

CORPORATE GOVERNANCE IN SERBIA: AN OVERVIEW OF RECENT DEVELOPMENTS

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Ksenija Denčić-Mihajlov

Faculty of Economics, University of Niš, 18000 Niš, Serbia

Abstract. *In attempting to establish market-based economy in the post socialist period, like other transition economies, Serbia has faced the serious challenges of creating the economic system, forming institutions and establishing incentives in order to improve economic performances. Corporate governance has been recognized as a crucial part of the reform process. Having reviewed significant interventions that have been made in corporate and security legislation in recent years, we analyze recent developments in corporate governance in Serbia. In the following paper we illustrate and discuss major characteristics and trends at Serbian market for corporate control as an external corporate control mechanism.*

Key Words: *corporate governance, regulatory framework, shareholder, market for corporate control.*

INTRODUCTION

Frye [1] speaks about corporate governance bluntly defining it as "a mechanism for reassuring the suppliers of capital that their investments in the firm will not be stolen". Rérolle [8] states that good corporate governance is a necessary, though not a sufficient condition for secure investment. These are just two, quite different, determinations of corporate governance concept. Although corporate governance can be defined in a variety of ways, generally it involves *the mechanisms by which a business enterprise, organized in a limited liability corporate form, is directed and controlled* (Cadbury Report). It usually concerns mechanisms by which corporate managers are held accountable to investors for the use of asset and corporate performance. Further, corporate governance aims to align the actions of the individual parts of an organization toward aggregate mutual benefit. It specifies: a) the relationships between, and the distribution of rights and responsibilities among, the main groups of stakeholders - the board of directors, the managers, the shareholders or owners, the workers, the regulators, the customers, the community, the

suppliers, and b) a means by which information can quickly flow between the various stakeholders to ensure that the changing nature of both the stakeholders' needs and desires and the environment in which the organization operates get effectively factored into decision processes [13].

In attempting to establish market-based economy in the post socialist period, like other transition economies, Serbia has faced the serious challenges of creating economic system, forming institutions and establishing incentives in order to improve economic performances. Corporate governance has been recognized as a crucial part of the reform process. The challenges of corporate governance in Serbia, that is moving toward EU membership, are particularly serious. As Frye [1] pointed out "corporate governance problems, especially in transition economies, reflect the environment in which they develop". In this sense, regarding the corporate governance quality, Serbia lags behind developed European countries partly due to former legal and regulatory deficiency and partly due to the self-management system's inheritance. Reformers in Serbian government as well as foreign investors view corporate governance as a key factor to develop and improve investment climate in Serbia. Thus, there are three main factors – globalization, economic forces (protection of investor's interest) and political forces (EU accession) – that press Serbia to build and ensure a regulatory regime and corporate governance practice that would provide a sufficient level of market efficiency and transparency.

The paper is organized as follows. In the following section we give the overview of the recently released investigations on legal extensiveness and effectiveness of corporate governance laws and regulation in Serbia. Section 2 contains an analysis of the recent developments in corporate governance in Serbia. In the third section we provide some evidence that emphasizes the emergent nature of the market for corporate control as an external corporate control mechanism in Serbian economy. The final section of the paper contains our conclusions.

1. THE ASSESSMENT OF LEGAL EXTENSIVENESS AND EFFECTIVENESS OF CORPORATE GOVERNANCE LAWS AND REGULATION IN SERBIA

According to a recently released investigation, significant improvements in corporate governance have occurred in Serbia at the beginning of the XXI century. On the basis on three governance indicators (voice and accountability, regulatory quality and control of corruption), Kaufmann [3] reports on significant changes in corporate governance that took place in Serbia in short-time period 1996-2004. However, according to Kaufmann, in the same period, no changes have been observed in other three dimensions of governance – government effectiveness, political instability and violence and regulatory burden.

In the EBRD project on the corporate governance sector assessment¹, twenty-seven European countries have been assessed according to changes in corporate governance legislative reform during 2003. The countries were rating from "A" – representing a very high compliance level of corporate governance system measured against OECD *Principles of corporate governance*, to "E" – representing a very low compliance level of cor-

¹ Available at: <http://www.ebrd.com/country/sector/law/corpgov/assess/report05.pdf>

porate governance system. According to the assessment results, Serbia and Montenegro improved its 2002 rating score and was rated in 2003 with medium compliance. In Serbia and Montenegro the corporate governance sector assessment reveals some lack of compliance in disclosure and transparency although the overall legal framework is improving and is generally in line with international standards.

Table 1.1. Level of compliance with international standards of corporate governance²

Very high compliance	High compliance	Medium compliance	Low compliance	Very low compliance
(none)	Armenia	Albania	Bosnia and Herzegovina	Azerbaijan
	FYR Macedonia	Bulgaria	Georgia	Belarus
	Hungary	Croatia	Romania	Tajikistan
	Kazakhstan	Czech Rep.	Turkmenistan	Ukraine
	Latvia	Estonia		
	Lithuania	Kyrgyz Rep.		
	Moldova	Serbia and Montenegro		
	Poland	Slovak Rep.		
	Russia	Slovenia		
		Uzbekistan		

The main findings of FSAP (Financial Sector Assessment Program), a jointly realized project of the World Bank and IBRD [11], are that even though Serbia has made good progress in macroeconomic stabilization, much work remains to be done on the corporate governance framework. As crucial weakness in this sense are cited: non satisfactory transparency of ownership, financial reporting, board responsibilities, minority shareholders protection in capital dilution and takeovers, weak institutional capacity, unregulated sphere of investment funds operation. Since November 2005, when the FSAP report was released, corporate governance framework in Serbia has been continuously improving. The majority of recommendations of the FASP as well as of the *White Paper on Corporate Governance in SE Europe* [7] had been implemented in the national regulative and will be discussed in the following text.

2. RECENT DEVELOPMENTS IN CORPORATE GOVERNANCE IN SERBIA

Serbian corporate governance was up to 2000 an area largely unexplored both from the standpoint of its main mechanisms and from comparative law perspective with other European countries. Corporate governance has been, directly or indirectly, the subject of more intensive activity in Serbia over the past few years. Many factors resulted in limited interest in corporate governance reform. Most companies in Serbia are still owner-controlled and not listed on the Belgrade Stock Exchange. From 1869 registered companies,

² Source: EBRD Transition Report 2005.

shares of 1062 companies are listed on the national stock exchange, while only 32 companies' shares are subjected to continual trade at the Belgrade Stock Exchange³. Limited interest in corporate governance reform is partly caused by the fact that many of large Serbian companies are still state-controlled. The privatization of the largest state-owned companies is to be finished during the following year. While institutional investors are to play a significant role in the process of corporate governance, their participation in Serbian companies, apart from the Pension and Share fund, are not significant. However, banks play an important role in corporate governance, participating a great deal in corporate financing and delegating their officers in companies' managing and supervisory boards.

In Serbia, like in the most countries of Central and Southeast Europe, significant interventions and reconstructions have been made in corporate and securities legislation last years. Significant progress has been made in promoting private sector development, bringing down inflation, deregulation, improving public administration. The condition of relative disorder and discriminatory regulation, which was encountered in the period of mass privatization in Serbia, has been changing rapidly during the last year [16].

After two years of preparation, in June 2006, the Government of the Republic of Serbia has put into force several laws, which are to regulate in a more efficient way the sphere of corporate governance, financial and accounting management and the activity at the capital market. This package of laws that consists of Law on takeovers, Law on investment funds, Law on accounting and audit and new Law on securities and other financial instruments market [9], is harmonized with the European standards. The law system in Serbia now regulates corporate sector and capital markets in a consistent way with the comparative regulative of the developed European countries. However, there are opinions that the above laws were adopted too late, at the end of the privatization process, when "strong" domestic and foreign investors had already acquired all the positive effects of buying undervalued Serbian companies.

The new Law on economic societies, largely based on EU practice, represents a significant advancement in comparison to the previous Law on enterprises. This law, that makes the regulatory basis for establishing the relation between shareholder and management structure, incorporates issues such as 1) scope, implementation and protection of shareholders rights, 2) structures, obligations and liabilities of the managing bodies, 3) judicial and other forms of protection. The Law on economic societies introduces improvements in the provisions relating to corporate governance, business combinations, corporate form conversion, disclosure requirement, and company liquidation outside bankruptcy. Another enhancement is the possibility of open and closed joint stock companies' existence. The provisions relating to limited liability companies have been simplified. Along with the improvements in regulative dealing with the operation of companies, the procedures for registration of new companies and filling of companies' documents have been much improved by putting into force the Law on Business Registry in January 2005.

Law on securities and other financial instruments market links directly the activity at financial markets with corporate governance elements by including provisions relating to:

³ Acquired on 11/08/06 from the Belgrade Stock Exchange official web site: www.belex.co.yu

1) the obligation of public companies to keep the public informed about the company's activities, 2) the liability to provide true and accurate data in the prospectus and 3) the issue of insider information and their abuse [10].

A particular progress in regulating corporate governance practice using external mechanisms is made by enacting the Law on takeovers. The importance of this law that regulates takeover bid procedure at Serbian market is particular having in mind that the law is fully harmonized with the Directive on takeover bids (2004/25/EC) adopted by EU parliament and the Council of the EU in April 2004. Key principles of the Law on takeovers are acquired from the Directive and refer to: (a) the equivalent treatment of all the shareholders of an offeree company; (b) sufficient time and information that are to enable the holders of the securities of an offeree company to make a proper decision on the bid; (c) the acting of the board of an offeree company in the interests of all the shareholders; (d) a prohibition of creation of false (artificial) markets of the securities of the offeree, offeror or of any other company concerned by the bid; (e) the announcing of a bid by an offeror after ensuring the fulfillment of any type of consideration; (f) non interrupting an offeree company to conduct its affairs during a bid duration.

The new legislation of takeover activity should effect in a higher level of minority shareholders protection and equal status of all the owners in the acquisition process at the Serbian market for corporate control. The Law introduces provisions relating to sell-out and squeeze-out right, the establishment of an equitable price in mandatory bids as well as creation of adequate "playing field" that guarantees the proper information to all the participants in the bid. Putting into force the new legislation should have as a consequence a higher level of market for corporate control transparency as well as the prohibition of manipulation and impact on the target firms shareholders.

Over the last years, a significant number of European countries have adopted (or are prepared to do so) voluntary corporate codes at the national or international level with the aim of better investor interest protection. Along with Serbian government growing concern about regulating corporate governance issues, a Code on corporate governance⁴ has been adopted in Serbia at the beginning of 2006. The Code on corporate governance (the Code) is issued by the Serbian Chamber of Commerce, the largest Serbian organization representing more than 120.000 economic entities in a wide range of industries and services. The Code does not offer an expressive definition of the term "corporate governance" – it provides only the main objectives of the Code. The Code is aimed at improving corporate practice of listed, open companies in Serbia and at making corporate governance as much transparent as possible "in a specific triangle between investors, managers and supervisors" (Code's Preamble).

Code rules, recommendations and suggestions attempt to create an addition to mandatory set of government requirements. The membership in the Chamber of Commerce implies the acceptance of the Code by the listed company at the Belgrade Stock Exchange. However, a listed company can voluntarily accept any other code on corporate governance, under the provision that the rights and duties of shareholders, supervisory and managerial bodies defined by this alternative code satisfy the minimum of requirements defined by the Code. Although the corporate governance issues addressed by the

⁴ The Code on corporate governance has been published in Serbian Official Gazette No.01/2006

Code are related to listed companies, the Code states that non-listed companies are also encouraged to follow these recommendations.

Main Code provisions are correlating with the provisions of corresponding European codes, i.e. relate to issues such as rights and treatment of shareholders (Chapter 2), roles, responsibilities, accountability and working methods of supervisory and managerial bodies (Chapter 3), organization and supervision of internal control systems (Chapter 4), disclosure practice (Chapter 5), financial statements audit (Chapter 6), the Code's offence (Chapter 7). Having in mind that the Code is adopted this year, there is no evidence on compliance of the companies with the Code rules and recommendations. However, in some successful listed companies in Serbia, interest in articulating standards and best practice of corporate governance is already evident. The analysis of the Code main rules and recommendations show that there is a great level of convergence between Serbian code on corporate governance and the EU member states codes. While different points of emphasis could be observed in those codes, their unique characteristic is recognition that good corporate governance practice is beneficial to listed companies, markets and all the stakeholders.

3. MARKET FOR CORPORATE CONTROL AS AN EXTERNAL CORPORATE GOVERNANCE MECHANISM IN SERBIA

As we have emphasized in the previous section, Serbian legal framework is largely brought into line with the relevant EU regulations. However, the corporate governance mechanisms, internal as well as external, still do not give satisfactory performances. Takeover activity at the market for corporate control is a typical external corporate governance mechanism. In regular conditions, at the developed market for corporate control, takeover mechanism minimizes the managerial (insiders) inefficiency due to the existence of high positive correlation between corporate managerial efficiency and the market price of shares. Operating efficiency is ensured by a natural selection mechanism at the market. The market registers signals from the companies that are poorly managed (share price and efficiency decline) and they become takeover targets. Furthermore, at the efficient market for corporate control, takeovers provide mechanism for outsider owner protection [15]. In the case of multiple bidder contests, rival bidders submit successively higher bids, control over corporate resources is acquired by a bidder with the highest bid and the real value of the target is revealed. In the case of Serbia, like in the most transition economies, the above-mentioned functions of the market for corporate control – managerial inefficiency minimization and outsider owner protection - are distort or missing. Regulatory inconsistencies, poor investor protection, concentration of ownership, confusing relationship between the state and financial sectors, weak judicial systems and absence or undeveloped institutions for building and monitoring market of enterprises lead to low price efficiency and illiquidity of the market for corporate control. An accelerated concentration of corporate ownership causes significant distortion of Serbian market for corporate control efficacy. In 63% of fully privatized companies one shareholder dominates in the size of shares, while in 80% of such companies one shareholder owns over 25% of the capital [5]. The observed high ownership concentration rate limits the function both of capital

market and the market for corporate control as disciplining mechanisms against managerial discretionary behavior.

The development of the market for corporate control and takeover practice, as external corporate governance mechanism, has begun in Serbia at the beginning of 2004, with the adoption of Rules of takeover's content and form⁵. Control transfer transactions have been realized predominantly at OTC market. According to Serbian Central securities, depositary and clearing house⁶, the value of completed control transfer transactions realized by takeover activity at OTC market in 2005. is 667,5 million EUR, while the number of realized transactions is 39.498⁷.

Judging from the structure, main characteristics and major trends, the market for corporate control in Serbia represents an emergent phenomenon. It is determined by all the features of the early transition process: accelerated ownership concentration, low corporate governance quality and low protection of minority shareholders [16]. At the beginning of the XXI century, acquiring control stock of interest of Serbian companies has been realized through open purchases at the Belgrade Stock Exchange and in the primary market (through capital increase). Takeovers have become frequent way of acquiring control over existing corporate resources of Serbian corporations during the last two years.

According to Serbian Central securities, depositary and clearing house⁸, 150 takeovers have resulted in acquiring control over target enterprises in period 1/1/2004 – 10/11/2006. Analyzing the Security Commission data, it can be generally observed that acquisitions targets are mostly enterprises operating in the same branch, i.e. horizontal transactions of control transfer are dominant. Taking into account the global nature of the merger activity with "wave pattern", it can be said that the Serbian market for corporate control in the beginning of XXI century passes through its first "merger wave". The characteristics of this wave are quite similar to these of the first "merger wave" that could be observed in USA, country with the most developed market for corporate control. Besides the dominancy of horizontal fusions, those two "waves" are also similar according to the braches in which control transfer transactions mainly took place (chemical, pharmaceutical, metal, food industry etc.). Consequently, a wave of consolidation and concentration of economic activity is expecting to be the result of the current merger wave.

Acquisition activity is directed toward successful companies, with high potential of return growth and quality manager teams. Those are mostly companies privatized according to the Law of Privatization from 1997. However, this is inconsistent with the "Entrenched management hypothesis", where the targets are inefficient companies, and where acquisitions are mainly disciplinary (aimed to replace inefficient management team

5 "Official Gazette of the Republic of Serbia", 102/2003, 25/2004, 103/2004, 123/2004

6 Acquired on 12/04/06 from the official web site of Central securities, depositary and clearing house, <http://www.crhov.co.yu/>

7 The comparison of trading at OTC and organized market according to the value of realized transaction, shows that the share of trading done at the Belgrade Stock exchange (58,7%) is slightly higher of the share of trading done at OTC market (41,3%). On the other hand, if we compare those two markets according to the number of transactions, we can observe that high percent of realized transaction has been realized at Belgrade Stock Exchange (76,7% of the total number of transactions).

8 Acquired on 11/08/06 from the official web site of Central securities, depositary and clearing house, <http://www.crhov.co.yu/>

of the target company). As to foreign acquirers, they profit in international acquisition activity by paying for existing company the price smaller than the costs that could have been incurred had the foreign firm invested in new plant and equipment. Thus, acquisitions of Serbian enterprises done by foreign acquirers represent a clear affirmation of Gonzales, Vasconcellos and Kish hypothesis on undervalued target enterprises (with Tobin's ratio less than 1) [2].

Low price efficiency is also one of the characteristics of the Serbian market for corporate control. The low price efficiency results in the low price to book ratio and Tobin Q ratio. In the circumstances involving combined activity of both factors, the transfer control activity risk increases [16]. The exclusive medium of acquisition financing is cash. That is in connection with high private valuation of bidders and existence of multiple bidder contests but also with high share supply and significant participation of external minority shareholders with low social status (for example, pensioners). They quickly accept the terms of tender offers because of the cash they are offered, regardless of the fact that their shares are undervalued. The expropriation of minority shareholders is thus obvious.

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Effective corporate governance in a nowadays globalized environment is seen as an essential protection for investment decision. The growing interest in corporate governance reflects an observation that foreign and domestic equity investors are considering the quality of corporate governance as much as business performance when judging the security and attractiveness of their investments.

Corporate governance has been, directly or indirectly, the subject of more intensive activity in Serbia over the past few years. Recent developments of corporate governance practice include improved legal and regulatory framework, the adoption of the corporate governance guideline as well as the reinforced role of stock exchange and security commission in monitoring of companies' governance. However, a relative satisfactory regulatory framework gives not satisfactory results in practice. Serious impediments to further development of corporate governance practice lie in poor enforcement of law, undeveloped judicial practice, and undeveloped capital market (with high capitalization and low liquidity). Finally, general impression is that managers, board members and shareholders of Serbian companies are both unaware of their rights and responsibilities and insufficiently educated in the area of corporate governance.

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PREGLED RAZVOJA KORPORATIVNOG UPRAVLJANJA U SRBIJI

Ksenija Denčić-Mihajlov

U nastojanju da uspostavi tržišno baziranu ekonomiju u post socijalističkom periodu, Srbija se, kao i ostale zemlje u tranziciji, suočava sa ozbiljnim izazovima kreiranja ekonomskog sistema, formiranja institucija i uvođenja podsticaja u cilju unapredjenja ekonomskog procesa. Korporativno upravljanje je označeno kao ključni deo reformskog procesa. Nakon pregleda značajnih izmena korporativnog zakonodavstva tokom poslednjih godina, u radu analiziramo najznačajnija dostignuća u praksi korporativnog upravljanja u Srbiji. U nastavku rada islustrujemo i diskutujemo osnovne karakteristike i trendove na srpskom tržištu korporativne kontrole kao eksternom mehanizmu korporativnog upravljanja u nas.

Ključne reči: *korporativno upravljanje, regulatorni okvir, akcionar, tržište korporativne kontrole.*