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**COMPLIANCE WITH MODERN LEGISLATIONS OF CORPORATE GOVERNANCE  
AND ITS IMPLEMENTATION IN COMPANIES**

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**Abstract**

*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". Modern legislations of corporate governance is based on vast experiences from good practices and corporate scandals from many countries and presents standards for governance of companies accepted by investors, governments, companies and other stakeholders. Compliance with modern legislations of corporate governance is important for every company and government in order to grow, develop, attract investors, lower risks and avoid corporate scandals and lawsuits. In the paper it will be discussed about the compliance of legislations of the Republic of Srpska with modern legislations of corporate governance. Moreover, the paper will analyze implementation of corporate governance principles and legislations in companies in the Republic of Srpska. The results of implementation of the principles of corporate governance in companies in the Republic of Srpska will be presented using the Scorecard analysis for evaluation of the implementation of (good) practices and principles of corporate governance in companies which are listed on the Official market of the Banja Luka Stock Exchange.*

**Key Words:** *Corporate Governance, Economic Growth, Republic of Srpska.*

JEL Classification: G 30; G 34; G 39;

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**1. Introduction**

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 fulfill their rights and interests in companies in which they invested their capital. Research problem of this paper is determining the level of implementation of corporate governance principles and modern legislations of corporate governance in companies in the Republic of Srpska. For investors one of the most important aspects when making an investment decision is a level of implementation of corporate governance principles, transparency (that is public disclosure of information), as well as protection of shareholder rights and equal treatment of shareholders, in other words well structured and functioning legal framework.

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## 2. Theoretical Background and Research Hypotheses

Work on corporate governance has been done for many years, but mostly by the Organization for Economic Co-operation and Development (OECD). The OECD gathers representatives of 34 member countries as well as other countries which are engaged into the OECD work. Together these countries make around 90 per cent world market capitalization. Their governments have interest to work in best interest of their citizens, to ensure good practice of corporate governance as a vital element in promotion of prosperity and economic growth. The OECD has published the Principles for corporate governance in 1999, which are first international code of good corporate governance approved by governments. The OECD Principles focus on publicly traded companies, both financial and non-financial, and have a goal to help governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance. They also provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance.

The OECD Principles of corporate governance are comprised of six main principles (OECD, 2004):

- I) Ensuring the basis for an effective corporate governance framework;
- II) The rights of shareholders and key ownership functions;
- III) The equitable treatment of shareholders;
- IV) The role of stakeholders;
- V) Disclosure and transparency; and
- VI) The responsibilities of the board.

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). Structure of corporate governance determines distribution of rights and responsibilities between various actors in company, such as boards, managers, shareholders and other stakeholders, and lays rules and procedures for making corporate decisions. This way, it 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).

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 no doubt that strong corporate governance system must be supported by well functioning legal framework and compliance with laws and regulations. The most important legal right shareholders have is the right to vote on important corporate matters, such as mergers and liquidations, as well as in election of boards of directors, which in turn have certain rights vis a vis the management (Manne 1965; Easterbrook and Fischel 1983). Legal environment and framework of a country has a large impact on the size and functioning of capital market. La Porta et al. (1997) state that good legislations, and legal framework protects investors from exploitation by managers and increases their willingness to invest their capital.

Moreover, the OECD Principles of Corporate Governance emphasise importance of securing legal framework for efficient corporate governance system. According to the OECD Principles of Corporate Governance (OECD 2004), to ensure an effective corporate governance framework, it is necessary that an appropriate and effective legal, regulatory and institutional foundation is established upon which all market participants can rely in establishing their private contractual relations. These Principles (OECD 2004) also state that corporate governance framework typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific circumstances, history and tradition. However, as new experiences accrue and business circumstances change, the content and structure of this framework might need to be adjusted.

Modern legislations of corporate governance is based on vast experiences from good practices and corporate scandals from many countries and presents standards for governance of companies accepted by investors, governments, companies and other stakeholders. Therefore, compliance with modern legislations of corporate governance is important for every company and government in order to grow, develop, attract investors, lower risks and avoid corporate scandals and lawsuits.

The main legislation in the Republic of Srpska covering and dealing with corporate governance is the Company Law passed in 2008 by National Assembly of the Republic of Srpska (and amended in 2009 and 2011) which replaced the Law on Enterprises passed in 1998, and the Standards of Corporate Governance issued by Securities Commission of the Republic of Srpska in 2011 which have replaced the Standards of Management of Joint Stock Companies from 2005. The listed companies (whose shares are traded in the official stock exchange) are obliged to implement the Standards of Corporate Governance or write their own codes. It is recommended that other joint stock companies adopt these Standards and incorporate them in their general acts. Besides these two main legislation covering and dealing with corporate governance in the Republic of Srpska there are other laws, regulations and rules which deal with specific aspects of corporate governance, which will be discussed further in the paper.

There is evidence from many researches that good corporate governance system based on the well functioning legal framework 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. And strong corporate governance system must be supported by well functioning legal framework and compliance with laws and regulations.

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### **3. Methodology and Results**

#### **3.1 Methodology**

The paper will discuss compliance of legislations of the Republic of Srpska with modern legislations of corporate governance. Moreover, the paper will analyze implementation of corporate governance principles and legislations in companies in the Republic of Srpska. The results of implementation of the principles of corporate governance in companies in the Republic of Srpska will be presented using the Scorecard analysis for evaluation of the implementation of (good) practices and principles of corporate governance developed by the Banja Luka Stock Exchange with the assistance of the International Finance Corporation (IFC). 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.

The research data was gathered from the database of the Banja Luka Stock Exchange, the National Assembly of the Republic of Srpska, Securities Commission and companies Web-Pages.

#### **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:

- Commitment to corporate governance principles;
- Rights of shareholders;
- Equal treatment of shareholders;
- Role of stakeholders in governance of joint stock companies;
- Publishing and transparency of information;
- Role and responsibility of the boards; and
- 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 Republic of Srpska. Achieving the total score of 100% should be an incentive for companies to implement higher principles of corporate governance (Strenger 2002).

#### **3.2 Results**

As mentioned earlier main legislation in the Republic of Srpska covering and dealing with corporate governance is the Company Law and the Standards of Corporate Governance. Besides

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these two legislations there are other laws, regulation and rules dealing with specific aspects of corporate governance or specific participants on the capital market. These legislations (further discussed in Table 1.) are the Security Market Law, the Law on Takeovers, the Rule of trading with securities, the Banja Luka Stock Exchange Rules and other laws, regulations and rules such as accounting, financial, auditing, criminal, etc.

Table 1: Main legislations in the Republic of Srpska dealing with corporate governance

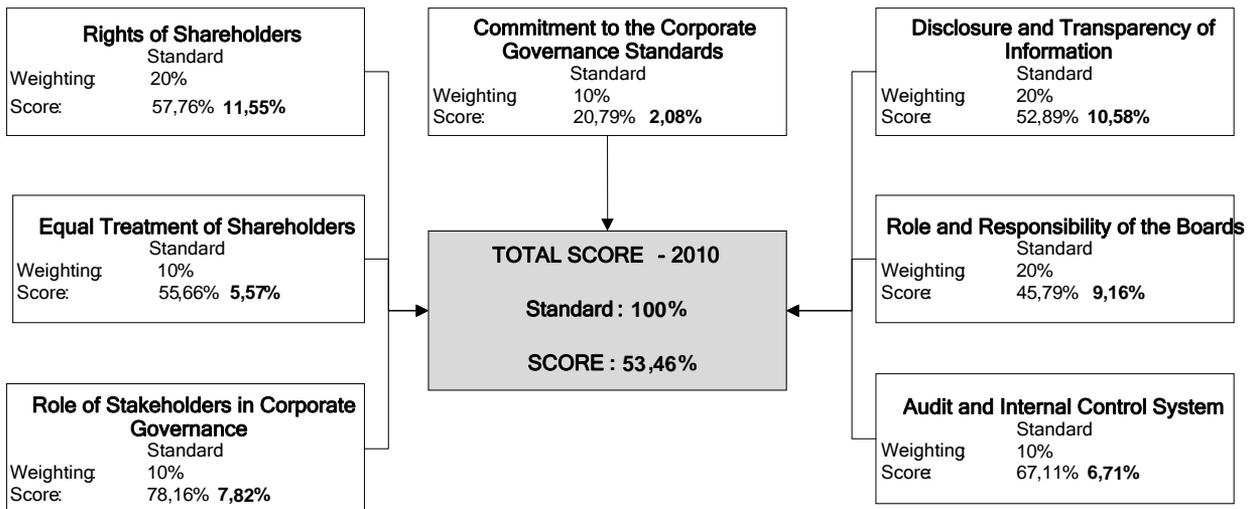
<i>Law/Regulation</i>	<i>Applicable to</i>	<i>Comments</i>
<b>Company Law</b> Official Gazette of Republic of Srpska No. 127/08, 58/09 and 100/11.	All companies	Regulates establishment, governance, rights and obligations of founders and shareholders, mergers and acquisitions, reorganization and bankruptcy and liquidation of companies.
<b>Security Market Law</b> Official Gazette of Republic of Srpska No 30/12.	All companies that issue securities by public offering	This law regulates: public offering of securities, transactions of securities, establishment and work of authorised participants on financial market, establishment and work of the Stock Exchange and other markets, establishment and work of the Central registry of securities, protection of interests and rights of shareholders, transparency in trading with securities on capital market, establishment and jurisdiction of Security Commission of the Republic of Srpska and other important issues for effective functioning of security market.
<b>Law on Takeovers</b> Official Gazette of Republic of Srpska No. 65/08 and 92/09	Open joint stock companies which shares are listed on the security market of the Republic of Srpska	This Law regulates procedure in takeovers of companies, conditions for takeover of shares, rights and obligations of participants in takeovers, as well as surveillance in takeovers of shares.
<b>Standards of Corporate Governance</b> The Official Gazete RS No 117/11 from November 25, 2011	The listed companies (whose shares are traded in the official stock exchange) are obliged to implement these standards or write their own codes. It is recommended that other joint stock companies adopt these Standards and incorporate them in their general acts.	These Standards of Corporate Governance are set on the basis of the Organisation for Economic Co-operation and Development (OECD) principles of corporate governance. These Standards of Corporate Governance (in addition to the Company Law, the Securities Market Law and other laws) set out more closely the mechanisms for functioning and protection of interests in interrelations among different stakeholders in a joint stock company.
<b>Rule of trading with securities</b> The Official Gazete RS No 11/07 and 96/07	Trading with securities: issued in privatisation, issued in public offerings, issued in private offering, establishment of open joint stock companies, trading with securities in takeovers and between authorised participants. Transfer of securities based on exchange, gift, borrowing, and other legal acts.	This rule regulates criteria and procedures of trading with securities registered in the Central registry of securities.
<b>Banja Luka Stock Exchange Rules</b> The Banja Luka Stock Exchange Management Board, decision No. 01-U0-638-1/10 from October 19, 2010	Joint stock companies listed on the one of markets of the Banja Luka Stock Exchange. Stock Exchange members and brokers	This Rule regulates listing and delisting of securities and companies on the Banja Luka Stock Exchange, conditions for listing on each segment of the market, temporary trading suspensions of securities, procedure in the case of alternation in capital of the issuer whose securities are listed on the official stock exchange market, responsibilities of issuers of listed securities, measures in event of issuer's incompliance, securities of foreign issuer, stock exchange members and brokers, improper conduct of stock exchange members and stock exchange intermediaries/brokers when trading on organized market, stock exchange surveillance.
<b>Other laws, regulations and rules (accounting, financial, auditing, criminal...)</b>	Specific type of companies or participants on the market	Regulating specific responsibilities and obligations of companies and participants on the market in the Republic of Srpska

Source: Authors

**Implementation of corporate governance principles in companies in the Republic of Srpska**

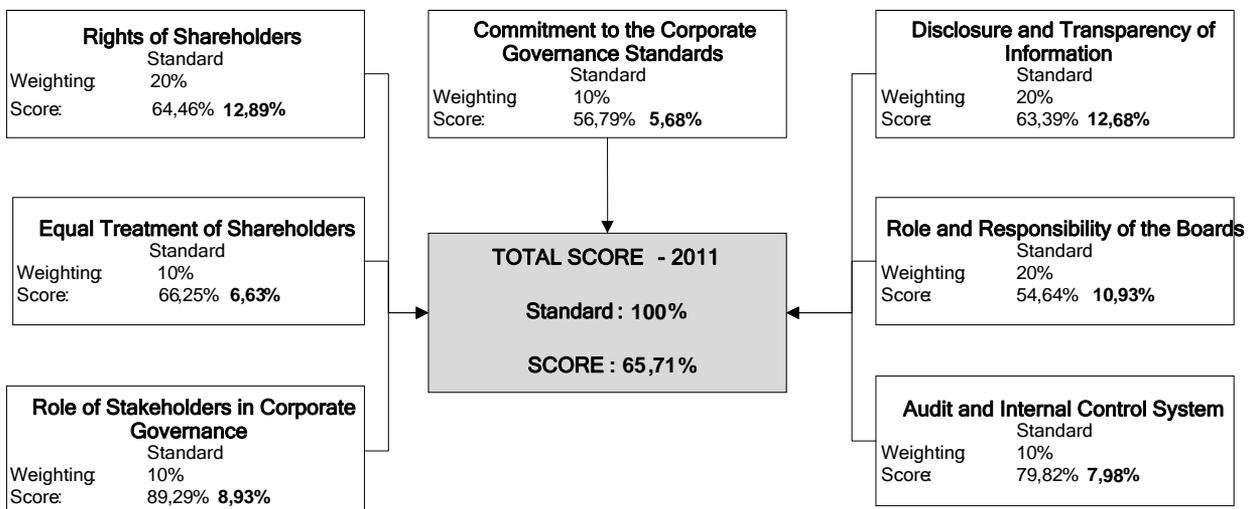
The results of implementation of corporate governance principles in companies from the Republic of Srpska determined using the Scorecard analysis for evaluation of the implementation of (good) practices and principles of corporate governance for the years 2010, 2011 and 2012 are presented in Figure 1, 2, and 3.

**Figure 1: Results of the Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance for companies in the Republic of Srpska for year 2010**



Source: The Banja Luka Stock Exchange and the University of Banja Luka, the Faculty of Economics (2010)

**Figure 2: Results of the Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance for companies in the Republic of Srpska for year 2011**



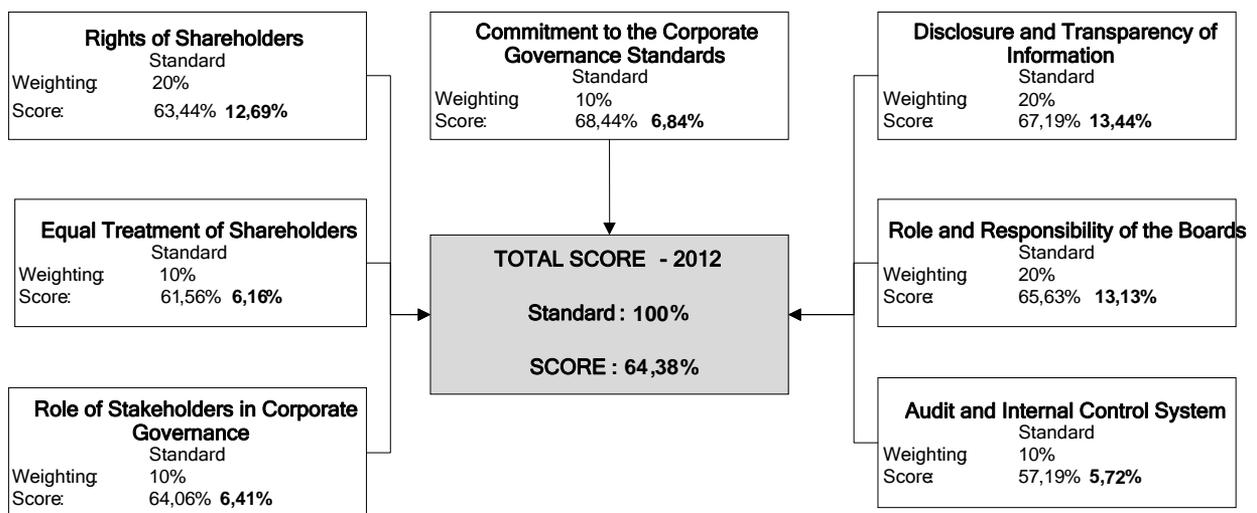
Source: The Banja Luka Stock Exchange (2011)

Total score of the implementation of practices and principles of corporate governance for companies in the Republic of Srpska for year 2010 is 53.46% which shows that implementation

of principles of corporate governance in these companies are not on satisfactory level, taking into account that companies that apply basic principles of corporate governance should have the score between 65% - 75%. Particularly low level is showed in commitment to the corporate governance standards, role and responsibility of boards, disclosure and transparency of information and rights and treatment of shareholders.

Total score of the implementation of practices and principles of corporate governance for companies in the Republic of Srpska for year 2011 is 65.71% which shows that implementation of principles of corporate governance in these companies are better than in year 2010 and goes slightly over 65%. While this score is improvement from year before implementation of principles of corporate governance is still not on satisfactory level, taking into account that companies that apply basic principles of corporate governance should have the score between 65% - 75%. Particularly low level is showed in commitment to the corporate governance standards, role and responsibility of boards, disclosure and transparency of information and rights of shareholders.

**Figure 3: Results of the Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance for companies in the Republic of Srpska for year 2012**



Source: The Banja Luka Stock Exchange (2012)

Total score of the implementation of practices and principles of corporate governance for companies in the Republic of Srpska for year 2012 is 64.38% which shows that implementation of principles of corporate governance in these companies are better than in year 2010, but lower than in year 2011. Therefore, implementation of principles of corporate governance is not on satisfactory level, taking into account that companies that apply basic principles of corporate governance should have the score between 65% - 75%. Particularly low level is showed in commitment to the audit and internal control system, equal treatment of shareholders, rights of shareholders and role of shareholders in corporate governance.

#### 4. Discussion

Results of the Scorecard analysis (showed combined in Table 2.) indicate that the state of corporate governance in companies from the Republic of Srpska is not satisfactory, and that implementation and compliance with principles of corporate governance is still in primary stage. 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.

Table 2: Combined results of the Scorecard analysis for companies in the Republic of Srpska for years 2010, 2011, and 2012.

<i>State Of Corporate Governance</i>	<i>2010</i>	<i>2011</i>	<i>2012</i>
Commitment to the Corporate Governance Standards	21%	57%	68%
Rights of Shareholders	58%	64%	63%
Equal Treatment of Shareholders	56%	66%	62%
Role of Stakeholders in Corporate Governance	78%	89%	64%
Disclosure and Transparency of Information	53%	63%	67%
Role and Responsibility of the Boards	46%	55%	66%
Audit and Internal Control System	67%	80%	57%
<b>TOTAL SCORE</b>	<b>53%</b>	<b>66%</b>	<b>64%</b>

Source: The Banja Luka Stock Exchange

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.

The Company Law and other legislation in the Republic of Srpska include only basic principles and rights of corporate governance. Only the Standards of Corporate Governance are in compliance with the OECD principles of corporate governance, which are obligatory for all joint stock companies listed on securities market but include recommendations and suggestions which joint stock companies are not obliged to implement. Legal and Corporate governance framework of the Republic of Srpska 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.

The Company Law puts an obligation on the all companies listed on the Official Market of the Banja Luka Stock Exchange to write their own corporate governance codes or to implement the Standards of Corporate Governance issued by Securities Commission of the Republic of Srpska in 2011. Trough research for the Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance and database of the Banja Luka Stock Exchange it was found that only three companies listed on the Official Market of the Banja Luka Stock Exchange have adopted its own corporate governance codes. Other companies listed on the Official Market have just adopted the Standards of Corporate Governance. Therefore, companies do not try to write its own model of corporate governance (corporate governance codes) which are based on company specific situation, industry and market, but they only adopted the Standards issued by Securities Commission of the Republic of Srpska.

Where as in countries with good system and practices of corporate governance, such as Austria, compliance with the Code of Corporate Governance is mandatory for all companies listed on the prime market according to the prime market rules of the Vienna Stock Exchange (2010), where companies have their own corporate governance codes written based on company specific situation.

Results of the Scorecard analysis for companies listed on the Official Market of the Banja Luka Stock Exchange shows that companies view as an additional legal obligation and not as a mechanism which is adjusted to company specific situation with aim to improve performance and decision making process, which is in interest of all stakeholders of company. Although companies have adopted the Standards issued by Securities Commission of the Republic of Srpska they very poorly disclose, in their annual reports, compliance with the Standards of Corporate

Governance. Even 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.

These problems in legal framework in the Republic of Srpska (together with legal framework in the Federation of B&H) dealing with corporate governance, compliance of companies with only minimum obligatory standards by the law and poor disclosure of compliance with corporate governance standards have put Bosnia and Herzegovina, according to the Global Competitiveness Report 2012-2013 of the World Economic Forum, in segment of regulation of securities exchanges at 112 position out of 144 countries, at 89 position in segment of Legal rights index, 138 place in segment of Protection of minority shareholders' interests, and 80 position in segment of Strength of investor protection. Furthermore, according to this report second most problematic factor for doing business in Bosnia and Herzegovina is Policy instability which is directly related efficiency of corporate governance system of the country.

## 5. Conclusion

In the Republic of Srpska there is a legal framework which protects rights of shareholders, laws and regulations regulating work of companies and other participants, as well as fines for non compliance with these laws. The main legislation in the Republic of Srpska covering and dealing with corporate governance is the Company Law passed in 2008 by the National Assembly of the Republic of Srpska. However, problem of supervision and enforcement of these laws is still the major problem which prevents efficient implementation of corporate governance in the Republic of Srpska. Lawmakers as well as supervisory institutions of capital market are not successful in adoption of changes which are necessary for implementation of efficient system of corporate governance in the Republic of Srpska. Researches in this field show that regulatory process consists of setting the rules or standards, monitoring compliance and enforcement (Otobo, 1997) and that lack of enforcement of existing regulatory measures, whether outdated or not, contributes to poor corporate governance practices (Okeahalam and Oludele 2003). This can be seen in the results of the Scorecard analysis for evaluation of the implementation of (good) practices and principles of corporate governance for the years 2010, 2011 and 2012 where implementation of corporate governance standards in companies in the Republic of Srpska is not on satisfactory level.

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. Therefore it is obvious that legal framework and company competence is fundamental element for good corporate governance.

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