to some

Figure 2: Auditor independence



inconsistencies in the implementation of the Law on State Audit Institution. Otherwise, the content of the Law is fully in line with the progressive legal practice in the European Union, and it was expected to bring about a positive trend, and especially the change in the behavior of state officials. Article 3 of the Law precisely defines the status of institution of the SAI as the supreme state body for auditing public funds. Further, the Law provides that the institution is an autonomous and independent state body, as well as the Government. However, the next paragraph of this article points out the fundamental principles of independence and objectivity of an independent state audit as follows: "Enactments by which the Institution performs its auditing competence cannot be a subject of dispute before courts and other state bodies." In this way, the Law has provided complete independence and objectivity of the external auditing of the state (see Figure 2). However, there are significant deviations in the implementation of this Law. Members of the Council of the State Audit Institution, the supreme body of state audit, are elected in the National Assembly, based on the proposal of member parties of the ruling coalition, which means that they automatically become dependent on the parties that have supported their candidacy. In this way, their proclaimed independence and the objectivity of their activities regarding the control of public finance are completely disabled.

Contemporary trends in corporate governance: Lessons for the future

In recent times, a large number of international organizations and institutions have started to study corporate governance. Besides, many nongovernmental organizations, corporations, business and investors associations also explore the relationships within corporations. International institutions dealing with the phenomenon of corporate governance are OECD, World Bank, MIGA, IFC [15, p. 45], International Chamber of Commerce, European Commission, UNIDO, and UNCTAD. According to the report, prepared by the Working Group of the United Nations Economic Commission for Europe, the OECD is considered as one of the most important international institutions dealing

with improvement in all segments of corporate governance (institutional, legal and regulatory structure), as well as creating a business environment for corporations. In cooperation with the World Bank, through the organization of the WB/OECD Global Forum on Corporate Governance [9, pp. 17-21], these institutions are engaged in improving corporate governance around the world. The World Bank mostly deals with the issue of implementation of various strategies. IOSCO is an institution which mainly focuses on regulatory aspects, with a special emphasis put on securities. The European Commission is also an important institution that regulates the area of corporate governance across the European Union. Other international institutions, with varying degree of success, mostly deal with specific areas of corporate governance. The main objective of the Organization for Economic Cooperation and Development (OECD) is to, through the Global Forum on Corporate Governance, ensure the improvement of standards of corporate governance and, in particular, their implementations in developing countries and countries in transition, then the development of entrepreneurial spirit, improvement of accounting practice, transparency, accountability and integrity in business. It has been achieving these goals through various forms of political dialogue, convening conferences on corporate governance, and organizing the round tables at the national and regional levels [22, p. 11]. The principles of corporate governance can be applied both in the countries with "civil law" and "common law" legal tradition, at different levels of ownership concentration. The main areas of the research of IFC/MIGA are the development of entrepreneurship and the efficiency of private investment, as well as the creation of favorable business environment. The intention is to integrate environment, corporate and public governance, and to provide that problems in corporate governance do not hamper potential investment. These goals are achieved through the transfer of knowledge by ensuring funding for private sector projects with good corporate governance, research, and consulting services. Therefore, the study of various aspects of corporate governance is in the initial stages of development, with no single international organization covering the area of corporate governance with a completely clear vision and in all its segments.

Summary

The normal functioning of the public sector is adversely affected by the current extremely difficult economic conditions, the global economic and financial crisis, illiquidity, as well as a decline in economic activity and subsequent decrease in the collection of value added tax and other public revenues. Therefore, it is necessary to intensify the efforts toward the establishment of the institution in charge of internal auditing in the public sector in order to ensure more rigorous control of public spending and more dynamic reform of public administration, thus contributing to a faster reduction of the budget deficit.

More intensive control of public finance through organized internal auditing in the coming period will contribute to faster achievement of the country's economic stability and lower degree of social tensions, and ensure that public expenditure will be more rational and more consistent with the need for a faster emergence from the long-term economic and social crisis in the country.

Preserving the market integrity should be imperative for all participants, capital market institutions, economic institutions, various occupations and professions. Upgrading the regulatory framework by detecting and sanctioning inappropriate behavior, as well as providing the education and training in this field, should be a part of regular professional development in state audit bodies, self-regulatory bodies and brokerage firms, and other professionals associated with the capital market. Also, technological development requires a special attention of all market participants due to the fact that it opens up new possibilities of abuse, but also new tools for their timely sanctioning. Continuous education should constitute a mandatory part of the professions of financial market participants.

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