A RESEARCH ON THE CODE OF CORPORATE GOVERNANCE IN CROATIAN BUSINESS PRACTICE

Dr.sc. Ljerka Mintas Hodak, lmhodak@zsem.hr
Dr.sc. Olivera Jurković Majić, ojmajic@net.hr
Helena Majić, mag.iur. helenamajic@yahoo.com

Zagreb School of Economics and Management

The economic and legal concept of the code of corporate governance differ one from another regarding code's form, functions and obligatory content. We have conducted a research consisted of three hypothesis with expected outcome to confirm corporate misunderstanding of legal provisions and inadequacy of legal provisions to modern business practice.

Key words: code of corporate governance, code of corporate governance in Croatian business practice, Croatian Commercial Entities Act, corporate social responsibility.

1. INTRODUCTION

A code of corporate governance is considered to be one of the most important pillars of corporate organization and business practice. However, it is disputable what this code represents in many differing organizational structures, cultures or even countries. Not only that its functions, meaning and content vary among companies and cultures, but also practitioners in the fields of economy and law can not agree on its form, functions and obligatory content (Scleifer and Vishny, 1997).

This paper will disclose both economic and legal concept of the code of corporate governance comparing the differences between these concepts as well as various goals being accomplished by them. By conducting a research on the code of corporate governance in business practice of Croatian companies, we will try to establish the conclusion on whether there are any discrepancies between these two concepts in Croatian corporate and legal culture. Following these conclusions, we will analyze the implementation and efficiency of Croatian positive regulation on the code of corporate governance with respect to the corporate willingness to act according to the law.

2. ECONOMIC CONCEPT OF CODE OF CORPORATE GOVERNANCE

The economists perceive a code of corporate governance within the meaning of corporate social responsibility. In an economist's point of view, this code comprises the most essential and general principles of business ethics applied to everyday issues of corporate governance and its contemporary challenges in the modern world and global market.

A code of corporate governance represents a set of corporate policies regarding relationships with employees and their professional ethics, non-discrimination policies and procedures for protecting the employee's rights; principles of professional ethics and guidelines for decision-making process in corporate management structures (directors and supervisors); sanctions for malpractice; procedures for solving and eventually eliminating possible conflict of interests (Fox, 2001). Giving examples of most common subjects being regulated by the code of corporate governance, we may conclude that this code sets standards of corporate social responsibility in internal organizational culture. Therefore, the management system (or system of corporate governance) should align its functions and actions
according to the given standards. With respect to ethical and responsible governance, these standards and code of corporate governance are even more important than law and regulatory supervision because they give a clear insight to the internal corporate culture. Given the fact that a code of corporate governance is an outcome of a specific internal organizational culture; given the fact that a specific organization sets its own standards of corporate social responsibility and voluntary subjects itself to the rules of corporate governance code, it is very probable that they will be more obeyed and familiar in a specific organization compared to the law as a form of external regulation and external standards. We may expect that the higher standards of corporate governance and responsibility are being established in those organizational structures that have internalized the mechanism of external morality or the rules imposed by their social environment (Fox, 2001).

A code of corporate governance does not determine only internal organizational behaviour and internal corporate culture, but also sets principles for managing the relationships with external subjects (corporate environment) such as: customer relations management, price management policy, consumer protection, principles of cooperation with business partners and suppliers, corporate attitude on donations to politicians and donations for humanitarian causes, awareness of environment protection and the so called „green policies“, etc. (Fox, 2001). Companies put effort in creating and defining the content of this code since they believe it is a very persuasive instrument of managing the corporate image and brand as a desirable and responsible employer, business partner, provider of goods and services and responsible actor in a social community.

According to the second thesis of Davis' model of corporate social responsibility, the companies should do business as open, reciprocal systems capable of receiving and adopting information and, at the same time, capable of revealing their activities to the interested public (Certo and Certo, 2008). Therefore, the code of corporate governance is also a communication channel to the targeted audiences. In times of modern technology and rising importance of Internet, most of the companies publish the various codes they implement on their corporate websites. The importance of such practice has been recognized among differing corporate cultures not only in respect of marketing and communication strategies with interested audiences, but also in respect of easy access to the capital markets and sources of financing (Sever, 2009). In order to inform properly the stakeholder, investors, creditors and regulatory bodies, companies also publish their financial reports on corporate websites, even more regularly than they are committed according to the positive regulation.

### 3. LEGAL CONCEPT OF CODE OF CORPORATE GOVERNANCE

However, lawyers do not focus their attention to corporate attitude on various ethical issues that might affect corporate image and reputation persuaded that these issues are not a lawyer's concern. A code of corporate governance in legal terms is an act that gives transparency to corporate internal affairs and relations with external subjects. It describes corporate organizational and managerial structures and relations between them, discloses relevant information on corporate financial position as well as personal information on the executives, ownership structure and consequently the sources of power to influence a decision-making process (Račić and Cvijanović, 2006). A code of corporate governance should also describe company's position in various financial environments and relationships with relevant financial actors – creditors, investors, associated companies etc. These requirements are a consequence of financial sector interest to be fully informed and company's aspiration to access capital markets and sources of financing.

Company's capability to access financial market and market's stability depends on transparency and corporate lawful conduct which are the reflection of corporate governance standards. The appropriate standards of corporate governance actually assure both financial position of a specific company and proper reaction of it's financial environment (Scleifer and Vishny, 1997). The key prerequisite to transparency and lawful practice is a highly professional, ethical, true and correct financial reporting (Sever, 2009). Therefore, lawyers analyze a code of corporate governance with respect to corporate
annual financial reports. Business ethics as a legal notion is accomplished by transparent management structures and structures of influence, transparent scheme of financial resources and destinations of capital outflow.

We may conclude that such a legal concept is put into function of transparent and lawful financial practice, one of many various aspects of company's business practice as a whole. While the economic concept of corporate governance code stresses out many various functions, from managing corporate image to managing relationships in internal organization and relationships with various interested actors in corporate environment, the legal concept has one, but crucial function with respect to company's financial position and financial environment. If we compare the content of legal concept to the economic one, it is obvious that economic concept has a much wider scope and content dealing with a variety of business aspects and problems. The content of code's legal concept is more specialized and specific. However, at the same time it is also predetermined by laws and other forms of regulation created by lawmakers, financial markets and regulatory bodies. The legal concept also focuses on adequate procedures for adopting and publishing the code, while these elements are not always a primary issue to the economic concept of code of corporate governance.

4. A CODE OF CORPORATE GOVERNANCE IN CROATIAN LEGAL SYSTEM

A code of corporate governance, including its form, obligatory content and the legal obligation to publish it within the annual financial reports, is regulated by Croatian Commercial Entities Act (art. 45., Act Ammending the Commercial Entities Act, Official Gazette of the Republic of Croatia, No 73/09) . This Act compels supervisory board or administrative board to abstract a statement on the implemented code of corporate governance into a special section of annual financial reports. However, this legal provision is applicable only to the joint stock companies with registered office in Croatia and listed on stock exchange or other regulated capital market. E.g. if a joint stock company withdraws from the stock exchange, or a corporation is founded in a form of a limited liability company, then they are not legally committed to draw up or publish a code of corporate governance.

Minimum obligatory content of the information disclosed in such statement refers to:

- the code of corporate governance implemented in the company and corporate procedures of publishing the code;
- the discrepancies between the standards set by the code and corporate practice and the causes of eventual discrepancies;
- description of supervisory and internal auditing system in the company as well as the implemented principles of risk management;
- the information on major shareholders and their power to influence the decision making process with special respect to the significant restrictions of the shareholder's right to vote on the general assembly;
- corporate organs of governance and the system of appointing and revoking their members as well as the system of reviewing and ammending corporate statute;
- the information on current structure of corporate organs, their authorities and the shares held by the members of these organs.

If we analyze these legal provisions, we may conclude that the content of a code of corporate governance in Croatian legal system does not meet with the economist's expectations of what the code of corporate governance should be. Its legal notion is far from the economic and business concept of
social responsibility because it excludes very important issues in business practice such as human resource management, employees protection, professional ethics, corporate attitude on malpractice etc.

So, what was the lawmaker's intention or what is the function of these legal provisions? Primary function is to make the internal corporate governance system transparent, especially in terms of decision making process. Other function is related to financial reporting. Instead of simple, descriptive approach to the financial results achieved in the past year, these provisions give a functional foundation for interpreting financial data and numbers given in the annual financial reports. They disclose internal corporate culture in which these financial results were achieved and eventually affected by it. If these functions were fully performed, the joint stock companies would operate as open systems that give a true insight to their financial position.

The achieved transparency would result into several benefits for internal and external corporate culture:

- detecting the power scheme in a specific company and possible conflict of interests;
- reducing corporate and white collar crime (preventive function);
- financial and capital markets making fully informed decisions on investing or disinvesting in a specific company;
- reduced financial risks for both the company and it's financial environment;
- higher level of employees protection;
- higher level of shareholders protection;
- strenghtening the system of corporate governance and internal corporate culture.

It was not only the lawmaker who recognized the importance of corporate governance codes to corporate culture in Croatia. Zagreb Stock Exchange and Croatian Financial Services Supervisory Agency have gone even further drawing up an examplatory Code of Corporate Governance recommended to the joint stock companies listed on stock exchange or taking part on other regulated capital markets. This Code is based on Commercial Entities Act provisions, but it's content is broader, more detailed and strictly specifies the standards and expectations on various issues such as shareholders protection, guarantees for fair exercising of shareholder's rights, standards of internal audit and control, disclosure of information and data dissemination, price sensitive information, conflict of interest, management earnings etc. The basic principles of this Code are: business transparency, clearly defined procedures for the activities of the supervisory board, management board, and other bodies and structures making important decisions, avoidance of conflict of interest, efficient internal control, efficient responsibilities system (ZSE, CFSAA Code of Corporate Governance, 2007). In order to support the corporate effort to disclose all the information required by this Code and Commercial Entities Act, Zagreb Stock Exchange has even published an Annual Questionnaire with structured questions and offered responses that would help out the companies to publish the data in a concise and short form.

However, the primary assumption of this paper is that nor one of these functions are being performed and the lawmaker's goals are not being attained. We believe that the provisions of Commercial Entities Act did not come into life in the practice and we assume the cause to it is a simple misunderstanding of these provisions rising from the conflict between the economic and legal concept of the code of corporate governance.

Therefore, from the position of law and economics methodology, we have researched the effects of the legal provisions on Croatian business practice. We were wondering: do Croatian companies truly
apply the Commercial Entities Act provisions to the practices of financial reporting and if so, what are the results and benefits of proper application to the business practice?

5. A RESEARCH: DO CROATIAN JOINT STOCK COMPANIES COMPLY WITH LEGAL OBLIGATION OF INCLUDING THE STATEMENT ON IMPLEMENTED CODE OF CORPORATE GOVERNANCE INTO ANNUAL FINANCIAL REPORTS?

5.1. OBJECTIVES

The primary objective of this research is to explore the effects and real application of legal provisions which regulate the code of corporate governance in Croatian legal system.

The results given by this research should have several outcomes:

1. establishing a concise conclusion whether the legal provisions on the code of corporate governance are really applied in the business practice or not;
2. establishing the effects of positive regulation on corporate behaviour with respect to the lawmaker's intentions and objectives;
3. offering relevant information upon which we can discuss whether the objectives of positive regulation were attained or not;
4. offering relevant information upon which we can discuss the corporate culture and corporate environment in Croatia;
5. discovering current tendencies in development of the corporate governance code in Croatian business practice;
6. offering relevant information that might give an incentive to the new legislative approach that would be more appropriate to current tendencies in the practice and the manner in which the business community understands and applies the code of corporate governance.

5.2. HYPOTHESIS

The research was based on three hypothesis:

a) H1 – Most of the Croatian joint stock companies did not include the statement on implemented code of corporate governance into annual financial reports.

This hypothesis rises from the assumption that Croatian companies compose annual financial reports according to International Standard of Financial Reporting and Croatian Accounting Act and therefore they neglect the provisions of Commercial Entities Act. This unlawful conduct is a result of negligence or ignorance related to misunderstanding of legal provisions. We associate this misunderstanding of law to the conflict between economic and legal concept of corporate governance code.

b) H2 – Most of the companies that did not include the statement on implemented code of corporate governance into annual financial reports have published some other form of code of corporate governance that does not comply with the legal requirements, but conforms with the economic concept of such code.

This hypothesis rises from the assumption that positive legal provisions regulating the code of corporate governance in Croatian legal system code do not correspond to the economic notion and
content of such code and therefore do not meet with corporate aspiration to manage social responsibility and corporate reputation.

In order to support H2 hypothesis thoroughly, the research have included a control group of 10 limited liability companies that are not legally committed to compose or publish the code of corporate governance according to Croatian Commercial Entities Act (so called supportive hypothesis). If most of them have such code, our supportive hypothesis will confirm H2 hypothesis as well.

c) H3 – Most of the Croatian joint stock companies that included the statement on implemented code of corporate governance into annual financial reports did not compose the code according to the provisions of Commercial Entities Act. Code's content does not comply to all of the legal requirements.

This hypothesis rises from the assumption that corporate management does not understand legal provisions that regulate the code of corporate governance or it is ignorant about them.

5.3. SAMPLE AND METHODOLOGY

The secondary research was conducted on the sample of 40 joint stock companies with registered office in Republic of Croatia that are listed on Zagreb Stock Exchange market. The sample was random and is consisted of companies that vary in market shares and profit. While creating the sample, we did not make any deliberate selection based on the sources of financing and ownership structure (government controlled companies or private capital companies). However, while interpreting the results, the distinction between government controlled companies and privately owned companies came into our focus as a very important variable. According to how significant is the contribution of each sector to Croatian GDP, we have tried to structure the sample evenly as much as possible giving appropriate attention to those sectors of production that are the most relevant to Croatian economy (retail and services, agriculture and food production, industrial engineering and construction and other relevant industries, financial sector). The financial sector is underrepresented to some extent, mostly because the financial services are not fully developed in Croatia comparing to the ones in developed countries and the competition in this sector is narrowed to only few relevant competitors that are included in the sample.

In order to support one of the hypothesis, we have also created a control group sample of 10 limited liability companies. This sample is researched separately from the joint stock companies sample and the reasons for introducing it in the research are explained previous in H2 hypothesis.

The research is based on secondary data collected from the official websites and annual financial reports of each company included in the sample. The annual financial reports refer to the year 2009. If any of the collected data were not published on corporate website and instead the website referred to some other source of information, these information were excluded from the research as insignificant. If available, the annual financial reports were consolidated and audited.

The research answered 4 questions in the joint stock companies sample selecting Yes or No answers:

1. Annual financial reports are published on corporate official website;
2. Statement on the implemented code of corporate governance is included in the report;
3. The statement is composed according to the Commercial Entities Act (it comprises all the obligatory elements);
4. The company has published some other form of the code of corporate governance on its official website.
While researching the so called other forms of the code published on corporate web sites, our approach was rather functional than formal. Therefore, the research also acknowledged public policies of the companies, standards, guidelines etc. that express official corporate policies in managing relationships in internal and external environment. However, while assessing the statements included in the annual financial reports, the approach was strictly formal and based on a letter of the law.

In the sample of limited liability companies, the research results answer the question if the company has published some form of a code of corporate governance on its official website, even though it is not legally committed to do so.

The primary research is conducted as a legal analysis of Commercial Entities Act provisions imposing legal obligation to publish the statement on the implemented code of corporate governance. We did not analyze only the content, but we have also analyzed the functions of these provisions as explained above.

In the end, the collected data from the secondary research in the joint stock companies sample were compared to the results of primary research (legal analysis) and then summarized.

5.4. RESULTS

H1 hypothesis is confirmed.

Only 10 out 40 joint stock companies (25%) have included the statement on the implemented code of corporate governance into a special section of the annual financial reports. Even though all of the reports were audited, none of the auditors made a remark regarding the absence of the statement or remarks regarding the reports compliance to Commercial Entities Acts. The prevailing tendency in the practice is composing the reports according to the International Standards of Financial Reporting what is not disputable. However, Croatian Commercial Entities Act comprises very complex and unambiguous provisions which regulate the obligatory content of annual financial reports published by the companies with registered office in Croatia. Disputable is the fact that most of the reports do not refer to this Act or either of its provisions. Instead, they are solely referred to ISFR and composed accordingly, thereby neglecting positive Croatian regulation.

H2 hypothesis is not confirmed.

Only 13 out of 30 companies (43%) that did not include the statement on the implemented code have published some other form of the code of corporate governance. Given the functional approach to other forms of the code, the result is even more defeating.

However, the supportive hypothesis is confirmed. In the control sample of 10 limited liability companies, 7 companies (70%) have published some form of the code, even though they are not legally committed to act accordingly. Only 3 of them do not have any form of the code.

At first, the result seemed to be inconclusive. But then, an obvious tendency arised from the research.

In joint stock companies sample, 21 out 30 companies that did not include the statement into annual financial reports are completely financed and controlled by private capital sources. However, 4 out 10 companies that fulfilled their legal obligation are to some extent controlled by the government. Other had a long history of government supported business. 2 out 10 are major Croatian banks, and Janaf, Konzum and Ericsson Nikola Tesla are fully developed operational and complex business systems with a relevant number of employees and dominant position on the market.

The tendency is even more obvious in limited liability companies sample, where all 3 companies that did not publish any form of the code are privately owned companies. All other 6 companies (we excluded Combis) that have published the code are in some way under government control or they are the providers of public services.
Regardless of the sample, a common practice regarding the code's functions and usual content imposed itself. This practice indicates that most of the other forms of the code are oriented to the external organizational culture and address the issues of ecology and environment, relationships with social and business community, humanitarian causes, employment policies for those seeking an employment, products quality and standards etc. Only a few of these codes address issues concerning internal organizational culture.

H3 hypothesis is confirmed.

7 out of 10 companies (70%) that have included the statement into the reports, did not compose the statement according to the law and they lack significant obligatory content prescribed by the Commercial Entities Act. Only 30% of the companies have composed the statement disclosing all the obligatory information. Usually, the statements lack information on ownership structure, and especially on the shares held by the members of management and their earnings.

PICTURE 1: SUMMARY OF RESEARCH RESULTS AND HYPOTHESIS

<table>
<thead>
<tr>
<th>J.S.C. SAMPLE N=40</th>
<th>L.L.C. SAMPLE N=10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement on the implemented code of corporate governance is included in the report</td>
<td>The statement is composed according to the Commercial Entities Act</td>
</tr>
<tr>
<td>YES 25%</td>
<td>YES 30%</td>
</tr>
<tr>
<td>H1 CONFIRMED</td>
<td>H3 CONFIRMED</td>
</tr>
<tr>
<td>The company has published some other form of the code of corporate governance on its official website</td>
<td>The company has published some form of a code of corporate governance on its official website, eventhough it is not legally committed to do so.</td>
</tr>
<tr>
<td>YES 43%</td>
<td>YES 70%</td>
</tr>
<tr>
<td>H2 NOT CONFIRMED</td>
<td>HYPOTHESIS SUPPORTIVE TO H2 CONFIRMED</td>
</tr>
</tbody>
</table>

6. RESEARCH RESULTS INTERPRETATION AND CONCLUSIONS

The provisions of Commercial Entities Act regarding the statement on the implemented code of corporate governance are not applied in business practice of Croatian companies. The provisions are mostly completely ignored by corporate practice in Croatia, or when rarely applied, they are not applied according to the law. Therefore, the efficiency of these provisions is neglectable. Since there is no proper application, we can not discuss regulatory effects on corporate practice.

One of the causes to this situation is the practice of composing the annual financial reports according to International Standards of Financial Reporting and Croatian Accounting Act. However, we can not understand why corporate practice does not acknowledge Commercial Entities Act provisions on financial reporting. The appliance of international standards makes financial reporting more suitable for external environment of international capital market and international financial sector. Nevertheless, that does not allow Croatian corporate sector to ignore national regulation. If there is an argument that Croatian companies are not acquainted enough with national regulation, it is a minor argument that would indicate the Croatian companies to be completely ignorant about the regulatory
environment in which they do business. This is a defeating fact that shows low corporate culture in Croatia overall.

Another interesting issue raising from the research results is the role of corporate lawyers profession and their treatment in corporate sector, as well as the role of auditors. If companies consulted their own legal departments, there is no doubt they would notice such obvious mistakes in financial reporting. Furthermore, most of these annual reports were as well confirmed by the auditor. It is also interesting why the regulators tolerate such practice of auditors who approve the illegal practice in composing financial reports.

Eventhough the Commercial Entities Act was amended many times, the provisions on code of corporate governance were slightly revised, but never revoked. It is also interesting why the lawmaker insists on legal provisions that do not perform their original function and have no effect in practice. Consequently, the lawmaker's objectives are not being attained. Therefore, the regulator should take into account a possibility to revoke these provisions and withdraw from the attempts to regulate the institute of corporate governance code. If he decided for the opposite approach, then the lawmaker should introduce additional regulatory instruments for compulsory enforcement of these provisions.

However, the fact that privately owned companies do not have any form of the code of corporate governance announced to the interested public worries even more than the fact of being ignorant about national laws. The research results have actually disputed our assumption that companies do not apply legal provisions due to conflict between economic and legal concept of the code of corporate governance. If companies have no interest to communicate with targeted audiences by publishing the code of corporate governance, then the research actually shows that most of the companies do not even understand it's economic concept and function. Again, this indicates low corporate governance culture among Croatian companies.

This discovery also disputes a traditional dogma of capitalism, and that is self-regulatory approach to private corporate sector as a more appropriate solution than external regulation and interventionsm. Therefore, there is no significant progress in corporate governance in developing countries, post-communism countries and emerging market without external coercion.

However, these conclusions were at first taken with suspicion due to inconclusive results between H2 hypothesis and supportive hypothesis. When we reconsidered both samples and their structure, we have noticed that supportive hypothesis was confirmed due to the sample structure which comprises more government controlled companies than the joint stock companies sample. Following this we have also examined how many companies in joint stock companies sample were under government control, or had a history of government supported business. Since these companies in majority have published some form of the code, we may conclude that corporate governance is slightly more developed in public companies than in private corporate sector. The fact that public companies are under constant surveillance of the government may result into higher understanding of the regulatory environment, without prejudice to what is business ethics like in public companies.

Among those few companies that fulfilled their legal obligation regarding the statement, the results are also unsatisfying. Most of these companies do not reveal all the obligatory information. These information mostly refer to ownership structure, major shareholders, shares held by the corporate management, management earnings and causes for eventual discrepancies between the code of corporate governance standards and real corporate practice. Published codes of corporate governance in other forms than the one legally prescribed mostly comprise data regarding relationships with customer, environmental policies, products safety and quality, human resources management etc. Structure of these codes show that Croatian companies have progressed in external corporate culture, but have done a little or almost nothing in communicating with the public the developments in internal corporate culture. Undisclosure of these information indicates that Croatian companies are still conservative systems with lack of transparency in their management system.
The conclusion regarding position of higher management structures is that they are very privileged causing intransparency in decision making process. Difficulties while determining power leverage in internal corporate culture may be demotivating for investors and other interested audiences, especially if financial outflow destined to management is not adequately disclosed. This is also a potential danger to revealing corporate malpractice, crime and corruption.

7. CONCLUSION

Unfortunately, Croatian corporate sector still neglects the importance of a code of corporate governance in its practice. Croatian companies do not understand nor economic functions of the code, nor the legal provisions that regulate the code of corporate governance, so there is no true conflict between economic and legal concept of the code. Therefore, the research has shown that without external regulation, Croatian corporate sector is not willing to self-regulate the mechanisms of corporate governance. Also, positive regulation of Commercial Entities Act is not adequate since its provisions are not applied efficiently and therefore the lawmaker should review its current position and decide on future legislative approach.

The research has shown that most of the Croatian companies implement the code of corporate governance in order to manage relationships within external corporate culture. However, internal corporate culture and internal mechanism of corporate governance are not being disclosed to the interested public showing high conservativeness among management structures and crucial lack of transparency. However, corporate governance mechanism are to some extent more transparent in public companies, showing again the reluctance of private sector to impose its own rules of governance even when they are not obeying the rule of law.

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