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COMPLIANCE OF CORPORATE GOVERNANCE IN BOSNIA AND HERZEGOVINA WITH EUROPEAN UNION STANDARDS

Received: October 15, 2018

Accepted: December 20, 2018

Review

Abstract

Corporate governance provides an answer to the question who controls the corporation and how. It involves a set of relationships between management, shareholders and stakeholders. Corporate governance in Bosnia and Herzegovina is within the legal jurisdiction of entities, and consequently there are two substantially aligned and yet completely distinct corporate governance systems, which separates Bosnia and Herzegovina as a state in the international environment into a specific category in terms of corporate governance.

This paper will analyze ownership concentration in order to identify the characteristics of the corporate governance systems, then it will present the principles on which the legal framework for corporate governance in Bosnia and Herzegovina is defined, compare the business transparency standards with the transparency directive in the EU, and measure the quality level of corporate governance in order to define key areas for improvement of corporate governance in Bosnia and Herzegovina. The development and characteristics of the corporate governance systems in Bosnia and Herzegovina will be explored and compared with the regulatory framework and standards of corporate governance in the European Union. Special emphasis is on comparing the transparency principles and standards of corporations in Bosnia and Herzegovina with corporations in the European Union. The aim of the research is to compare the regulatory framework and characteristics of the corporate governance system in corporations in Bosnia and Herzegovina with the standards in the European Union, to identify similarities and differences and to define key areas for improvement of corporate governance in Bosnia and Herzegovina.

Keywords: *corporate governance, corporate governance system in entities of Bosnia and Herzegovina, transparency in the operation of corporations in Bosnia and Herzegovina, European Union transparency directives, quality of corporate governance in Bosnia and Herzegovina, LCG index*

JEL: G28, G34, K20

1. INTRODUCTION

Corporate governance is defined as a set of processes and procedures for management and control of corporations. Corporate governance shows how rights and responsibilities are distributed among different stakeholders in corporations. Corporate governance provides an answer to the question who controls the corporation and how. It involves a set of relationships between management, shareholders and stakeholders. Corporate governance defines the framework for setting corporate goals, determining the means for achieving the set goals and monitoring performance and efficiency. This paper will explore the development and characteristics of the corporate governance systems in Bosnia and Herzegovina and compare them with the regulatory framework and standards of corporate governance in the European Union. Special emphasis is on comparing the transparency principles and standards of corporations in Bosnia and Herzegovina with corporations in the European Union.

The aim of the research is to compare the regulatory framework and characteristics of the corporate governance system in corporations in Bosnia and Herzegovina with the standards in the European Union, to identify similarities and differences and to define key areas for improvement of corporate governance in Bosnia and Herzegovina.

2. CORPORATE GOVERNANCE IN BOSNIA AND HERZEGOVINA

Corporate governance is a very broad term and there are many approaches to its definition, each being concerned with the analysis of governing structures and processes in corporations. However, one definition of corporate governance can be singled out, the definition of the Organization for Economic Cooperation and Development (OECD), which states that "*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. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders...*"¹ Through its acts, especially through the document Principles of Corporate Governance, the OECD has greatly contributed to the development and

¹ Organisation for Economic Co-Operation and Development: *OECD Principles of Corporate Governance*, OECD Publication, Paris, 2004, p. 12.

standardization of both concepts and standards of corporate governance at the global level.

Corporate governance in Bosnia and Herzegovina is within the jurisdiction of entities, and consequently there are two substantially aligned and yet completely distinct corporate governance systems, which separates Bosnia and Herzegovina as a state in the international environment into a specific category in terms of corporate governance. Here, we must also bear in mind the Brcko District, the territory of Bosnia and Herzegovina that makes this story even more complex with its separate institutional framework.

In the research section, ownership concentration will be analyzed in order to identify the characteristics of the corporate governance systems, then the principles will be presented on which the legal framework for corporate governance in Bosnia and Herzegovina is defined, the business transparency standards will be compared with the transparency directive in the EU. In the third section of the paper, the quality level of corporate governance will be measured in order to define key areas for improvement of corporate governance in Bosnia and Herzegovina.

2.1. Ownership concentration in financial and non-financial corporations in Bosnia and Herzegovina

In order to determine the characteristics of corporate governance systems in Bosnia and Herzegovina, data on ownership concentration for non-financial corporations, banks and insurance companies in Bosnia and Herzegovina will be integrated and compared (Table 1). For the purposes of this research, 87 non-financial corporations, 24 banks, and 26 insurance companies were analyzed, where their ownership concentration was determined, based on which the characteristics of corporate governance systems in Bosnia and Herzegovina were defined. The study of non-financial corporations analyzed the data of 87 corporations from the territory of Bosnia and Herzegovina whose shares are traded in the entities' capital markets, of which 49 corporations are located in FBiH, and 38 are located in RS. With respect to financial corporations (banks and insurance companies), all banks (totally 24, of which 16 are located in FBiH and 8 in RS) and all insurance companies holding an operating license issued by the competent agency (totally 26, of which 12 are located in FBiH, and 14 in RS) were examined.

Table 1. Ownership concentration in Bosnia and Herzegovina as of 31 Dec 2017

	Non-financial corporations (n=87)	Banks (n=24)	Insurance companies (n=26)	Total BiH
Owner 1	51.47	78.03	82.34	61.98
Owner 2	13.24	5.49	13.96	12.02
Owner 3	7.27	5.49	7.53	7.01

Owner 4	4.63	2.56	3.46	4.05
Owner 5	3.27	2.38	1.77	2.83
Owner 6	2.29	1.51	1.11	1.93
Owner 7	1.77	1.31	0.97	1.54
Owner 8	1.36	1.22	0.75	1.22
Owner 9	0.97	1.23	0.54	0.93
Owner 10	0.72	0.82	0.45	0.69
TOTAL				94.19

Source: Author's analysis according to the data from securities registries of FBiH and RS.

In each of the three observed cases, the first and largest owner has a share greater than 50% on the average. In a large number of corporations, the first and largest owner has a controlling block of shares. The highest ownership concentration is in insurance companies, where the largest owner on the average holds almost 3/4 of the total capital, while in banks the largest owner holds 2/3 of the capital. In the banks that were analyzed in detail, the situation is also specific in that the six largest banks have a situation that the majority owner holds more than 90% of the capital and has absolute control of business operations and management.

All this suggest that financial and non-financial corporations in Bosnia and Herzegovina have the properties of a closed corporate governance system. The fundamental characteristic of a closed system is primarily high ownership concentration, key control and power is held by the largest owner, and corporations in a closed system have a problem with lack of transparency in business operations and relations with different stakeholders.

2.2. Legislative framework for corporate governance in BiH

The legislative framework for corporate governance in all countries includes a set of laws that cover various areas of corporate governance and are supplemented by bylaws such as codes and recommendations. The complexity of the state system of Bosnia and Herzegovina has also determined the complexity of the entire legal framework. It can be said that there are three separate corporate governance systems in Bosnia and Herzegovina, and they are related to two entity systems, and the Brcko District. Both entity institutional frameworks will be analyzed in this research.

Table 2. Institutional framework for corporate governance in Bosnia and Herzegovina

State/BiH level of regulation	<i>It is related to the laws being applied equally in both entities and Brcko District. There are four laws enacted at the state level and being applied on an equal basis in both entities.</i>
Entity level	<i>It is related to 14 entity laws being applied in parallel in the Federation of BiH and Republic of Srpska entities. Each of these laws is mutually harmonized, but still significantly different.</i>
Entity-level bylaws	<i>It is related to entity-level corporate governance codes (the most important acts for corporate governance) and other bylaws and generally accepted international standards adopted at the entity level, which are concurrently applied for the regulation of certain areas.</i>

Source: Author

The institutional framework for corporate governance in BiH consists of two institutional frameworks, which have 18 different regulation areas (of which there are four organic laws at the state level and 14 entity laws), entity codes (related to stock exchanges), and International Accounting Standards and International Financial Reporting Standards. Based on all the above, it can be concluded that corporate governance in Bosnia and Herzegovina is based on two mostly aligned, but still significantly different institutional frameworks. In the true sense, that departs from the international recommendations and standards of corporate governance that advocate a single harmonized system, brought into line with international standards. This situation impedes the very research, since it opens up the possibilities of different criteria, and different approaches to the same criteria, being present in the two entities.

2.3. Compliance of transparency in the operation of corporations with European Union standards

The analysis of transparency in the operation of corporations in Bosnia and Herzegovina looked at the policy of management's relations with all stakeholders. Analyzing the policy of relations with stakeholders, it was examined how many corporations have an active website, publish general acts, publish reports on business operations in the local and foreign language, and submit reports to the entity stock exchange. The transparency analysis examines communication channels and method and contents of communication with the environment.

The analysis of business transparency of the observed corporations in Bosnia and Herzegovina looked at key business transparency standards, which are defined by the transparency directive, and these are:²

² European Parliament and Council: Directive 2004/109/EC, 2004, pp. 40-49.

- *uniform publication deadlines* - four months after the end of the reporting period for annual financial reports and two months for interim financial reports
- *annual financial statements* should include audit reports and management reports
- *semi-annual financial statements* must include an additional management report
- publications must be *available to the public for at least five years*
- *interim management reports* for share issuers should be published in the first and third quarter (refers to a business development and performance review and description of main risks facing the corporation management)
- *mandatory publication on the Internet.*

The following table analyzes the stakeholder relations policy, examining how many corporations have an active website, publish general acts, publish reports on business operations in the local and foreign language, and send reports to the entity stock exchange. In other words, it analyzes how the corporation communicates with stakeholders.

Table 3. Communication method and relations with stakeholders of the corporations in Bosnia and Herzegovina

Criteria	Non-financial corporations (n=87)	Banks (n=24)	Insurance companies (n=26)
Website	86.78%	100.00%	100.00%
Company's general acts	42.53%	53.12%	53.57%
Report on overall business operations in 2016	69.54%	93.75%	95.83%
Reports in a foreign language (English)	16.09%	35.93%	16.06%
Sending reports to the entity stock exchange	96.55%	81.25%	87.48%

Source: Author

The analysis shows that most corporations have websites (100% of banks and insurance companies and 86.78% of non-financial corporations), but as far as publishing of general acts is concerned, the percentage of corporations that publish acts is approximately 50%, while the availability of reports in foreign languages is at a very low level in all corporations. With regard to publishing of overall business reports, more than 90% of banks and insurance companies publish financial statements, while slightly more than 2/3 of non-financial corporations publish financial statements. Regarding the submission of reports to entity stock exchanges, almost 90% of corporations submit reports to entity stock exchanges.

The analysis of transparency in business operations of the observed corporations in Bosnia and Herzegovina examined the availability to the public of business goals, reports from shareholders' meetings, reports on events of particular interest and potential risks, audit reports, publishing of periodic reports and periods for which the reports are published.

Table 4. Transparency in business operations of corporations in Bosnia and Herzegovina

Criteria	Non-financial corporations (n=87)	Banks (n=24)	Insurance companies (n=26)
Business goals	64.94%	3.13%	34.51%
Reports from shareholders' meetings	62.64%	62.50%	76.16%
Reports on events of particular influence on financial operations	43.68%	34.38%	45.22%
Information on potential business risks	33.33%	0.00%	4.16%
Audit report and opinion	48.28%	53.13%	76.10%
Publication of semiannual or quarterly reports	61.49%	62.50%	91.66%
Number of years for which reports are published	<5	>5	>5
Published reports for five or more years	85.06%	90.63%	57.71%
Not having any published annual reports	0.00%	0.00%	0.00%

Source: Author

From all the observations, it can be concluded that the level of transparency in business operations in financial corporations is slightly higher than in non-financial corporations. Corporations publish all mandatory financial statements, as well as reports on overall business operations (more than 2/3 of corporations), significantly more regularly. Most corporations (more than 2/3 of financial and non-financial corporations) publish all mandatory financial statements and keep them available on websites for more than 5 years. There is not a single corporation that has not published any reports. The main reason is that publishing of these reports is mandatory, so the corporations themselves treat them in a more responsible manner in their policies.

All other reports that are in the category of voluntary and non-mandatory reports are significantly less published and presented on websites and in corporate acts. This especially applies to business goals, reports on events of particular influence on financial operations and information on potential risks, where less than 50% of the corporations fulfilled the prescribed criteria.

If we synthesize all the above and analyze the overall performance of the corporations in accordance with the transparency directive, it can be concluded that the corporations are significantly more responsible in the directive segments that are incorporated into the laws in Bosnia and Herzegovina. The corporations fulfill all that the law stipulates, and do not fulfill to a significant measure (mainly less than 50%) the other part that falls into the domain of voluntary reporting.

With regard to the transparency directive, corporations observe the report publication deadlines, publish semiannual and annual reports, publish audit reports, keep reports available on their websites for five or more years. All this is an integral part of the legal framework of Bosnia and Herzegovina (entity laws) and that is what corporations do respect, but the corporations fulfill to a significantly lesser extent and passively observe all that falls into the domain of voluntary reporting and all that is regulated by bylaws.

3. THE QUALITY LEVEL OF CORPORATE GOVERNANCE AND AREAS FOR IMPROVEMENT OF CORPORATE GOVERNANCE IN BOSNIA AND HERZEGOVINA

The quality of corporate governance is defined by the international standards (OECD Principles of Corporate Governance), entity legal framework, and corporate governance codes. This measurement approach is based on measuring deviations from the set standards, which are determined by the corporate governance quality index. The quality of corporate governance is assessed through six categories containing the analyzed prescribed criteria. The corporate governance quality assessment categories are:³

- I. Commitment to the principles of corporate governance and social responsibility,
- II. Shareholders' meeting,
- III. Supervisory board/non-executive directors,
- IV. Board of Directors – Management,
- V. Audit and internal control mechanisms,
- VI. Transparency of business operations.

³ The number and types of categories and their weights in the overall assessment are adjusted to the 2004 OECD Principles of Corporate Governance, then the Corporate Governance Standards of RS from 2011 and the Corporate Governance Code for companies listed on the market of the Sarajevo Stock Exchange from 2009. The measurement model and analysis of the obtained results were formed on the model of the Scorecard for German Corporate Governance and experiences related to indices created on the basis of the Sarbanes - Oxley Act in the United States, Combined Code in Great Britain, as well as other attempts to measure the quality of corporate governance. The weight value was determined on the basis of the existing experiences and results of studies of the importance of individual evaluation components for socio-interest groups and of their influence on the overall quality of corporate governance.

The index developed for the analysis of corporate governance in BiH is called *LCG* (*abbrev. Level of Corporate Governance*). It is developed and tested on the model of the index Scorecard for German Corporate Governance, intended for German corporations whose shares are traded on German capital markets. For the purposes of this research, the first version of the index is completely changed and adapted to the criteria set out in the 2004 OECD Principles of Corporate Governance, then the Corporate Governance Standards in RS from 2011 and the Corporate Governance Code for companies listed on the market of the Sarajevo Stock Exchange from 2009. The final form of the index structure is given in Table 5.⁴

Table 5. The structure of the level of corporate governance index in BiH - LCG index

Ser. No.	Description and method of criteria evaluation	Number of criteria in category	Share/weight in overall assessment
I.	Commitment to the principles of corporate governance and social responsibility	7 criteria	15%
II.	Shareholders' meeting	9 criteria	15%
III.	Supervisory board/non-executive directors	7 criteria	10%
IV.	Board of Directors – Management	9 criteria	20%
V.	Audit and internal control mechanisms	5 criteria	10%
VI	Transparency of business operations	9 criteria	30%
TOTAL		46 criteria	100%

Source: Author

The total and final assessment can be expressed in a number of ways, the first certainly being in the original form and values achieved by the analysis, and the other possibility is through a set of classes of the achieved values (three, five, seven

⁴ The LCG index (the first version was called BHCog) was developed and tested as part of the research for the purposes of scientific master's thesis of the author Nikola Papac on banks in BiH, and was subsequently revised and adapted to changes in the institutional framework (the second version was named the LCG Index). The BHCog index was created completely on the model of the DVFA index, while the LCG index took into account the policies and rules of the DVFA and BHCog indices, but for creating the criteria, the corporate governance codes of the Sarajevo and Banja Luka stock exchanges were precisely taken into account.

Adapted from: Matić, B. and Papac, N.: *Measuring the quality of corporate governance in the banking sector of Bosnia and Herzegovina*, Economic Research-Ekonomska Istraživanja, Vol. 27, No. 1, 2014, pp. 784–798, Published by Routledge - Taylor & Francis group, link: <http://dx.doi.org/10.1080/1331677X.2014.974338>

or ten). The achieved ratings will be accompanied by the associated comments on the meaning of rating, as well as identification of the factors that may affect the assessment. The final rating is established by summing up the values achieved by each individual category in the total rating, which could be presented in the form:

"Category 1" + "Category 2" + ... + "Category 6" = assessment of the corporate governance quality of the company according to the LCG index

The quality level of corporate governance is presented by the rate of fulfillment of the set criteria. The assessment of corporate governance, as an important non-financial indicator of business operations, in any case is not a replacement for financial business indicators, nor will it ever be; it is primarily its supplement aimed at creating and increasing confidence in the observed corporation.

The purpose of this testing is the fact that emphasizing financial business indicators and overemphasizing financial and economic results may lead the management to make short-term investments and disregard creating a long-term value. Therefore, monitoring the non-financial corporate governance quality indicators is aimed at achieving long-term business goals. Consequently, non-financial indicators are a significant supplement to financial indicators for a model of balanced goals.

The research was carried out on 87 corporations (49 in FBiH and 38 in RS) in three time periods, so that we can say that 261 project observations were examined.

Table 6. Level of corporate governance quality measured by the LCG index in Bosnia and Herzegovina

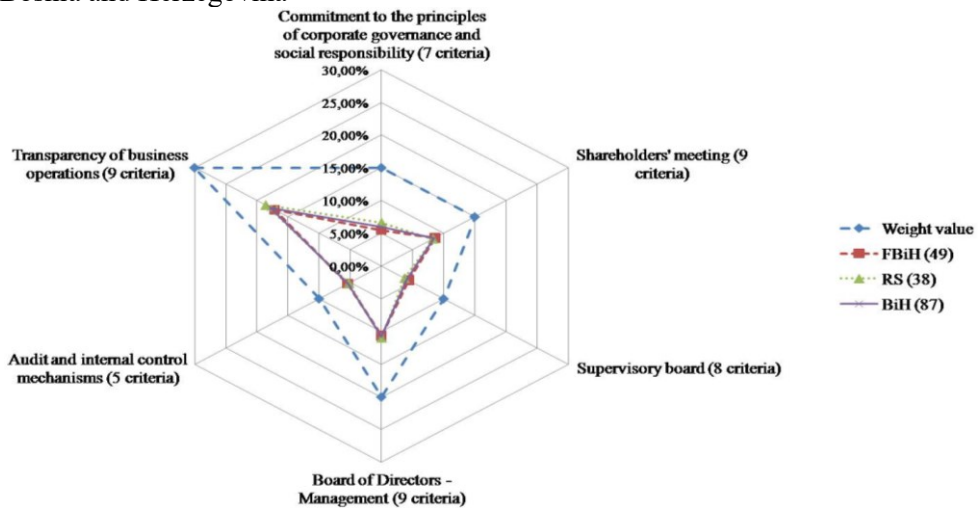
No.	Index category	Weight value	FBiH (49)	RS (38)	BiH (87)
I.	Commitment to the principles of corporate governance and social responsibility (7 criteria)	15%	5.49%	6.63%	5.99%
II.	Shareholders' meeting (9 criteria)	15%	8.60%	8.26%	8.45%
III.	Supervisory board (8 criteria)	10%	4.35%	3.72%	4.07%
IV.	Board of Directors - Management (9 criteria)	20%	10.62%	10.95%	10.76%
V.	Audit and internal control mechanisms (5 criteria)	10%	5.41%	5.23%	5.33%
VI.	Transparency of business operations (9 criteria)	30%	17.18%	18.55%	17.78%
	TOTAL		51.66%	53.33%	52.39%

Source: Author

Based on the LCG index, the overall rating of the quality of corporate governance in BiH is a 52.39% fulfillment of the prescribed criteria. This shows that only half

of the total prescribed criteria are met. The first and third category are significantly below the set standards, or at almost one third of achievement of the set standards for this category, while in all other categories, approximately half of the total prescribed criteria are met. As far as comparison of entities is concerned, Figure 1 clearly shows that the level of corporate governance in both entities is almost the same.

Figure 1. Level of corporate governance quality measured by the LCG index in Bosnia and Herzegovina



Source: Author

When analyzing Figure 1 in more detail, it can be concluded that the level of corporate governance quality by individual categories is very similar in both entities, and the existing differences for particular categories are less than 10%. The only significant difference is concerned with the first category "Commitment to the principles of corporate governance and social responsibility", and the author believes that the main reason of this difference (the value is greater in RS) is the fact that the Republic of Srpska earlier joined the process of developing an institutional framework for corporate governance (the first index in RS was adopted in 2006, and in FBiH in 2009).

If we observe only the descriptive statistics, we can see that values of the level of corporate governance range from 0 to 100%, and the study was conducted on 87 corporations (49 in FBiH and 38 in RS) in three time periods, so that we can say that 261 project observations were examined.

Table 7 shows the descriptive statistics for the LCG variable.

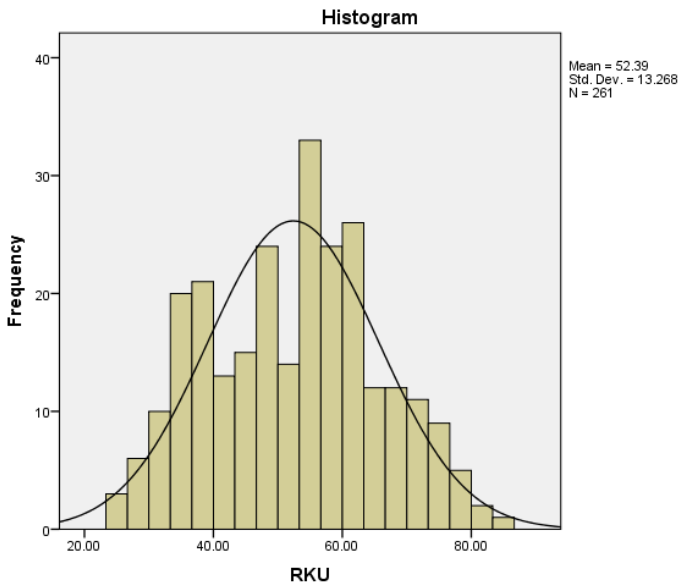
Table 7. Descriptive statistics for *LCG*

		LCG
N	Valid	261
	Missing	0
Mean		52.3898
Median		53.7500
Std. Deviation		13.26799
Skewness		.027
Kurtosis		-.732
Minimum		25.60
Maximum		86.20

Source: Author

The LCG indicators range from 25.60 to 86.20 with an arithmetic mean of 52.39. The skewness and kurtosis indices indicate that the distribution of the LCG variable frequencies has an approximately normal pattern, which can be seen on the histogram (Figure 2).

Figure 2. Histogram of LCG index results in Bosnia and Herzegovina



Source: Author

By checking the boxplot graphics, not a single outlier was observed for this variable, which could be assumed based on the presented form of frequency histogram (Figure 2), so it can be concluded that the distribution of frequencies of the LCG index values for both entities in Bosnia and Herzegovina has a normal form.

According to all the above, it can be concluded that compliance in the operation of corporations with international standards (OECD principles) is the lowest in the field of defining regulations and principles and applying international standards and principles, and the highest in the field of transparency of business operations. The main suggestion of the research is that Bosnia and Herzegovina and its entities must align their own regulations with international standards (OECD principles and EU directives). Such a step forward will contribute to the development of corporate governance, but also all the positive effects of corporate governance development on the overall market and economic development.

4. CONCLUDING CONSIDERATIONS

Corporate governance shows how rights and responsibilities are distributed among different stakeholders in corporations. Corporate governance provides an answer to the question who controls the corporation and how. This paper explored the characteristics of corporate governance systems in Bosnia and Herzegovina and compared them with corporate governance standards in the European Union. Special emphasis is on comparing the transparency principles and standards of corporations in Bosnia and Herzegovina with corporations in the European Union. The goal of the research is to compare the regulatory framework and characteristics of the corporate governance system in corporations in Bosnia and Herzegovina with the standards in the European Union, where the key objective is to identify similarities and differences and to define key areas for improvement of corporate governance in Bosnia and Herzegovina.

The ownership concentration in 87 non-financial corporations, 24 banks and 26 insurance companies from the territory of Bosnia and Herzegovina was analyzed in the first step of the research. The conclusion of the analysis is that the first and largest owner has a controlling block of shares in the largest number of corporations. The highest ownership concentration is in insurance companies, where the largest owner on the average holds almost 3/4 of the total capital, while in banks the largest owner holds 2/3 of the capital. From this it can be concluded that financial and non-financial corporations in Bosnia and Herzegovina have the characteristics of a closed corporate governance system. The fundamental characteristic of a closed system is primarily high ownership concentration, key control and power is held by the largest owner, and corporations in a closed system have a problem with lack of transparency in business operations and relations with different stakeholders.

After the analysis of ownership concentration, the legal framework for corporate governance in Bosnia and Herzegovina was analyzed. Regulation of corporate governance in Bosnia and Herzegovina is based on two predominantly aligned, but still significantly different institutional frameworks. In the true sense, that departs from the international recommendations and standards of corporate governance

that advocate a single harmonized system, aligned with international standards. Compliance of transparency in business operations with international standards and the EU directive on transparency in business operations of corporations was analyzed in the next step. Regarding the transparency of business operations, corporations observe the report publication deadlines, publish semiannual and annual reports, publish audit reports, keep reports available on their websites for five or more years. All this is an integral part of the legal framework of Bosnia and Herzegovina (entity laws) and that is what corporations do respect, but the corporations fulfill to a significantly lesser extent and passively observe all that falls into the domain of corporation's voluntary reporting.

Finally, an analysis of the quality of corporate governance in corporations in Bosnia and Herzegovina was made, and it is concerned with compliance in the operation of corporations with international corporate governance standards (OECD principles and EU directives). Compliance in the operation of corporations with international standards (OECD principles) is the lowest in the field of harmonization of regulations and principles. The main suggestion of the research is that Bosnia and Herzegovina and its entities must align their own regulations with international standards (OECD principles and EU directives). Such a step forward will contribute to the development of corporate governance, but also all the positive effects of corporate governance development on the overall market and economic development.

Based on all this, it can be concluded that improvement of the legal framework and its compliance with international standards is a key area of non-compliance that generates all other problems and discrepancies. The development and alignment of the legal framework with international standards is the key to improving corporate governance in Bosnia and Herzegovina and the foundation for achieving all the positive effects of applying good corporate governance. When it comes to Bosnia and Herzegovina, the only way to address all these problems is to continue the process of approaching the European Union as a fundamental imperative for the development of the entire society, and thereby of corporate governance too, but also for the development of the economy as a whole.

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