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IMPACT OF CORPORATE GOVERNANCE ON PERFORMANCE OF COMPANIES

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Abstract

Corporate governance is system by which companies are directed and controlled, but also the relationship between companies and interest groups which determines its strategic direction and performance. Through appropriate application of the principles of corporate governance a company increases profitability and returns, improves its competitiveness, credibility and reputation and improves relations with key stakeholders such as investors, business partners, employees, customers, etc. Companies that insist on the highest standards of governance reduce many risks that arise from daily operations. Such companies are able, by better performance and returns, to attract investors whose investments could help finance further growth and development. The study will assess the level of implementation of corporate governance and level of performance in companies from the Republic of Srpska. Results of implementation of the corporate governance in companies will be presented using Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance on a sample of 19 companies which are listed on the Official market of the Banja Luka Stock Exchange. Level of performance will be assessed by determining the net profit margin and earnings per share for the same sample of companies. Results will be compared with results obtained by a similar analysis conducted for companies listed on the Vienna Stock Exchange to determine the impact of corporate governance on performance of companies.

Key Words: *Corporate Governance, Firm Performance, Net Profit Margin, Earnings per Share, Scorecard Analysis, the Republic of Srpska.*

JEL Classification: G30, G34, G39

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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 that "the governance of the corporation is now as important in the world economy as the government of countries" (Wolfensohn, 1998).

Good corporate governance can help to prevent corporate scandals, fraud, and potential civil and criminal liability of companies. 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. There is evidence from many researches that good corporate governance produces direct economic benefit to the company, making it more profitable and competitive.

For investors one of the most important aspects when making an investment decision is level of implementation of corporate governance principles (public disclosure of information, protection of shareholder rights and equal treatment of shareholders) and profitability, which ensures return on their investment.

Research problem of this paper is based on determining the impact of level of implementation of corporate governance on performance of companies. Level of performance will be as-

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sessed by determining the net profit margin (NPM) and earnings per share (EPS), while level of implementation of the principles of corporate governance in companies will be assessed using Scorecard analysis for evaluation of the implementation of (good) practices and principles of corporate governance. Research will be done on a sample of 19 companies from the Republic of Srpska, which are listed on the Official market of the Banja Luka Stock Exchange. Results will be compared with results obtained by a similar analysis conducted for companies from Austria, which are listed on the Prime market of the Vienna Stock Exchange.

2. THEORETICAL ASPECTS OF CORPORATE GOVERNANCE

Discussion on corporate governance started in early 80's during which American managers had neglected interests of shareholders which coursed fall of share price.

Work on corporate governance has been done for many years, but mostly by the Organization for Economic Co-operation and Development (OECD). Governments of OECD member countries 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 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.

Arrangements, implications and responsible institutions for corporate governance vary from country to country, and experience from developed and transition countries shows that there is no universal framework for all markets. Therefore the Principles are non-binding or obligatory, but voluntary in form of recommendations, so every country can adapt and implement them in accordance with specific circumstances of individual countries and regions, that is to individual tradition and market conditions.

In 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). 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). 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 Organization 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).

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).

Good corporate governance plays a key role in enhancing integrity and efficiency of companies, as well as financial markets in which company operates. Poor corporate governance weakens company's potential and in worst care can open the way for financial difficulties and frauds. Companies which follow the best practice of corporate governance usually raise capital easier and by lower price and in long term are more profitable and competitive than companies that have poor corporate governance. Companies that insist on the highest standards of governance reduce many risks that arise from daily operations. Such companies are able, by better performance and returns, to attract investors whose investments could help finance further growth and development.

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.

3. METHODOLOGY OF RESEARCH AND RESEARCH HYPOTHESES

To determine the impact of level of implementation of corporate governance on performance of companies, Scorecard analysis for corporate governance, net profit margin (NPM) and earnings per share (EPS) were used.

Data for analysis was gathered from databases of the Banja Luka Stock Exchange and Vienna Stock Exchange, Reuters Observer station, companies' web pages and interviews with companies' top managers.

Level of implementation of the principles of corporate governance in companies from the Republic of Srpska was assessed using Scorecard analysis for evaluation of the implementation of (good) practices and principles of corporate governance, while level of performance was assessed by determining the net profit margin (NPM) and earnings per share (EPS).

Research was done on a sample of 19 companies which were listed on the Official market of the Banja Luka Stock Exchange.

To determine the impact of level of implementation of corporate governance on performance of companies, gathered results for companies listed on the official market of the Banja Luka Stock Exchange was compared with results obtained by a similar analysis conducted for companies listed on Prime market of the Vienna Stock Exchange.

The Scorecard for the Standards of governance of Joint Stock Companies 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 (The Banja Luka Stock Exchange, 2009).

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.

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. Achieving the total score of 100% should be an incentive for companies to implement higher principles of corporate governance (Strenger, 2002).

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

H0: Level of implementation of corporate governance has a positive impact on performance of companies.

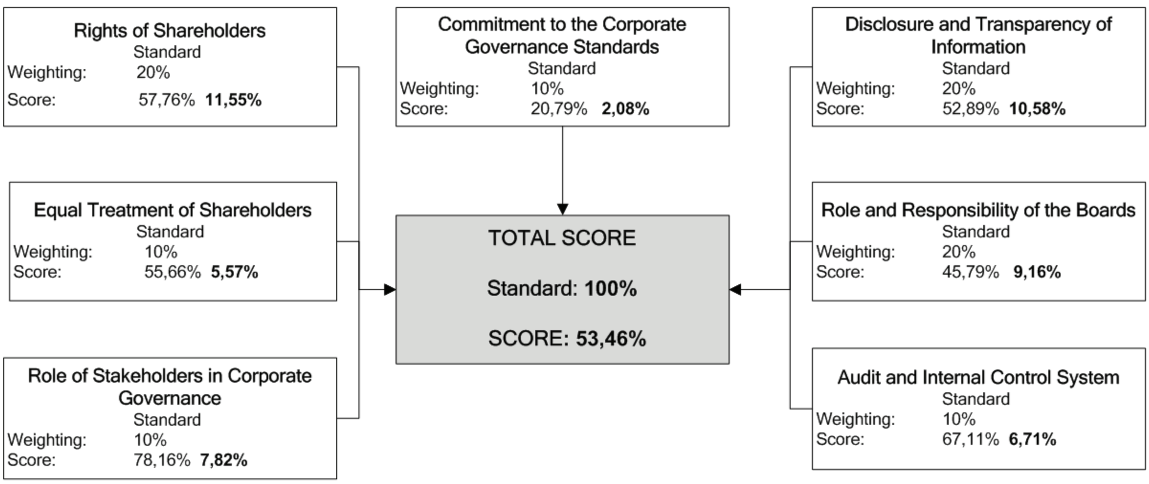
H1: Companies with higher level of implementation of corporate governance have higher earnings per share (EPS).

H2: Companies with higher level of implementation of corporate governance have higher net profit margin (NPM).

4. AN ANALYSIS OF INFLUENCE OF CORPORATE GOVERNANCE ON PERFORMANCE OF COMPANIES

Shleifer and Vishny define corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return of investment" (Shleifer and Vishny, 1997:2). Therefore, it is important to find out whether the level of implementation of corporate governance is correlated with performance of companies. If it is so, companies should follow the best practice of corporate governance to attract investors and raise finance at lower price. To determine this, results of level of corporate governance, net profit margin and earnings per share for companies from the Republic of Srpska will be analyzed and compared to findings for companies from Austria.

Figure 1: Results of Scorecard analysis for evaluation of the implementation of practices and principles of corporate governance for companies form the Republic of Srpska



Source: The author's research

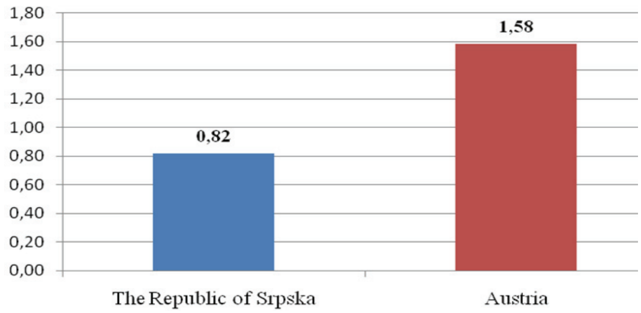
As shown in Figure 1 total score of the implementation of practices and principles of corporate governance for companies from the Republic of Srpska is 53,46% which shows that implementation of principles of corporate governance in these companies are not on satisfactory level, taking into account that 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.

Net profit margin (NPM) for companies from the Republic of Srpska is negative, showing at -7,11%, while earnings per share (EPS) for companies from the Republic of Srpska is 0,82 EUR.

These results indicate that companies from the Republic of Srpska have low level of implementation of principles of corporate governance and low performance shown by Scorecard analysis score and net profit margin.

To show impact of corporate governance on the performance of companies these results will be compared to the results obtained by a similar analysis conducted for companies listed on the Vienna Stock Exchange.

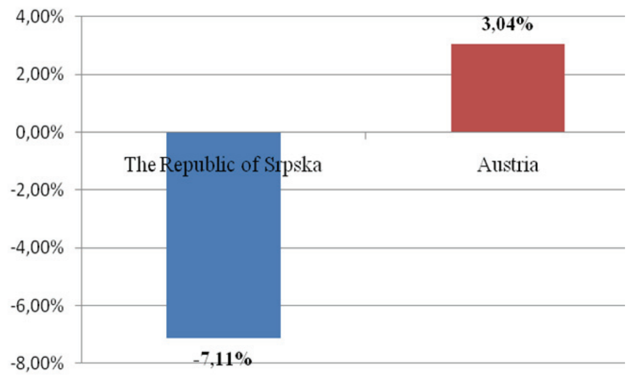
Figure 2: Results of earning per share (EPS) for companies from the Republic of Srpska and Austria



Source: The author's research

Earnings per share (EPS) for companies from Austria is 1,58 EUR which indicates that on average these companies are more profitable and generate more earnings that can be converted to dividends, showing better returns to investors and higher value on stock market than companies from the Republic of Srpska.

Figure 3: Results of net profit margin (NPM) for companies from the Republic of Srpska and Austria



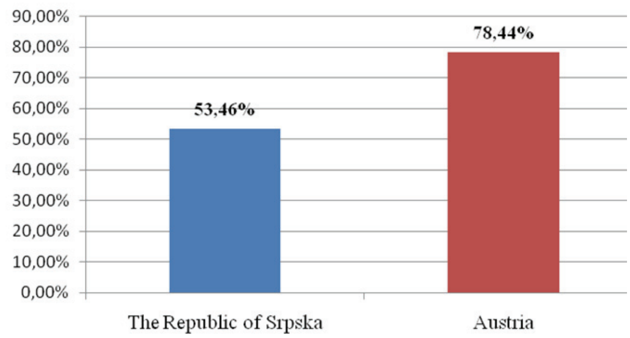
Source: The author's research

Net profit margin (NPM) for companies from Austria is 3,04% which indicates that on average these companies are more profitable, more effective at converting revenue into actual profit and have better control over its costs compared to companies from the Republic of Srpska. This shows that companies from the Republic of Srpska have lower margin of safety and high risk for investors due to losses and negative margin.

Total score of the implementation of practices and principles of corporate governance for companies from Austria is 78,44% which is based on the Corporate governance index (Kaufmann, 2004:101). Also according to the prime market rules of the Vienna Stock Exchange compliance with the Code of Corporate Governance is mandatory for all companies listed on the prime market. Companies from the Republic of Srpska have total score of the implementation of practices and principles of corporate governance of 53,46%.

This shows that companies from Austria have higher level of implementation and are more committed to principles of corporate governance than companies from the Republic of Srpska.

Figure 4: Results of corporate governance score for companies from the Republic of Srpska and Austria



Source: The author's research

5. DISCUSSION

Results from Figure 2, 3 and 4 shows that companies from the Republic of Srpska have lower level of implementation of principles of corporate governance, lower net profit margin, and lower earnings per share compared to the companies from Austria.

These results show that companies with higher level of implementation of corporate governance principles have higher net profit margin and earnings per share. While companies that have lower level of implementation of corporate governance principles have lower or negative net profit margin and lower earnings per share. This indicates that companies with higher level of implementation of principles of corporate governance and better practice of corporate governance are more profitable and have better performance. As a result, implementation and compliance with principles and good practice of corporate governance has an impact on performance of companies.

Therefore, companies with lower level of implementation of corporate governance principles (companies from the Republic of Srpska) should implement and should comply with corporate governance principles and standards, increase disclosure of information, and increase protection of shareholders, if they are to survive in global market, become more competitive, profitable, attract investors and raise capital at lower price.

6. CONCLUSION

Results of the analysis indicate that there is an obvious correlation and impact of implementation of principles of corporate governance on performance of companies.

Companies from the Republic of Srpska which are listed on the official market of the Banja Luka Stock Exchange have lower level of implementation and compliance with principles of corporate governance, lower net profit margin and earnings per share than companies from Austria which are listed on prime market of Vienna Stock Exchange. This indicates that companies with higher level of implementation of principles of corporate governance and better practice of corporate governance are more profitable and have better performance.

Therefore, if companies want to increase their performance, survive in global market, become more competitive, profitable, attract investors, customers and raise capital at lower price, they must implement corporate governance principles and standards in their strategy and decision making process.

One of the main barriers for implementation of principles of corporate governance by companies is seeing corporate governance as a good will and not as an essential part of responsible business practice. They view corporate governance only through cost of implementation. Moreover, companies do not understand positive influences which corporate governance can have on company's performance, especially on relations with investors. Therefore, responsible institution of capital market should draw attention of companies to potential benefits and advantages of implementation and compliance of corporate governance, as well as give them support for implementation of corporate governance.

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