

Metë BEQIRAJ

1.5. KEY ELEMENTS OF CORPORATE GOVERNANCE AND THE FUNCTIONING OF STATE-OWNED ENTERPRISES IN KOSOVO

Summary

Public Enterprises (PEs) in Kosovo are of strategic importance for the country, employing about 14,000 workers and the impact on the economy over 20% of GDP over the past 5 years. Corporate Governance (CG) in Kosovo is a new concept and is in the process of continuous development and improvement. Government supported by the international community has made progress and has adopted laws based on best practices and international standards in general and the promotion of CG in particular, the challenge of enforcing the law in practice. The aim of the research is to analyse the mechanisms of CG and its legal framework in PE. CG in Kosovo as a result of the challenges of transition is closely related to the consolidation of the rule of law, ownership structure, as well as professional and institutional capacities. The basic hypothesis is that the weaknesses of the CG mechanisms affect the quality of the CG. Methodology: The research sample will be 17 PEs, 100% owned by the government. The research method will be combined primary data with secondary ones such as annual reports, analysis of the legal framework and mechanisms of CG. For primary data is a used survey with key actors in the CG. Results of the survey will identify strengths and weaknesses in the nature and enforcement mechanisms at CG and in this way to strengthen policy dialogue that will identify reform priorities that lead to improved performance CG and economic.

Keywords: corporate governance, mechanisms, public enterprises

Introduction

Corporate Governance (CG) is one of the most debated issues in contemporary literature, and in the last decade has attracted and is receiving widespread attention across the globe, as well as in Kosovo. Empirical studies confirm that companies with good CG standard are valued higher in financial markets (McKinsey, 2002). Promoting CG has become a global movement developing wide array of standards, codes and criteria for evaluation. Countries and companies that have not addressed the problems of the CG are threatened to be left behind in the global race for capital. For investors, one of the most important aspects when making investment decisions is the level of implementation of the principles of CG (information disclosure, protection of shareholders rights and equal treatment of all shareholders and other stakeholders) and profit that provides return on their investment. PEs have multiple and contradictory objectives, influenced by excessive political interference and lack of transparency, considered the main problems facing PEs in Kosovo.

Theories of Corporate Governance

CG theme is becoming increasingly important on a global scale after the Asian financial crisis of 1997, Russian in 1998 and bankruptcy and scandals in the USA during 2001 and 2002 and the outbreak of the financial crisis that engulfed the global

economy in 2008 (GCGF, 2012). In response to these scandals OECD developed a set of standards and guidelines on CG. OECD Principles on CG were accepted in 1999 and were reviewed in 2004. The OECD Principles are internationally recognized and treated by the entire CG framework. OECD Principles have served as a reference point for the development of a growing number of CG standards in different countries. After infamous scandals, many academic, expert and professional organizations presented their recommendations (Bech, 2005). Experiences show that the issue of salaries of managers and their relation to performance was at the centre of debates and literature from CG (Baker, 1988) and (Jensen and Murphy, 1990). OECD has developed guidelines on CG state enterprises, designed to meet the OECD principles on CG (OECD, 2005). OECD is seeking to push the implementation of the OECD principles on non-CG member countries by organizing round tables, such are organized in Asia, Latin America, Russia, Eurasia and Southeast Europe (OECD, 2003). PEs in Kosovo are government owned (Law No. 03/L-087, 2008), and may be subject to guidelines (OECD, 2005). PEs in Kosovo turned into corporations in 2005 where CG was adopted for the first time. Different authors define the concept of CG in different ways. Universally accepted definition of the term is derived from the ratio of CG Sir Adrian Cadbury, as the system by which the company is directed and controlled (Cadbury, 1992). Internationally accepted definition is given (OECD, 1999, 2004). CG in Kosovo is a new concept and is in the process of continuous development and improvement. Kosovo government supported by international institutions operating in Kosovo: International Development Agency of the United States (USAID), IFC, World Bank (WB), OECD, etc., has shown a commitment to CG improved. The Government of Kosovo has achieved inter alia approved the Law on Business Organizations (Law No. 02/L-123, 2007), the Law on PE (Law No. 03/L-087, 2008) which was amended later (Law No. 04/L-111, 2012), Code of Ethics and Corporate Governance for PE (2010), the amended and published in (July 2014), and has established, Policy and Monitoring Unit of PE (PMUPE). Since the CG implies a different set of relationships between management, board, shareholders and stakeholders, and establishing conditions for setting goals and means to achieve them, an important part of this process are the means to gain the control. CG mechanisms exist and work for this purpose.

There are two main mechanisms of control: internal and external mechanisms. Internal control refers to the direct monitoring of the owners at work management discipline. External control occurs when other interest groups influence mechanisms in defining and achieving company goals. Internal mechanisms of control are: 1) The Board of Directors 2) Compensation of Management 3) Concentration of ownership 4) Relationships with stakeholders 5) Financial transparency and disclosure of relevant information (corporate reporting). External mechanisms include: 1) The market for corporate control 2) legal infrastructure 3) protection of small shareholders and 4) Conditions for competition.

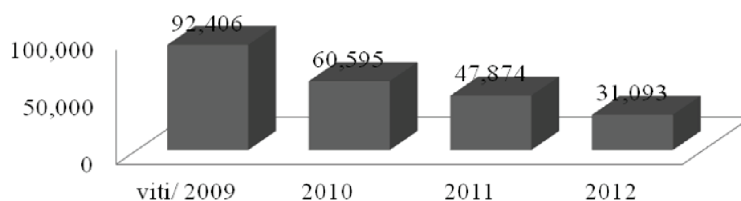
Internal mechanisms and their relationships are included in the CG of company's code. Foreign influence is observed mainly from the perspective of national level or from the perspective of belonging to a system of CG. Kosovo generally applies one-level model, in which the impact of the internal control mechanisms prevail. One characteristic of PE is that the state ownership does not imply the existence of a

corporate control market. Therefore, there is no opportunity to oversee the success of the company following the share price. Therefore, boards of directors, especially their structure, should have a key role in the CG of PE. Board of Directors (BD) is an instrument used by the government (shareholder) to influence the behaviour of PE management in Kosovo.

Operation of the PEs

PEs in Kosovo are of strategic importance for the country. PE provide vital services to people and employ about 14,000 workers, of whom 12,042 or 88% of men and only 1,607 or 12% are women. PEs are incorporated in December 2005 and operate under the CG, based on the principles of the OECD for CG. Kosovo has a very large public sector which has significant impact on the economy of the country with an average of over 20% of GDP over the past 5 years (Ministry of Finance, SAA, pp. 142-143). PEs have a high level of bad debts, high technical and commercial losses, and face low collection level, so PE continue to burden the government budget, due to the inability to achieve the appropriate level of financial sustainability (Figure 1).

Figure 1: Financial support of the government for PE



Source: Ministry of Economic Development, (PMUPE), PE performance reporting 2010 p. 10, 2011 p. 21, and 2012, p. 17.

Government policies for financial support to PE have a declining trend as a result of improved financial performance of companies. It is expected in the upcoming years that this government support would be even further reduced (PMUPE, 2010/2011). This is very important in terms of expected negotiations for a Stabilization and Association Agreement (SAA). Likewise, the level of collection from customers for provided services is very small, especially in the waste sector where the collection rate is about 62%, in the water sector is about 68%, (PMUPE).

External mechanisms of CG

According to the law, a set of one-level model of governance (Anglo-American model) is provided to all PE, in which the impact of the internal control mechanisms prevails. External mechanisms include four factors: the market for corporate control, the legal infrastructure, the protection of small shareholders and the conditions for competition.

The market for controlling the corporate

One of the most effective mechanisms for corporate control is the managers' market, which forces managers to operate effectively because they can always be replaced by other more effective managers. In case of CG in PE of Kosovo, the role of the market for corporate control of the company is performed by BD.

Legal and institutional basis

Law on PE (Law No. 03/L-087, 2008), as amended and supplemented on 20.04.2012 (Law No. 04/L-111) is a foundation for the form of management, reporting and ownership, for all PE's. According to the law, the Government is obliged to supervise the management of these enterprises and report to Assembly on an annual basis.

Kosovo's legislation is largely in line with the EU because of the considerable technical assistance provided by the United Nations (UN) and the EU in recent years (EBRD, 2013). However, the level of implementation of this legislation is less advanced. Some of these laws are:

- Law (No. 02/L-123) on Business Organizations, September 27, 2007.
- Law (No. 03/L-087) on Publicly Enterprises, June 13, 2008.
- Law (No. 04/L-006) on Amending and Supplementing the Law No. 02/L-123 on Trade Associations, June 23, 2011.
- Law (No. 04/L-111) on Amending and Supplementing the Law No. 03/L-087 on Public Enterprises, May 30, 2012.
- Establishing of PMUPE
- Code of Ethics and CG (June 2010), amended and revised (July 2014).
- Instructions on becoming a director of PE (April 2010), and
- Government's Decision No. 01/119, date 13/03/2013, on remuneration of PE directors

The means of this Law established a legal framework for governing the exercise of property rights in PE, CG of enterprises in accordance with internationally recognized principles of CG of PE's, and effective reporting structures and responsibility to allow proper supervision of PE activities have been set. According to the Law on PE, Article 4, item 4.1, all PE's shall be organized as a joint stock company (JSC) in accordance with applicable laws on commercial companies (Law No. 02/L-123). According to the Law on PE, Article 40, paragraph 40.1 if an enterprise is or becomes less than 50% owned, directly or indirectly, by the Government, this enterprise is not a PE and the remaining shares are governed by the Law on Trade (Law No. 02/L-123).

Code of Ethics and Corporate Governance

Law on PE, Article 35 (35.1) states: Every PE shall prepare, adopt and implement a mandatory code of ethics and CG. According to the law, PMUPE has compiled and published the model code of ethics and CG which was distributed to all PE. This model establishes the code of ethics and standards of CG expected from PE, its employees, officers and directors. CG code in Kosovo was developed in cooperation with international institutions operating in Kosovo and technical support from the USAID and is in accordance with the law and largely meets international standards of CG as OECD principles. Above from the research shows that only 3 PEs have

published a code of ethics in their web site and by all companies only (KOSTT JSC) has reported that it is implemented in practice this code.

Internal Auditor

Literature and many academics of CG argue that the internal audit function is an integral part of an effective system of CG. It is assumed that this is the first line of defense against misuse of company accountants. According to the OECD, the board of directors of an enterprise must necessarily define an internal audit function. Law sets internal audit as one of the senior most important officials of PE. Based on research, all PE (100%) have established committees of internal auditors and held on average of 10÷13 meetings during the year, whereas more complex PE, such as KEK and PTK have teams of auditors, who enhance significantly the internal control (PMUPE, 2011). The number of committees other than the audit committee established by enterprises is from 1÷6 (one to six), and now the new Code has reduced them to three with a temporary 6-months mandate with the possibility of extension by the BD.

External Audit

Under Article 33.1 of the Law on PE, each PE shall be subject to an annual external audit by an objective, independent, competent and qualified auditor. External audit is conducted by the Office of the Auditor General (OAG), or elected by the public enterprise through a selection process based on criteria and conditions set out in the Public Procurement Law (PPL). Every PE has the external audit completed for 2011, 2012 and 2013. The reports resulted in opinions on the compatibility and consistency of financial statements and internal control processes with standards and legal requirements, and in comparison with previous years, recently there is a progress in the opinions of external auditors.

Protecting the interests of shareholders

That the system of corporate governance and best practices are still evolving, PE are still at risk due to non-transparency of operations, which reflect the position of shareholders as a whole, particularly the position of small shareholders. PE are owned by the government of Kosovo, and after the introduction of the private sector in these enterprises, it is necessary to ensure equality among shareholders, especially in matters of timely and accurate transactions etc. Law on PE, Article 13 stipulates that PE is subject to the same legal treatment as private enterprises. Law on PE, Article 12 stipulates that all shareholders shall be treated equitably. According to the law, an equal market for all stakeholders is intended, and this is in conformity with the principles of the OECD (2005) and it poses a challenge for the government to implement it in the future.

Internal mechanisms CG

Internal mechanisms of control are: 1) The Board of Directors 2) Compensation of Management 3) Concentration of ownership 4) Relationships with stakeholders and 5) Financial transparency and disclosure of relevant information (corporate reporting).

Composition of Board of Directors

Law on PE (Law No. 03/L-087) defines the model as a one-tier board, known as the Anglo-American model. According to the Law on PE, Article 15, paragraph 15.1 the Board of Directors (BD) of a PE shall consist of five or seven directors. All directors, except one, shall be selected by the government and each such selected director shall have a 3-year term. The other director will be Executive Director (ED) of the PE and shall be selected by the Board of PE based on Article 21 of this Law. According to the Law on PE, Article 17, paragraph 17.2 all directors, except the ED, shall be independent; hence 82.5% of PE directors are independent and 17.5% ED. Article 37, paragraph 37.1 stipulates the establishment of PMUPE within the Ministry in order to support the Minister and the Government in exercising the responsibilities for PE which were conferred upon them by this law. PMUPE is responsible for organizing the training for directors of PE, and based on our research findings, such trainings, in collaboration with the International Development Agency of the United States (USAID) and the International Finance Corporation (IFC), were organized every year. The manner and criteria for selection of directors are defined by the same law. Some of these criteria are professional adaptability, political impartiality, conflict of interest and to not be prosecuted. So the issue of appointment of directors lies in the law. In practice, it turns out that the selection of the list of candidates that shall be voted on by the Assembly of Kosovo is non-transparent and politically influenced. Although defined by the law, the evaluation of the professionalism of the Board of PE still remains problematic because of the lack of transparency in the board nomination process.

The findings show that no data for the professional and biography of BD members are published, but we indirectly learn that all members of BD possess a university degree. Referring to the Law, all BD mandate have expired in December 2011, even after the announcement of the two competitions in 2012, no selection of board took place because of political interference. Selection of the Board of PE remains disputed issue with the opposition, non-governmental organizations and civil society. Criticism had to do with lack of transparency, political appointments, professionalism in boards and high fees. The research revealed that PE boards are even used as a sector where political party militants can be hired. Hiring the party militants enables political parties to have more impact on these companies so they can push forward their policies. It also gives more employment opportunities for even more politicized people at the lower ranks of the company.

In the past two years, BD were incomplete and non-functional, the situation at the beginning of 2015 shows that only two BD were selected, whereas other PE had no boards selected, and based on political agreement of the parties in power in January 2015 a competition for selection of BD was publicly announced, yet no board was selected. Research also shows that the average number of BD sessions is 12.6, and the audit committee held 10 meetings in 2012 and 2013, above the European average which is 9.4 meetings per year (Heidrick and Struggles, 2011, p.26).

In 17 PE analysed, BD counted 97 members, of whom six are women (6.19%) and 91 men (93.81%).

Based on research findings, only 2 out of 17 PE distributed dividends for the government, while 15 other PE are not financially viable. During 2012, PTK has declared and distributed dividends to the shareholder, amounting to 45 million euro's and 3.0 million euro's KOSTT (PMUPE, July, 2013).

Remuneration of PE Directors

Remuneration along with bonuses represent one of the instruments of internal governance that are used more often and are generally assumed to be a good motivational tool used to align the interests of the owner (maximization of profit) with management interests. Law No. 04/L-111 on Amending and Supplementing the Law No. 03/L-087 PE Article 12 (1) limits the performance incentive remuneration which is determined after the annual audit of the financial statements and the publication of reports on the performance of the regulatory offices.

This compensation (bonus) is now paid to directors, an amount up to 50% of the basic fee referred to in paragraph 2 of this article. Research findings show that the directors have received high bonuses without reaching the performance and also benefited from PE in other forms of use of vehicles, trips abroad and other illegal forms.

Research results show that many BD of PE so far were part of, or related to politics. Research also shows that wages and salaries that the directors of these boards receive are very high compared with the average wage of the country. The government's decision No. 01/119 dated 13.03.2013 that reverses previous decisions, adopt rules on the amount of compensation of PE board members. Research results points out that BD have illegally distributed bonuses before the end of calendar year and without assessing their performance. Members of the Board of PE in the past four years gained 3 million on behalf of salaries and bonuses (Newspaper Zëri, 09.05.2014).

Office of the Auditor General (OAG) in its report (August 2014) found that total compensation for members of the BD for the period 2009÷2012 was 2,439,710 €. From this value for BD meetings was € 1,691,304, compensation for € 204.268 audit committees, compensation for other committees and retroactive payment € 528.368 payment of members of BD € 15.770, whereas bonuses allocated in this period were in the amount of € 1,207,139. Total compensation and bonuses for BD for the period 2009 ÷ 2012 was € 3,646,849. From the analysis of the OAG report it can be seen that the total payments to other committees from PE for the period 2009÷2012 was € 528.368 (OAG, 2014).

Directors, except representation in PE boards, are engaged in a primary work through private or public organizations. Except engagement as a regular member of the PE boards, participating in audit committees, directors are also engaged in several other committees within one month. The whole commitment of BD members in primary and secondary work indicates that boards may not be functional and cannot perform their job efficiently.

The above statements on PE distributed bonuses by PE did not meet the criteria for measuring the long-term performance of PE developments in order to win the right to compensation because these criteria are not consistent with the purpose of the law on

incentive compensation. The provided statements show that only four PE have partly met the criteria.

PMUPE in its website published a consolidated annual statement on PE for 2012. The analysis above shows that only three PE did not distribute bonuses for BD.

Concentration of ownership in PE

The main hypothesis that prevails in nowadays literature on the CG is that corporate profitability is positively associated with the concentration of ownership. Although the concentration of ownership of large shareholders is considered a mechanism for reducing conflict between shareholders and management, it can be a potential source of conflict of interest between large and small shareholders (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000).

However, empirical evidence about the relationship between concentrated ownership and financial performance of the companies is unclear and unconvincing in different markets within the same market. In transition economies, characterized by underdeveloped capital markets, to understand the effects of ownership structure, the authors start off from the general assumption that the private property leads to improved performance (Frydman, Gray, Hessel and Rapaczynski, 1999).

In the case of Kosovo, the ownership structure of PE of Kosovo is focused on only one shareholder (the government, as 100% shareholder), which does not imply the existence of the market for corporate control, and therefore reflects the composition of BD which has a key role in CG of PE. PE in Kosovo continues to have low performance and delay in providing quality services to citizens. PE have been consistently followed by a series of negative phenomena such as mismanagement, corruption, weak and non-professional boards, political interference, non-transparency, having too many staffers and militants of rulers, budget deficit, etc. This made PE not attractive to investors. Kosovo's government has made it clear to the introduction of the private sector in these sectors. Privatization of state-owned shares in certain PE has moved very slowly, which at the current level of their management and financial sustainability means relatively low quality of CG of PE in Kosovo. Moreover, it is rightly to assert that the best solution for PE in Kosovo is privatization and most effective way to improve the performance of these PE.

Pristina International Airport (PIA) was granted on concession for 20 years by the Government of Kosovo for the first time in 2010. Also the government of Kosovo in June 2012 awarded the company Limak and Calik to privatize the Distribution and Electricity Supply (KEDS) priced 26.3 million, whose ownership was transferred in May 2013. This process was not opposed with regard to transparency from the opposition, non-governmental organizations and the public at large.

The government failed several times in succession in the sale of 75% PTK shares stake and in enhancing new energy capacities. Research findings show that BD are politically influenced by the shareholders (the government) and exert a positive and significant effect on employment, while they negatively affect the performance of the PE. However, the practice confirms the existence of direct political interests that undermine the efforts of the Board of PE to achieve these objectives.

Relations with interest groups

PE should recognize the importance of relations with interest groups, for the sound and financially stable companies. State ownership policy should fully recognize the PE responsibilities towards stakeholders and lay down demands that they report on relations with other stakeholders. It is necessary for PE to continue active cooperation with all stakeholders in order to create jobs, prosperity and the preservation of financial stability of the company.

Reports based on Law on PE

The existence of PE website and quality online reporting greatly facilitates the access to existing and potential investors with relevant and timely information for companies. The law obliges all PE to submit every 3 months certain reports. Based on research, from the total number of 17 PE analysed, only 13 of them possess internet website. It is also noted that the maintenance of existing web-pages is insufficient. Results of the survey show that there are few relevant information to current and potential shareholders and other interested parties.

From 17 PE that were analysed, only 9 have published: mission, vision, annual business plan, organizational chart, financial statements and independent auditors' report, etc., for 2010-2013 periods on their website. PMUPE has published annual reports for the 17 PE and the external auditor's report on its website for the year 2010-2013 for all PE but this site is poorly maintained and not all the reports can be opened, whereas in 2014 there is no reporting conducted, although the law requires 75 days after the end of the calendar year to report to the Assembly. The above delays in annual reports and insufficient information on the websites of companies and their non maintenance lowers level of public confidence, investors, and the quality of the CG.

Conclusions

Among the achievements of the Kosovo government worth of highlighting is the provision of legal and institutional framework, which largely meet the standards and principles of the OECD and other international experiences, but their implementation in practice remains a challenge. Weak enforcement of legal provisions and non-qualitative supervision of PE activity by the shareholder shows that there are delays in the delivery of quality services to citizens. It should reflect the positive effects of greater transparency and greater public access to information on the operation of the PE. As in other countries, in Kosovo effective governance of PE is a difficult and complex matter. Research analysis shows that the government as a shareholder is not that much interested to improve the performance of PE and political interference are highly influencing the appointment of directors and management. PE are responsible for the procurement of goods and services that are in fact the most corrupted practices in terms of tenders abuses by certain political groups and the governors who, beyond a shadow of a doubt, are a cancer to the health of PE in Kosovo. Political appointments of unqualified and inexperienced people ate the boards and management, but supported by certain political groups, weaken the quality of the CG. CG in PE of Kosovo has made progress over time but more efforts should be done and focus on enhancing the

quality of the board of directors, whose members should be professionally trained, have better information about the company's operations, and should have greater independence and not be subject to political influence, because strengthening the role of the board of directors would allow high efficiency and win the company's reputation. These results reflect that the concept of CG in Kosovo is in the beginning stage. It is evolving and not well understood or applied. Research results show the need for raising awareness about the importance of the CG and its implementation.

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