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Corporate governance in Southeast Europe: in search for transparency and efficency

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Editorial

One of the most important challenges in raising competitiveness and creating a new, better society in the 21st century is the promotion and development of good corporate governance practices at the global level. Good corporate governance depends on the balance of relations between internal and external mechanisms which ensure the efficiency of governing and help in the resolution of natural problems, as well as the possible conflicts that may occur within a corporate structure.

Historical, cultural, political and economic realities play a crucial role in modelling system of corporate governance. A closed system of corporate governance, characteristic of Continental Europe, is defined by a myriad of legal, cultural and institutional relations, through which the influence of individual stakeholders on setting goals and supervising the firm's business policy are determined and is based on the activities of blockholders and banks. Good corporate governance is based on adequate combinations of the legal protection of investors and the level of ownership concentration.

South East Europe is one of the regions we should look at more closely. It is a region full of surprises; conflicts and wars in past, on the one side, but huge growth potential on the other side. The history of SEE countries, their characteristics, their resources, their cultural roots and their political structures shape their paths. Most of SEE countries have attained political stability, modest but steadily growing prosperity and orderly economic activity. In other words, in SEE countries we find aspiring economics with increasingly stable conditions and rapidly growing opportunities for business. South East Europe has excellent chances of continuing the strong growth path it kicked off at the start of the millennium. But key sectors, economic system and other infrastructure still need to be developed to tap this potential.

SEE countries, as an integral part of continental Europe, have a closed system of corporate governance, but with a number of special features. They have been passing through a difficult transitional period in the past twenty years, burdened with myriads of different post-socialist problems and slow adaptation to the modern economic system. In almost all countries of the region, rapid privatization - often carried out under suspicious circumstances - led to a range of long-term problems from which a significant number was related to corporate governance issues. Substantial efforts are required to improve corporate governance practices and even though noticeable improvements are seen in recent years, there is still much work ahead.

This special issue of International Journal of Management Cases, titled “Corporate Governance in Southeast Europe: In search for Transparency and Efficiency”, portrays some of the challenges, problems and corporate governance issues faced by companies in this region. The authors of the articles presented their research conducted in Bosnia and Herzegovina, Montenegro, Macedonia, Slovenia, Serbia, Romania, Bulgaria and Croatia. We were calling on them to present their research and insights.

The focus of the papers is devoted to interesting questions such as: institutional determinants of corporate governance and methodological discontinuity of corporate performance measurement, corporate governance effectiveness, disclosure and transparency of public companies, protection of minority shareholders, fraud prevention and detection, relation between top management turnover and stakeholder orientation, cross-border mergers and acquisitions in the region, social responsibility practices in companies, interdependence of controlling and corporate governance etc.

We hope that this special issue is interesting and inspiring for all those engaged in the areas of corporate governance and management in transition countries.

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Editors

TOP MANAGEMENT CHANGES AND STAKEHOLDER ORIENTATION: CASE OF CROATIA

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Abstract

Stakeholder theory of the corporation was developed as an alternative to the prevalent system of corporate governance with shareholders being the only group managers are responsible to. Top management's responsibility goes far beyond shareholders alone, because the corporation is not merely an instrument for maximizing shareholders' wealth, but also is a social entity with broader and more complex purpose and role.

Top management should balance multiple interests, demands and claims of various stakeholder groups and therefore top management's success can not be easily and unambiguously described using traditional performance measures based on return on equity. The challenges top managers are facing can be better expressed by a question: How can they satisfy (often conflicting) stakeholders' demands while maximizing firms' wealth creating capacity at the same time?

Top management's position and role within the structure of corporate governance are determined by firm's stakeholder orientation; power constellations, shifts in negotiating positions and interactions between various stakeholder groups, so our main research goal was to expand the understanding of the context, reasons and circumstances of top management changes, starting from the basic premises of the stakeholder theory of the corporation.

The results of this research indicate that there are differences in stakeholder orientation regarding top management changes, and the observed differences are even larger when the change was forced. The results of this research also suggest that managers may engage in active stakeholder management as to protect their own position-as part of a managerial entrenchment strategy.

Keywords: corporate governance, stakeholder orientation, top management changes

Theoretical overview

Stakeholder model of the corporation is a widely accepted conceptualization of the modern business organization. Value is generated through interactions with various stakeholder groups so value can not be distributed exclusively to shareholders. Proponents of the stakeholder approach suggest that a firm should be governed to satisfy interests of all groups that have legitimate stakes in the company's success, and the mechanisms of governance should protect and ensure fair returns to stakeholders' investments. In its most basic sense, stakeholder theory arises from the rejection of the idea that the corporation should single-mindedly strive to maximize the benefits of a single stakeholder, the shareholders (Wijnberg, 2000, p 329).

The stakeholder approach was firstly introduced by Freeman (1984). This perspective has conceptualized the firm as an aggregation of groups or individuals who affect or are affected by the firm's activities. Shareholders, customers, employees, suppliers and other stakeholder groups are increasingly and vitally affecting business success and corporate survival. Managers must ensure that their interests are incorporated into, rather than ignored, in corporate strategy (Letza, Sun and Kirkbride, 2004). Without stakeholder support and stakeholders' efforts, an organization cannot contribute to the value chain (Freeman and Liedtka, 1997) and as a result the achievement of its objectives will remain unrealized.

Freeman and McVea describe stakeholder management as follows: 'The stakeholder framework does not rely on a single overriding management objective for all decisions. As such it provides no rival to the traditional aim of "maximizing shareholder wealth". To the contrary, a stakeholder approach rejects the very idea of maximizing a single-objective function as a useful way of thinking about management strategy. Rather, stakeholder management is never ending task of balancing and integrating multiple relationships and multiple objectives' (2001, p 194). Stakeholder theory attempts to address the question of which groups deserve or require management's attention. Arguments are often normative, such as 'the interests of key stakeholders must be integrated into the very purpose of the firm, and stakeholder relations must be managed in coherent and strategic fashion' (Freeman and McVea, 2001, p 193). Clarkson (1995, p 112) for instance, argues that 'the economic and social purpose of the corporation is to create and distribute wealth to all its primary stakeholder groups, without favouring one group at expense of others.'

Donaldson and Preston (1995) distinguished between descriptive, instrumental and normative approaches to stakeholder theory. Normative elaboration of the stakeholder concept is based on reasons why stakeholders' interests should be taken into account. Descriptive approach attempts to identify whether stakeholders' interests are taken into consideration or not. Instrumental or strategic approach to stakeholder theory is concerned with the effects of stakeholder management on corporate performance-if managers treat stakeholders in line with the stakeholder concept, than the organization will be more successful or more likely to be sustainable.

Clearly, the instrumental approach to stakeholder theory is the most attractive to researchers in the field of business. Resource-dependency theory (Pfeffer and Salanick, 1978) is the most widely used theory in instrumental approach (Mitchell, Agle and Wood, 1997; Rowley, 1997; Frooman, 1999). The central idea is that firms are dependent on resources in its environments to produce long-term value. Berman et al. (1999, p 491) claim that attention to stakeholders' interests is necessary because 'it is the stakeholders that control resources that can facilitate or enhance the implementation of corporate decisions'. In that sense, stakeholders who make firm-specific investments and contributions and bear risks in the corporation should participate in corporate decision-making as a way of enhancing corporate efficiency.

While management may receive financial capital from shareholders, still they depend on employees and other external stakeholder groups to fulfil strategic intentions. The problem with the stakeholder concept of corporation is that it amplifies agency problem. Top managers can have their own utility function and their own goals and objectives that diverge from that of principals. If managers are accountable for balancing and managing multiple objectives (as proposed by the stakeholder approach), all stakeholders, including shareholders can be worst off, because management could be committed to pursuing self-interest solely. As Jensen noticed, 'multiple objectives is no objective' (2001, p 301).

When faced with a multi-valued objective function, the relationship between managerial behaviour and firm's performance becomes uncontrollable. Stakeholder management practices obviously set high-discretion context where managers have greater latitude of action. When it is difficult to establish clear cause-effect relationships, it is hard to judge how much of an outcome is due to the agent's effort and capabilities and how much is owing to unpredictable events and factors. In these circumstances, principals are reluctant to sanction the agent, who is then freed to pursue self-interest (Carson, Madhok and Wu, 2006).

Goll and Rasheed (2004) have found that social performance and stakeholder management practices have greater effects on corporate performance in contexts where managers have broader latitude of action. This is in line with the theory of Hambrick and Finkelstein (1987) suggesting that managers can contribute more to firm performance in contexts where they have higher discretion.

The effects of stakeholder management on firm performance ultimately depend on how such discretion is used. When managers exercise their enlarged power in the interest of the organization and its stakeholders, stakeholder management is likely to enhance performance; when this discretion is employed for self-serving interests, the social standing and financial performance of the organization may be negatively affected (Cennamo, Berrone and Gomez-Mejia, 2008, p 492).

Divergent stakeholders' interests, difficulty in individualizing and addressing stakeholder salience and claims, and uncertainty in establishing trustable and idiosyncratic relationships explain why, once they are formed, these relationships may be difficult to imitate, giving the firm competitive advantage (Cennamo, Berrone and Gomez-Mejia, 2008). Top management has a central role in establishing and maintaining these relations so opportunistic behaviour is always a threat in stakeholder oriented corporation. Greater level of stakeholder participation in corporate governance processes (decision making and strategy formulation processes) should assure monitoring and control of management's behaviour to all relevant stakeholder groups.

Stakeholder orientation or stakeholder management can be a source of competitive advantage if it is a part of a long-term wealth generating strategy. On the other hand, it can be detrimental to firm's performance if it is a part of entrenchment strategy of opportunistic and self-serving management.

Efficient systems of corporate governance should replace poor performing managers (and prevent managerial entrenchment practices). Top management changes may be forced and voluntary (non-forced). Voluntary top management changes are a kind of natural fluctuation of management, mostly neutral towards corporate governance practices. On the other hand, forced top management changes are the result of better or poorer effects of external or internal corporate governance mechanisms. Good corporate governance is associated with a potential of the entity in the position of corporate control to 'discipline' managers so they would not act solely in their own interests. The ultimate measure of 'disciplining' is the dismissal, an ad hoc situation when managers depart against their will.

Methodological framework and research design

Empirical researchers interested in the way firms interact with various stakeholder groups rarely have quantified stakeholder orientation or stakeholder management. Greenley and Foxall (1997) use survey methodology to measure firm's orientation towards multiple stakeholders while others use measures of corporate social performance (Berman et al, 1999; Hillman and Keim, 2001; Shropshire and Hillman, 2007). The Kinder, Lydenburg and Domini (KLD) index of social performance can only roughly illustrate firm's relationship with primary stakeholders like shareholders, employees, customers, suppliers and communities (Clarkson, 1995) and only to a limited extent can explain each stakeholder groups' role and contribution to firm's value creation process.

Even though effective stakeholder management, in terms of relations with primary stakeholder groups, is viewed as a source of competitive advantage (firms that meet stakeholders' needs and expectations will outperform competitors in terms of long-term value creation), non-dominant and even marginal stakeholder groups can, over time, gain sufficient power to make their claims and interests not only legitimate, but also critical to company's success (Hart and Sharma, 2004).

With respect to theoretical and empirical contributions of researchers within the field of stakeholder theory and context specificity in which Croatian companies exist we have identified eight relevant stakeholder groups; (1) shareholders, (2) employees, (3) customers, (4) suppliers (including creditors), (5) government, (6) communities, (7) media and (8) universities. Even though 'management' is recognized as one of the major 'constituencies' of the firm (Williamson, 1985, p. 298), its strategic position within the firm viewed as 'forum for stakeholder interaction' (Hummels, 1998, p 1411) is better described as trustees who respect and promote not only financial interest of shareholders, but also broader interests of firm's current and future stakeholders in order to develop firm's wealth generating capacity in a long-term perspective (Letza and Sun, 2002).

In what is commonly regarded, at least in the academic circles, stakeholders are defined as 'any group or individual who can affect or is affected by the achievement of the organization objectives' (Freeman, 1984, p 46). Stakeholder groups' involvement in strategic decision making or stakeholder participation in corporate governance processes has its normative, but also its instrumental argumentation. Stakeholders participate in the decision making process because it is ethical and socially responsible (normatively right) but also because stakeholder participation in organization objectives and strategy formulation process will facilitate strategy implementation and achievement of organizational goals (instrumental argumentation).

It is important to determine, for each relevant stakeholder group, the magnitude of power and influence they exert over organization, but also to identify the extent to which organizations can exert power over various stakeholder groups (Friedman and Miles, 2006; Freeman, Harrison and Wicks, 2007). Stakeholder orientation measure is operationalized in order to capture three major segments of firm-stakeholder interactions.

1. Understanding the interests and expectations of each stakeholder group. This segment of stakeholder orientation index includes both formal research importance in understanding stakeholder interests (e.g. surveys on customer satisfaction, employee satisfaction, shareholders' satisfaction regarding the quality of corporate governance, etc.) and managerial judgment importance in understanding stakeholders' interests and expectations (Greenley and Foxall, 1997; Wheeler and Sillanpää, 1998). Since stakeholders' interests are divergent and difficult to individualize and address, only those managers who understand interests and expectations of each relevant stakeholder group can develop superior stakeholder management practices that lead to competitive advantage.

2. Stakeholder participation in decision making processes. This segment of stakeholder orientation index is operationalized in order to reflect different aspects and levels of stakeholder inclusion; information, consultation, participation in decision making and ownership (Oxley Green and Hunton-Clarke, 2003). Moreover, this segment of the index includes the measure of actual fit between stakeholders' interests and expectations and firm's long-term objectives and strategy.

3. Organizational culture that supports stakeholder participation. When top management's personal believes, attitudes, values and expectations are pro-stakeholder oriented and openly discussed when addressing corporate culture, stakeholder participation will be more certain (Kilmann, Saxton and Serpa 1985; Jones, Felps and Bigley, 2007; Freeman, Harrison and Wicks, 2007).

For each of the eight stakeholder groups; (1) shareholders, (2) employees, (3) customers, (4) suppliers (including creditors), (5) government, (6) communities, (7) media and (8) universities, the measure of stakeholder orientation is calculated. The description of variables used in this research is given in Table 1. Since many of the variables are based on perceptual measures (five-point Lykert scales were applied), reliability coefficients are calculated and reported in the Table 1.

As it can be seen from the Cronbach's alpha coefficients reported in the Table 1, all of the constructs used in this research show acceptable reliability (coefficients are consistent with those reported in similar types of investigations). Regarding the fact that all of the coefficients are considerably above 0,8 we can conclude that the research instrument is highly reliable.

Large companies have long-term relationships with owners of key resources and therefore more stable resource base, so the large company was defined as the main research unit of this investigation process.

Table 1-Description of variables and reliability coefficients

Variable	Description	Cronbach's alpha
Understanding stakeholders' interests and expectations – **first segment of the stakeholder orientation index**	Construct is made up of items: -the importance of formal research in understanding each stakeholder group interests and expectations -the importance of managerial judgment and action in understanding each stakeholder group interests and expectations	0,862
Stakeholder participation in decision making processes **– second segment of the stakeholder orientation index**	Construct is made up of items: -level of information regarding firm's competitive position and strategies toward each stakeholder group -level of consultation in strategy formulation process toward each stakeholder group -level of participation in decision making processes for each stakeholder group -level of participation in ownership for each stakeholder group -level of fit between firm's long-term objectives and strategies and each stakeholder group interests and expectations	0,911
Organizational culture that supports stakeholder participation – **third segment of the stakeholder orientation index**	Construct is made up of items: -stakeholder issues are openly discussed -values reflect and support stakeholder engagement	0,926
Overall measure of stakeholder orientation	**First segment of index + second segment of index + third segment of index**	**0,903**
Shareholder orientation	Derived from the stakeholder orientation index	0,880
Employee orientation	Derived from the stakeholder orientation index	0,896
Customer orientation	Derived from the stakeholder orientation index	0,859
Supplier orientation (including creditors)	Derived from the stakeholder orientation index	0,830
Government orientation	Derived from the stakeholder orientation index	0,886
Community orientation	Derived from the stakeholder orientation index	0,901
Media orientation	Derived from the stakeholder orientation index	0,824
University orientation	Derived from the stakeholder orientation index	0,853
Top management changes	Number of the President of Management Board changes in period 2003-2009; used as dummy, "1" if change occurred, otherwise "0".	
Forced top management changes	Number of non-voluntary President of Management Board changes in period 2003-2009; used as dummy, "1" if non-voluntary change	

The research was conducted in June 2010 on the population of 500 largest Croatian non-financial companies (by total revenues). The Presidents of Management Boards were asked to answer series of closed format questions. 61 questioners were collected via mail survey, so that overall response rate was 12,2% (the response rate is acceptable and very close to those reported in similar studies). We have collected data on management changes (number of changes in the position of the President of Management Board in period 2003-2009) for 47 companies. For the purpose of this research, the number of changes that occurred in the analysed period has little practical relevance. Rather, what is relevant is if the change actually occurred or not. We also collected data on the existence of a dominant entity in the ownership structure (holder of 50% or more of firm's stocks). Presence of a dominant owner shapes control patterns in firm's governance structure meaning that there should be enough motivation (and instruments) for 'punishing' self-serving management.

SPSS 18 for Windows was used for statistical analysis of the data collected.

Research findings

In our sample 65% of the companies are predominantly privately owned, while 35% of the companies are predominantly state owned.

55,7% of the Presidents of Management Boards in the sample have the academic degree of master of science (arts), while 39,3% have a university diploma. Only one respondent (1,6%) has a high school diploma, while 3,3% of the respondents have college diploma. Educational background analysis by primary field of education reveals that 59% of the respondents have undertaken education in the field of business, while 28% of the respondents have undertaken education in engineering. Other fields of education are less represented (13%).

The greatest proportion of respondents (37,7%) have reported tenure on the current position up to five years, while almost third of the respondents have reported tenure longer than five years but less than ten years (30%). 11 respondents (18%) have reported tenure longer than ten years. Only 14,3% of respondents have reported tenure of less than one year.

Research results presented in Table 2 show that, from the perspective of the Presidents of Management Boards in large Croatian companies, influence and power that stakeholders exert over the organization (in terms of influencing decision making processes and management behaviour) is higher than the influence and power that an organization exerts over various stakeholder groups (decisions that are made on organization's apex affect stakeholders). Variables "Stakeholder influence and power over organization" and "Organization influence and power over stakeholder" are numerical variables that are composed of eight ordinal variables (each representing one relevant stakeholder group).

Further analysis reveals groups that have above average influence on decision making processes in companies in the sample; shareholders (mean influence 4,21), customers (mean influence 3,47) and government (mean influence 3,33). This finding suggests that political elites have significant influence over decision making processes in Croatian companies and that the transition towards the market economy is still an on-going process in Croatia. On the other hand, we have identified above average influence of the organization on shareholders (mean influence 3,67), employees (mean influence 3,78), customers (mean influence 3,47) and suppliers (mean influence 3,27). These stakeholder groups are corresponding to primary stakeholder groups-those who own and control critical resources. Community, media and universities are non-dominant stakeholders from the perspective of the Presidents of Management Boards in large Croatian companies.

We further analysed the interdependence between influence and power stakeholder groups exert over the organization and influence and power that the organization exerts over different stakeholder groups.

The results presented in Table 3 show that the most obvious relationship between variables "Stakeholder influence and power over organization" and "Organization influence and power over stakeholder" exists for non-dominant stakeholder groups. Community, media and universities have the least bargaining power from the perspective of the Presidents of Management Boards in large Croatian companies. For those groups of stakeholders that have the potential to affect power (a)symmetry in Croatian companies correlation coefficients are lower (shareholders-rs=0,363; employees-rs=0,270; customers-rs=0,432; suppliers-rs=0,379; government-rs=0,266). Power can exist only when there is an unequal (unbalanced) relationship between social entities; when the observed magnitude of influence that a stakeholder exerts over the organization isn't equal to the magnitude of influence that the organization exerts over a stakeholder.

Results regarding stakeholder orientation index and top management changes are presented in Table 4. Descriptive statistics for three segments of the index and for the overall measure of stakeholder orientation is given for the total sample, for companies in which a top management change occurred in the period 2003-2009, and for the companies in which forced top management turnover occurred in period 2003-2009. Top management turnover measure was used as a dummy variable (1 if the change occurred; 0 otherwise).

As it can be seen from Table 4, when a top management change occurred in the period 2003-2009, overall measure of stakeholder orientation is slightly lower as opposed to the sample in general. Also, measures reflecting different segments of the stakeholder orientation index are lower (only the level of stakeholder participation in decision making process is slightly higher). On the other hand, when a top management change was forced (which is usually motivated by poor performance), all the segments of the index, including the overall measure of stakeholder orientation, are slightly higher. We have tested observed differences using Mann-Whitney test, but found no statistically significant differences.

We also tested for the effects of dominant owner's presence. In a situation when there is a dominant entity in the ownership structure (and a top management's change occurred), we have identified a mean value of the stakeholder orientation index of 2,84 (N=17), as opposed to a situation where we identified no dominant owner (2,60; N=9). Observed difference is statistically significant, although at the 10% level (z=-1,789; p=0,074). If the change was forced, differences are even higher, and statistically significant at 5% level (z=-2,741; p=0,003 - mean value of stakeholder orientation index is 2,90 (N=12) in a situation where we have identified a dominant owner, and 2,25 (N=8) otherwise).

Table 2-Influence and power stakeholder groups exert over organization and influence and power organization exerts over different stakeholder groups

	N	Min	Max	Mean	Std. deviation
Stakeholder influence and power over organization	61	1,12	4,75	3,11	,779
Organization influence and power over stakeholder	60	2,00	5,00	2,85	,638

Table 3-Correlations between stakeholder's influence and power over organization and organization's influence and power over stakeholder (Spearman's rho coefficients)

	Shareholders	Employees	Customers	Suppliers	Government	Community	Media	Universities
Shareholders	,363** ,005							
Employees		,270* ,037						
Customers			,432** ,001					
Suppliers				,379** ,003				
Government					,266* ,040			
Community						,513** ,000		
Media							,634** ,000	
Universities								,594** ,000

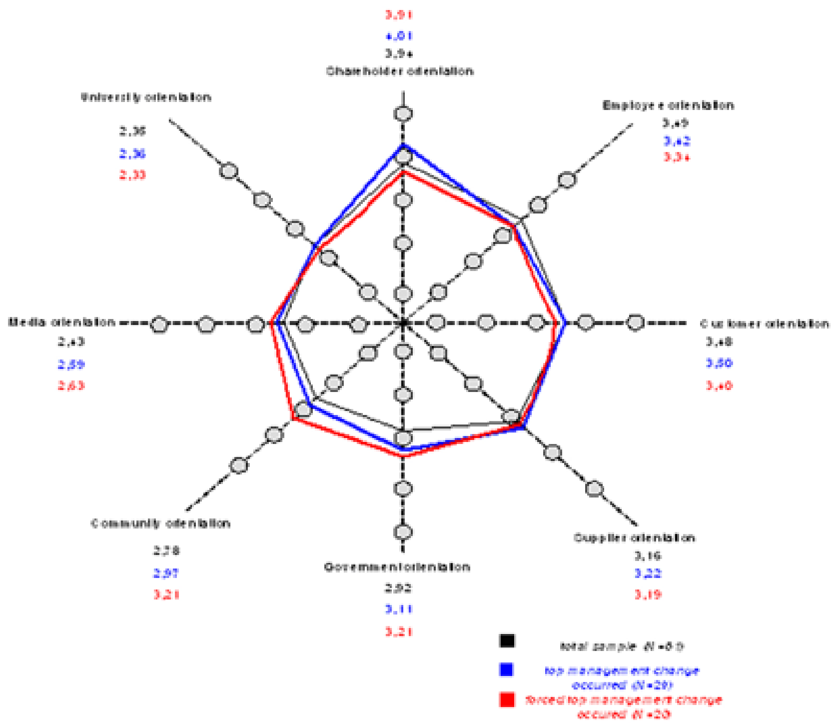
** - correlation is significant at the 1% level (two-tailed test)

* - correlation is significant at the 5% level (two-tailed test)

Table 4-Stakeholder orientation index and top management changes

	N	Min	Max	Mean	Std. Deviation
Understanding stakeholders' interests and expectations – first segment of the stakeholder orientation index	61	,62	3,00	2,06	,429
Understanding stakeholders' interests and expectations – first segment of the stakeholder orientation index (management change occurred in period 2003-2009)	29	,62	2,68	2,17	,415
Understanding stakeholders' interests and expectations – first segment of the stakeholder orientation index (forced management change occurred in period 2003-2009)	20	,62	2,68	2,22	,457
Stakeholder participation in decision making processes – second segment of the stakeholder orientation index	61	1,50	3,93	2,82	,563
Stakeholder participation in decision making processes – second segment of the stakeholder orientation index (management change occurred in period 2003-2009)	29	1,62	3,93	2,89	,582
Stakeholder participation in decision making processes – second segment of the stakeholder orientation index (forced management change occurred in period 2003-2009)	20	1,62	3,93	2,91	,610
Organizational culture that supports stakeholder participation – third segment of the stakeholder orientation index	61	1,50	4,31	3,23	,640
Organizational culture that supports stakeholder participation – third segment of the stakeholder orientation index (management change occurred in period 2003-2009)	29	1,81	4,12	3,25	,596
Organizational culture that supports stakeholder participation – third segment of the stakeholder orientation index (forced management change occurred in period 2003-2009)	20	1,81	4,12	3,19	,626
Overall measure of stakeholder orientation	61	1,65	3,50	2,70	,427
Overall measure of stakeholder orientation (management change occurred in period 2003-2009)	29	1,65	3,43	2,77	,406
Overall measure of stakeholder orientation (forced management change occurred in period 2003-2009)	20	1,65	3,43	2,77	,436

Figure 1-Orientation toward different stakeholder groups and top management changes



We further analysed the orientation toward different stakeholder groups regarding top management changes. Even though this wasn't obvious from previously presented research results, top management changes have the potential to change bargaining power of certain stakeholder groups. As it can be seen from the Figure 1, when top management change occurred, some stakeholder groups are improving their position (shareholders, customers, suppliers, government, community and media). University orientation is not affected by top management change, while employee orientation is slightly lower. Shifts in the orientation toward different stakeholder groups are even greater when the change was forced. All primary stakeholders are deteriorating their position, while non-dominant stakeholders are improving their position (government, community, and media). This could mean that the newly established management perceives that establishing close relationships with "outside" stakeholders is more important than engaging in improving relationships with "inside" stakeholders (while gaining legitimacy and anchoring their position within firm).

Conclusion

Most commonly it is argued that stakeholder orientation is instrumental in increasing efficiency, competition and profitability. Moreover, failure to address stakeholders' interests may be detrimental to company's performance and competitive position.

Stakeholder orientation, as a measure of stakeholders' inclusion in decision making processes has rarely been quantified. We used survey methodology and perceptual measures of stakeholder orientation on a sample of large Croatian companies. The results of this research indicate that there are differences in stakeholder orientation regarding top management changes.

Also, there are evident differences in stakeholder orientation when we were able to identify a dominant owner as opposed to situation where we weren't able to identify dominant center of power and control within corporate governance structure. Results of this research have shown that only non-dominant (secondary) stakeholders have the potential to shape the power structure within Croatian companies, and that is particularly the case when forced management changes occurred. Managers may then engage in active stakeholder management as to protect their own position (or as part of an entrenchment strategy).

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RELATED PARTY TRANSACTIONS AND PROTECTION OF MINORITY SHAREHOLDERS

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Abstract

The issue of protection of minority shareholders has been in the focus of different approaches to corporate governance in recent years, with particular attention to the protection from self-dealing in related party transactions. The research has shown that economies with the greatest investor protection are characterized by precise definitions of related party transactions, comprehensive disclosure requirements, shareholder participation in making key decisions, clear standards on insiders' liability and well-functioning judiciary. Bearing this in mind as well as the important issues of regulation according to Djankov et al (2008), in our paper we consider the most important issues concerning the regulation of such transactions in general and analyze the existing legislation in Bosnia and Herzegovina (B&H), especially in terms of approval and disclosure requirements.

Keywords: related party transactions, minority shareholders, self-dealing

Introduction

The issue of protection of minority shareholders has been in the focus of different approaches to corporate governance in recent years, with particular attention to the protection from self-dealing in related party transactions (RPTs) i.e. protection from misuse of corporate assets by insiders for personal gain. The extent of protection in Bosnia and Herzegovina, according to indicators presented in Doing Business 2011 report, is below the regional average which is lower than the average for OECD countries. Thus, the B&H is ranked 93 out of 183 countries covered by the report with the value of index measuring strength of investor protection being equal to 5.0.

Today regulators pay a special attention to related party transactions. The research has shown that economies with the greatest investor protection are characterized by precise definitions of RPTs, comprehensive disclosure requirements, shareholder participation in making key decisions, clear standards on insiders' liability and well-functioning judiciary. Bearing this in mind as well as the important issues of regulation according to Djankov et al (2008), in our paper we consider the most important issues concerning the regulation of such transactions in general and analyze the existing legislation in B&H, especially in terms of approval and disclosure requirements.

Related party transactions: definition and classification

Related party transactions usually are defined as contracts that directors and other authorized persons conclude in the name of joint stock companies with their large shareholders, companies with which they are associated, their relatives, as well as contracts where they themselves appear as the counterparty. Purchases, leasing and sales of assets, acquisitions of production inputs, etc. are listed as possible examples of such contracts (Ryngaert and Thomas, 2011, p 1).

A transaction between related parties as defined in International Accounting Standard (IAS) 24 - Related Party Disclosures is considered to be a transfer of resources, services or obligations between related parties, regardless of whether the price is charged. At the same time it is pointed out that with respect to each relation between the parties, the attention should be focused on the essence and not merely legal form of relationship. The Standard precisely defines when a party is deemed to be related to an entity.

There is not much research on impact of these transactions on companies and shareholder wealth. According to Ryngaert and Thomas (2011), the reason is mostly time-consuming collection of data on such transactions. These authors observe a sample of US small and medium-sized companies and based on their study results hold the view that the time of implementation of RPTs can have significant effects on shareholder wealth. In this respect they distinguish between ex ante and ex post transactions with related parties. Ex ante transactions are denoted as those that occurred before the company went public or before the other party acquired the status of a related party. In contrast, ex post transactions are those that occurred afterwards i.e. after the company went public and when the other party already has the status of a related party.

The authors in their study consider the first as being harmless and potentially useful, unlike ex post transactions that show a significant negative relation with operating profitability and potentially negative impact on shareholder wealth. They also establish the existence of higher probability of subsequent financial difficulties and going dark for the ex post, but not for the ex ante transactions. Interestingly, the same authors consider setting relatives to the top executive positions in family companies as a special form of a RPT (Ryngaert and Thomas, 2007, p 3).

The last decade's corporate scandals, such as cases of Enron and Parmalat, actualize the issue of regulating RPTs concerning the fact that they can be harmful to external shareholders. On the other hand, beside the possible expropriation of shareholders, it is considered that those transactions under certain conditions can be useful to shareholders due to the more efficient contracting (Ryngaert and Thomas, 2011, p 8).

Self-dealing and protection of minority shareholders

Self-dealing is considered to be one of the most important issues in corporate governance that is of a particular concern for minority investors (WB&IFC, 2010, p 47). A potential instrument for self-dealing is RPTs, given that insiders can use their position to influence the conclusion of contracts with related parties under terms in their favour. As stated by Ryngaert and Thomas (2011, p 1), the expropriation occurs when a company achieves a lower net benefit from the RPT compared to the same transaction with unrelated party.

Self-dealing transactions can be defined as real transactions through which the controlling shareholder and/or company director transfers funds from a joint stock company for his own benefit. In other words, self-dealing is the use of corporate assets by insiders to achieve personal gain (WB&IFC, 2010, p 47). Insiders are usually considered to be both managers and controlling shareholders. The most common examples of self-dealing are RPTs that allow controlling shareholder to gain profit at the expense of financial health of a company either through sale of company assets at excessively low prices, purchasing assets at inflated prices, or through loans granted under favourable conditions. In this context, Filipovic (Gorenc et al, 2004, p 791) stands out that tying operations of a subsidiary and its appearance on the market to the parent company can be particularly dangerous, emphasizing the importance of technology development in associated companies.

It is interesting to note that the Delaware court in interpreting the concept of self-dealing takes the view that it 'is not confined to those cases where the controller enters into a contract with the corporation'. The court holds that 'self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary'(Dammann, 2008, p 688).

Some authors distinguish between direct and indirect self-dealing. Osugi (2000, p 3) outlines three tactics of direct self-dealing: asset stripping, transfer pricing and share dilution. In the case of asset stripping managers of a company A establish a company B and transfer a major portion of the company A's assets to the company B at prices much lower than market value. The use of transfer prices in the case of these companies would imply that company A sells its products or materials to company B at a lower price, while B sells its products or materials to A at a higher price than the fair market value. The same effect is achieved in the case of paying market prices for goods or services of greater or lesser quality.

Important issues in regulating related party transactions

The regulation of RPTs in which insiders are in a conflict of interest represents an important company law issue. The approach of leaving market forces to solve this problem is not used by any of the countries today. The ultimate goal is to reach the conclusion of transactions that involve conflict of interest under the same conditions, at least approximately, at which they would be concluded with an independent third party. Pizzo (2011, p 3) indicates the presence of many inconsistencies and gaps in regulation in spite of the increased attention. Often there is no legal definition of a RPT or it is not comparable. According to him, the disclosure requirements prevail with some significant differences between the jurisdictions.

According to Djankov et al (2008) important issues in regulating RPTs include: who can approve the transaction; what must be disclosed to the board of directors or supervisory board, shareholders, stock exchange and regulator; duties of board members and controlling shareholders; the possibility of questioning validity of the transaction; possible legal actions in case the company suffers damages; what needs to be proved in case of taking these actions; who has the right to sue; the availability of direct and derivative claims; access to information and right to its disclosure; and possible sanctions.

The research has shown that economies with the greatest investor protection are characterized by precise definitions of RPTs, comprehensive disclosure requirements, shareholder participation in making key decisions, clear standards on insiders' liability and well-functioning judiciary (WB&IFC, 2010, p 47). The indices developed according to Djankov et al (2008) methodology are used to measure the protection of minority shareholders from self-dealing in transactions with related parties. The strength of investor protection index represents an average value of three indices: the extent of disclosure index, extent of director liability index, and ease of shareholder suits index.

Johnson et al (2000, p 5) observe significant differences between the common and civil law in regulating self-dealing. The civil law countries prefer predictability and rely on legal provisions to regulate such behaviour, which may encourage insiders to creatively design unfair transactions that will meet the letter of the law. On the other hand, in common law countries priority is given to the concept of fairness to minority shareholders with a high degree of judicial discretion. As a result of that and the application of fiduciary duty institute, which intends to cover situations that could not be predicted or categorized, corporate law in those countries experiences a continuous evolution.

The traditional approach of American corporate law to solving problems of minorities' protection in terms of the existence of a controlling shareholder is a transaction oriented approach that implies monitoring of individual transactions that are suspected of being used by controlling shareholders at the expense of others. One form of this approach is applied in Delaware and is recognized in the literature for its perceived effectiveness and consistency in dealing with the problem of self-dealing, although there are some criticisms of its certain aspects.

In Delaware all contracts between controlling shareholders and the corporation are automatically subjected to the entire fairness test, even when they are approved by a majority of minority shareholders or board of independent directors. The situation becomes more complicated when the controlling shareholders' behaviour does not involve a contract with the corporation. Dammann (2008, p 685) points out that when applying this approach the level of extraction of private benefits of control depends on how the individual controlling shareholder is positioned to exploit loopholes in the concept of testing fairness. The reasons are related to the burden of proof and the impossibility of subjecting all the relevant decisions to the entire fairness test.

Approving related party transactions

The literature distinguishes three possible approaches in respect of the issue: (1) a complete ban (2) a prohibition of most of these transactions with some flexibility in terms of enabling the approval of certain types of transactions by uninterested members of the board and/or uninterested shareholders, and (3) simply requiring a prior approval from these uninterested entities (Avilov, G et al, 1998, p 28).

Theoretically, it is possible to completely prohibit transactions with related parties due to the existing conflict of interest. However, this approach is not considered useful because of the economic benefits arising from such transactions (Djankov et al, 2008, p 431). In terms of their approval the choice between requiring the approval of uninterested shareholders, board or shareholders' general meeting is considered crucial. The following rule applies: the greater participation of shareholders and less of interested board members, the greater protection is provided to minority shareholders.

Some jurisdictions and individual exchanges require the approval of minority shareholders for certain transactions, and some even a previous review of an independent third party, audit committee, financial expert or an independent auditor. For example, in Israel, in cases when share based compensation is given to controlling shareholder or to its relative, the approval is requested from the audit committee and at least one third of votes of shareholders who have no personal interest in the transaction (IOSCO, 2009, p 23). Requesting the approval of a majority of minority shareholders for self-dealing transactions Goshen (2003) considers as a key mechanism for the protection of minority shareholders. In that case the influence of minorities in decision-making becomes larger with the increase of controlling shareholder's ownership share.

The approval mechanisms work well only if there are no many exceptions to the rule and approval is required at the time of the transaction occurrence. Cases when shareholders can vote on RPTs only at the annual meeting (after the transaction has already occurred) and when the shareholder approval is required only if the transaction does not occur in the 'ordinary course of business' without defining this concept are considered as bad examples (WB&IFC, 2010, p 51). There was a case in Italy when it was impossible to apply the legal rules on conflict of interest because the transaction was characterized as an everyday business transaction, while the mentioned solutions were applicable only to the collective organ's decisions. There were also cases where courts preferred the interests of the group as a whole in relation to the interests of a subsidiary and its minority shareholders (Johnson et al 2000 pp 8).

Some jurisdictions accept the institute of temporary exclusion of shareholder's voting rights in cases of conflict of interest of a particular shareholder with the company's own interest. Vasiljevic (2007, p 353) points out that the application of this institute is very problematic from the standpoint of foundation of the idea.

On the other hand, Anderson and Reeb (2004) emphasize the importance of the role of committees in protection of minority shareholders, especially their independent members. When it comes to approving RPTs it can be useful for a committee to create a policy of requiring different levels of approval depending on the transaction value.

Corporate governance in B&H is in the entities' jurisdiction which resulted in the establishment of two completely separate regimes. The Law on Companies in Federation of B&H (LoC FB&H) does not contain specific provisions on RPTs and their approval. In addition to general provision on prohibiting competition which applies to members of supervisory board and management of a joint stock company, the Law contains provisions on the prohibition of competition and conflict of interests of members of the supervisory board and management. The chair and members of the supervisory board are required to carry out duties and responsibilities in accordance with the interests of shareholders and the company and they cannot perform the activities that are competitive to company's activities without notification and approval of other members of the supervisory board.

The chair and members of supervisory boards in the FB&H are obliged to report to the supervisory board the existence of every direct or indirect interest in a legal person with which a joint stock company has or intends to enter into a business relationship and cannot decide on matters pertaining to this relationship. In the case of an opposite treatment, the company shall be entitled to compensation for damages, while the chair and members of the supervisory board will be jointly and severally liable for damages caused by failure to perform or negligent performance of their duties. The duty of reporting also applies to managers who may participate in such a business relationship solely if a written consent of the chairman of the supervisory board has been provided. As for the shareholders, they are excluded only from voting on decisions related to their actions, claims and liability to the company (LoC F B&H Art 34-35, 199, 264-279). The Law on Securities Market in FB&H defines related persons within the meaning of that Law, as well as the concept of control over a legal entity.

On the other hand, the Law on Companies in other entity of B&H (LoC RS) uses the Law on Companies of the Republic of Serbia from 2004 as a model and transplants the common law institute of fiduciary duty. Thus, in the RS controlling shareholders and board members are required to act conscientiously and loyally towards the company. They are required not to use the company's assets for their personal interests and privileged information for personal enrichment, not to abuse the position for personal enrichment, not to exploit the company's business opportunities for their personal needs, etc.

It is precisely defined what would be considered a personal interest in the above sense. Thus, according to the LoC RS personal interest exists if a person that has a duty to the company or a member of his family is: (a) a party to a legal transaction with the company, (b) in a financial relationship with a person in the legal transaction or action that concludes a contract with the company or has a financial interest in the transaction or action on the basis of which could reasonably be expected to influence his conduct contrary to the interests of the company, and (c) is under a controlling influence of a party from the legal transaction or action, or a person who has a financial interest in the legal transaction or action, so that it can be reasonably expected to influence his conduct contrary to the interests of the company. The Law also defines the related parties and persons who will be considered as family members.

The LoC of the RS allows the conclusion of legal transactions which involve a conflict of interest if they are approved, in good faith and with knowledge of all material facts concerning the personal interest, by a majority vote of the board members who have no interest in that transaction, and in case such a majority does not exist, by a majority vote of shareholders who have no personal interest. The general meeting is being informed about the board approval and the legal transaction.

A shareholder in the RS cannot vote at the meeting when deciding on: the exemption from or reduction of its liabilities and related party's obligations to the company, the initiation or withdrawal of a litigation against him or the related party, the approval of transactions in which there is a conflict of interest between him/related parties and the company, the exclusion of pre-emption rights in a private share offering in which he and/or a related party is a pre-known customer, the establishment and association with other legal person in which he and/or related party has a share greater than 5% of the equity and payment of dividends to employees and board members in the event that the related person(s) has that status in the company. If approval is not granted such a transaction is null and void.

In addition, in the RS a 2/3 majority of represented voting shares need to approve a contract on special relationship between the parent and its subsidiaries or on transfer of profits. In case of violation of the rules on conflict of interest and prohibiting competition, in addition to the right to compensation, the company shall be entitled to recognition of such transactions as transactions performed on behalf of the company, including the right to the collected amount and all claims arising from the transaction, and these rights also belong to a shareholder who has or represents at least 5% of the equity (LoC RS Art 33-39, 291, 309, 319, 366).

Disclosure of related party transactions

It is known that the disclosure requirements in many countries around the world were tightened following recent corporate scandals and the global financial crisis. When it comes to disclosures on RPTs, one should distinguish between ex ante disclosures that are required of parties involved in the transaction prior to its eventual approval and periodic disclosures in reports such as the annual report, which usually are of ex post character. Disclosure may be required in the financial and annual reports, reports submitted to the shareholders before the general meeting, reports to the national regulator, etc.

The question of which information about such a transaction should be disclosed is of a paramount importance. Many jurisdictions use the concept of material information in determining which kind of information should be disclosed, as the information whose omission or wrong expression could influence the decisions of users of this information, with the emphasis on timeliness (IOSCO, 2009, p 15). The issue of regulation is quite complex and raises a number of questions. For example, Austria and Switzerland have strict regulations regarding disclosure, but only of 'material' transactions that are not carried out 'in the ordinary course of business'. However, considering that legal systems of these countries do not provide a definition of such transactions, there is a possibility that RPTs with the value of more than 10% of the company's assets are considered to be carried out 'in the ordinary course of business'. In contrast, the Belgian and French laws define the 'ordinary course of business' so as to exclude transactions with the value of 10% or more of the assets (WB&IFC, 2010, p 50).

Some national regulators introduce requirements for disclosure of the company's procedures for review and approval of such transactions. Regarding the fact that ex ante transactions are also subject to these disclosure requirements, Ryngaert and Thomas (2011) based on their study results conclude that the additional disclosure requirements should be aimed at assisting investors in distinguishing ex ante from ex post transactions. The EU Action plan requires the listed companies to include reports on corporate governance in their annual reports, which among other things should disclose direct and indirect relationships of shareholders with major ownership rights with the company, and all the material transactions with other related parties.

The current requirements in terms of disclosure and transparency in B&H are generally assessed as relatively high. Financial reporting is regulated by the entity laws on accounting and auditing that came into force as of January 2010. Companies are required to apply the International Accounting Standards and International Financial Reporting Standards. However, it seems that a 'profound transformation in the attitude of all participants to the very idea of transparency' (Đulić, 2008, p 82) is needed i.e. the companies must recognize their own interests in it while investors must show a greater demand for information.

According to IAS 24 RPTs are disclosed in company's financial statements. The Standard requires disclosing the nature of relationship between the parties and information about the transactions that are needed for understanding the potential effects on financial statements. It is allowed to disclose that the transactions occurred under conditions corresponding to those prevailing in transactions at arm's length only if it can be substantiated. The Standard also requires disclosure of compensation paid to the management in total and for each of the defined categories, and disclosure of relationship between the parent and its subsidiaries. Generally, it is appropriate to disclose the relationship between the parties in case of existing control, irrespective of whether any transactions occurred.

Liability of board members

Given that even RPTs which have been approved in accordance with the law and properly disclosed can be harmful to the company, attention is paid to the possibilities of achieving compensation through the courts i.e. the rights of minority shareholders to require annulment of the transaction and raise the complaint, the provisions on liability of the board members and the right to collect evidence in order to prove wrongdoing. Djankov et al (2008, p 436) particularly emphasize the importance of the assumption on fulfilling all the requirements in respect of the approval and disclosure.

Generally, in most countries there are rules on directors' liability in such situations, but those rules have many gaps. Although the value of extent of director liability index for B&H is above the regional average, it is important to note that the LoC FB&H provides neither possibility of subsequent annulment of the transaction nor the possibility of raising direct or derivative suit by shareholders. Attention is drawn to the fact that the report does not provide the information on how the indices were calculated for the B&H which is characterized by different entity rules (WB&IFC, 2010).

The ease of shareholder suits index provides a measure of kinds of evidence that can be collected before and during the trial. In most jurisdictions the right to compensation belongs to the company and not to individual shareholders. Minority shareholders often face numerous obstacles in raising derivative claims so the access to corporate information and the efficiency of the judiciary are of great importance.

Conclusion

The most important issues in regulating RPTs include approving and disclosing those transactions, liability of board members and controlling shareholders and possible legal actions in case the company suffers damages. Economies with the greatest investor protection are characterized by precise definitions of RPTs, comprehensive disclosure requirements, shareholder participation in making key decisions, clear standards on insiders' liability and well-functioning judiciary.

The approval mechanisms work well only if there are no many exceptions to the rule and approval is required at the time of the transaction occurrence. Requesting the approval of a majority of minority shareholders for self-dealing transactions Goshen (2003) considers being a key mechanism for their protection. The LoC FB&H does not contain specific provisions on RPTs and their approval. The chair and members of supervisory boards in the FB&H are obliged to report to the supervisory board the existence of every direct or indirect interest in a legal person with which a joint stock company has or intends to enter into a business relationship and cannot decide on matters pertaining to this relationship. The duty of reporting also applies to managers. On the other hand, the LoC RS transplants the common law institute of fiduciary duty, and controlling shareholders and board members are required to act conscientiously and loyally towards the company.

Many jurisdictions use the concept of material information in determining which kind of information should be disclosed, as the information whose omission or wrong expression could influence the decisions of users of this information, with the emphasis on timeliness. Given that even RPTs which have been approved in accordance with the law and properly disclosed can be harmful to the company, attention is also paid to the possibilities of achieving compensation through the courts. The LoC FB&H provides neither possibility of subsequent annulment of the transaction nor the possibility of raising direct or derivative suit by shareholders.

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INSTITUTIONAL DETERMINANTS OF CORPORATE GOVERNANCE AND METHODOLOGICAL DISCONTINUITY OF CORPORATE PERFORMANCE MEASUREMENT IN MONTENEGRO

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Abstract

This case study on corporate governance aims to shed light on the question of institutional determinants of corporate governance in Montenegro and its implications for methodological discontinuity of corporate performance measurement. A method of descriptive research design and secondary sources of data have been used to describe the issue in line with concepts developed in: (1) the theoretical model on diversity of corporate governance determinants and dimensions developed by Aguilera and Jackson, complemented with Helmke and Levitsky's framework of informal institutions in corporate governance, and (2) Dossi, Patelli and Zoni transaction costs economics form of governance structures with emphases on the design of corporate performance measurement systems. The main inference is that there is a methodological discontinuity in corporate performance measurement due to the discontinuity in development of corporate governance. This inference should be further empirically tested in future researches on compatibility of corporate performance measurement systems in transitional countries with those used in developed market economies, serving as a measure of progress made in corporate governance development.

Keywords: corporate governance, institutions (formal and informal), corporate performance measurement

Introduction

While a national institutional environment by no means determines its corporate governance , in this paper we take a more individual methodological approach to describe institutional arrangements that focus on the business firm. The emphasis is on the structure of rights and responsibilities of stakeholders of the firm and its implications for methodological discontinuity of business performance measurement under contemporary transitional circumstances in Montenegro. Despite the privatisation process in this country has been almost completed and governance structures are seemingly close to those in developed market economies, there are firms in several important sectors, such as aluminium, steel, transportation, energy, mining and tourism industries, that are yet to be privatised (Privatisation and Capital Investment Council, 2011) or that have been either owned by controversial private investors or unsuccessfully privatised (Krcic, 2008). These conditions exercise a significant influence on Montenegrin corporate governance institutions and practice, particularly if perceived and evaluated from the perspective of Montenegrin European accession process (EBRD, 2011).

In attempt to make a descriptive insight into the question of what institutions, and in what ways, determine corporate governance in Montenegro and how it influences methodological discontinuity in corporate governance measurement over transition process, we structure the approach around two blocks: (1) institutional configuration, and (2) methodological discontinuity of corporate performance measurement.

Institutional configuration

We approach the institutional configuration of Montenegrin corporate governance from the points of view of its formal and informal determinants. For the formal institutional determinants we borrow from Aguilera and Jackson's (2003) model aimed at examining corporate governance in advanced capitalist economies, presuming moderate economic development and an established rule of law . Nevertheless, we find it could be used as complementary approach along with Helmke and Levitsky's (2004) framework of informal institutions in corporate governance since it takes into consideration a social construction of interests i.e. interplay of institutions and firm-level actors, and their embeddedness in different social contexts.

Aguilera and Jackson, firstly, associate several dimensions of possible behaviour to each – capital, labour and management stakeholder. Secondly, they specify institutional domains/ determinants that shape their behaviour. Thirdly, and of a particular value, are propositions they developed to explain how each institutional domain separately shape stakeholder behaviour along each dimension, allowing for numerous interplays i.e. sets of combinations and interactions that result in a specific national configuration of corporate governance system, enabling more sophisticated classification than Anglo-American vs. German/ Japanese grouping allows.

On the other side, since the most important issues of Montenegrin European accession process are those of rule of law, corruption and organised crime (World Bank, 2009b; EC 2011) corporate stakeholders can not avoid the influence of informal institutions, either. For that purpose we will use Helmke and Levitsky's framework that examines influence of informal institutions on: (1) effectiveness of formal institutions of corporate governance, and (2) compatibility of goals between formal and informal institutions of corporate governance.

Capital institutional determinants

As to the institutional determinants that shape capital control over firm's resources Aguilera and Jackson addressed institutional domains of property rights, interfirm networks and financial system. These domains influence capital stakeholder to behave in following manners: financial versus strategic, liquidity versus commitment and equity versus debt oriented behaviour.

The domain of property rights in Montenegro is characterised by large shareholders that are in advantageous position due to the institutional gap between market–based legal features of corporate governance, market-based financial system, privatisation process based on dispersed mass-voucher ownership, on one hand, and a high degree of ownership concentration in post-privatisation period with 45-50% shares in a possession of the first top owner (Kalezic, 2010, p 37), underdeveloped capital market, debt financing and commitment as a controlling mechanism (Heritage, 2011), on the other hand. As Aguilera and Jackson argued, under these conditions capital tends to pursue strategic interests toward the firm and exercise control through commitment.

When interfirm networks domain is concerned, the networks that shape the way firms access critical resources and information, then if there is a high degree of multiplexity in interfirm networks capital exerts a strategic type of interests over the firm and pursue control through commitment. It could be speculated that under Montenegrin transitional circumstances the nature of interfirm networks is determined by informal ties, as illustratively described in ICIJ/CIN report (200-) on Montenegrin ex Prime Minister Djukanovic's business of strong family and friends ties that enable them the access to critical resources and information.

In a domain of financial system Montenegro adopted the system that is close to Anglo-Saxon legal traits where interfirm networks are looser. In addition to already mentioned debt financing and commitment as a controlling mechanism (Heritage, 2011), Backovic-Vulic research showed that Montenegrin capital market is small, emerging and inefficient, supporting a reasoning stated in the World Bank survey (2009b) that in these circumstances firms tend to rely on internal funds and extended informal family and friends sources. To summarise, it seems that capital in Montenegro is strategically committed toward bank financed informal family and friends networks.

Labour institutional determinants

Aguilera and Jackson propositions that addresses labour control over the firm resources distinguish following three institutional domains - representation rights, union organisation and skill formation, each of them shaping labour behaviour toward participation versus control and portable versus firm specific skills.

As in other post-socialist countries, privatisation process in Montenegro has significantly changed a position of labour. It is almost entirely opposite to the institutional position of capital – from an ex post residual right claimants to a mere factor of production with no participation in corporate governance envisioned by Company Law (Privatisation and Capital Investment Council, 2002). Still, labour representation at firm and industry levels, and national and municipal levels, is regulated by three laws in last five years: Law on Social Council, Labour Law and Law on Trade Union Representation. Despite the labour has not a formal participatory but collective bargaining and representative role in companies, according to the Eurofound survey (2010), encouragement to participate in important decisions is at a relatively high level of 75.1%. On the other hand, on-the-job-training is at the level of 11.9% (op cit), which is the lowest in the region, making skills of employees rather portable than firm specific.

Taking into account that the degree of labour market freedom in Montenegro is assessed as significant (Heritage, 2011) with a persisting skill mismatch and high unemployment rate reported by European Commission (EC, 2011), and that there is more than three times higher average number of permanent full time workers in Montenegrin large companies than in its counterparts in Eastern Europe & Central Asia and upper middle income countries (World Bank, 2009b), series of strikes that have happened over last few years in various industries, just to mention those in aluminium, steel and mining industries, as well as in public administration, a plethora of issues emerged relating to labour behaviour in terms of its real participation vs. control in decision making and portable vs. firm specific skills it holds.

Management institutional determinants

Aguilera and Jackson find ideology and careers as being complex institutional domains that determine management orientation toward the firm along two dimensions: autonomous versus committed and financial versus functional orientation. They set focus to a value-based legitimization of managerial authority and goals, different from typologies of various management ideologies (as German corporatism, French cadre system, British laissez-faire) or national cultures.

Particularly important for Montenegrin circumstances is their argumentation that managerial ideologies are influenced by their educational background, shared models of managerial control, on the one hand, and informal norms and routines that shape the degree of managerial autonomy i.e. hierarchically structured decision-making, on the other. Following this line of reasoning Montenegro seems to have managerial ideology shaped by: (1) general management education system, with an emphasis on finance rather than scientific specialization, (2) formally promoted management culture, based on shareholder values and financial control (Vukotic, 2009), (3) informal norms that foster managerial commitment to relationships and informal networks external to the firm, and functional type of control that goes hand in hand with the informal networks of business groups, familial networks, state through the local Party, bureaucratic elites and oligarchic shareholders (ICIJ/CIN, 200-; Perovic-Korac and Tadic-Mijovic, 2011; Radulovic, 2011a).

It is easy to see that model of shareholder control that has been formally promoted is not coupled with the proper degree of managerial autonomy, on the contrary – high degree of managerial commitment to informal external ties doesn't even fit into the managerial ideology whereby managers are committed to the firm and its functional type of control, as they are in economies with higher degree of ownership concentration.

The second institutional domain that influences management behaviour is a domain of management career patterns that could be developed within closed or open managerial labour markets, each being characterised by a plethora of incentives and opportunities for top management mobility. In case of Montenegro there is a gap between formally adopted model of an open market and the informal labour market that actually works - vacancies are often filled via political memberships and connections, managers are generalists exercising loyalty to the ruling elite, and their promotion and remuneration depend on their attachment to the same elite, no matter if they spend their careers within one or in numerous firms (Vijesti, 2011).

Institutional interplay

As argued by Aguilera and Jackson, a combination of capital, labour and management institutional domains make unique national institutional configuration that shape a mode of its corporate governance i.e. behaviour among firm stakeholders. If different institutional domains contribute to the same stakeholder behaviour along each dimension of behaviour then those domains are said to be complementary, as opposed to the situation when institutional domains are conflicting. It is interesting to see that in Montenegrin corporate governance almost all institutional domains, formally perceived, should shape very clear stakeholder behaviour toward: (1) financial, liquidity and equity oriented capital, (2) controlled labour with portable skills, and (3) autonomous and financial oriented management. Still, in practice: (1) capital is strategically oriented and committed toward external informal networks, and it is debt oriented, (2) labour is often controlled at the firm level, but at the industry level it has a certain degree of power, while having skills that are more portable than firm specific, and (3) management is committed toward interests of external informal networks and exercises functional control in favour of those interests. These inconsistencies are subject to further research, presumably in a domain of informal institutions and their influence on stakeholder behaviour, as addressed later on within the section on informal institutions.

Stakeholder interactions

In addition to institutional impact on each stakeholder, institutions influence interactions that arise among stakeholders by structuring conflicts or coalitions and defining a range of various outcomes (Scharpl, 1997 cited in Aguilera and Jackson, 2011, p 459): class conflict, insider-outsider conflict and accountability conflict.

Class conflict

UNHCR Survey (2010) clearly addressed problems that arise from law that regulates right to collective bargaining and strike. Also, anti-union discrimination and employers threats to sue strikers are not uncommon in practice. Concerning distributional issues, illustrative examples are aluminium and steel industries that continue to struggle in face of wage arrears and factory closures, while credibility of owners (among them the State), their profits and soft budget constraints disputable (MANS, 2005-2010; Pokret za promjene, 2011). In addition, Montenegro is among the most unequal countries in the Western Balkans with a prospect of widening gap between rich and poor (UNDP, 2006) culminating in series of strikes.

Having in mind that both capital and management have aligned their interests with external informal networks, neglecting employees' interests in stable employment, regular and satisfactory wage, it seems that an issue of whose interests firms actually serve should be additionally addressed.

Insider-outsider conflicts

When labour and management i.e. insider interests are in conflict with those of outsider owners of capital, than there is a possibility for insider-outsider conflicts to arise. As we have seen earlier, Montenegrin corporate governance is characterised by a high degree of ownership concentration in post-privatisation period, close management alignment to interests of large shareholders and informal external networks, labour market under the control of informal external networks and labour skills that are more portable than firm specific, not fully workable protection of minority shareholders rights and stock market functioning in their early phases of institutional development, and shareholder activism almost unknown in a practice. All these factors enhance prospects for insider-outsider conflicts to emerge, albeit they rarely explicitly happen in Montenegro, due to a privileged position of large stakeholders and management attachment to their interests.

Accountability conflicts

The accountability issue concerns interests of capital and labour in relation to interests of management. If both capital and labour are strategically oriented toward firm then management can not practice autonomous behaviour toward fulfilment of its own financial interests, as in German corporate governance system of committed block-holders and labour participation in supervisory board. But when their interests are in sharp contrast, as it could be in Anglo-American corporate governance, then management is considerable autonomous in pursuing its own goals via "managerial firm". Situation in Montenegro is far from that one of common strategic interests of capital and labour and their commitment to the firm, as described under previous section on class conflicts. It is neither a situation that enables managers to pursue their own goals, since management is strongly aligned with interests of large shareholders that are externally networked through informal institutions.

Informal institutions

Since Aguilera and Jackson's model is useful in explaining corporate governance in developed countries where the rule of law is at the significant level, it is not surprising that behaviour of corporate stakeholders in Montenegro appeared to be inconsistent with the propositions they developed. In addition, Murrell (2005) emphasised that in a course of transition change within existing firms takes more time than change in institutions, and that natural selection is possibly required for their alignment, while informal incentives and constraints underlie real behaviour of firm and undermine formal institutions. Therefore, it is necessary to encompass both, informal and formal, institutions of corporate governance within one framework. For that purpose the framework that Helmke and Levitsky (2004) developed on the ideas of Douglas North (1991) could be useful for further research of the issue. They examine two characteristics of informal institutions: (1) their influence on effectiveness of formal institutions of corporate governance, and (2) degree of compatibility between stakeholder goals in formal and informal institutions of corporate governance. On that basis they classified a variety of informal structures in four types of institutions: complementary, accommodating, competing and substitutive.

Taking into account characteristics of Montenegrin corporate governance discussed earlier in the paper, along with a considerable concern of public opinion on corruption (UNODC, 2011), no action to prosecute high-level corruption (Uljarevic and Muk, 2011), unclear origin of funds used to acquire companies or business during privatisation that is lacking in transparency (Know Your Country, 2011) and privatisation area being recognised by Montenegrin Government (Ministry of Finance, 2011) as an area of corruption under special risk, it can be implied that despite the existence of market supporting laws and codes of governance (Komisija za hartije od vrijednosti, 2009; Montenegroberza, 2009) they are not legally enforced due to judicial inefficiency and corruption (European Commission, 2011). On the other hand, as documented in numerous cases of privatisation (MANS, 2011), formal agents and agents working within informal institutions (business groups, familial networks, state through the local Party, bureaucratic elites, oligarchic shareholders) are not working toward the same goals. It seems that, due to the similar influence of informal institutions, the approach that Estrin and Prevezer (2010) suggested for Russia could be adopted for the examination of relationship between formal and informal corporate governance institutions in Montenegro. As they say:

'For Russia, where the key informal institution has been identified as the operation of blat networks, the perspective and level of analysis should be through an analysis of those networks and how they intersect with ownership and control arrangements. So for an understanding of the working of governance in Russia and how formal rules interact with informal, it would be important to pinpoint empirically who shareholders of companies are, the extent of their interlocks across companies, the composition of networks and to get some handle on how these networks cut across formal rules and how they compete with official institutions'. (p 31)

In a word, various information support the stance that formal and informal institutions in Montenegro work against each other, undermining market functioning and question the functioning of formally adopted corporate governance institutions and policies.

Methodological discontinuity of corporate performance measurement

Transition to a market economy certainly means a change of governance structure from dominantly hierarchical toward market dominated and hybrid governance structures, each being different from a transaction costs perspective. As Murrell (2005) pointed out, it requires a sophisticated governance mechanisms to avoid a hold-up problem that emerged from a dissolution of large socialist firms and escape high transaction costs due to negotiating, contract enforcement and implementation of contract, specification of control rights and mechanisms of resource allocation. Hence, in the absence of mature formal institutions - socialist are replaced by capitalist that are still developing) - firms have joined informal governance networks for support. In that sense Balcerowicz's classification (Boehlke, 2010) is useful since it takes into account different types of economic systems - market capitalism, scientific socialism, market socialism, distorted capitalism or quasi-capitalism, and tightly controlled interim economy - that differ along three dimensions: entrepreneurial regime, ownership structure and coordination mechanism. He also pointed out that each type of economic system has its specific efficiency indicators, companies' internal structures, behaviours and corporate governance mechanisms. Moreover, Boehlke argues that there is a methodological discontinuity in analysis between socialist and capitalist enterprises, since there is no total compatibility of respective instruments of analysis.

This methodological discontinuity is obvious in case of Montenegro where its previous system of self-governed mixed economy has been established on the basis of social property, different from state property, and the labour as a representative of interests of non-class society. Prasnikar, Svejnar, Mihaljek and Prasnikar (1994) presented a general theoretical framework that adequately portrayed the behaviour of participatory firms in which the main stakeholders were labour, management and government officials. It is a tripartite bargaining model which is, by inertia, still informally present in those Montenegrin firms that have been either partially or unsuccessfully privatised, with the accompanying soft budget constraints that cover management and Government bad decisions (Radulovic, 2011b). It should be emphasised that there is no a transitional institutional corporate governance model in Montenegro that could be compared with the transitional model deliberately developed in China that allows for gradual changes in formal corporate governance institutions.

Nowadays, corporate governance in Montenegro is formally similar to the Anglo-Saxon system but significantly influenced by informal rules that don't support formally adopted system. It is interesting to see how in these circumstances various formal and informal stakeholders align their interests i.e. in what degree corporate performance measurement system and managerial incentives are compatible with the systems that are in use in developed market economies. We follow Dossi, Patelli and Zoni's work (2010) who examined corporate performance measurement systems (CPMSs) and chief executive officers incentive plans (CEOIPs) from transaction costs perspective i.e. governance structures point of view. They examine CPMSs and CEOIPs as control systems that govern the relationship between owners and managers and propose the design of the systems to be contingent on the form of governance. Specifically, for emerging markets, that is also relevant for the Montenegro's economy (EBRD, 2011), they stated:

'Stock markets in emerging markets are affected by numerous inefficiencies and investor protection is weak. Writing and enforcing complete contracts is difficult. Hence, the governance of large publicly traded firms in emerging markets should rely on a complex mix of forces exercised by the financial market, organizational hierarchy, government intervention, and international partnerships. Within such hybrid governance structures, the integration between CPMS and CEOIP could support better achievement of management control by avoiding the separation between the investors, the CEO, and the organization, and by reducing risk of opportunism'. (p 549)

This moves us back to the issue of institutions of corporate governance examined earlier, concerning institutional interplay and informal networks, in other words, to the questions of who are the owners of Montenegrin firms, what their interests are and what kind of management compensations are in use to align competing stakeholder interests and achieve management control. Montenegrin experience in privatisation shows that the mix of forces exercised by the financial market, organisational hierarchy, government intervention and international partnerships has often been matched in a way that favours controversial informal external networks, as it has been shown up in numerous privatisation cases (ICIJ/CIN, 200-; Krcic, 2009; MANS, 2011; Radulovic, 2011a).

To make a progress toward market supportive corporate governance performance measurement systems, at least two questions should be examined in further researches: firstly, what are formal and informal CPMSs and CEOIPs that are in use in Montenegro, and secondly, in what degree they are complementary to those functioning in developed market economies.

Conclusion

This case study shed light on the formal and informal institutions of corporate governance in Montenegro and their implications for methodological discontinuity of corporate performance measurement. The individual methodological approach focused on rights and responsibilities of firm stakeholders indicates that institutional determinants are not in accordance with the formally adopted market oriented corporate governance system and that informal institutions have prevailing effects on stakeholder behaviour undermining market based functioning of corporate governance. Further, the transitional discontinuity in corporate governance system, as a result of change from a participatory to the market envisioned albeit in practice distorted governance system, has radically changed positions and relationships among different stakeholders. It inevitably led to a methodological discontinuity in the ways corporations align organisational goals with stakeholder interests i.e. in ways of corporate performance measurement, particularly under circumstances that support management to be committed to external informal networks, as indicative of Montenegro. Nevertheless, indications presented in this case study should be empirically tested in future researches on corporate governance both in Montenegro and in countries that have similar institutional determinants and stakeholder behaviours. It would enable more general conclusions to be drawn and national corporate governance politics to be improved in support of development of a viable corporate governance system.

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CROSS-BORDER MERGERS AND ACQUISITIONS IN SOUTHEAST EUROPE: CASES FROM CROATIA, ROMANIA AND BULGARIA

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Abstract

Researches regarding cross-border M&A are present in economic literature for a long time period starting from 1890s, but nowadays in time of globalization their impact is particularly remarkable in terms of size and geographical dispersion. The focal interests of this paper are cross-border transactions in selected Southeast European countries. These countries (Croatia, Romania and Bulgaria) are deficient in cross-border transaction analysis and are interesting for academic research since they are comparable economies and resemble in political history. Analyzed transactions were cross-border mergers and acquisitions, precisely cross-border acquisitions since they account more than 95% of all cross-border transactions in selected countries. Results indicate that trends in M&A activities in selected countries are consistent with general - national and globe – economic tendencies. Furthermore, the dynamics of cross-border M&As are largely similar to those of domestic M&As for each country, even though they differ in volume. However, due to their international nature, cross-border M&As also involve unique challenges, as countries have different economic, institutional (i.e., regulatory), and cultural structures. Due to the growing importance and popularity of cross-border M&As, this study provides relevant review of the extant literature across different areas, applicable empirical research concerning influence of cross-border M&As for economic development of transition economies and finally provides potential areas for future research.

Keywords: cross-border M&As, Croatia, Romania, Bulgaria

Introduction

In turbulent business environment of 21st century companies are forced to use different growth strategies in order to successfully position with respect to competition and to preserve and increase their profit margins. Growth strategy is part of the corporate strategy which emphasizes corporation as a whole and provides answers regarding business scope of the corporation and recourse allocation (Tipurić, 2005). Growth strategies are concerned with increasing the size and viability of the business over time. A successful growth strategy will allow companies to increase its customer base, market segments, geographical scope, and/or product lines, which should lead to revenue growth. Permanent growth enables them to build and sustain their competitive market position. In planning growth strategies, managers are concerned with three key issues: (1) where do we allocate resources within our business in order to achieve growth, (2) what changes in business scope do we see as compatible with growth and overall strategic decision, and (3) how do we time our growth moves compared to competitors (Harrison and St. John, 2008)?

In the following section we define mergers and acquisitions. The focal interests of the paper are cross-border transactions and we provided relevant literature review across different areas. Analysis of cross-border M&As was conducted in transition economies. Selected Southeast European countries are Croatia, Romania and Bulgaria. Analyzed transactions were cross-border mergers and acquisitions, precisely cross-border acquisitions since they account more than 95% of all cross-border transactions in selected countries. In conclusion we stress the importance of M&As as growth strategies but also the importance of organizational variables for cross-border M&A success.

Conceptualization of M&A

Acquisition refers to purchase of controlling interest of company “A” in company “B”. Controlling interest presents purchase of more than 50% voting shares of company “B”. In most cases, payment instrument of controlling interest is cash, shares of company “A” or combination of cash and shares. Acquirer is usually bigger than target company (Agwin, 2007). Target company becomes an integral part of a company that is bigger, has larger market share and occasionally takes its name. Sometimes target company keeps its own name while operating within the new group but loses operational autonomy and instead of its previous strategy uses the strategy of acquirer company (Tipurić and Markulin, 2002). According to the Companies Act regarding acquisition of one or more companies from another company, one or more company can transfer all its assets (assets of target) to another company (Barbić, 2007).

In foreign and domestic literature just like in business world, English terms takeover and acquisition are often used as synonyms. Regardless the facts that there is no tangible difference between these two terms, in practice and literature, these terms are used interchangeably. Main distinction is reflected in the fact that the term takeover is used to indicate a hostile takeover in which the target company resists the takeover, while the term acquisition is used more for takeovers that have a friendly character (Orsag and Gulin, 1996).

Friendly takeover is one in which management of target company does not resist the takeover and thinks that it is good option for owners of the company. In this situation, the management of target company, after an agreement on the sale of shares to the acquirer, informs the owners about the sale and advises them to sell their shares too. In most cases the owners are asked to transfer their shares to a specific financial institution with authorization under which their shares are transferred to the acquirer (Birgham and Ehrhardt, 2005). A hostile takeover is a takeover in which management of the target company opposes takeover and thinks that it is not good option for owners of the company. In a hostile takeover there is no agreement between the management of target company and acquirer, and the management of acquirer is trying to buy shares of the target company directly from the shareholders through a hostile tender offer trying to avoid the management of target company (DePamphilis, 2008). Takeover can be characterized as hostile if management of target company rejects takeover bid and acquirer persists in takeover and in the case when management starts the acquisition without informing the management target company. In the case of a successful hostile takeover the management of target company is usually replaced as opposed to friendly takeover when management of target company retains in many cases the position it had before the acquisition (Tipurić, 2008). Hostile takeovers are often closed at a much higher price than friendly takeovers because they can attract other bidders who initially were not interested in target company. For this reason and due to the fact that the integration of target company in the acquiring business system is much faster the takeover actors tend to favour acquisitions which have a friendly character (DePamphilis, 2010).

Unlike takeovers, where one company buys another and continues to operate integrating acquired company into his own business system, the merger is joining two or more companies. During the merger of two or more companies result is a new company, and companies that were independent before cease to exist (Nickels, McHugh and McHugh, 2002). In accordance with the theoretical knowledge gained in the merger process, as a rule, egalitarian companies decide to merge in order to form a new organization with an emphasis on retaining the best business practices of all participants in the merger process. Mergers are always characterized by a voluntarily of all participant in such process, they are usually financed by exchanging shares. In practice, usually two companies are joining the new business entity. Replacement ratios depend on market prices of both companies (Tipurić, 2008). Name of new business entity usually involves names of both companies involved in merger. For example, the merger of Pricewaterhouse and Coopers & Lybrand has resulted in a new name PricewaterhouseCoopers (Agwin, 2007). According to the Companies Act two or more corporations can merge so that the liquidation is not carried out, establishing a new company which passes the entire assets of each of the companies that come together in exchange for shares of new company (Barbić, 2007).

The Companies Act also defines a cross-border merger. Under the provisions of the Act cross-border merger is a merger in which at least one of the participating companies in the merger, is publicly traded or limited liability company duly incorporated according to Croatian law and at least one of the companies participating in the merger is capital company in the sense of Article 2 Item 1 2005/56/EZ Directive of the European Parliament, which has been duly incorporated under the law of other country of the European Union or a country that is contracting party of Treaty on the European Economic Area. Cross-border is also a merger where one of companies is duly incorporated and has its headquarters in a country that is not a member of the European Union nor the Contracting Parties of the Treaty on the European Economic Area, and provided that the other company is duly incorporated according to Croatian law and has registered office, central administration or central place of business in the Republic of Croatia (Barbić, 2008).

Characteristics of cross-border M&A activities

The increasing globalization of business has heightened the opportunities and pressures to engage in cross-border M&A activities (Hitt, 2000). Herein we define cross-border M&As as those involving an acquirer firm and a target firm whose headquarters are located in different home countries. Several factors are responsible for fuelling the growth of cross-border M&As. Among these factors are the worldwide phenomenon of industry consolidation and privatization, and the liberalization of economies.

Despite the increasing popularity of mergers and acquisitions, it has been reported that, more than two-thirds of large merger deals fail to create value for shareholders. Ravenshaft and Scherer found that profitability of target companies, on average declines after an acquisition. The propensity for mergers and acquisitions' failure to meet anticipated goals is corroborated by Erez-Rein et al. (2004) and Carleton (1997) who noted that the rate of M&A failure range from 55 to 70 percent (Lodorfos and Boateng, 2006). Cross-border M&A activities due to their international nature, also have unique challenges as countries have different economic, institutional and cultural structure (Hofstede, 2001).

Cross-border M&A activities pose tremendous challenges, in particular in the post-acquisition stage (Child, Falkner and Pitkethly, 2001). Recent evidence suggests that they are not highly successful. For example, a study by KPMG found approximately that only 17% of cross-border M&As create shareholder value, while 53% destroyed it. Given the increasing number of cross-border M&As and their growing importance in the global market, a better understanding of the opportunities and challenges for the firms following this growth strategy is required.

Cross-border mergers and acquisitions process should be seen as a series of largely independent events, culminating in the transfer of ownership from the seller to the buyer rather than just an independent event. In theory, thinking of a process as discrete events facilitates the communication and understanding of numerous activities required to complete the transaction. Thinking of M&As in the context of transaction-tested process, while not ensuring success, increases the probability of meeting or exceeding expectations (DePhampilis, 2010). When pursuing cross-border M&As, firms consider various conditions, including country-industry-and firm-level factors, which relate both to the acquiring and to the target firm. At national and industry level, factors such as capital, labour and national resource endowments, in addition to institutional variables such as legal, political and cultural environment, are highly significant. At the firm level, organizations pursing an international strategy need to identify and evaluate potential targets to acquire in the host countries (Shimizu, et al, 2004).

Cross-border mergers and acquisitions result in major changes in lives of corporations and those employed by them. The changes occasioned by acquisitions are often wide ranging. They may change strategies, operations, cultures, the relationship between staff and managers, team relationships, power structures, incentive structures and job prospects. Cross-border M&A may require individuals to change their life styles, behaviour, personal beliefs and value systems. Acquisitions create anxiety, fear and often are traumatic events for those who might lose their jobs (Reilly, Brett and Stroh, 1993). However, it is not just the merger that makes employees anxious, it is the perceived decline in the organization before the merger takes place, the lack of other jobs elsewhere, or other constraints that do not allow the employee to leave that create excessive stress. The turbulence associated with acquisitions may impact on career loyalty, organizational loyalty, job involvement and satisfaction with job security. Employees have been known to experience the merger as a loss of a loved one, or may vicariously live the situation as a personal crisis and panic. When an organization merges with another, employees feel as though they have lost control over important aspects of their lives. That creates heightened stress within the individual, which usually leads to lower productivity and reduced job satisfaction. In case of underperforming target companies, there may be dissatisfaction with present and therefore greater readiness to accept the imperative of change. Change is always opportunity for someone and threat for other. Managers may see change as an opportunity to profit out of their stock options while lower level managers may see change as a threat (Sudarsanam, 2005).

Cross-border mergers and acquisitions have, historically, been analyzed from economic perspectives like transaction cost economics and ownership-location-internalization framework (Williamson, 1975; Dunning, 1993). A major focus in these researches has been the uncertainty and risk associated with different national cultures and institutional settings. These frameworks provide limited insights for M&As implementation processes. Recent research has examined the value of international expansion and cross-border M&As from resource-based perspective and organizational learning perspective (Vermeulen and Barkema, 2001). Given the increasing strategic importance of cross-border M&As, both from practitioner and research perspective, Shimizu, et al (2004) suggest that additional theoretical insights and broader focus of research are required.

Comparison of cross-border M&A activities in selected Southeast European countries

The focal interests of the paper are cross-border transactions in Croatia, Romania and Bulgaria. Data was obtained from Mergermarket database covering transactions of 5 million USD and more in the time horizon from 1998 until 2010. Cross-border M&A values are reported at the time when the deal was announced.

Dynamics and volume of M&A activities reflect the economic growth intensity as well as economic recession and periods of recovery. Table 1. presents M&A activities in Croatia, Romania, Bulgaria, EU and world from 1998 until 2010. Analyzed time period from 1998 until 2010 is chosen because of few reasons. Firstly, it covers period of growth and prevalent dynamics as well as period of recession and severe activity decline. Furthermore, major M&A activities started in 1999 and 2000.

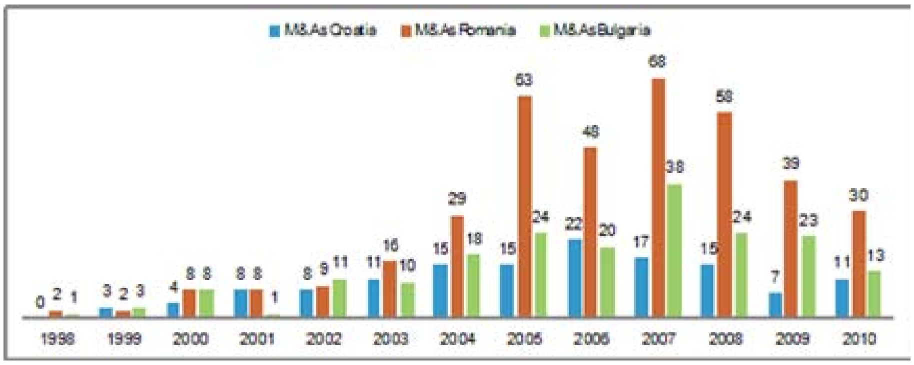
The end of 20th century and beginning of 21st century illustrate significant increase of business deals including mergers and acquisitions, strategic alliances, joint ventures worldwide. It is evident from table 1. that there was effect of September 11th 2001 on reduction of business deals, especially in USA. Global financial and economic crisis that started in 2008 affected the volume of M&A activities in the world. When comparing year 2007 with year 2009, the M&A activities' reduction is alarming. Global activities decreased by 43,3%, EU activities by 45,6%, in Croatia by 58,8%, in Romania by 42,6% and in Bulgaria by 39,4% from 2007 until 2009.

Figure 1 presents dynamics of Croatian, Romanian and Bulgarian M&A activities from 1998 until 2010. In analyzed period, the total of 136 large transactions have been recorded in Croatia, 380 in Romania whereas in Bulgaria there were 194 large M&A transactions. Most of these transactions are acquisitions, while mergers are very rare. None of Bulgarian transactions in the analysed period were mergers, and only 3 transactions in Croatia and Romania were mergers. The most active years were 2006 for Croatia with 22 transactions and 2007 for Romania and Bulgaria.

Table 1-Dynamics of M&A activities in Croatia, Romania, Bulgaria, EU and world from 1998 until 2010

	M&As Croatia	M&As Romania	M&As Bulgaria	M&As EU	M&As World
1998	0	2	1	1010	1331
1999	3	2	3	1396	1827
2000	4	8	8	2510	3427
2001	8	8	1	2360	3311
2002	8	9	11	2311	3113
2003	11	16	10	3042	4057
2004	15	29	18	4272	5791
2005	15	63	24	4810	6773
2006	22	48	20	5525	7767
2007	17	68	38	6069	8420
2008	15	58	24	5028	7074
2009	7	39	23	3302	4774
2010	11	30	13	1756	2515
total	**136**	**380**	**194**	**43391**	**60180**

Figure 1-Comparison of M&A activities in selected countries



Private M&A is transaction that does not require shareholder approval in a public forum either from the bidder, target or vendor shareholder while public transaction requires one. Figure 2 indicates that 11,7% of all Croatian M&A activities and 9,5% of all Romanian M&A activities from 1998 until 2010 are public, while 88,3% are private Croatian and 90,5% are private Romanian M&A activities. 7,4% of all Bulgarian M&A activities from 1998 until 2010 are public, while 92,6% are private activities. This is consistent with proportions in other European countries e.g. Germany with 5% public and 95% private transactions, France with 8% public and 92% private transactions and Italy with 5,6% public and 94,4% private transactions. Partial explanation for proportion of private and public transactions for selected countries and previously mentioned European countries are characteristics of Continental corporate governance system which is unique for all of them.

Domestic transaction is a transaction concluded within a nationally boundary i.e. a deal involving two or more increment nationals, while cross-border is transaction that is conducted across national boundaries i.e. a deal that involves companies from at least two different nationalities. It is evident from figure 3 that 16,9% of M&A transactions in Croatia, 15,9% of M&A transactions in Bulgaria, 14,6% of M&A transactions in Romania are domestic.

Figure 2-Comparison of M&As' arena among selected countries

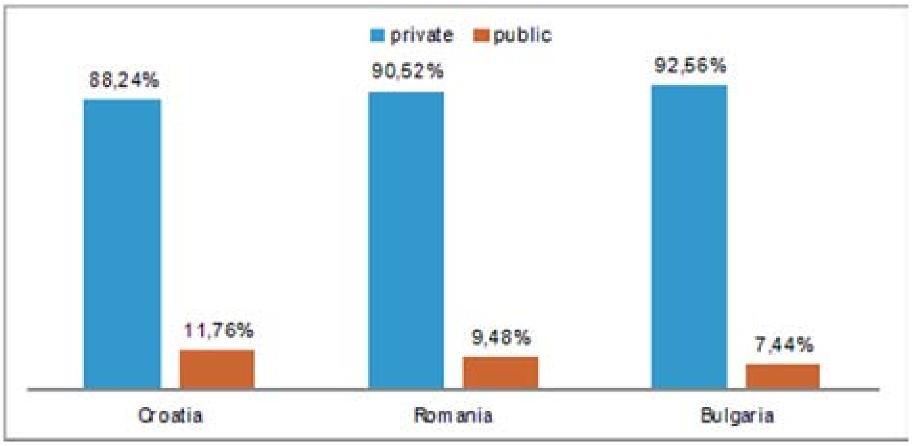
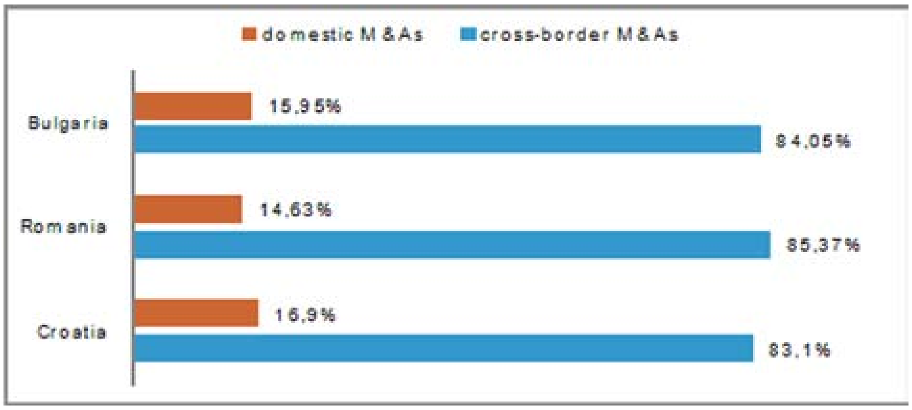


Figure 3-Deals geography from 1998 until 2010



Meanwhile, in Croatia 83,1% are cross-border transactions whereas in Bulgaria 84,1% and in Romania 85,4% transactions are cross-border. Among these cross-border activities in Romania 62 transactions meaning 19,7% were transatlantic transactions. 10% of Croatian cross-border activities have transatlantic character and that means that it involves one company from the United States, Canada or Central America.

These statistics are not consistent to leading European countries that do not have such imbalance. E.g. Germany has 42% domestic and 58% cross-border transactions; France has 51% domestic and 49% cross-border transactions; Italy 57% domestic and 43% cross-border transactions. Since capacity of these selected economies and their markets are limited and less developed when compared to leading European countries, therefore many activities in Croatia, Romania and Bulgaria have cross-border character.

In selected Southeast European countries all of the largest transactions in terms of value are cross-border transactions which confirm their role for economic development of these transition economies.

The largest activity in Croatia was recorded in 2006. In 2006 the largest transaction was acquisition of Croatian pharmaceutical company Pliva d.d. Zagreb by USA-based specialty pharmaceutical company Barr Pharmaceuticals, Inc., for 2,094 billion Euros followed by financial sector acquisition of HVB Splitska Banka d.d. by Societe Generale de France (transaction value

1 billion Euros). After that, acquisition of 22,15% stake of oil and gas exploration and production company INA d.d. by MOL Hungarian Oil and gas Public Limited Company (870 million Euros) conducted in 2008 and acquisition of 35% stake of Croatia Telecom by Deutsche Telecom in 1999 for 788 million Euros followed by additional 16% stake acquisition of Croatia Telecom by Deutsche Telecom in 2001 for 500 million Euros. However, the largest acquisition by Croatian bidder happened in 2010 with deal value of 382 million Euros. Croatia based holding company that unifies distributors of customer goods, producers of foods, cosmetics and hygiene products Atlantic Grupa d.d. Zagreb acquired Slovenia based food and beverage company Droga Kolinska.

In the analysed period the largest transaction in Romania was acquisition of 62% stake of Banca Comerciala Romana SA by Austrian Erste Group Bank for 3,7 billion Euros. In 2005 was conducted second largest transaction – acquisition of 79% stake of Mobifon S.A. and Czech Oscar Mobil a.s. by Vodafone International Holdings NV with transaction value of 3,3 billion Euros.

The largest transaction in Bulgaria was conducted in 2007. It was transatlantic acquisition of 90% stake of Bulgarian Telecommunications Company (BTC) by AIG Capital Partners Inc. (transaction value 1,644 billion Euros). Two years prior to that transaction was conducted second largest transaction with value of 1,6 billion Euros and that was acquisition of Mobiltela AD by Telekom Austria AG.

It is important to stress that Romania is the most active country - among selected Southeast European countries - in terms of mergers and acquisitions from 1998 until 2010. Two largest transactions, in terms of value, were conducted in Romania, followed by largest transaction in Croatia and finally in Bulgaria.

Leading global and European industries in M&A activities are customer industries (food, drinks, retail and other services), industrial product and electronics, followed by financial sector. Industrial structure of the largest transactions in selected Southeast European countries is very similar, with telecommunications present in all countries. For example, Croatian M&A activities encompass industries such as customer industries, financial, pharmaceutical, industrial products and services, and that structure is similar with European countries.

Logically, industrial structure of Croatian M&A activities is comparable to industrial structure of Croatian economy. Austrian, Italian and French bidders significantly participate in financial sector of M&A activities in Croatia since leading Croatian banks have been acquired by banking groups based in Austria, Italy and France. Industrial structure of Croatian M&A activities corresponds to the industrial structure of the other selected Southeast European countries that are in the focus of this research.

Conclusion

With increased external pressures companies have increasingly searched outside their internal boundaries and national borders to build or reinforce their competitive capabilities. The relevance of cross-border M&A activities as critical part of growth strategies has been identified and analyzed. It is indicative that trends in M&A activities are consistent with general - national and globe – economic tendencies. Empirical research ratifies the relevance of cross-border M&A activities for selected CEE companies. Moreover, many similarities among selected Southeast European countries are identified regarding cross-border M&As that are verified as significant segment in total M&A activities.

Since mergers and acquisitions are popular choice for growth and expansion, companies from selected Southeast European countries will have to engage in these transactions more often if they want to be competitive. Therefore it is extremely important that they peruse growth strategies but also take into consideration presented evidence about the importance of organizational variables for cross-border M&A success. Republic of Croatia is on its way to European Union (expected entering date confirmed by EU Commission is 01.07.2013.) so an increase in cross border M&A activity can be expected, and it is extremely important that changes affecting target employees should be managed carefully both by practitioners and foreign investors.

Figure 4-Comparison of selected CEE countries with leading EU countries in cross-border activities, from 1998 until 2011

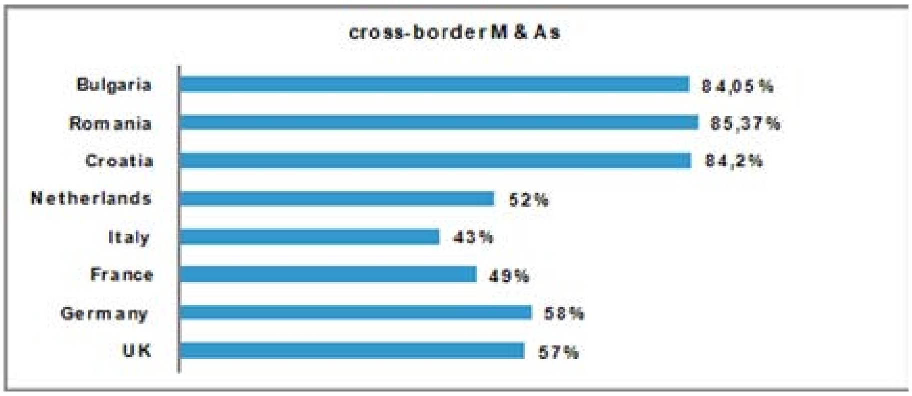
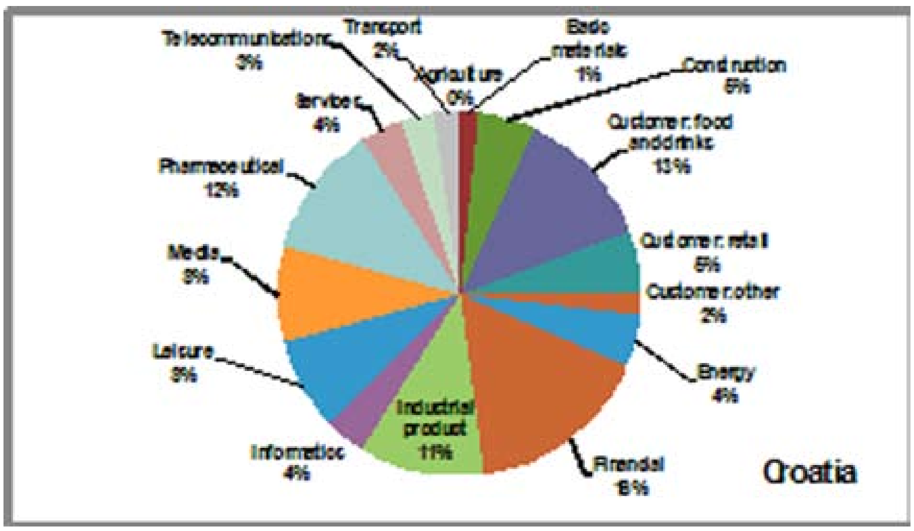


Figure 5-Industrial structure of Croatian M&A activities



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CORPORATE GOVERNANCE IN SLOVENIA: DISCLOSURE AND TRANSPARENCY OF PUBLIC COMPANIES

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Abstract

In the past five years, the Republic of Slovenia (the RS) has achieved substantial legal progress in the field of disclosure and transparency of public companies. The combination of imperative rules and soft law established suitable legal basis which helped to improve corporate governance of public corporations, not only in words but also in practice. In addition to the overview of the development, this article provides information of the revenues of the management board members in public companies. As a rule, public companies in RS use a two-tire system of corporate governance

Key words: Corporate governance, Slovenia, disclosure and transparency, two-tire system, remunerations

Introduction

In the past five years, the Republic of Slovenia (the RS) has achieved substantial legal progress in the field of disclosure and transparency of public companies. Disclosure and transparency were introduced by imperative rules of law and soft law. The combination of both techniques established a legal basis which helped to improve corporate governance of public corporations, not only in words but also in practice. In addition to the overview of the development, this article provides an analysis of the revenues of the management board members in public companies. The information will be provided to support the affirmation of the progress, achieved in regulations and practice, relating to the implementation of the above principles since 2005.

Some Regulations and Codes in the RS from 2005 to 2010

In the field of corporate governance of public companies, the RS has complied with EU regulation by implementing Regulations and Directives of the European Union (the EU), as well as its Recommendations and other acts of soft law.

In addition to accountancy, financial reporting and revision field, Slovenia harmonized the company law with transparency regulations of the EU. The RS thus amended its basic company law (hereinafter the Companies Act (ZGD-1)) by recently adopting two acts amending the Companies Act, namely ZGD-1B and ZGD-1C.

Furthermore, the RS implemented the recommendations of the EU as well as OECD principles of corporate governance in the preparation of its corporate governance codes. (OECD, 2004) Slovenian Corporate Governance Codes have been developing since the 2005.

The harmonized text of the first Slovenian Corporate Governance (CG) code ("Kodeks upravljanja javnih delniških družb") was put into force on 18 March 2004 and signed by the Ljubljana Stock Exchange (LJSE), the Managers' Association of Slovenia (the MA) and the Slovenian Directors' Association (SDA). (hereinafter: 2004 Slovenian CG Code).

The changes and supplements of the Code from 2004 were adopted by the same signatories on 14 December 2005. (hereinafter: 2005 Slovenian CG Code).

The next changes of the 2005 Slovenian CG Code were again brought by the same signatories and were adopted on 5 May 2007. (hereinafter: 2007 Slovenian CG Code).

Only just recently, more precisely on 8 December 2009, a new code was enforced, signed again by the same parties (hereinafter: 2009 Slovenian CG Code) and applied a new approach which is going to result in the disclosure and transparency of the data provided in annual reports of the public companies.

Disclosure and Transparency in RS regulation and practice

The disclosure and transparency principle is an interesting tool which could eliminate negative effects regarding the conflict of interest among the management bodies of public corporations. It is understood that the execution of the supervisory function within a corporation is of key importance, particularly in those areas where it is estimated that there exists a possibility of a conflict of interests between different management bodies or when shareholders do not have the possibility of direct decision-making. Such circumstances may arise, in particular: a) upon the appointment of directors, b) in remuneration to directors, and c) in the audits of corporations. (EC Action Plan, 2003).

We therefore tried to find out what kinds of results were achieved in the field of remuneration of directors in the RS. In order to establish what kind of consequences brought the gradual improvement of disclosure and transparency in this area in practice, we analysed several annual reports of public companies in the RS, focusing mainly on the payments of the members of the supervisory boards in 2007 and 2008.

The Association of Supervisory Board Members of the RS provided a research dealing with remunerations of the supervisory boards. (ASBM Research, 2007).

For the years 2005 -2006 the ASBM Research showed that the remuneration structure of management bodies of public joint-stock companies was not disclosed to the shareholders and the situation was even worse in the area of disclosure of data which would ensure the shareholders a constant overview over the severance grants paid out to management bodies and their relationship to the actual remuneration policy of joint-stock companies or the envisaged remuneration structure. As regards the remuneration of management bodies, the ASBM Research was able neither to identify the criteria that individual joint-stock companies deem as the most important nor establish whether individual companies formulate short-term and long-term remuneration policies at all or in what manner. (ASBM Research, 2007, pp 12, 27, 28)

Some results of the 2005–2006 ASBM Research were then compared with the data of public joint-stock companies from the first stock-exchange listing for 2007, as indicated in the annual reports published on the websites of the Ljubljana Stock Exchange (Hereinafter: Stock Exchange).

We expected that the 2007 Slovenian CG Code provisions improved the analysed situation as the CG Code 2007 introduced the principle of comply and explain. Simultaneously, companies were required by law to explain the use of this basic CG Code 2007 principle which allows the companies to deviate from the CG Code’s recommendations (except from the provisions referring to the temporary legislation).

Therefore not all of the 2007 Slovenian CG Code recommendations were binding for the companies.

The CG Code 2007 stipulated that the amount and the method of determining the amount of individual payments, reimbursements and other benefits of supervisory board members should be set by a resolution of the general meeting or by the Articles of Association. The Code recommends that the criteria for payments to supervisory board members, which are set out and adopted by a relevant professional organization, should also be taken into account mutatis mutandis. (ASBM Recommendations on Remuneration, 2007)

Accordingly, ASBM Recommendations on Remuneration encouraged general meetings of joint-stock companies to adopt a resolution whereby to determine the remuneration, reimbursement of costs and benefits (hereinafter: overall remuneration) of members of supervisory or management boards. Moreover, under point 5.11. thereof, the general meeting of a joint-stock company may, by means of a resolution, authorize the supervisory board to determine autonomously the remuneration of individual members of committees, payable from the budget of the supervisory board.

As regards the structure of the overall remuneration, the recommendations also extend to more detailed definitions of individual categories of the overall remuneration which, under point 5.14. Thereof, consists of: a) a remuneration for the performance of duties; b) meeting fees and c) the reimbursement of costs and benefits for the performance of duties. The ASBM Recommendations on Remuneration also provide more detailed explanations of the indicated remuneration categories.

When reviewing annual reports of public joint-stock companies filed in the first stock-exchange listing for 2007, one can establish that the structure of the remuneration of the supervisory board is more transparent, considering that the annual reports for 2007 disclose the remuneration of supervisory board members by remuneration structure and break it down into the following categories: monthly allowance for the performance of duties, meeting fees, fixed and variable components of remuneration, participation in profit sharing, and option emolument. The reports are deficient in a way that they disclose individual remuneration structures for the entire supervisory board and not by individual members or in that they disclose the overall remuneration by individual supervisory board members without breaking down its structure in greater detail. On the other hand, the reports of certain companies fail to identify more specifically the remuneration of the supervisory board.

The above comparisons illustrate that in the RS the disclosure and transparency principle has been gradually improving in the field of remuneration from 2005 to 2007. More detailed data's about the structure of the payments for the supervisory board members were disclosed to the shareholders and/or investors.

However, no information regarding the general corporate governance policy of the particular public company was provided in the annual reports. This fact is not surprising as the Slovenian Law or Code has not yet considered the CG Policy in 2007.

The examination of annual reports of the joint-stock companies in 2008 has once again shown an additional improvement in the disclosure of the data. The 'comply or explain' principle in compliance to the Code was used by the public companies entering the standard Stock Exchange listing in 2008. With regard to the remuneration of supervisory board members of the joint-stock companies entering in the first Stock Exchange listing for 2008, the remunerations were disclosed both by structure and individual members.

In 2008, the RS supplemented the institute of corporate governance statement with the supplements of the provision of paragraph 5 of Article 70 of ZGD-1-UPB3.

Subsequently, the decision to disclose or not to disclose was no longer questionable. Within the framework of the Article 70 of ZGD-1-UPB3, it is mandatory for public joint stock companies to report about the content of corporate governance issues included in the corporate governance statement. Being an obligatory instrument for public companies, the corporate governance statement should include the material information which should be revealed to the shareholders.

A step forward was therefore made again by the Ljubljana Stock Exchange Inc, the Association of Supervisory Board Members and the Managers' Association of Slovenia, with the decision to accept the 2009 Slovenian CG Code.

This Code envisages that there is no need for the new code to still contain the binding statutory provisions regulating the governance of the listed companies. Since the Code initially came into effect, the companies as well as the public have become increasingly familiar with the provisions of the previous Code that were phrased with the modal 'must' (shall, is obliged to, shall not, etc.) and that listed companies are obliged to abide by under the law. These provisions represent the statutory minimum of corporate governance. Companies can summarize them on the basis of Article 70 (5) of the Slovene Companies Act in the description of the governance system they use. All provisions of the amended Code have the nature of recommendations, which are not legally binding. However, since they represent the basis of a sound corporate governance system, the companies must disclose any deviations from these provisions in their CG Statement annually, the main objective being to inform the investors of any deviations from the Code and the reasons for them. All such deviations must also be disclosed by non-public joint stock companies which base their CG Statement on this Code. (2009 Slovenian CG Code, p 2)

The above regulative development of the Disclosure and Transparency was framed by considering the Corporate Governance Policy (hereinafter: CG Policy) of a particular public company as a necessary instrument of the control of shareholders, stakeholders and the public, with particular reference to the issues posing risks from the perspective of conflicts of interest between the management bodies of public joint-stock companies. According to the point 8 (1) of the 2009 Slovenian Code, the supervisory board monitors the company throughout the financial year, takes an active part in drawing up the corporate governance policy and in establishing the corporate governance system, carefully evaluates the work of the management board and performs other tasks pursuant to the law, company regulations and the Code.

Declaration of the development

Following the examination of the annual reports of the joint-stock companies which entered in the first Ljubljana Stock Exchange listing of 2008, 2009 and 2010 one can perceive an additional improvement in the disclosure of the data in the Annual Reports .

It will take additional years to be able to check whether companies have improved their corporate governance practices and not only published some data in the statements on corporate governance and yearlies reports.

The answer to such a question will indeed depend on the ability of companies to precisely measure and anticipate their risk areas and the level of risk they can manage which is the objective of the corporate governance rules. However the examination of the annual reports of the joint-stock companies entered in the first Stock Exchange listing for the year 2008, has shown an additional improvement in disclosing of the data's on the remuneration of supervisory board members, considering that the reports, as a rule, disclose them by structure and by individual members. This fact illustrates also the practical improvement of public companies and brings hope for better corporate governance in RS in the future.

The frequency of disclosure and transparency of the data of corporate governance and the potential conflicts of interest in this field from 2009 to 2010 are ever greater in the annual reports of Slovenian public joint-stock companies. This illustrates that the practice in the RS is following the legislation demands and has been developing in harmony with the regulations of the ZGD-1-UPB3 and the provisions of the Slovenian CG Codes

Conclusion

Slovenian legal tradition and the culture of CG could not be compared to the tradition of the other EU member states, such as Great Britain, Germany or France. As the first Companies Act in Slovenia was adopted in 1993, the principles of CG of the joint stock companies or limited liability companies as suitable legal forms for capital investment have only been used for the past 15 years.

Ethical principles and norms of the non-binding Slovenian CG Codes created a suitable legal basis for the development and a better implementation of CG in Slovenian public companies.

The 2004 Slovenian CG Code represented the first act that showed the way of the practical execution of the provisions in the field of corporate governance in the RS as a new EU member. It has been followed by other improvements in regulations and theory, analysed in the article.

The analysis provided in this article also suggests that the practice in the RS follows the legislation demands and has been developing in harmony with the regulations of the ZGD-1-UPB3 and the provisions of the Slovenian Codes from 2005 to 2010. The use of techniques of obligatory disclosure of non-compliance with the Code provisions seems to be more efficient than previous regulation techniques without such obligation. Regardless to the fact that no sanctions have been taken by the Slovenian authorities and that the effectiveness of the CG Code is not being measured systematically in Slovenia, the progress could be seen by following the corporate information offered to the public and shareholders.

It is evident from a historical overview and a comparative analysis that the disclosure and transparency of corporate information in public companies are on the increase.

Such a development should contribute to the better results of the shareholders supervision process and also helps to accelerate the capital ivestments in the Republic of Slovenia.

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Endnotes

1. This article is particularly concerned with the following EU directives: Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (2006) OJ L224/1; Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (2006) OJ L157/87; Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies (2007) OJ L184/17.

2. The Act Amending the Companies Act (ZGD-1B) was published in the Official Gazette (OG) of the Republic of Slovenia no 68/2008 of 8 July 2008 and the Act Amending the Companies Act (ZGD-1C) in OG 42/2009 of 5 July 2009. This article takes into account both the amendments to the Companies Act (ZGD-1), OG 42/06 and 60/06, Corrigendum 26/07; the Act Amending the Workers' Participation in Management Act (ZSDU-B), OG 33/07; the Act Amending the Court Register Act (ZSReg-B), OG 67/07; and the Financial Instruments Market Act (ZFTI), OG 10/08). The abbreviation ZGD-1-UPB3 denotes the official consolidated version of the Companies Act, including the cited acts amending ZGD-1 (ZGD-1B and ZGD-1C) and has been published in OG RS, 65/2009.

3. Among the recommendations that were taken into account in the drawing-up of the 2007 Slovenian Management Code for Publicly Traded Companies (hereinafter: the CG Code 2007) was the Recommendation on the Role of Non-Executive or Supervisory Directors of Listed Companies and on the Committees of the (Supervisory) Board of 2005, as well as others, cited in the reference section of this article

4. Slovenian Directors' Association (the SDA , has been previously named: The Association of Supervisory Board Members of RS and The Association of Supervisory Board Members for Effective Corporate Governance; We are all the time talking about the same organization.

5. As noted in the World Bank's 2004 Report on the Observance of Standards and Codes; Corporate Governance Country Assessment, Slovenia, May 2004 ROSC,2004) several areas were identified where changes to the laws would increase compliance with OECD guidelines. The enforcement of corporate governance rules, particularly the disclosure provisions, remained the key challenge. The World Bank stated that the Slovenian law incorporated most recommendations under the OECD principles, including the disclosure of financial and operating results, company objectives, major share ownership and voting rights, as well as information about

board members and key executives. The law, however, did not cover the disclosure of material foreseeable risk factors, material issues regarding employees and other stakeholders, or governance structures and policies. Per/In the same report, the listed companies had to submit annual audited and consolidated reports. Publicly traded companies also had to disclose material events that might affect the share price. In case a company does not comply with the disclosure rules, the Security Market Agency has several means to take action; for example, it can issue an order to eliminate the violation or recommend fines to the administrative judge. Finally, the World Bank recommended that the Ljubljana Stock Exchange establishes an electronic information system for statutory and public information disclosure. (E standardsforum, Financial Standards Foundation, Slovenia, Principles of Corporate governance – FSF 2009, pg. 3).

6. European Bank for Reconstruction and Development, "Commercial Laws of Slovenia - An Assessment by the EBRD, Report assessed the effectiveness of the legislation according to institutional environment, enforceability, complexity and speed. The EBRD found Slovenia's legal framework to be relatively effective, but with some shortcomings, especially with respect to the time needed to reach an executive judgment in case of an action for redress or disclosure. (EBRD,2006).

7. The changes were introduced mostly on the basis of the changes of the legislation in 2006 (ZGD-1 Companies Act, ZTVP-1 Securities Market Act and Zpre-1Takeovers Act).

8. In the RS, companies may choose a two-tier management system by appointing a management board and a supervisory board or a one-tier management system by appointing a board of directors. Art 253 ZGD-1-UPB3;UL, RS 56/2009 .As a rule, public companies (PC) use a two-tire system of corporate governance.

9. The ASBM Research covered 72 public joint-stock companies quoted on the Ljubljana Stock Exchange and with a market capitalization of a minimum of EUR 1.04 million.

10http://seonet.ljse.si/default.aspx?doc=PUBLIC_ANNOUNCEMENTS_BY_PRIME_MARKET_ISSUERS. Date of access: 19 January 2012).

11.Ibidem.

12. The Recommendations for the Membership, Work and Remuneration of Members of Supervisory and Management Boards, adopted in 2007 by the Association of Supervisory Board Members of the RS. (Hereinafter: ASBM Recommendations on Remuneration, 2007) indicate more definite policies with regard to the structure of the overall remuneration of members of supervisory boards and their committees. http://www.zdruzenje-ns.si/zcnsweb/vsebina.asp?s=381&n=1. (Date of access: 18 January 2012).

13.Port of Koper,

14http://seonet.ljse.si/default.aspx?doc=ANNUAL_AND_SEMI_ANNUAL_REPORTS&doc_id=31464(Date of access: 19 January 2012).

15.Petrol, http://www.petrol.si/za-vlagatelje/letna-porocila (Date of access: 19 January 2012).

16. The company Gorenje thus states: When assessing the work of the Supervisory Board, the Supervisory Board evaluates the work of the entire Supervisory Board and not the work of its individual members. As a rule, the Supervisory Board convenes in full composition and all its members participate regularly in discussions, thereby contributing to the quality of work with their responsibility, commitment, and professional and other experience, for which reason the Supervisory Board deems individual evaluation unnecessary. For their work, the Supervisory Board Members are entitled to the payment for attendance at the session (attendance or meeting fee) and to the reimbursement of costs arising from their attendance of the session. The existing practice, which allows for the possibility of emolument receivable by the Supervisory Board Members for their work performed in the form of profit-sharing, if so decided at the General Meeting, has proven to be appropriate. Gorenje Company 2007 Annual Report, 2007, pg.15; http://www.google.si/#sclient=psy-ab&hl=sl&source=hp&q=letno+poro%C4%8Dilo+dr

u%C5%BEbe+Gorenje+2007&pbx=1&oq=letno+poro%C4%8Dilo+dru%C5%BEbe+Gorenje+2007&aq=f&aqi=&aql=&gs_sm=e&gs_upl=1750l17297l0l18515l52l29l7l8l8l2l1797l9597l0.3.17.4.3.1.8-1l43l0&bav=on.2,or.r_gc.r_pw.,cf.osb&fp=43b3b2acab36d5b2&biw=1024&bih=563. (Date of access: 18 January 2012).

17See 2008 Annual reports of the companies Aerodrom, Terme Čatež, Etol, etc. http://seonet.ljse.si/default_en.aspx(Date of access: 18 January 2012).

18. The Intereuropa 2008 Financial Report, for example, discloses and breaks down the remuneration of individual supervisory board members by the following categories: fixed component of remuneration, variable component of remuneration (long-term and short-term stimulation for better performance and part of the remuneration in relation to company performance which is not participation in profit sharing), participation in profit sharing, option emoluments, other remuneration (severance grants, additional insurance, bonuses), meeting fees, total gross income, total net income. See, Intereuropa Annual Report, p.160. http://seonet.ljse.si/default.aspx?doc=ANNUAL_AND_SEMI_ANNUAL_REPORTS&doc_id=36620. (Date of access: 18 January 2012).

19. Article 70 of ZGD-1-UPB3 provides that the business report of a company must set out a fair presentation of the development and the results of the company's operations and its financial position, including the description of essential risks and uncertainties the company is exposed to. In accordance with paragraph 5 of Article 70, companies whose securities are traded on the regulated market include a corporate government statement as a special part of their business reports. As a minimum, it quotes some sections of the corporate governance code and includes information on: a) the use of the corporate governance code; the way of using the rule of 'comply and explain' with regard to a particular code; and reasons for not applying the exact parts of the code; b) the basic characteristics of the internal control and risk management systems in connection with accounting report system procedures etc. It also includes information on: a) significant direct and indirect ownership of the company's securities in the sense of achieving a qualified stake as stipulated by the act regulating acquisitions; b) each holder of securities carrying special control rights; c) all restrictions related to voting rights, in particular: restrictions of voting rights to a certain stake or number of votes; deadlines for exercising voting rights; agreements in which, on the basis of the company's co-operation, the financial rights arising from securities are separated from the rights deriving from the ownership of such securities; d) the company's rules on the appointment or replacement of members of management or supervisory bodies, and changes to the articles of association; e) authorizations of members of the management, especially authorizations for issuing or purchasing their own shares; f) the operation of the company's general assembly and its major competences; g) the structure and operation of the management and supervisory bodies and their committees. For more information on the topic, see D. Djokić, 'Dodatna razkritja korporacijskih informacij po ZGD-1B' ('Additional Disclosures of Corporate Information under the Act Amending the Companies Act (ZGD-1B)') (2008) 8 Podjetje in delo 1637-1648.-(Djokic.D.2008).

20Code considered the EU Recommendations, such as: Commission Recommendation 2004(913)EC), Commission Recommendation 2005(162)EC and, as of recently, Commission Recommendation on Remuneration Policies and Commission Recommendation on Remuneration Regime. (See the full title of the abbreviations for the Recommendation in the references).

21. Note: http://seonet.ljse.si/default_sl.aspx?doc=ANNUAL_AND_SEMI_ANNUAL_REPORTS. (Date of access: 18 January 2012).

22.Ibidem

EVALUATING BOARDS IN LARGE COMPANIES IN MACEDONIA

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Abstract

Over the last two decades the area of corporate governance underwent two crises: the first one in the year 2001, and the second one in the year 2008. The interest in the corporate governance was significantly increased with the collapse of one of the biggest American companies Enron, followed by the collapse of World.com, Tyco International, Maxwell and others in 2001. The interest in corporate governance would be also increased in the future. The intensive research in the field of corporate governance is a confirmation of the complexity and importance attached to this issue. Corporate governance is a bridge between the managers and the institutional shareholders. The Board of Directors has a key role for the success of an organization.

The aim of this paper is to evaluate the boards of corporate governance in large shareholding companies in transition economy, as is the case with the Republic of Macedonia, and to verify whether the corporate governance in large companies in transition economies during their early development phase of introducing corporate governance has any similarity or difference with the corporate governance in economies with longer experience. A total of 46 questionnaires were collected from the largest companies. The statistical analysis of the data was made by using descriptive and non-parameter statistics i.e. the Wilcoxon's Test. The descriptive statistics was used for the purpose of analyzing statistical data that are related to the way in which the corporate governance is organized in the shareholding companies.

Keywords: evaluating boards, corporate governance, organization, efficiency of Boards' meetings

Introduction

Evaluating effectiveness is a complex activity which includes internal evaluation of the Board and its Directors and external evaluation of the Board. The internal evaluation of the Board includes: evaluating the Board as a whole, evaluating the President of the Board, evaluating the Board Members and evaluating the Board Committees. The internal evaluation of managers means evaluating the Chief Executive Officer, as well as evaluating the team of top executive managers, whereas the external evaluation of the Board includes evaluation made both by the shareholders and by the stakeholders. Kiel and Nicholson, (2005, p 624) propose that the Board evaluation should be made by using either quantitative or qualitative techniques. Such an evaluation contributes in having a more effective Board and improving the corporate financial performance. The overall system of Board evaluation consists of four blocks, Minichilli at al (2007). The evaluation of the Chief Executive Officer has a positive and independent effect on the Board members as well as on the overall effectiveness of the Board. The evidence regarding the growing importance of effectiveness shows that the rate of total effectiveness is significantly greater in those Boards that make evaluation of their Chief Executive Officer than in those Boards that do not make such an evaluation, i.e. their ratio is 4.16 to 3.77, Conger at al (2001, pp 90-91). 'It is not advisable that the President of the Board of Directors is also a Chief Executive Officer because these two positions require different combination of skills, and maybe different characters as well; what should also be considered is the fact that Board governance is skill-demanding and time-consuming. It is also considered that presiding over the Board of Directors represents an office that requires more specialized role than the generally perceived one' (Cadbury, 2002, p 112). Effective corporate governance has crucial role for companies in developing countries because it can help companies with a weak corporate governance to raise capital and attract foreign investors.

There are many factors that contribute to the Board not operating effectively. "A well-functioning and effective board of directors is the holy grail sought by very ambitious company. A company's Board is its heart and as a heart it needs to be healthy, fit and carefully nurtured for the company to run effectively" (Solomon and Solomon, 2005, p 65). Good corporate governance creates benefits for different stakeholders (Berg, 2006). There is also a recipe for a "good Board" (Solomon and Solomon, 2005). Evaluating Board's efficiency means covering the controlled factors related to the Board, its composition, the committees (der Walt, Ingley, 2001). The way Board of Directors/ Supervisory Board is organized has an impact on the value created by the Boards themselves, on their authority and the types of authority the Boards have (Carver and Oliver, 2002). Finegold at al (2001) developed a model of relations between the Board of Directors and the company's performance, which includes factors of internal and external environment of the company.

As regards to the company performances, some researchers have attached importance to the Board's size. Conyon and Peck (1998, p 299),for example, noted that Board's size has positive influence on the company's economic performance. Lehn et al (2009) stated that there are positive correlations between company's size and size of the Board of Directors during the 65 years period of time; and that the size of the Board also has an influence on the effects and the value of the company, (De Andres et al 2005). Ning et al (2007) is of the opinion that the Board's size of companies from different sectors has undergone some slight changes.

The Board's composition which reflects the interests of the major shareholders, has significant influence on the culture (Lamm, 2004). Hilb (2005) also investigated that Board's composition has an influences on the process of creating effective culture. Lorsch (1995) found that only the authorized Board has the power. The role the President of the Board is of major importance when it comes to creating a team work environment within the Board (Coulson-Thomas, 1993).Specially emphasized is given to the role of the internal and external Board Members and the influence they have on objectivity in the decision-making (Hitt, 1999).The importance of the relations between the external Directors and the financial operation of the company (De Andres et al 2005). Long et al (2005) gives an emphasize to the importance of the non-executive directors for the strategic development of both the companies that are listed on the Stock-Exchange and those that are not listed. In their research, der Walt, Ingley (2001) stated that the ranking of the external directors is especially important for the contribution they give for enabling effective operation of the Board.

The committees represent a part of the Boards' structure and it is the Board that determines their power. The supervisory role of non-executive or supervisory directors is commonly perceived as crucial in three areas where the potential for conflict of interest among the management is particularly high, especially when there are such matters which are not under a direct responsibility of the shareholders: nomination of directors, remuneration of directors, and audit. (Commission recommendation, 2005). The committees' representation stays unchanged, between three audit, compensation and nomination and five audit, compensation, nomination, finance and executive (Spencer Stuart Board Index-2009). 'As opposed to the market structure of the outsiders corporate Boards, there is also a corporate governance with internal structure, also known as insiders, which is characterized by non-transparency of data and information. In this closed structure, the role of the capital market is significantly smaller than the one with the open structure. The corporate control market rarely makes interventions, while on the other hand the disclosure of information is limited and insufficiently developed' (Tipuric et al 2008, p 91). Mallin (2004, p 124) emphasizes that the difference between the bank oriented and market oriented financial systems is hardly visible. Cohen and Boyd, (2000, p 8) stated that there are different elements between the American system on one hand, and the Japanese and the German system on the other hand.

The Board's meetings have direct influence on the corporate governance efficiency. The efficiency of Board's meetings is an issue that has been intensively dealt with over the last ten years. There is no universally accepted formula for effective meetings. Yet, the small amount of empirical research in the field of Board's meetings efficiency gives an opportunity to develop guidelines on how to increase the efficiency of these meetings (Schneider and Clutterbuck, 1998).

The study provides significant current information on the corporate governance practice, and barriers hindering its development and implementation in the Republic of Macedonia. The studies in this area also show that many changes that have occurred in developing and emerging countries have led to faster diffusion of corporate governance, however the research and literature are focused primarily on developed countries producing frameworks and models that are not necessarily applicable for developing or emerging countries.

The descriptive statistics was used for the purpose of analyzing statistical data that are related to the way in which the corporate governance is organized in shareholding companies.

Research Methodology

After the questionnaire had been designed, it was distributed, by random choice, to large shareholding companies over the entire territory of the Republic of Macedonia, in person or by post in a printed form. A total of 46 questionnaires from large shareholding companies with different years of operation and from industry sectors were received in the period from February till June 2009. The sample of the companies consisted of variety of industries, in accordance with the traditional classification of shareholding companies: trade (one company), service (10 companies), production (32 companies) and construction (three companies). The final demographic statistics of the sample is related to 24 out of 46 shareholding companies listed on the Stock Exchange, where 26 out of 46 use one-tier system, 15 out of 46 use two-tiers system and five out of 46 are from the service sector, banks.

Findings

The initial phase of the corporate governance development within the shareholding companies in the Republic of Macedonia produced an evolutional concentration of shareholding ownership. At the beginning of the privatization process a dispersed ownership structure was developed, while over the last years there was concentration of shareholding ownership and slow development of the stock market. Of the total number of shareholders in the Republic of Macedonia, or out of 255,070, 98.5% are physical entities, whereas 1.5% are legal entities. Out of the total number of physical entities shareholders, 88% own shares only in one shareholding company, and 4.5% own shares in more than two companies.

It can be said that the shareholding of physical entities is to a great extent concentrated among the employees of the shareholding companies. Given in figures it is as follows: 41% of the currently employees, 48% of the former employees and only 6% of the shareholders who have never been employed in those companies but are their owners. Most of of shareholding companies i.e. 82.5% have minority shareholders who own less than 10% of the total amount of issued stocks. The employees and the managers of the enterprises that underwent privatization participated in the shareholding with over 75%, privatization (Koevski, 2005, p. 374). The role that the institutional investors have in the corporate governance is more than modest.

The research on the presence of corporate governance systems in 35 countries shows that the one-tier system is dominant. The practice proves that 25 countries use one-tier system, 10 countries use two-tier system (Mallin, 2004, p.125).The data also shows that most of the European countries, 19 of them, have one-tier system, and 10 of them use two-tier system. This research also shows that only two countries, Macedonia and Bulgaria, use simultaneous systems, one-tier and two-tier. The systems of governance in the Republic of Macedonia are regulated by Article 342 of the Law on Trade Companies. Such simultaneous use of both systems makes the corporate governance effectiveness more difficult. But, on the other hand, the possibility to replace the one-tier system by a two-tier and vice-versa, additionally makes the effectiveness worse, and also has a negative impact when comparison is made between the systems within one trade company or with other trade companies.

The beginnings of corporate governance in the Republic of Macedonia are linked with the adoption of the Law on Trade Companies from 1996 and the new Law form 2004. The establishment of a legal framework that will regulate the internal relations as well as the operation of the shareholding companies is of extreme important. The legal framework for establishing appropriate conditions for putting in place corporate governance in the shareholding companies is based on the following laws and regulations: Law on Trade Companies, Law on Stocks, Law on Shareholding Companies' Takeover, Law on Banks, Code of Corporate Governance, Regulations on Companies' Listing on the Macedonian Stock Exchange, Regulation on Solid Corporate Governance, OECD Corporate Governance Guidelines, OECD White Paper on Corporate Governance in South-East Europe, EU Corporate Governance Action Plan and other regulations (such as taxes and bankruptcy).

The statistical analysis of data is made by using descriptive statistics and non-parameter statistics – Wilcoxon's Test.

Descriptive statistics was used to analyze statistical data related only to some aspects of the total research on corporate governance in large shareholding companies, such as: structure of the shareholding companies in terms of their business activity, the way corporate governance is organized, the criteria for nominating Board members, the entities responsible for nominating members for the Board of Directors/ Supervisory Board, the role and responsibilities of the President of the Board and the benefits of the Chief Executive Officer/the General Manager.

Organization of Boards in Shareholding Companies

Size of Board of Directors. The minimum and maximum numbers of Board members, is regulated by the Law. Therefore, the number of the Board of Directors members is from three to 15, as stipulated in Article 367 of the Law on Trade Companies, whereas the number of the Supervisory Board members is from three to 11, as stipulated in Article 374 of the same Law. It is within these established frameworks that the optimum number of members is defined. The research shows that out of the 26 surveyed shareholding companies that use one-tier system, 89% have relatively small Board of Directors with up to nine members, whereas out of the 15 surveyed shareholding companies using two-tier system, 94% have small Boards with up to seven members in the Managing Board, respectively Supervisory Board. The conclusion drawn is that the majority of shareholding companies with Boards that have relatively small number of members are dominant, Figure 1.

The composition of Board of Directors with regard to the executive and non-executive members. The composition of the Board of Directors has multiple importance for the corporate governance. Out of 26 shareholding companies using one-tier system, in 22 shareholding companies the dominance of non-executive over the executive members is insignificant, whereas in four shareholding companies the number of non-executives is the same as the number of executives. The number of executives and non-executive directors in the Board of Directors is presented in Table 1. The analysis shows that the number of executive members in the composition of the Board of Directors is greater in those shareholding companies with bigger total number of members in the Board of Directors. All the surveyed shareholding companies have non-executive members in their Board of Directors.

The data regarding the total number of Supervisory Board Members in shareholding companies that use two-tier system shows that 14 companies have smaller total number of members in the Supervisory Board,between three and seven members, and one shareholding company has a total of 11 members in its Supervisory Board, Figure 2.

The data regarding the participation of insiders in the Supervisory Board shows that in 13 shareholding companies the number of insiders is between one and four, in one shareholding company the number of insiders is seven, whereas there is also one shareholding company with no insiders. Similar are the results from the research on the number of outsiders in the Supervisory Board. In 14 shareholding companies the Supervisory Board has from one to six outsiders, while in one shareholding company there are no outsiders. Interesting is the fact that in 10 out of 15 shareholding companies that use two-tier system. The insiders dominate over the outsiders, whereas in the remaining five shareholding companies, the outsiders dominate over the insiders.

Figure 1-Size of Board of Directors

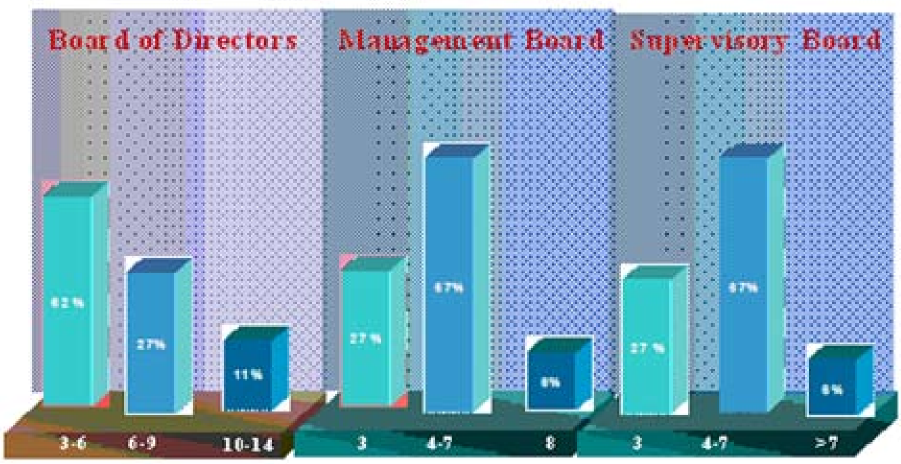

Table 1-Composition of Board of Directors

Number of members	Executive Directors	Non-executive Directors
1	12	-
2	12	6
3	1	8
4	1	8
6	-	3
9	-	1
Total	26	26

Figure 2-Members in Supervisory Boards

The analyzed data regarding the governance in banks, shows that five banks have two to four members in their Management Board, all of them insiders. The Supervisory Board has five to seven members, consisting of outsiders, and independent members which is in accordance with Article 88 of the Law on Banks.

The Board's committees are part of the corporative governance organization and they are entrusted to deal with matters such as compensation, nomination, audit, finance, ethics, stocks, corporate responsibility and strategic planning. The practice confirms that most frequently the shareholding companies set up compensation committees, nomination committees and audit committees. However, their presence in shareholding companies is more than modest. From the empirical research on their frequency of presence conducted in all shareholding companies the following conclusions are drawn:

- in two out of five surveyed banks four committees were established i.e. two committees for compensation and two for audit, and
- in 12 or 29.26% of the total of 41 surveyed shareholding companies committees for compensation, nomination and audit were established.

The number of Board's meetings in shareholding companies serves as a basis for evaluating the corporate governance effectiveness. Regarding the 26 surveyed shareholding companies, the Board of Directors/the Supervisory Board held between one to six meetings, in nine of the shareholding companies Boards held between 10 to 12 meetings, in two shareholding companies the Boards held between 13 to 20 meetings, in one shareholding company the Boards held between 20 to 25 meetings and in five shareholding companies the meetings were held depending on the needs, Table 2.The data clearly confirms that the shareholding companies hold either a large number of meetings or when needs, which is again a clear proof of the non-effectiveness of the corporate governance.

In all of the surveyed banks, the Supervisory Board held regular meetings on monthly basis or 12 meetings annually, which is a legal obligation, whereas the Management Board of three banks held 52 meetings, the Management Board members of one bank, have between 10 and 12 meetings, and the Management Board members of one bank held its meetings depending on the needs.

Table 2-Number of meetings in shareholding companies

Number of meetings	One-tier System	Two- tier System		Banks	
	Board of Directors	Management Board	Supervisory Board	Management Board	Supervisory Board
1-6	11	6	13	-	12
10-12	8	4	1	1	12
13-20	1	3	1	-	12
20-52	1	2	-	3	12
In accordance with needs	5	-	-	1	12
Total	26	15	15	5	5

The non-parameter statistics is conducted using the elements on corporate governance of the Wilcoxon's Test, which analyzes statistical data related to the following aspects: the number of Board members, the number of meetings held, the number of compensations and benefits to the Board members and the number of compensations and benefits to the Chief Executive Officer/the General Manager, in shareholding companies using one-tier and two-tier system of governance, in companies listed or not listed on the Stock Exchange, as well as in the shareholding companies dealing with production and services, as presented in the Table 3. Data are systematized in three groups, as follows:

- System of governance (one-tier and two-tier system);
- Shareholding company's business activity (production and service);
- Shareholding company's listing on the Stock Exchange (companies that are listed and those not listed on the Stock Exchange).

The above listed groups are analyzed according to the following four elements: the number of Board members, the number of Board meetings held, the number of compensations and benefits for the Board members and the number of compensation and benefits for the Chief Executive Officer/the General Manager.

Systems of governance. The analysis of the data in Table 3 shows that the one-tier system, compared with the two-tier system, is characterized by bigger average number of Board members and bigger average number of compensations and benefits for the Chief Executive Officer/the General Manager, and smaller number of meetings held, and smaller number of compensation and benefits for the Board members. In order to establish whether such differences are statistically significant for this research, the Wilcoxon's Test was applied, where statistically significant difference is established in the number of Board meetings held ($Z = -2, 417$, $p = 0, 016$ while $p < 0, 05$, i.e. statistical significance of 95%) and in the number of compensations and benefits for the Board members ($Z = -2, 134$, $p = 0, 033$ while $p < 0, 05$, i.e. statistical significance of 95%).

Shareholding Company Business Activity. The data analysis of the second group included only production and service shareholding companies since they are mostly represented in the research sample, respectively 42 out of a total of 46 shareholding companies. The data analysis shows that shareholding companies dealing with production, compared with those dealing with services, are characterized by bigger average value of compensations and benefits for the Chief Executive Officer/the General Manager, and smaller average number of Board members, smaller average number of meetings held and smaller average value of compensations and benefits for the Board members. The Wilcoxon's Test showed significant difference in the number of Board meetings ($Z = -1. 667$, $p = 0. 095$, while $p < 0.1$, i.e. statistical significance of 90%) and in the number of compensations and benefits for the Chief Executive Officer/the General Manager, ($Z = -1. 877$, $p = 0. 061$ while $p < 0. 1$, i.e. statistical significance of 90%).

Table 3-Wilcoxon's Test of corporate governance elements

System of Governance	One-tier System (Average Value)	Two-tier System (Average Value)	Z -statistics	p-Value
Number of Board Members	6.19	5.55	-0.359	0.720
Number of Board Meetings	9.17	12.97	-2.417	0.016*
Number of compensations and benefits for the Board members	1.92	2.55	-2.134	0.033*
Number of compensation and benefits for the Chief Executive Officer/General Manager	4.58	4.05	-0.584	0.559
Shareholding Company's business activity	Shareholding companies production (Average Value)	Shareholding companies service (Average Value)	Z -statistics	p-Value
Number of Board Members	5.69	6.36	-0.657	0.511
Number of Board Meetings	10.10	14.36	-1.667	0.095**
Number of compensations and benefits for the Board members	2.06	2.55	-1.255	0.210
Number of compensations and benefits for the Chief Executive Officer/General Manager	4.63	3.00	-1.877	0.061**
Listed on Stock Exchange	Shareholding companies Listed on Stock Exchange (Average Value)	Shareholding companies not Listed on Stock Exchange (Average Value)	Z -statistics	p-Value
Number of Board Members	5.71	6.14	-0.448	0.654
Number of Board Meetings	12.43	9.19	-0.055	0.956
Number of compensations and benefits for the Board members	2.33	2.05	-0.822	0.411
Number of compensations and benefits for the Chief Executive Officer/General Manager	3.88	4.86	-1.439	0.150

* Statistical significance 95%

** Statistical significance 90%

Shareholding Company listed on Stock Exchange. The analysis of data of the third group shows that the shareholding companies listed on the Stock Exchange compared with those not listed are characterized by larger average number of meetings held, larger average number of Board members, larger average value of compensations and benefits for the Board members, and smaller average number of Board members and smaller average number of compensations and benefits for the Chief Executive Officer/the General Manager. The Wilcoxon's Test showed that there is no significant statistical difference in none of the compared elements.

Conclusion

This research shows that evaluating boards in large companies can generally contribute to effectiveness in corporate governance which is absolutely essential for the success of an organization. Consequently, the study suggests that appropriate functioning of the corporate governance is of crucial importance for the organizational effectiveness.

The effectiveness greatly depends on matters such as the organization of the boards, their composition, setting up committees, efficiency of the meeting, the role of President of the Board, ownership and management. The results provided additional insights into corporate governance practices in Republic of Macedonia.

This study should contribute to expanding the knowledge in the literature existing in this area by evaluating characteristics of boards in large companies in transition economy. Practical implications related to establishing different characteristics for the Boards in such a way that they would enhance the corporate governance effectiveness and give useful suggestions to managers by focusing their efforts on the effective corporate governance practice. This study indicates that there is a need of improving the corporate governance by introducing a more formalized, explicit and ongoing process, in several major areas of crucial importance, such as: evaluating boards, directors, committees and CEO; the role of the president of the board; type of committees, non-executives vs. independent directors; corporate culture; evaluating effectiveness of corporate governance; management succession; rating and reputation of corporate governance; institutional investors. The findings can also be used as an instrument to identify and overcome the barriers to effective corporate governance, as well as to establish a crucial direction for improving the corporate governance, the organizational performance and activities necessary for the effective implementation of corporate governance.

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CORPORATE GOVERNANCE PRACTICES IN FRAUD PREVENTION AND DETECTION - EMPIRICAL EVIDENCE FROM CROATIA

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Abstract

This paper presents the results of an empirical research conducted in the Republic of Croatia, based on the importance of the relevant corporate governance elements related to fraud detection and prevention. For the purpose of this research, the following hypothesis was tested: „The development of corporate governance system, based on the establishment of code of ethics, internal control system, independent and responsible work of internal auditors and audit committee, is crucial for fraud prevention and detection". Based on the results of an empirical research, the practices of Croatian companies in fraud prevention and detection are examined and presented. Also, this paper examines the possible improvements in corporate governance practices in Croatian companies, including the model of integrating forensic fraud investigation into the corporate governance system.

Keywords: corporate governance, fraud, fraud detection, fraud prevention, forensic fraud investigation, audit committee

Introduction

Management is responsible for the presentation of accurate, reliable and timely information in financial statements, so it is management's duty to establish a reliable financial reporting process and effective fraud prevention and detection measures. For the prevention of fraud, management must ensure that effective internal controls are in place, and that internal audit and audit committee perform their duties in an independent and responsible manner. In that context, the importance of corporate governance is discussed for the past decade (Gulin, 2004; Žager i Tušek, 2004; Tušek, 2004; Moizer, 2005; O'Brien, 2005; Sarra, 2005; Soltani, 2005; Tipurić, 2006; Clarke, 2007; Solomon, 2007; Lee, 2007; Tipurić 2008).

It is management's responsibility to promote corporate governance in a company, but it involves other participants also. Prepared financial statements are examined and tested by external auditors, followed by the work of internal auditors and audit committee in ensuring the reliability of financial reporting process for the purpose of protecting the owners and investors in capital markets.

In the circumstances of goods, services, labour and capital market globalization, increased use of information technologies and increased complexity of business transactions, accounting systems and regulatory requirements, strong accountability of management for a complete and true disclosure of data on company's financial position and business results and the growing public interest and care for the ethical behaviour of companies, the role of audit committees is becoming more and more significant and the scope of their responsibilities and tasks is widening. In some countries audit committees are obligatory for listed business entities, while in others audit committees are established and function as an economic necessity and as a result of the need to delegate relevant supervisory functions. Apart from this, audit committees may have different responsibilities, depending on local business culture and specific circumstances in each company. In both the continental system of corporate governance, characterized by a two-tier management structure - supervisory board and management board - and the Anglo-American corporate governance system, where the roles of the management board and the supervisory board are integrated in a single board of directors with executive and non-executive directors, the audit committee is one of the specialized subcommittees to which relevant supervisory functions are delegated. In continental corporate governance systems the audit committee is a specialized subcommittee of the supervisory board, while in the Anglo-American system of corporate governance the audit committee is a specialized subcommittee to which some supervisory functions of the board of directors are delegated. Primary functions of the audit committee are most frequently related to the area of internal controls and risk management, financial reporting, compliance with legal regulations and the relevant fields and issues related to external and internal audit processes. Responsibilities and authorities of the audit committee are normally defined and recorded in the form of an audit committee charter. Beside a clear and precise definition of responsibilities, authorities and tasks of the audit committee, an important pre-requisite for its functioning in concrete situations is the appropriate appointment of its members and the determination of its internal organization and particularly of the issue of its cooperation with external and internal auditors and communication with management. When properly structured and assigned clear authorities, audit committees may be of great benefit to management, shareholders and other stakeholders, external and internal auditors.

Therefore, external auditors, internal auditors, and audit committee, can be viewed as the protectors of integrity of financial reporting process for the purpose of maintaining the stability of capital markets. Their functions are interrelated and form a quality corporate governance system, with a primary role of fraud prevention and detection. Efficient corporate governance system uses fraud protection mechanisms to prevent fraud, and all available tools in the process of internal audit and audit of financial statements to detect fraud and to improve internal control system deficiencies. Therefore, in the context of fraud prevention and detection, corporate governance can be defined as a process in which all the participants contribute to the detection and prevention of fraud, with an aim to ensure long term profitability and prosperity of a company, which in turn contributes to creating an added value for shareholders and to the protection of other stakeholders of company's financial reports.

Some of the successful fraud prevention measures include the establishment of the code of ethics for management and employees of the company, which clearly states the proper and improper examples of conduct in a working environment, along with the sanctions for every breech of the code. Every breech of the code must be reported by other employees, customers, suppliers, and other interested parties. This can be achieved by promoting the ethical values of the company and by establishing a reliable and anonymous line for reporting such unethical and fraudulent behaviour of perpetrators.

Empirical research on the subject of corporate governance practices in the Republic of Croatia have been conducted previously (Tipurić, 2006; Zagreb School of Economics and Management, 2009; Sever, 2009), but the research on the importance of fraud prevention and detection measures in corporate governance systems were not covered by these studies. Therefore, this paper explores fraud prevention and detection measures in the context of corporate governance practices of Croatian corporations. More specifically, the purpose of this study was to determine the practices of these companies in regard to the effectiveness of the internal controls, the implementation of code of ethics and anonymous hotlines, and the practices of internal auditors and audit committee.

Research hypothesis

For the purpose of this research, the following hypothesis was tested:

"The development of corporate governance system, based on the establishment of code of ethics, internal control system, independent and responsible work of internal auditors and audit committee, is crucial for fraud prevention and detection."

This hypothesis was tested to determine the following: (1) practices of Croatian companies in fraud detection and prevention, (2) the importance of some particular fraud prevention measures, and (3) the importance of some particular fraud detection measures.

Research methodology

The empirical research on the subject of fraud detection and prevention measures in Croatian corporations was conducted from October to December 2010, using a survey method. Secondary research was conducted first, in order to analyze the founding of previous research of various authors internationally, in the area of corporate governance importance and best practices, which was later used as a conceptual framework for preparing the survey questions. The practices of Croatian companies in fraud detection and prevention was examined in 100 corporations, while the importance of some particular fraud detection and prevention measures were tested in three different groups – corporations, shareholders and auditors.

The objective was to collect 100 responses from each group. The list of corporation was found on the internet site of Croatian Chamber of Economy. Information on ten biggest shareholders of listed corporation was used to distribute the survey by e-mail to the shareholders of such companies, and by using a snowball sampling method, these shareholders were asked to generate information on additional shareholders. Information on certified auditors was found on the internet site of Croatian Audit Chamber. The needed 100 responses from auditors were collected by group survey, during an obligatory yearly education seminar for auditors, in November 2010.

Research findings

To determine the current practices in Croatian corporations, the respondents were asked to answer the series of questions (table 1). When asked to evaluate the efficiency of the internal controls in their company, 56% of respondents agreed that their internal controls are efficient enough, and another 23% think they are completely efficient. Code of ethics is implemented in more than 60% of surveyed companies, but only half of these companies have clearly defined penalties for breeches of the code which are later executed. Other companies do not use the penalties guidelines in practice or do not have any penalties defined.

Table 2 presents the frequency of fraud education for managers and employees in Croatian corporations. More than half of the surveyed companies never organized any kind of education on fraud prevention and detection for their managers (50%) and employees (56%). Only small number of companies has regular yearly education on the subject of fraud.

The presence of internal audit department and audit committee in surveyed Croatian companies is shown in table 3.

The vast majority of companies (72%) does not have an internal audit department and does not conduct surprise audits for the purpose of fraud detection. Also, audit committee is not formed in almost 80% of the surveyed corporations. In contrast to this, an empirical research (Paape, Snoep and Scheffe, 2002) conducted in 2002 on a sample of the total of 105 business entities from 15 European countries, showed that two thirds of respondents have an audit committee or a similar committee.

Poor corporate governance practice in surveyed companies in the Republic of Croatia can also be seen in regard to the presence of anonymous hotlines, which is implemented in only nine companies.

The importance of fraud prevention measures

In order to test the importance of specific fraud prevention measures, participants in the respondents were asked to distinguish three measures of good corporate governance they find crucial for fraud prevention in a company. The following measures were included in the survey: (1) anonymous fraud hotline, (2) surprise audits performed by the internal auditors, (3) efficient internal controls, (4) audit committee oversees the financial reporting process, along with the work of internal and external auditors, (5) external auditors obtain education in fraud detection in order to increase their chances for fraud detection during the audit of financial statements, (6) there is a possibility or requirement to hire forensic auditors, (7) management and employees of a company attend yearly education in the field of fraud detection and prevention, (8) code of ethics clearly states penalties for perpetrators and the perpetrators are sanctioned in accordance with the code, (9) positive and ethical tone at the top (10) pre-employment check-up for every employee.

Table 1-Internal controls and code of ethics in Croatian corporations

	Number of companies
The internal controls in a company are efficient	
Strongly disagree	2
Disagree	6
Neither agree nor disagree	13
Agree	56
Strongly agree	23
Total	100
The existence of code of ethics	
Company has a code of ethics	63
Company doesn't have a code of ethics	35
No answer	2
Total	100
Penalties in the code of ethics	
Penalties are defined and are strictly followed	37
Penalties are defined, but the breeches of the code are not always sanctioned	18
The code doesn't define any penalties	7
Company doesn't have a code of ethics	35
No answer	3
Total	100

Table 2-Education on fraud for employees and managers in Croatian corporations

Education	Managers	Employees
Once a year	16	8
Less than once a year	32	36
No education	50	56
No answer	2	0
Total	100	100

Table 3-Internal audit and audit committee in Croatian corporations

		Number of companies
Internal audit department existence	Yes	28
	No	72
Internal auditors perform surprise audits	Yes	24
	No	73
Audit committee existence	Yes	19
	No	79

Table 4 presents the answers to the question on the three most important fraud prevention measures. According to the research, the most important fraud prevention measure is “efficient internal controls”, since 125 respondents chose that particular measure as one of the three most important measures. The other important fraud prevention measures are “anonymous fraud hotline” with 116 responses, followed by the measures “code of ethics clearly states penalties for perpetrators and the perpetrators are sanctioned in accordance with the code”, and “possibility or requirement to hire forensic auditors”.

To further test these measures, the respondents were asked to rate the importance of each measure on the Likert scales from one to five (one being unimportant and five being very important). Table 5 presents the average responses to that question. According to the responses to that question, three most important fraud prevention measures are “positive and ethical tone at the top”, “efficient internal controls", and "code of ethics clearly states penalties for perpetrators and the perpetrators are sanctioned in accordance with the code ".

To test the consistency between responses to these two questions on fraud prevention measures, correlation coefficients were calculated (table 6), which showed high correlation between three chosen measures and scale of importance. For example, correlation coefficient for all respondents is 0,882, which suggests high positive correlation with significance of 1%.

Table 7 presents the ranks of individual measures as one of the three most important fraud prevention measures. The measure "efficient internal controls" was considered the most important measure according to the responses from the respondents from all three groups, and respondents from corporations and auditors. The measure "possibility or requirement to hire forensic auditors" is considered the most important fraud prevention measure according to the survey results from shareholders.

Table 8 presents the ranks of individual fraud prevention measures according to the average responses with regard to the importance of each measure. The majority of responses from all three groups of respondents, and from the corporations, were collected for the measure "positive and ethical tone at the top". The measure "possibility or requirement to hire forensic auditors" was considered as most important in the views of shareholders, while auditors think efficient internal controls are most important for fraud prevention.

To test the consistency between responses to these two questions on fraud prevention measures, rank correlation coefficients were calculated (table 9).

Table 4-The importance of fraud prevention measures according to the opinion of respondents – three most important measures

Fraud prevention measures	All respondents	Auditors	Shareholders	Corporations
Anonymous fraud hotline	116	43	35	38
Surprise audits performed by the internal auditors	91	23	37	31
Efficient internal controls	125	52	28	45
Audit committee oversees the financial reporting process, along with the work of internal and external auditors	61	18	25	18
External auditors obtain education in fraud detection in order to increase their chances for fraud detection during an audit of financial statements	103	27	40	36
There is a possibility or requirement to hire forensic auditors	108	41	45	22
Management and employees of a company attend yearly education in the field of fraud detection and prevention	63	24	15	24
Code of ethics clearly states penalties for perpetrators and the perpetrators are sanctioned in accordance with the code	109	37	32	40
Positive and ethical tone at the top	103	33	32	38
Pre-employment check-up for every employee	21	7	7	7
Total	900	305	296	299

Table 5-The importance of fraud prevention measures according to the opinion of respondents – average responses (1 - Unimportant-; 2 - Of Little Importance; 3 - Moderately Important; 4 - Important; 5 – Very Important)

Fraud prevention measures	All respondents	Auditors	Shareholders	Corporations
Anonymous fraud hotline	3,77	3,59	3,88	3,84
Surprise audits performed by the internal auditors	3,76	3,47	3,90	3,89
Efficient internal controls	4,03	4,06	3,92	4,12
Audit committee oversees the financial reporting process, along with the work of internal and external auditors	3,65	3,29	3,85	3,78
External auditors obtain education in fraud detection in order to increase their chances for fraud detection during an audit of financial statements	3,95	3,53	4,13	4,15
There is a possibility or requirement to hire forensic auditors	3,90	3,66	4,26	3,78
Management and employees of a company attend yearly education in the field of fraud detection and prevention	3,79	3,53	3,86	3,97
Code of ethics clearly states penalties for perpetrators and the perpetrators are sanctioned in accordance with the code	3,96	3,82	3,89	4,17
Positive and ethical tone at the top	4,06	3,93	4,03	4,21
Pre-employment check-up for every employee	3,29	3,05	3,35	3,46

Table 6-Correlation coefficients for the three most important fraud prevention measures and the responses on the Likert scale in tables 4 and 5

	All respondents	Auditors	Shareholders	Corporations
Correlation coefficient P-value	0,882 0,001*	0,872 0,001*	0,869 0,001*	0,877 0,001*

Table 7-The ranks of individual fraud prevention measures as one of the three most important measures (1 – greatest number of responses, 10 – smallest number of responses)

Fraud prevention measures	All respondents	Auditors	Shareholders	Corporations
Anonymous fraud hotline	2	2	4	3
Surprise audits performed by the internal auditors	7	8	3	6
Efficient internal controls	1	1	7	1
Audit committee oversees the financial reporting process, along with the work of internal and external auditors	9	9	8	9
External auditors obtain education in fraud detection in order to increase their chances for fraud detection during an audit of financial statements	5	6	2	5
There is a possibility or requirement to hire forensic auditors	4	3	1	8
Management and employees of a company attend yearly education in the field of fraud detection and prevention	8	7	9	7
Code of ethics clearly states penalties for perpetrators and the perpetrators are sanctioned in accordance with the code	3	4	5	2
Positive and ethical tone at the top	5	5	5	3
Pre-employment check-up for every employee	10	10	10	10

Table 8-The ranks of individual fraud prevention measures according to the average responses (1 - Unimportant-; 2 - Of Little Importance; 3 - Moderately Important; 4 - Important; 5 – Very Important) with regard to the importance of each measure (1 – the greater importance rank, 10 – the lowest importance rank)

Fraud prevention measures	All respondents	Auditors	Shareholders	Corporations
Anonymous fraud hotline	7	5	7	7
Surprise audits performed by the internal auditors	8	8	5	6
Efficient internal controls	2	1	4	4
Audit committee oversees the financial reporting process, along with the work of internal and external auditors	9	9	9	8
External auditors obtain education in fraud detection in order to increase their chances for fraud detection during an audit of financial statements	4	7	2	3
There is a possibility or requirement to hire forensic auditors	5	4	1	8
Management and employees of a company attend yearly education in the field of fraud detection and prevention	6	6	8	5
Code of ethics clearly states penalties for perpetrators and the perpetrators are sanctioned in accordance with the code	3	3	6	2
Positive and ethical tone at the top	1	2	3	1
Pre-employment check-up for every employee	10	10	10	10

Table 9-Spearman's rank correlation coefficients for the three most important fraud prevention measures and the responses on the Likert scale presented in tables 7 and 8

	All respondents	Auditors	Shareholders	Corporations
Correlation coefficient	0,669	0,867	0,407	0,845
P-value	0,035**	0,003*	0,243	0,002*

The results showed high correlation between the rank of three chosen measures and the rank of responses in the scale of importance. For example, correlation coefficient for all respondents is 0,669, which suggests high positive correlation with significance of 5%. Correlation is significantly higher for auditors and corporations, whereas the correlation for shareholders is low and not statistically significant. However, the use of Spearman's rank correlation coefficients showed that the responses were consistent.

The importance of fraud detection measures

The importance of specific fraud detection measures was also tested, in line with the survey on fraud prevention measure. The respondents were asked to distinguish three most important measures of good corporate governance, which they find crucial for the detection of fraud. The following measures were presented in the survey: (1) anonymous fraud hotline, (2) surprise audits performed by the internal auditors, (3) efficient internal controls, (4) external auditors are focused on fraud detection while performing an audit of financial statements, (5) forensic fraud investigation is conducted, (6) the presence of "fraud triangle" elements is observed for every employee of a company.

Table 10 presents the respondent's views on the three most important fraud detection measures. External audit is considered the most important for fraud detection by 186 respondents. The other two important fraud detection means include forensic fraud investigation (177 responses) and anonymous fraud hotline (164 responses).

To further test these measures, the respondents were asked to rate the importance of each measure on the Likert scales from one to five (one being unimportant and five being very important). Table 11 presents the average responses to that question. According to the responses, three most important fraud prevention measures are "forensic fraud investigation is conducted" (4,21), "external auditors are focused on fraud detection while performing an audit of financial statements" (4,11), and "efficient internal controls" (4,00).

To test the consistency between responses to these two questions on fraud detection measures, correlation coefficients were calculated (table 12), which showed relatively high correlation between three chosen measures and scale of importance. For example, correlation coefficient for all respondents is 0,899, which suggests high positive correlation with significance of 5%. Correlation is significantly higher for auditors and corporations, whereas the correlation for shareholders is low and not statistically significant. However, the use of correlation coefficients analysis showed that the responses were consistent.

Table 13 presents the ranks of individual measures as one of the three most important fraud detection measures. The measure "external auditors are focused on fraud detection while performing an audit of financial statements" was considered the most important measure according to the responses from the respondents from all three groups, as well as auditors and respondents from corporations. The measure "forensic fraud investigation is conducted" is considered the most important fraud detection measure according to the survey results from shareholders, while the auditors chose the measure "efficient internal controls" as most important.

Table 10-The importance of fraud detection measures according to the opinion of respondents – three most important measures

Fraud detection measures	All respondents	Auditors	Shareholders	Corporations
Anonymous fraud hotline	164	57	54	53
Surprise audits performed by the internal auditors	131	43	38	50
Efficient internal controls	152	64	36	52
External auditors are focused on fraud detection while performing an audit of financial statements	186	50	68	68
Forensic fraud investigation is conducted	177	60	69	48
The presence of "fraud triangle" elements is observed for every employee of a company	64	17	22	25
Total	874	291	287	296

Table 11-The importance of fraud detection measures according to the opinion of respondents – average responses (1 - Unimportant-; 2 - Of Little Importance; 3 - Moderately Important; 4 - Important; 5 – Very Important)

Fraud detection measures	All respondents	Auditors	Shareholders	Corporations
Anonymous fraud hotline	3,84	3,59	3,95	3,95
Surprise audits performed by the internal auditors	3,84	3,66	3,74	4,10
Efficient internal controls	4,00	4,07	3,76	4,18
External auditors are focused on fraud detection while performing an audit of financial statements	4,11	3,60	4,36	4,34
Forensic fraud investigation is conducted	4,21	4,01	4,41	4,19
The presence of "fraud triangle" elements is observed for every employee of a company	3,29	3,01	3,38	3,45

Table 12-Correlation coefficients for the three most important fraud detection measures and the responses on the Likert scale in tables 10 and 11

	All respondents	Auditors	Shareholders	Corporations
Correlation coefficient	0,899	0,879	0,492	0,912
P-value	0,023**	0,021**	0,322	0,011**

Table 13-The ranks of individual fraud detection measures as one of the three most important measures (1 – greatest number of responses, 6 – smallest number of responses)

Fraud detection measures	All respondents	Auditors	Shareholders	Corporations
Anonymous fraud hotline	3	3	3	2
Surprise audits performed by the internal auditors	5	5	4	4
Efficient internal controls	4	1	5	3
External auditors are focused on fraud detection while performing an audit of financial statements	1	4	2	1
Forensic fraud investigation is conducted	2	2	1	5
The presence of "fraud triangle" elements is observed for every employee of a company	6	6	6	6

Table 14 presents the ranks of individual fraud detection measures according to the average responses with regard to the importance of each measure. The majority of responses from all three groups of respondents, and from the shareholders, were collected for the measure "forensic fraud investigation is conducted". The measure "external auditors are focused on fraud detection while performing an audit of financial statements" was considered as most important in the views of corporations, and the measure "efficient internal controls" was considered the most important in auditor's opinion.

To test the consistency between responses to these two questions on fraud detection measures, rank correlation coefficients were calculated (table 15).

The results showed high correlation between the rank of three chosen measures and the rank of responses in the scale of importance, only for shareholders. For other two groups of respondents, correlation coefficients are relatively high, but not statistically significant. However, they do imply that the responses were consistent.

Conclusions and recommendations

For the purpose of this research, elements of corporate governance relevant to fraud prevention and detection were abstracted, in order to test their significance in the same area. To test the research hypothesis, a survey method was used to collect and analyze the views of corporations, shareholders and auditors on the chosen fraud prevention and detection measures. Method of comparison was then used to compare the results of a primary research with corporate governance practices in other countries, to determine the necessary improvements in current corporate governance practices in the Republic of Croatia. According to the conducted research, corporate governance practices in the Republic of Croatia need improvement in several areas, regarding fraud prevention and detection. Only 37% of surveyed companies have strict code of ethics policies. More than third of the companies doesn't have a code of ethics implemented at all. Therefore, the code of ethics is one area which requires special attention, and companies need to be introduced to the importance of implementing such a code in a company, in order to specify proper and improper conduct of employees and managers, which helps in preventing fraudulent behaviour. According to the global research on fraud, the most effective means of detecting fraud are anonymous hotlines and surprise audits conducted by internal auditors. Considering the fact that these two measures of fraud detection are not available in the vast majority of surveyed companies, the risk of fraud is greater in their companies. Also, the possibility of fraud schemes and fraudsters to remain undetected is much greater in those companies, in comparison with the companies that already have these measures implemented. Anonymous hotlines are commonly governed by the internal audit department or audit committee, and non-existence of both in majority of companies contributes to poor corporate governance practice and low rate of fraud detection cases. Although the companies find the subjected elements of the corporate governance system – code of ethics, internal controls system, internal audit and audit committee – important measures for fraud detection and prevention, they are not implemented in practice in Croatian companies. Therefore, the research hypothesis is only partly confirmed.

When considering at the presence and functioning of audit committees in Croatia in comparison to market-oriented developed countries, we can definitely conclude that the knowledge and experience in this respect are very moderate, however, not inexistent, especially in major companies. With the gradual harmonization of our legislation in this field with the requirements of the European Union, followed by a real change in the level of awareness and activity of all participants in the corporate governance system, it can be expected that the practice of the organizing and functioning of audit committees will, for certain categories of companies, become more and more extensive. In regard to the presented results of empirical research, several recommendations can be helpful in promoting better fraud prevention and detection practices, regarding the duties of audit committee in Croatian companies. Since all public companies have an obligation to form an audit committee, it is important to add a new task for the audit committees in the law, which obligates the committees to establish a system of anonymous reporting of fraudulent activities in a company via anonymous hotline. In turn, this would require an establishment of greater whistleblower protection in the Republic of Croatia, which is also not satisfactory at the moment.

Table 14-The ranks of individual fraud detection measures according to the average responses (1 - Unimportant-; 2 - Of Little Importance; 3 - Moderately Important; 4 - Important; 5 – Very Important) with regard to the importance of each measure (1 – the greater importance rank, 6 – the lowest importance rank)

Fraud detection measures	All respondents	Auditors	Shareholders	Corporations
Anonymous fraud hotline	5	5	3	5
Surprise audits performed by the internal auditors	4	3	5	4
Efficient internal controls	3	1	4	3
External auditors are focused on fraud detection while performing an audit of financial statements	2	4	2	1
Forensic fraud investigation is conducted	1	2	1	2
The presence of "fraud triangle" elements is observed for every employee of a company	6	6	6	6

Table 15-Spearman's rank correlation coefficients for the three most important fraud detection measures and the responses on the Likert scale presented in tables 13 and 14

	All respondents	Auditors	Shareholders	Corporations
Correlation coefficient	0,657	0,600	0,943	0,486
P-value	0,156	0,208	0,005*	0,329

The second new role of audit committees can be related to forensic fraud investigation. The results of a survey imply that forensic fraud investigation is an effective way of fraud detection, as well as an important mean of fraud prevention. This is particularly important in the views of shareholders, so in terms of achieving greater confidence in financial reporting and auditing processes in the eyes of shareholders, it would be very effective if such an investigation would be covered by the law. In that case, the Law on Auditing would require from audit committee to consider hiring a certified fraud examiner to conduct a fraud investigation, if there is a suspicion of fraud existence in a company. This model of implementing forensic fraud investigation in practice doesn't generate high cost for all companies, but only in the companies where the suspicion of fraud exists. Also, this model is a great mean of fraud prevention, since the potential fraudsters may be deterred from committing fraud, if they would know that an anonymous fraud hotline system is established in a company, which can be used to report fraud, and that audit committee can hire a certified specialist to investigate these received fraud suspicions. The only problem is that currently there are no certified fraud examiners available in the Republic of Croatia to conduct such investigation. Therefore, to strengthen the corporate governance practices in fraud prevention and detection in the Republic of Croatia, the following steps need to be taken: (1) implement a requirement in the Law on Auditing for an audit committee to establish an anonymous hotline to report fraud, (2) implement a requirement in the Law on Auditing for an audit committee to consider hiring a forensic fraud examiner, (3) establish a greater whistleblower protection, (4) initiate the development of fraud investigation specialists profession. The implementation of these measures would result in better fraud prevention systems in companies, and the higher rate of detected frauds, which would result in greater confidence of investors and other stakeholders in capital markets in the processes of financial reporting and auditing.

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INTERNET BASED OVERVIEW OF CORPORATE SOCIAL RESPONSIBLE PRACTICE IN FOUR COUNTRIES IN SOUTHEAST EUROPE

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Abstract

Many would agree that the whole world is on the crossroad, and that would be profoundly true for the European Union (EU) as well. At the present time, the EU is attempting to reinforce centralised control of its less developed periphery, and yet its foundations have been shaken by its very core principle of existence - unity between financially responsible and developed countries on the one hand, and spendthrift and less developed countries on the other. In South-Eastern Europe there are six countries that used to share a common socio-political frame within the former Yugoslavia. Today they are independent, but oriented towards the EU that is again similar political form of different countries with different cultures, languages, dominant religions and ethics. In that sense some similarities can be drawn between what is happening today in the EU and past events in the former Yugoslavia. Requirements for unanimity and consensus have slowed down the process of decision-making that has affected the efficiency of the EU in the same way as to what happened in the former Yugoslavia. Moreover, it is known that one of the most powerful tools modern society has at its disposal is business. Academics and practitioners widely support the view that a new era has dawned in which business must adopt a new concept of its purpose and conduct by integrating responsibility into all of its activities. In October 2011 the European Commission published a new policy on corporate social responsibility (CSR) that clearly defined it as a base model for the global competitiveness of the EU. In this paper we explored differences between socially responsible practices of business organisations in four Southeast European countries with common, but different history.

Keywords: corporate social responsibility, comparative analysis, reporting practice, European Union

Introduction

In a fast-changing world, the European Union (EU) is resolute to become a smart (educated, knowledgeable and innovative), sustainable (resource-efficient, administrative-effective, greener and competitive) and inclusive economy (with high employment and economic, social and territorial cohesion). These three mutually reinforcing priorities should help the Member States deliver high levels of employment, productivity and social cohesion. This vision of Europe's social market economy for the 21st century is based on a partnership between different stakeholders. In that sense some similarities can be drawn between what is happening today in the EU and what happened in the former Yugoslavia. They were both built on ideas that some facts of mutual life, notwithstanding divergent interests, could not be challenged: such as right to make mistakes as prerequisite for development; cooperation to be more important than confrontation; trust to overcome contempt; and need to make everlasting friendship to overcome need to define common enemy. Now we are witnessing that both systems have encountered serious problems for rather similar reasons.

Moreover to what was previously mentioned, there are many other trends indicating that the EU, as we perceive it today will not last much longer. The most obvious are economical indications. In addition to the disparity between new under-developed and old developed Europe, there is also a clear threat of collapse of intensively deregulated neo-liberal market model, monetary unity and fiscal sovereignty of all Member States. Besides economical, there are also social and ecological trends that are equally influential and important, such as distorted trust among major stakeholders, increasing social division, insufficient social and natural resources, multi-dimensional ecological crises resulting in more frequent natural disasters, and radical transparency enforced by constant development of modern technology. Therefore, the main focus has rather been on different trends changing our world, than on understanding the role of the most powerful entities such as companies. It seems fairly clear that, after the family, companies are perhaps the major unit of modern society since they influence almost every aspect of our lives and our societies (Henriques, 2010). In that sense it is interesting to observe how the EU is treating business organisation as one of the most important and powerful entities. Despite numerous efforts to bring about a clear and unbiased definition of corporate social responsibility (hereafter CSR), there is still some confusion as to how CSR should be defined (Dahlsrud, 2008), but one thing is for sure, responsible business practice is acting beyond what is prescribed by law (Visser, Matten, Pohl, and Tolhurst, 2007; McBarnet, Voiculescu and Campbell, 2007; Crane, McWilliams, Matten, Moon and Siegel, 2008). In the recent communication on corporate social responsibility issued by the European Commission - Enterprise and Industry it is stated that to fully meet their responsibility, enterprises should have in place a process to integrate social, environmental, ethical and human rights concerns into their business operations and core strategy in close collaboration with their stakeholders (EC, 2011). Companies now need to consider the wider social and environmental consequences of their action (McWilliams and Siegel, 2001). The aim is both to enhance positive impacts, i.e. through the innovation of new products and services that are beneficial to society and enterprises themselves; and to minimize and prevent negative impacts.

Therefore CSR is generally accepted as a base model to achieve competitive advantage among the EU economies since it creates conditions within the business environment where business organization is perceived as a synergy vehicle that creates and maintains sustainable growth and development. It comprises activities that ensure early adaptation to market needs while avoiding risks and meeting the expectations of a wide range of stakeholders. It is now more clear than ever that business paradigm has changed from profit maximization to company's responsibilities to a broad range of stakeholders including employees, customers, clients, investors, suppliers, unions, community members, citizens and environment in general (Omazic and Vlahov, 2011). CSR follows from a decision by management to expand traditional governance arrangements to include accountability to the full range of stakeholders noted above. CSR in its core brings together business interests with interests of society (Hopkins, 2003; Baller and de Bry, 2003). Numerous authors emphasize a significant positive impact of CSR in the implementation of systematic activities that examine the impact of factors on the success that future operations have on the organisation (Black and Haertel, 2004; Omazic, 2008) and therefore it is necessary for organisation to embrace it as a basis for strategic development with no hidden intentions (Hollender and Breen, 2010). It is not static and linear concept, but the process of continuous negotiation and redefinition of what is feasible. The outcomes that corporate responsibility covers are changing over time and according to the cultural aspect. Activities associated with CSR typically represent firms' efforts to do more to address a wide variety of social problems than they would have done in the course of their normal pursuit of profits (Vogel, 2005; Visser et al 2007; Crane et al, 2008; Omazic, 2008; Hollender and Breen, 2010). Being responsible is not a fixed, unchanging state that is established by applying some business activities in practice and how they are integrated into the business. Being responsible is more related to the willingness, capacity and capabilities upon which businesses learn and integrate changing expectations of society in their risk, change and opportunity management, as well as ways in which these business practices meet the demands of the business environment. Corporate social responsibility is incorporated into every aspect of business strategy and decision-making since it became essence of sustainable success. CSR, therefore, represents actuality and keeps constantly changing its manifestation thereby altering the boundaries of possibility. It can offer a platform for short-term performance and long-term health of the organization, set proper aspirations and create a timeline for their achievement (Omazic, 2008). In that sense on a wide range of issues corporations are encouraged to behave socially responsibly and sustainable (Vogel, 2005; Welford and Frost, 2006; Visser, 2007; Crane, 2008; Hollender and Breen, 2010). However, no matter which definition is chosen, all the above mentioned shares two basic principles, responsibility scope of the company and creation of value added by business activities. It is a primary set of strategic activities that have, as the final result, mutual benefit for the company and for certain social context. Changing societal expectations have caused firms to consider more carefully their wider social responsibilities, not only out of altruistic reasons, but also of the need to consider the potential impact of their policies on stakeholder relationships. This should be even more critical during precarious economic climates (Lacey and Kennett-Hensel, 2010). Companies are not just fighting for our minds but also for our hearts, for human cognition, emotion, motivation and will (Omazic, 2011). In that sense an important question has been already raised and that is if a corporation have a conscience (Goodpaster and Matthews, 1982).

Corporate social responsibility is not a new concept, but has gone through many transformations throughout history. In 1930s it was the time when moral and responsibility of businessmen came into spotlight of the research, in mid 1950s, corporate responsibility was developed more rapidly, but with no consensus towards the meaning of the term, while in 1970s, this concept was fully recognized (Baller and de Bry, 2003). With the awareness of issues like safety and health in the workplace and equal opportunities for all, as well as closely reviewed business practices by public, a company could no longer justify its existence only by its economic success or liability to shareholders. As they were perceived as social factors, companies that wanted to preserve their reputation, needed to pay a lot of attention to their social responsibilities and aim at a wider audience. Thinking about CSR went from considering it a part of the business entity social contract, to becoming a strategic part of every business practice. There are a number of financial ratios and other benchmarks that can be used to document the questionable future company's role within a society after the formal recession has ended (Kumar and Tiwari, 2011). Managers must engage, and firms must hire managers with the ability to do more than just manage the financial issues (Kemper and Martin, 2011).

Research methodology

Perhaps never in the history has so much been written about the role of business in modern society. This renaissance of interest in that topic is also reflected in a bumper crop of books and articles published during the last year, the quality of which runs the gamut from one to another extreme. Developing countries often lack important statistical data, and even in the most advanced countries many critical kinds of observations still have not been systematically made. The aim of this paper is to examine the degree of availability of information on corporate social responsibility in companies operating in Southeast Europe. The analysis was performed through available Internet based electronic content on corporate social responsible practices of 40 companies based in four Southeast European or so called Balkan countries: Croatia, Slovenia, Serbia, and Bosnia and Herzegovina.

Subjects of the analysis were ten companies from each of the four countries that recorded the highest revenue in fiscal year 2009 and that were registered in one of four countries, irrespective of their origin and ownership of capital. Selected four Southeast European countries had until 1990 a common market and historic background within the Social Republic of Yugoslavia, therefore we found this research particularly interesting since it presents different development of practices within similar context. And yet after 1991 with the breakdown of the former Yugoslavia and international recognition and independence, the development of market and business in those countries went on with different dynamics and pace, depending on the socio-political framework. Slovenia became a Member State of the EU in 2004, Croatia is in process of joining in 2013, while Serbia issued candidate application in 2009; and Bosnia and Herzegovina is waiting for signing the accession negotiations.

Objects of the analysis were electronically available content including:

- Companies official website's content

- Annual reports for business year 2009
- Reports on sustainable development and/or corporate social responsibility for business years 2008 and 2009. The reason for including reports from both 2008 and 2009 is the fact that reporting on corporate social responsibility practices was not mandatory in selected countries. Therefore, some companies chose to publish their corporate social responsibility reports for longer time period, sometimes for two-year period.

Content was analysed and categorized within three main groups of CSR indicators:

1. Economic indicators
2. Environmental indicators
3. Social indicators.

Each group of CSR indicators encompassed specific and relevant aspects of corporate social responsibility already defined by four most relevant international standards of corporate social responsibility reporting: Global Reporting Initiative (GRI), UN Covenant on Economic, Social and Cultural Rights, Accountability (AA1000) and UN Global Compact. For the purpose of this research, CSR indicators were divided in groups as follows.

Economic indicators:

1. Business risks and opportunities
2. Business income
3. Income by region
4. Costs of materials, goods and services
5. Personnel costs
6. Profit before taxation
7. Income tax
8. Average gross employee wages
9. Total value of donations
10. Structure of suppliers.

Environmental indicators:

1. Compliance with environmental laws and regulations
2. Person/department for environmental protection
3. Raw materials and process materials
4. Energy consumption monitoring
5. Water consumption monitoring
6. Biodiversity promotion
7. Greenhouse gas emissions monitoring and reduction
8. Waste management
9. Unpredicted events with significant environmental impact
10. Initiatives to mitigate environmental impacts
11. Usage of renewable source
12. Providing environmentally acceptable technologies and services
13. Integration of environmental protection aspects into supply chain.

Social indicators:

1. Human rights
2. Health and safety of the workforce
3. Lifelong education and training of the workforce
4. Diversity and equal opportunities
5. Anti-discrimination programs and initiatives
6. Freedom of association and collective bargaining
7. Anti-forced labour initiatives
8. Anti-child labour initiatives
9. Anticorruption programs and initiatives
10. Transparent supply policy
11. Human rights among suppliers and partners
12. Supply chain management
13. Product responsibility and customer protection
14. Donations and sponsorships programs.

Availability of information related to a each group of CSR indicators was evaluated and categorized into three degrees: zero (0) – unavailable information – no information was detected; one (1) – partially available information – there were some information mentioned certain indicator, however they were superficial, incomplete or rare in comparison to norms, and they needed further processing and completion; two (2) – completely available information – information about certain indicator met standards and were relevant, descriptive and detailed in character.

To capture the complexity of the corporate social responsibility concept, the research was conducted in four phases:

1. Creation of indicators' matrix – the matrix was designed in order to cover all relevant aspects of relevant international standards (GRI, UN standards, AA1000 and Global Compact), which were then categorized into three basic CSR indicators
2. Matrix pilot testing – the matrix was tested on a sample from all four countries: Croatia, Slovenia, Bosnia and Herzegovina and Serbia. After pilot testing, certain indicators were excluded for the reason of their irrelevance and repetition
3. Selections of sample – companies from each of four countries were selected according to the highest revenue in business year 2009. Information on income of companies in selected countries as well as their ranking was publicly available data
4. Entry and processing of results – all aspects of CSR indicators were analysed and marked with zero (0), one (1) and two (2) points in order to facilitate quantitative research. Each company received a percentage of availability for each indicator and a percentage of average availability of a group of indicators.

Analysis and results

According to obtained results, 67.50% of analysed companies published annual reports for business year 2009 while 32.50% did not have their annual reports published. Most of companies (97.50%) had official websites on the Internet, while 2.50% of companies did not have official website. On the other hand, reports on sustainability or corporate social responsibility most of companies (82.50%) did not have while 17.50% had such reports published.

Economic indicators

The economic dimension of corporate social responsibility concerns the impact the organization has on the economic conditions of its stakeholders and on economic systems at local, national and global levels. They illustrate the efficient use of resources, the competitiveness of business and the viability of the business regarding its influence to different dimensions of organizational excellence.

The analysis of availability of economic indicators in 40 companies in the entire sample indicated a strong division between companies that had complete information on their economic performance (48.25%) and the ones that had no information on economic indicators (50.50%). The economic indicators completely available in most of analyzed companies (72.50% and higher) were information on business income, profit before taxation and income tax. On the other hand, the indicators that were unavailable in most of companies (85.00%) were average gross employee wages, total value of donations and structure of suppliers.

Environmental indicators

The environmental indicators are structured to reflect the inputs, outputs and modes of impact an organisation has on the environment. They represent simple measures that indicate what is happening in the environment and how business is affecting it. Since the environment is very complex and has many different, yet connected dimensions, indicators provide a more practical way to track the state of the environment.

Table 1-Economic indicators within the entire sample (n=40)

Economic Indicators	Complete	Partial	None
Business risks and opportunities	40.00%	0.00%	60.00%
Business income	75.00%	0.00%	25.00%
Income by regions	65.00%	0.00%	35.00%
Costs of materials, goods and services	67.50%	0.00%	32.50%
Personnel costs	70.00%	2.50%	27.50%
Profit before taxation	72.50%	0.00%	27.50%
Income tax	72.50%	0.00%	27.50%
Average gross employee wages	5.00%	2.50%	92.50%
Total value of donations	12.50%	2.50%	85.00%
Structure of suppliers	2.50%	5.00%	92.50%
Average:	**48.25%**	**1.25%**	**50.50%**

Table 2-Environmental indicators within the entire sample (n=40)

Environmental Indicators	Complete	Partial	None
Compliance with environmental laws and regulations	37.50%	35.00%	27.50%
Person/department for environmental protection	7.50%	5.00%	87.50%
Raw materials and process materials	20.00%	17.50%	62.50%
Energy consumption monitoring	27.50%	17.50%	55.00%
Water consumption monitoring	22.50%	17.50%	60.00%
Biodiversity promotion	7.50%	10.00%	82.50%
Greenhouse gas emissions monitoring and reduction	22.50%	25.00%	52.50%
Waste management	30.00%	22.50%	47.50%
Unpredicted events with significant environmental impact	2.50%	0.00%	97.50%
Initiatives to mitigate environmental impacts	40.00%	15.00%	45.00%
Usage of renewable sources	25.00%	10.00%	65.00%
Providing environmentally acceptable technologies and services	22.50%	20.00%	57.50%
Integration of environmental protection aspects into supply chain	2.50%	12.50%	85.00%
Average:	**20.58%**	**15.96%**	**63.46%**

Results of the analysis of the environmental indicators indicated the complete average availability of information up to 20.58% of companies. No information on environmental indicators had 63.46% of selected companies. The information on aspects that were completely available (in range of 30.00% - 40.00% of companies) was compliance with the environmental laws and regulations, waste management and initiatives to mitigate environmental impacts. Most of companies included in this research had no available information on person and/or department for environmental protection (87.50%), indicator of biodiversity promotion (82.50%), unpredicted events with significant environmental impact (97.50%) or indicator of integration of environmental protection into supply chain (85.00%).

Social indicators

The categories such as labour, human rights, product responsibility and involvement in the society address both social impacts associated with specific stakeholder group such as employees or customers; and the company's approach to dealing with social groups such as communities in which they operate. The social indicators are probably the most complex ones since many are in part economic, environmental and sustainability measures as well. Thus, it is important to recognize this reality and draw clear line between important ones and less important ones.

Table 3-Social indicators within the entire sample (n=40)

Social Indicators	Complete	Partial	None
Human rights	17.50%	10.00%	72.50%
Health and safety of the workforce	35.00%	15.00%	50.00%
Lifelong education and training of the workforce	42.50%	25.00%	32.50%
Diversity and equal opportunities	25.00%	10.00%	65.00%
Anti-discrimination programs and initiatives	25.00%	10.00%	65.00%
Freedom of association and collective bargaining	22.50%	10.00%	67.50%
Anti-forced labour initiatives	10.00%	2.50%	87.50%
Anti-child labour initiatives	10.00%	0.00%	90.00%
Anticorruption programs and initiatives	15.00%	20.00%	65.00%
Transparent supply policy	20.00%	17.50%	62.50%
Human rights among suppliers and partners	10.00%	5.00%	85.00%
Supply chain management	10.00%	5.00%	85.00%
Product responsibility and customer protection	15.00%	25.00%	60.00%
Donations and sponsorships programs	45.00%	22.50%	32.50%
Average:	**21.61%**	**12.68%**	**65.71%**

Analysis performed on selected companies indicated the balance between social indicators in terms of degree of availability. 65.71% of companies had in average no information available on social indicators. The indicators that were unavailable within most companies (up to 85.00% and higher) were concerning fighting forced and child labour, human rights among suppliers and partners and supply chain management. However, 21.61% of the companies had the average complete information on social indicators. The most available information within social indicators were ones on health and safety of workforce (35.00%), lifelong education and training of workforce (42.50%), and on donations and sponsorships programs (45.00%).

The country availability rank

The rank of countries that indicated completely available information on all three economic, environmental and social indicators had the same order. Croatian companies in all three groups of CSR indicators demonstrated the highest complete average availability of information. Reporting on environmental and social aspects seemed to have the lowest average availability score in all selected countries, while the complete average availability of the economic indicators was significantly higher for all four countries.

Limitations and further research

This study has several limitations. Firstly, selected companies represented the most successful ones in recorded revenue and their results in this research should not be used for making general conclusions on the actual situation of corporate social responsibility in those countries. Although it is sure that selected companies do set trends and influence local and foreign markets in which they operate. The second limitation of the research is the nature of the sample itself, since the selection criteria was recorded revenue. Small and medium-sized enterprises perhaps cannot be compared in terms of height of revenue with large companies; however their number on market is definitely significant and should not be underestimated. Moreover, in many countries, small and medium-sized enterprises make up to 95% of the total number of registered enterprises. Another limitation is related to the methodology used in this research. If information on certain CSR practice is not publicly available and communicated through electronic media, it does not prove its absence. CSR practices could have been strategically implemented, but without being necessarily announced in public. Last limitation is a notable lack of data collected during a longer period of time that is necessary for credible and more complex statistics.

Figure 1-Complete average availability of economic indicators in four analyzed countries

	Croatia	Slovenia	Serbia	Bosnia and Herzegovina
Economic indicators	57%	55%	46%	35%

Figure 2- Complete average availability of environmental indicators in four analyzed countries

	Croatia	Slovenia	Serbia	Bosnia and Herzegovina
Environmental indicators	30%	22%	17%	14%

Figure 3-Complete average availability of social indicators in four analyzed countries

	Croatia	Slovenia	Serbia	Bosnia and Herzegovina
Social indicators	33%	30%	21%	2%

Thus, further studies should address corporate social responsible practices within small and medium-sized enterprises in order to obtain a detailed insight into the implementation of social responsibility in business sector regardless amount of revenue and number of employees. Likewise, this type of research should be conducted longitudinally and at regular time intervals. By continuous measuring, progress, trends and development of corporate social responsibility in selected countries could be monitored and assessed in more qualitative way.

Discussion

Reporting on corporate social responsibility is a way of measuring, disclosing and being accountable to internal and external stakeholders, and thus should provide a representation of practices with both positive and negative contributions. The benefits of reporting are multiple. It enables benchmarking and assessing CSR performance with respect to laws, norms, codes and standards. It also demonstrates how the company influences or is being influenced by encouragement of corporate social responsibility. Last but not least, it assures the possibility of comparing practices within the company and between different companies over certain period of time, and by this encourages others to become involved.

Part of the economy dies every day and is replaced by something new (Hawken, 1983). This paper shows that the major challenge for business today is not so much in defining responsible practice within its context, as in understanding how responsible practice is socially, economically and ecologically wisely-constructed among specific stakeholders, and how to take that into account when business strategies are developed. Economic, social and environmental objectives can to a certain degree, develop synergies but they are not always mutually supportive and sometimes they even can compete with each other. Where this is the case, the concept of sustainability refers to the need to strike the right balance between its three elements. Our main goal was to explore the corporate social basis for sound decision-making though integration of complex and inter-connected issues, in order to provide simple overview of CSR milestones for decision makers in business sectors. It seems evident that modern information technologies increase the flow of information and its availability but not necessarily our ability to absorb and make sound decisions. As dramatic as the last years were, they probably offer a representative tableau of the economic, social, political, and environmental turbulence yet to come and there is interesting comparison that could be built around similarities between Southeast European context regarding what's going on currently in EU and the role of business in that. Therefore, we need information tools that condense and digest information for rapid assimilation as well as we need sufficient time series in order to track how business is influencing what already was rather turbulent context. This paper is to mark initiation of this complex process.

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SOME RELEVANT CORPORATE GOVERNANCE ISSUES IN CROATIA AND BOSNIA AND HERZEGOVINA

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Abstract

This paper offers a comparative analysis of key contemporary issues of corporate governance in Croatia and Bosnia and Herzegovina - efficiency of corporate boards and efficiency of minority shareholders' protection. Also the paper argues how nature of corporate governance in transition countries is not solely a determinant of legislative effects as most literature suggests but is also determined by the implementation of legal instruments.

Problems in corporate governance systems arise where mechanisms of protection of certain shareholders are the weakest. High ownership concentration in most European transition economies can help prevent the opportunistic managerial behaviour. However, high ownership concentration has its price – block-holders are in the position to pursue their own interests at the cost of minority shareholders. In other words, from the position of control they have over the corporation, block-holders in transition countries are in able to expropriate minority shareholders.

This paper argues how agency problem of difference between cash flow control and ownership in the hands of one or several shareholders poses the biggest threat on stability of corporate governance system in European transition economies.

Key words: corporate governance system, transition, Croatia, Bosnia and Herzegovina, minority shareholders, board effectiveness

Introduction

The development of good corporate governance practices is a conditio sine qua non for growth and survival of any company. It is crucial for gaining competitive advantage and obtaining additional capital but it is also important for the whole economy because it influences foreign investment and stimulates investments in the private sector on the basis of increasing investor confidence and generally improving the economic efficiency and growth (Kaen, 2003, Blair, 1995, Tipurić, 2006).

Theory and practice of corporate governance in transition countries has shown that there are two fundamental issues – efficiency of corporate boards and efficiency of minority shareholders' protection. This paper focuses on the comparative analysis of these key issues of corporate governance in Croatia and Bosnia and Herzegovina.

Legal framework for corporate governance in Croatia and Bosnia and Herzegovina

Croatia and Bosnia-Herzegovina have a closed (the European-continental) system of corporate governance. Major characteristics of this system are significant ownership concentration and the active role of block-holders. From another point of view this system is also described by the minor role it gives to the capital markets, limited and underdeveloped market for corporate control and lack of transparency, especially in terms of underdeveloped mechanisms for the protection of minority shareholders.

The legal framework is one of the external mechanisms of corporate governance which purpose is to ensure the efficiency of management teams. Without proper regulations and legal standards it is not possible to implement a functional system of corporate governance. For this purpose, apart from the legal framework, in recent years we have witnessed a development of numerous codes of corporate governance, at national level but also the so-called supranational regulation of corporate governance.

Legal sources that directly or indirectly regulate the area of corporate governance include a number of laws and regulations which regulate companies, securities and capital markets, accounting and auditing, etc. In the consideration and analysis of relevant legal provisions of Croatia and B&H we should keep in mind that both countries are subject to harmonization with EU legislative.

Among the legal sources which regulate this field in Croatia most important are the Companies Act (Zakon o trgovačkim društvima), Capital Market Act (Zakon o tržištu kapitala) and Act on the Takeover of Joint Stock Companies (Zakon o preuzimanju dioničkih društava). The Companies Act was passed in 1993 and since then has seen a series of amendments of which the last one in 2009. The Act on the Takeover of Joint Stock Companies and Capital Market Act, which replaced the Act on Securities Market, have been adopted in 2007 and 2008, respectively. National Code of Corporate Governance has been introduced in 2007 and since January, 1st 2011 in application is the revised Code of Corporate Governance.

Supervision and regulation of the Croatian capital market are entrusted to the Croatian Financial Services Supervisory Agency (hereinafter: HANFA - Hrvatska agencija za nadzor financijskih usluga) as an independent legal person with public authority within its jurisdiction and responsible to the Croatian Parliament. Trading of securities is carried out on the Zagreb Stock Exchange. Maintenance of a central depository for dematerialized securities and a central registry of financial instruments , including management of a system of clearing and settlement are carried out by the Central Depository and Clearing Company (hereafter: SKDD - Središnje Klirinško Depozitarno Društvo).

Legal and regulatory framework for corporate governance in Bosnia and Herzegovina should be viewed in the context of a specific state system. Bosnia and Herzegovina consists of two entities – the Federation of Bosnia and Herzegovina (the Federation) and Republika Srpska (RS). Corporate governance is within the responsibility of those two entities. They have their own laws and institutions, which resulted in the establishment of two completely separate regimes. Of the significant legislation in the Federation we should emphasise the Companies Act (Zakon o privrednim društvima), Securities Market Act (Zakon o tržištu vrijednosnih papira) and the Takeover and Mergers Act (Zakon o preuzimanju dioničkih društava). Those acts correspond to the Republika Srpska's companies Act (Zakon o privrednim društvima), Securities Market Act (Zakon o tržištu hartija od vrijednosti) and the Takeover and Mergers Act (Zakon o preuzimanju akcionarskih društava). It is important to emphasize that there are significant differences in those two legal systems. Those differences include a variety of board structures and mechanisms to protect shareholders. Contrary to expectations, recent amendments to the Companies Act of the Federation, which took place in 2008, have introduced conceptually and legally inconsistent and confusing provisions of the legislation relating to corporate governance (Trivun et al., 2008). The Republika Srpska introduced the new Companies Act on January 1st 2010. Rajčević (2008) points out that with its adoption Republika Srpska moved to the second phase of the transitional legislation.

In Bosnia and Herzegovina there are also two parallel stock exchanges, Sarajevo and Banja Luka, which organize and supervise the trading of securities in two major political entities. Those two institutions are responsible to the Securities Commission of the Federation (Komisija za vrijednosne papire u FBiH) and the RS (Komisija za hartije od vrijednosti RS) for regulation and control of emissions, traffic and other operations with securities. Securities accounts are placed in the entity registers - Register of Securities in the Federation (Registar vrijednosnih papira) and the Central Registry of Securities (Centralni registar hartija od vrijednosti) in the RS.

Entity committees have adopted "codes" of corporate governance and in early 2009 the Code of corporate governance for companies listed on the market of the Sarajevo Stock Exchange was adopted. Acceptance of the Code was compulsory only for companies that are listed in the quotation of the Sarajevo Stock Exchange.

It is evident that in recent years in both countries there was a series of amendments and enactment of new legislation in area of corporate governance. Similar to the situation in other transition countries, some changes are coming too late and their expected performance is lower than if they had been implemented at the beginning of the reforms.

Ownership concentration and agency problems

The concentration level of companies' ownership structure differs between countries (Friedman et al, 2003, Tipurić, 2011, Hruška, 2010). Various sources confirm that in most European countries, the largest shareholders hold significant equity stakes in companies whose shares are traded on regulated markets (Tipurić et al, 2008). It can be claimed that a model of corporate control by large shareholders prevails in continental Europe. Earlier studies indicate that Croatia and Bosnia and Herzegovina, as well as other transition economies, are characterized by a relatively high level of ownership concentration, which indicates the presence of agency problem that arises because of conflict of interest between block-holders and minority shareholders.

Concentration of ownership is an important internal mechanism of corporate governance mostly due to an active participation of large shareholders in governing the company (Tipurić et al, 2008). Suitable combination of investor's legal protection and the level of ownership concentration is a cornerstone of good corporate governance (Schleifer, Vishny, 1997). High level of ownership concentration is a characteristic that mostly differentiates the German form the Anglo-Saxon system of corporate governance (La Porta et al, 1999). High dispersion of ownership – i.e. lack of a single big principal, leads to a higher influence of management which intensifies the agency problem. Main research question of the open system of corporate governance is the question of collective action of dispersed shareholders (La Porta et al, 1999).

Research on the level of ownership concentration and its consequences primarily comes from the USA and UK and is very limited for transition countries. Literature recognizes many different measures of ownership concentration. Numerous researches use the framework developed by Demsetz and Lehn which measure ownership concentration in respect to group of shareholders, usually measured as a total number of shares held by a certain number of shareholders (for instance 5 or 20 biggest shareholders) (Demsetz and Lehn, 1985). In other studies Holderness and Sheehan (1988) as well as Wruck (1989) examine only block-holder ownership (more than 5% of equity) and managerial ownership. Prowse (1992) in his research considers five largest shareholders as well as Hovey et al (2003). Claessens et al (2000) as a measure of ownership concentration take the level of ownership of the largest shareholder.

Studies conducted in Croatia on a sample of non-financial public companies have showed a high ownership concentration in Croatian companies and its gradual increase in the past decade

(Tipurić et al, 2008; Tipurić, 2011). Table 1 shows the ownership concentration indicators of Croatian companies from 2000 till 2008.

The average share of the largest shareholder (concentration indicator C1) has increased in the last nine years by more than 7,5 percentage points: from 43,17% in 2000 to 50,81% in 2008. The collective stake of ten largest shareholders (C10) increased only slightly in the observed period (form 79,75% in 2000 to 81,68% in 2008).

In a relatively small number of companies (17.3%) the largest shareholder had a share of less than 20%. On the other hand, more than 20% of companies have a dominant shareholder that owns over 80% of company's equity (Tipurić et al, 2008; Tipurić, 2011). Croatian companies, as shown by our research from 2011, mostly have an external majority shareholder (84.5%), while a smaller number of firms have employees and/or managers as the dominant shareholders (11.6%) (Tipurić, 2011).

Although there is no exact data on the ownership structure of companies in Bosnia and Herzegovina, one can assume that in most companies there is a majority shareholder (World Bank, 2006). According to the results of research in the Federation from 2009, 78% of companies are characterized by majority or dominant ownership (Karić, 2009). That B&H companies are characterized by concentrated ownership is also indicated by the results of research conducted in the RS in 2008 which shows how 54% of companies have a shareholder who owns more than 50% of the shares (Jeftić, 2008).

Efficiency of the boards

Boards and management remuneration are among the most important internal mechanisms of corporate governance. In the continental or so called two-tier model of corporate governance, which is implemented by Croatia and Bosnia and Herzegovina, two types of boards are established: a supervisory board, which has a role of surveillance and monitoring of operations, and a management board, whose role is the administration of the company. The supervisory board has a key role in corporate governance because it represents a link between the shareholders and management.

Studies of the role of the supervisory boards in Croatian companies have pointed to the existence of a substantial control over this body by the major shareholder. Also, a smaller number of board members and fewer board sessions are noticed in companies with higher levels of ownership concentration (Tipurić, 2011). These facts indicate a need to professionalize and strengthen the role of supervisory boards.

Supranational regulation also emphasizes the importance of boards as the key element of corporate governance. Thus, the OECD Principles of corporate governance state that corporate governance framework should ensure the strategic guidance of the company, effective monitoring of management by the board and the board's accountability to the company and shareholders. According to the World Bank estimates in 2006 these elements were partially implemented in B&H. However, a material non-compliance was assumed in the principle of actions of board members on the basis of complete information in good faith, with due care and attention, and in the best interests of the company and all shareholders. Accept these issues the World Bank estimated limited and unclear responsibilities of board members, limited liability, and the existence of several different board structures (World Bank, 2006).

These weaknesses are due to, among other things, differences in the entity regulations in the area of corporate governance. Joint stock companies in the Federation have a supervisory board, which have an odd number of members (at least three) appointed by the general assembly, and a management. Open joint stock companies in the RS have a board of directors elected by shareholders. There are no requirements regarding the independence of board members in both entities (except in the RS for the companies listed on the official stock exchange market) and committees have no legal obligations to any interest-group except shareholders. According to many opinions, in practice they act in the interests of the controlling shareholders who appoint them. To avoid situations of expropriation of minority shareholders some legislative solutions impose participation of minority interest in boards but it is not the case in B&H.

Table 1 Indicators of ownership concentration C1, C4 and C10 (2000.–2008.), %

	2000	2001	2002	2003	2004	2005	2006	2007	2008
C1	42,17	44,69	46,79	46,97	48,72	50,72	51,51	50,75	50,81
C2	59,23	59,85	61,38	59,83	61,85	63,38	63,84	63,15	63,17
C4	72,21	72,68	73,22	71,19	72,92	73,85	73,6	73,5	73,61
C10	79,75	80,67	81,49	78,22	79,72	80,79	81,1	81,26	81,68

Research results suggest that in the Federation supervisory boards are probably the weakest link in the corporate governance system. In most of the observed companies in the research (77%) members of the supervisory board had no training in corporate governance and the practice of accepting memberships in supervisory boards only because of the existence of certain compensation or privileges is noticeable. One of the research findings show that board membership is easily accepted mostly because of the privileges and rights it brings and that the corresponding responsibilities are of minor concern. Remuneration of management boards in 45 of 79 surveyed companies is fixed (57%), which means that it does not depend on the company performance. Similarly, salaries and benefits of supervisory board members are fixed in 51 examined companies (65%) (Karić, 2008). A study in the RS in 2008 shows that in 85% of cases there is no rulebook on the remuneration of management and is not linked to business performance (Jeftić, 2008).

The latest amendments to the Companies Act of the Federation of Bosnia and Herzegovina opened up the space to additional complications in practice, because regulation of the election, appointment, dismissal, composition and decision-making authorities in the companies is left to the company's statutes. It may be noted that with the recently adopted amendments to the Companies Act established vertical corporate governance system is changed. Before the amendments the general assembly is giving mandate and responsibilities to the supervisory board and the audit committee. With introduced changes the election, appointment and dismissal of management is also in jurisdiction of the general assembly which is in charge of enacting the company's statute. This solution is raising the question of solving conflicts in the relationship between management and supervisory boards. The supervisory board loses jurisdiction and responsibility for the appointment of management. Depending on the solutions that the company adopts in its statute, it may happen that the formal competence of the supervisory board - to monitor management performance, ends up without any material content (Silajdzic et al, 2009). 'The decision on the appointment and /or revocation of the appointment of the president and board members is one of the most important legal decisions of the supervisory board... Revocation of the appointment is the only crucial decision that the supervisory board may adopt as an autonomous body of corporate governance' (Barbic et al, 2006).

Protection of minority shareholders

A number of studies in recent years have highlighted the connection between a better protection of minority shareholders and a higher valuation of corporate assets and opportunities to use external sources of funding, and developing capital markets (Prado and Salama, 2008). Vutt (2009) indicates that the protection of minority shareholders is the central problem of company law, emphasizing the need for their protection. The OECD Principles of corporate governance are also considering this problem to be very significant in the context of transition economies (Avilov et al 1998). By improving the legal environment it is possible to limit the possibility of expropriation of minority shareholders and reduce agency conflicts between majority and minority shareholders. Legal protection implies not only the content of the law but also the quality of its implementation in practice (La Porta et al, 1999b, Đulić, 2008). From another point of view Dammann (2008) points out that the company's law in this case has a difficult task, since it needs to protect minority shareholders, but also try to preserve the benefits associated with the presence of a controlling shareholder.

Several indexes which seek to measure and compare the degree of protection of minority shareholders in different countries and regions in the world have been constructed in the last ten years (La Porta et al, 1998; Pistor, Reiser and Gelfer, 2000; Pajuste, 2002; Lele and Siems, 2007; Djankov et al, 2008; Pistor 2009). According to the report 'Doing Business 2011' which presented four indexes (Djankov et al, 2008) used to measure the protection of minority shareholders from self-dealing in transactions with related parties, Bosnia and Herzegovina ranked 93 and Croatia 132 out of 183 countries covered by this report.

Value of the index that presents the strength of investor protection, which represents the average value of the index of disclosure, director liability index, and ease of shareholder suits index, shows how both countries are below the regional average, which is again lower than the average for OECD countries. The reasons for the significantly lower values are mostly in the segment of index of disclosure which covers the requirements for approval and disclosure of transactions with related parties. The value of this index for Croatia is only 1 which was the reason that Croatia found itself on the list of 10 countries which in this segment offer the least protection of minority shareholders.

According to the report of the World Economic Forum, on the count of protection of minority shareholders' interests Croatia is ranked 123, while Bosnia and Herzegovina as the last, 139, out of 139 countries (World Economic Forum, 2010).

On the other hand, comparative analysis of the legal measures available to protect minority shareholders shows a relatively high degree of protection in Croatia and the RS while legal solutions in the Federation abound with ambiguities. Measured values of the index according to the methodology of La Porta et al (1998), Pistor, Reiser, and Gelfer (2000) and Pajuste (2002) suggest that highest protection of minority shareholders provides the legislative of RS. The law in the Federation has a number of shortcomings, while the index value for Croatia points to deficiencies in the segment of shareholders leaving shareholder structure and the rules aimed at protecting minority shareholders (Mrgud, 2011).

Problems related to the protection of minority shareholders in Croatia and Bosnia are similar to problems that other countries in transition have faced and/or are still facing. Poor enforcement of legal measures and the general weakness of the institutions have proved to be crucial. It seems that even the modern legislation cannot substitute for bad enforcement (Đulić, 2008). Minority shareholders in Croatia are faced with problems such as lack of control, illiquidity, squeezing out of the shareholder structure and the realization of equality with the majority shareholders (Hruška, 2007). In a similar position are the minority shareholders in B&H, where poor liquidity is indicated as the main problem of the capital market.

In order to solve the problem it is, above all, necessary to strengthen the mechanisms of implementation of existing legislation. Some authors propose the introduction of legal standards of Anglo-Saxon jurisprudence, notably the institute of fiduciary duty, despite the fact that there is no tradition of that institution in the continental law (Vasiljevic, 2007). However, a series of studies has demonstrated the difficulties and inefficiencies of transplantation of the institutes of common law in the countries of continental-European system, mostly due to the ubiquitous problem of insufficiency of resources which such lawsuits require.

European-continental system proposes conferral of proactive law enforcement and the residual legislative powers of their flexibility and adaptability to the regulators. The Anglo-American system is generally assumed better in the protection of minority shareholders because of its flexibility which is accomplished through the court system. In transition countries it is also necessary to incorporate mechanisms to achieve flexibility without relying on the judicial protection, where it is possible. This could be achieved by expanding the powers of market regulators to adopt binding regulations for companies that will be based on the constant analysis of their practice.

Given that judicial protection is not proved to be effective even in many developed countries, it is unrealistic to expect that the activities on its strengthening can improve the protection of minority shareholders in the near future. The legal solutions of the Croatian law, modeled on the German law, abound in the procedural hurdles in raising the claims of minority shareholders, which will need to be removed. On the other hand, law of the Federation does not recognize the possibility of direct and/or derivative suit of an individual shareholder or minority groups in the case of opposition to the decisions of management and supervisory board.

Conclusion

This paper offers insight on contemporary legal and managerial issues of corporate governance in Croatia and Bosnia and Herzegovina. On a more broader scale the paper describes a perspective of transition economy where corporate control mechanism are more unstable and fragile than they are in countries with longer tradition of market for corporate control.

Corporate governance systems of transition countries of east and central Europe share several common characteristics (Pučko, 2005). Firstly, supervisory and executive functions are rarely separated due to the fact that executive managers are often most influential shareholders. Secondly, even in case when managers do not have significant ownership of the company they try to establish a significant level of control though concentration of voting rights. Thirdly, there is a significant influence of workers in corporate governance structures. And finally, supervisory boards of companies in transition European economies are rarely composed of experts.

In this paper we argue how the nature of corporate governance in transition countries is not solely determinant by legislative effects as most literature suggests but is also a matter of implementation of legal instruments. Besides that we argue how level of corporate governance quality can be approximated by attributes of corporate board's structure and work and by the level of protection of minority shareholder's interests.

Major contemporary issue of transition corporate governance is not the conflict between large number of dispersed shareholders at one side and professional management at another side as it is in countries of Anglo-Saxon business circle. Concentrated ownership in the hands of several or even one block-holder insures a significant level of control that allows them to directly influence the nomination and efficiently control the managerial team. High ownership and control concentration significantly reduces a crucial problem of the Anglo-Saxon corporate governance system but opens another agency problem – expropriation of minority shareholders rights by controlling shareholders. We argue that this agency problem is fundamental for the balance of powers within transitional system of corporate governance.

Bearing in mind the experiences of other countries, it can be concluded that the activities should be directed towards increasing the efficiency of corporate boards and strengthening the exercise of ex ante shareholder rights designed to protect minority shareholders. Laws generally provide all the available protection mechanisms, but due to various problems its implementation is often lacking. Legal reform in Croatia and B&H should therefore be directed towards the removal of identified barriers. In terms of the underdeveloped and illiquid capital markets, rules that facilitate shareholders leaving the company are particularly important.

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Zakon o tržištu vrijednosnih papira FBiH, Službene novine FBiH, 85/08

DEVELOPMENT OF CORPORATE GOVERNANCE IN SOUTH EAST EUROPE - CASE OF CROATIA

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Abstract

The purpose of this paper is to illustrate main characteristics of corporate governance development in the Republic of Croatia since its independence until today. Reviewing the existing literature, summarizing and evaluation of collected data in the field of corporate governance practices of Croatian corporations from different periods of time has been done. The paper provides an assessment of the fulfilment of normative frame of corporate governance in terms of building the legal and institutional regulatory framework. It also provides an evaluation of the most important participants in terms of meeting the set of standards and best practices in corporate governance. The defined aim and object of the research is followed by evaluating internal and external mechanisms of corporate governance. Croatian corporate governance development assessment has been made comparing two years data about fulfilment of normative aspects of corporate governance as well as the degree of objectives attaining.

Key words: corporate governance, Republic of Croatia, corporate governance development, corporate governance practice, corporate governance mechanisms

INTRODUCTION

The modern corporation is the most important form of business in the history of the world. It is a form of business organization where the owners are no longer personally liable for any business-related obligations. The main characteristic of the modern corporation is the separation of ownership and control which means that owners have delegated part of their control and the use of rights to managers but they still ultimately keep the most important residual right. This gives them the opportunity to take away the delegated control and use of rights from the managers if they are dissatisfied with how the firm is managed (Padilla and Kreptul, 2004).

Corporate governance has been a dominant policy issue in developed market economies for more than a decade. Since the late 1990's in the transitional economies it become one of the most intensive debated issues (Bobrica and Miclaus, 2007,1).Simply said, corporate governance can be defined as a system by which companies are directed and controlled (The Cadbury Report, 1992). Building a good system of corporate governance should help to answer the following questions: who managers represent and why; to whom are managers responsible; what is the nature of the owner – manager relationship; how are managers controlled and how they should be controlled, what is the relationship between majority and minority shareholders; how are the rights of minority shareholders protected; how is the corporation related to the community and to potential investors; how are stakeholders involved in corporation's operations, especially workers, and how are their rights protected and their requirements considered; how is corporate social responsibility of the corporation expressed.

Modern processes of corporate governance development in the Republic of Croatia started in the late 1980's. By adopting the new Constitution in 1990 Croatia has determined its own economic development based it on free market principles and liberalization of its economy and it stood side by side to the world's most developed countries. Transformation and privatization processes of state ownership set the grounds for the development of relationships in the society, economy and businesses. No issue of transition has become so discussed by the researchers of economic science and creators of economic policy than the issue of corporate governance (Ivanovic, 2001, p 2).

INSTITUTIONAL AND LEGISLATIVE FRAMEWORK DEVELOPMENT

Institutional and legislative framework development can be traced through a chronological overview of adoption of various laws and regulations relevant to the development of economic and financial system which have had a stronger or weaker influence on the development of corporate governance in Croatia. This refers to the Enterprises Law (1989), Securities Law (1991), Law on the Transformation of Socially-Owned Enterprises (1991), Company Law (1993, 2003, 2007), Issuing and Trading of Securities Act (1995), Investment Fund Act (1995, 2005), Law on the Protection of Market Competition (1995), The Law on Takeovers of Joint Stock Companies (the Takeover Act) (1997, 2002, 2007), Act on Privatization of Investment Funds (PIF) (1997), Compulsory and Voluntary Pensions Funds Act (1999), Act on Croatian Financial Services Supervisory Agency (2005), The Capital market Act (2008). The development of corporate governance in Croatia was also advanced by the foundation of the: Zagreb Stock Exchange (ZSE) (1991), Croatian Privatization Fund (CPF) (1993), Varaždin Stock Exchange (VSE) (1993), Insurance Supervisory Directorate (1994), Croatian Securities Exchange Commission(1996), Croatian Securities Depository Agency (SDA) (1997), Competition Agency (1997), Agency for Supervision of Pension Funds and Insurance (HAGENA) (2000), Croatian Agency for Supervision of Financial Services (HANFA) (2006) as well as the merger of the ZSE and VSE.

The process of privatization in Croatia has happened in several phases. Firstly, in the eighties, as per the program orchestrated by the then Yugoslav Prime Minister Ante Markovic. Then, in the period between 1991 and 1997 in accordance with the Croatian PIF Law from 1997; Initial Public Offering and Public-Private Partnership models. This means that the privatization saw a number of different mechanism, including Croatia's own interpretation of managerial loans, under the table wheeling and dealing, injecting of new capital, declarations of bankruptcy, conversions of outstanding dues into acquisition capital and buying of savings from those who had deposits in collapsed banks.

The processes of institutional and legislative framework development in Croatia followed different dynamics. As a rule, the laws were sanctioning currently established states and processes. On the other hand they tried to catch up with and regulate the dynamics of real-life. As well as in the major financial systems, the financial markets in Croatia also were in front of regulator. Only after minor or major problems regulatory institutions have been developed and a new and adequate financial system infrastructure was established. As it happened in USA - Securities and Exchange Commission (SEC) was established only after large financial crisis (1934), so happened in Croatia - Croatian Securities Exchange Commission (CSEC) was established in 1996 when simply said "all was already over." However, at the time, so it seemed, but after fifteen years, when looking at the achievements that this institution has had on the corporate governance system development in Croatia, more objective assessment can be made.

Along with the development of the financial system scientific research work also has been developed in this field. Significant changes emerged at all levels of educational system. At the beginning of the 1990, there was a reform of educational systems. Educational systems were developing and contributing to the reinforcement of the Croatian social, political, economic and financial system. During the past twenty years Croatia has established itself in the international community. Being a member of various international institutions and acceptance of the norms and best practices contributed to its overall development (becoming a part of the IMF, WB, IOSCO, the Council of Europe, WTO, etc., up to fulfilment of all requirements necessary for the EU membership). Although until the end of World War II Croatia was involved in the political and economic mainstreams of Europe and the whole world which were based on free market economy and political parliamentary democracy, a period of almost 50 years has wiped out that memory. The process of the new system developing started just in 1989. This process was accelerated through democratic changes despite Patriotic War till 1995 when new moment of strengthening the infrastructure of corporate governance in Croatia started.

Today's system of corporate governance is normatively aligned with the best practice of the European legal system. However, despite great achievements, compliance with all legal regulations as well as the monitor of laws implementation is not yet at the satisfactory level. A great deal of work is still remaining to be done. In the institutional framework the "weakest link" is the judiciary. Over a decade the judges are overcrowded with a many new laws and amendments. Accumulation of unresolved cases has even more slowed down their professional development through education. Because of low wages, great number of those who have acquired the relevant knowledge went in professional practice. Although in this decade the situation is better than in the previous one, there is still much left to do to block the judiciary to be a "bottleneck".

With the publication of the first "Annual Report on Corporate Governance for publicly listed companies in the Republic of Croatia in the 2010" Croatian Agency for Supervision of Financial Services in 2011 made a significant step forward providing a testimony to all achievements in the field of corporate governance development in the Republic of Croatia.

DEVELOPMENT OF CORPORATE GOVERNANCE PRACTICE

Corporate governance can be defined as a system of supervisory mechanisms by which all suppliers of crucial inputs should ensure the returns on their investments in the corporation, without affecting its long-term survival and prosperity (Tipuric et al., 2008, 6). Regulations and good legal standards are the presumption of the good corporate governance (Tipuric et al., 2008, 191).

The subject of corporate governance commenced attracting attention at national level in developed markets in the late 1900's. Increasing number of codes of best practice containing the general principles upon which acceptable corporate governance frameworks should be based have been developed by leading international bodies such as the OECD. The principles of corporate governance advocated in these codes provides best practice recommendations on corporate governance development and they are used as a benchmark for indentifying best corporate governance practices. New Principles of corporate governance were adopted by the Presidency of the OECD in April 2004. The principles cover the following six key areas of corporate governance: (1) development of the corporate governance framework, (2) the rights of shareholders, (3) the equitable treatment of shareholders, (4) the role of stakeholders (5) disclosure and transparency (6) the responsibilities of the board (Tipuric et al., 2008, 219).

Corporate governance is a key element in improving economic efficiency and growth as well as enhancing investor confidence (OECD Principles, 2004). Numerous changes in Croatian Company Law and corporate governance have been made in the past decade, mainly as a result of compliance with acquis communitaire of the EU. In order to develop the best corporate governance practice in Croatia, the Croatian Financial Services Supervisory Agency and the Zagreb Stock Exchange (ZSE) have created a national Code of Corporate Governance. The Code is made in accordance with the guidelines of the OECD, and also using the experiences of other national codes. Corporate governance in the EU, as in Croatia, is based on the comply – or - explain principle. Namely, Croatian national Code contains recommendations that do not have binding character, but publicly listed companies must make a declaration that they complied with those recommendation, and if not they must explain why is that so. (Tipuric et al., 2008, 233). This approach has been proved to be very good in practice because it can be adjusted to the specific needs of each society. (Tipuric et al., 2008, 234).

After several attempts publicly listed companies in the Croatia have been finally defined at 1995 and 2002. So at the end of 2010 in Croatia shares of 219 publicly listed companies were listed at ZSE which is lesser for 8,86% comparing with the 2009. The most common reasons for withdrawal from listing are the General Assembly decisions as well as bankruptcy, crowding out minority shareholders, reduce of capital, merger with other listed companies and similar. Out of the total number, 197 publicly listed companies in 2010 and 220 in 2009 were included on the regular market, while and 19 in 2010, and 17 in 2009 on the official market. The total number of shares being listed on the Zagreb Stock Exchange on 31st Dec 2010 was 233 from 216 different listed companies, what represents a decrease for 8,27% compared to 1st Dec 2009. Out of the total number of shares, 21 of them were not traded since its listing until 2010. Number of listed ordinary shares declined by 8,82%, what is the result of the delisting of 21 companies, while the number of listed preference shares remained unchanged. Out of the 21 listed companies that were delisted from official market during 2010, the six of them is from tourism, five from the food industry (food, beverages, tobacco), and two from financial sector (2 banks). The amount of active shares in the year 2010 was 182, and in the year 2009 were 196.

During 2010, 28 listed companies belonged to the financial sector, while the remaining 188 belonged to the non-financial sector. In 2009 there were 30 listed companies from the financial sector and 207 from the non-financial sector. In 2010 the most listed companies were from the tourism industry - in total 51 of them (57 of them in 2009), then from the food industry - in total of 25 of them (30 of them in 2009) and from the trade industry - in total 20 of them (21 of them in 2009). In comparison to the year 2009 in 2010 the total market capitalization of the regulated market increased by 3,68%. The incensement of market capitalization of official market for 38.36% has contributed to this growth. The market capitalization of the regular market decreased for 16,71%. The total market capitalization of 21 listed companies that has been delisted from the regulated market during 2010 has been 10 billion kn (on the 31.12.2009.), while the total share capital amounted to nearly 4 billion kn.

CORPORATE GOVERNANCE MECHANISMS

Corporate governance tackles all the relationships between manager, management board, supervisory board, shareholders and other stakeholders. It defines a framework for goals setting, for determination of the means for goals achievement, as well as for monitoring company performance-enhancing. It should provide answers to the following question: who monitors the corporation, and why; how a corporation is managed and in whose interest. Throughout the history of corporate governance in recent centuries different mechanisms of corporate governance have been developed, which, among other things, include control of large shareholders and creditors, the mechanisms of internal controls, external audit, the legal framework within which the corporate operates, etc. (Goergeen and Ronnebog , 2004).

Depending on the context in which they are presented or used, it is possible to identify (1) internal and (2) external mechanisms of corporate governance (Tipuric et al., 2008, 35). The internal mechanisms of corporate governance are: board of directors (supervisory board and management board), executive compensation, ownership concentration, stakeholder relations and disclosure. External mechanisms includes: the market for corporate control, legal and regulatory framework, protection of minority shareholders and competitive conditions.

Good corporate governance depends on a balanced relationship among the various internal and external mechanisms. This balance ensures the effectiveness of management and helps in solving the problems and potential conflicts that appears in corporate structures.

Internal Corporate Governance Mechanisms

Internal mechanisms of corporate governance work to check and balance the power of mangers, shareholders, directors and stakeholders. A well governed corporation needs to balance the roles of three groups of players: shareholders (and employees, if they have a governance role), boards of directors, and manages, while meeting all of its financial commitments and other obligations to a broad array of stakeholders (Babatunde and Olaniran, 2009, 3).

Board of directors (Supervisory Board and Management Board)

Board is an organizational mechanism through which shareholders influence manager's behaviour in order to ensure that the company is managed in their interest. Board is the core internal governance mechanism. It is a bridge between management and owners, other stakeholders, and the outside world.

Since the October 2007 there are two modes of board organising in Croatia: (1) establishing a single unitary board (The Board of Directors) or (2) establishing two boards: Supervisory Board and Management Board. The OECD Principles of Corporate Governance pointed out that board members should act in the best interest of the company and its shareholders. They should base they work on full information availability and should have quality business insight, acting in good faith with the care of a good businessman. Board has specific responsibilities that include the establishment of a company ethical code, ensuring that way the compliance with laws and standards as the existence of internal control of financial reporting.

Out of the total number of listed companies, at the end of 2010, only two had a one-tier system, while the rest 184 listed companies had two-tier system. The average number of board members is a slightly above two and was not significantly changed in the last two years (it was 2,10 in 2009 and 2,06 in 2010). The largest number of the listed companies (88 of them) had just one board member in both years. The share of women in the total number of board members is still very low. It has decreased in 2010 compared with 2009. Namely, in 2009 the share of women in the total number of board members was 18,16%, while in the 2010 it decreased at 17,75%. Women are president of the board at almost every tenth listed company. The average number of supervisory board members is 5,14 and is not significantly changed in the observed two years (+0,93%). The share of women in the total number of supervisory board members has increased from 19,70% in 2009 to 20,60% in 2010, while the number of women as supervisory board president has decreased by 8,00% (from 25 in 2009 to 23 in 2010).

The average Management board members tenure in 2009 was 5,76 years and 6,04 years in 2010. The average tenure of Supervisory board members was 4,85 years in 2009, and 5,23 years in 2010. Forty-eight listed companies in both year indicated that they have a schedule of Management board meetings. Sixteen listed companies in both year indicated that they have the opportunity to participate in board meetings by agent. Sixty-nine listed companies in both years indicated that has a schedule of Supervisory board meetings. Fifty-two listed companies in both years indicated that they have the opportunity to participate in the Supervisory board meetings by agent.

The largest number of listed companies established the Audit Committee which has the largest number of members, an average of 3,77 in 2010 and 3,73 in 2009. The average number of the Appointments Commission members was 2,67 in 2010 and 2,90 in 2009, while the average number of members of the Remuneration Committee was 2,75 in 2010 and 2,92 in 2009. Four listed companies in both years indicated that they had formed an additional commission (for corporate governance, strategy and relationships with influential interest groups, for development and for the property).

Hundred and thirty-one listed companies in 2010 and 2009 submitted data about fixed amount paid to the members of the Supervisory board. Only six listed companies have provided data about variable payments to the Supervisory boards members in both years.

In 2010 eight, while in 2009 five listed companies has not held a General Assembly. The most common reasons for lack of their maintenance are: the attitude - it will be held next year, then blocking bank accounts, financial statement was reviewed and miscellaneous etc. In 2010 one hundred forty-eight listed companies held only one (regular) General Assembly, while twenty nine of them held two or more. In 2009 one hundred fifty listed companies held only one General Assembly, and thirty of them held more than one. In 2010 out of 186 listed companies who have submitted completed questionnaire 61,29% had established a system of internal control, while 34,41% had established a system of internal audit.

Executive Compensation

Structure of executive compensation and their control are extremely important in the corporate governance process. In some countries executive compensations are transparent, and in other there are mechanisms for the protection of their disclosure. Executive compensation can be fixed or variable, or formed in various combinations. The variable compensation can be paid in cash, in the form of profit sharing, bonuses and stock options. It is linked to the business goals achievement and it contributes to a stronger linkage of owners and managers interest. In order to improve corporate governance practices, the European Commission has adopted recommendations for executive compensations for the companies whose shares are listed on stock exchanges. Taking into consideration the differences in corporate governance systems the European Commission stresses the need for transparency acting of all stakeholders.

Rewarding top managers is one of the most important mechanisms of corporate governance. Adequate compensation should be designed the way that they encourage manager for making profitable decisions and that ties him down for a long term to the company. On the other hand, the numerous corporate scandals, breakdowns and disproportionately high fees for top managers in large corporations drew public attention to this issue. Hence, the idea of salary that cannot be discredited is becoming increasingly important in the field of corporate governance as well as for the long-term value creation for shareholders.

Listed companies are the least transparent relating to the fixed and variable compensation for board members. Only 92 listed companies in 2010 and 93 in 2009 provided data for fixed amounts paid to the board members, while only 16 of them provided data about variable amounts in both years.

Ownership concentration

Ownership concentration is an important internal governance mechanism because it determines the distribution of power and control between managers and owners. The way company is managed depends on whether ownership is fragmented or consolidated. According to survey results that were conducted in 2004 and 2006 it can be argued that the ownership concentration grows in Croatian joint stock companies as the share of the largest shareholder (over 51%) and the shares of the two largest shareholders (over 70%). In more than 52% of companies majority shareholder had more than 50% of ownership, while in only 17% of the companies majority shareholder had less than 20% of the shares. A similar situation exists in the other European countries (Tipuric et al., 2008, 56).

During the year 2010 the smallest percentage of ownership structure refers to the EBRD, DEG and ESOP (total 0,51%), then to the administration (2,80%) funds (3,01%) Supervisory board of the listed companies (4,21%), financial institutions (5,16%) and to the custodial accounts (5,73%). In the ownership structure Republic of Croatia is represented by 13,81%. The largest percentage of the ownership structure is distributed among the shareholders who have more than 5% and are not included in some other group of shareholders (in total 41,57%) and the shareholders who have less than 5% (in total 21,66%).

The ownership structure of the listed companies share has not changed significantly in 2010 compared to 2009. All changes are less than 1% (Republic of Croatia, custodial accounts and funds), expecting the category “other„ (more than 5%) which has dropped by 1,09%. The share of category DEG, EBRD, own shares, Supervisory board, Management board, financial institutions, ESOP has increased (less than 5%). The share of own shares was increased from 1,50% to 1,54%. The changes in ownership structure are primarily a consequence of the delisting of 21 companies, and indirectly are the result of changes within each group of shareholders.

EBRD, DEG and the ESOP don’t have the preferred shares in ownership structure. The share of preferred shares of the Republic of Croatian is significantly lower (-11,70%) compared to the ordinary shares. The shares of Supervisory board, Management board, treasury shares and funds are also smaller. Significantly higher proportions have financial institutions (7,89% higher compared with ordinary shares). The following are categories of the public (less than 5%) then the custodial accounts and others (more than 5%). It is interesting that the listed companies have its own preference shares (0,11% compared to 1,65% in ordinary shares).

Relationship with stakeholders

Stakeholder are individuals, groups and organizations, and their coalitions within and outside companies who have some rights, claims or interests in the company. The primary stakeholders are the owners, managers, employees, customers and suppliers, who have a direct and tangible interest in the company. Secondary ones are those which influence the company, directly or indirectly, often as action or reaction to its work: the consumers, competitors, government, public society as a whole and the media. The OECD Principles specifically outflows that mechanisms for workers’ participation should be developed for the purpose of the incensement of company's effectiveness (eg, workers council, ESOP).

In 2010 the 179 listed companies stated that they have own web page in the Croatian language, compared to 176 of them in 2009. The145 listed companies in 2010 stated that their website publishes information on the transparency, compared to 142 of them in 2009. The 48 listed companies in 2010 stated that their website has the calendar of important events, compared to 46 of them in 2009.

During the 2010 the 29 listed companies has decided to pay dividends for a total of 32 different shares (3 listed companies have decided to pay dividends for ordinary and preference shares), and during 2009 the 40 listed companies has decided to pay dividends for a total of 45 different shares (5 listed companies has decided to pay dividends for ordinary and preference shares). The 93 listed companies in 2010 have published data about the Management board members on their website during their tenure, and 85 listed companies have published those data in 2009. Information about members of Supervisory board on the website of the listed companies during their tenure has published 78 listed companies in 2010 and 71 listed companies in 2009.

Disclosure

Information disclosure and financial transparency of companies are not only important for existing investors but also for the potential ones. Mandatory reporting is governed by the law, while voluntary reporting stems from good corporate governance practices (Tipuric et al., 2008, 63). Preparation and submission of financial reports is prescribed by the Company Law (ZTD), the Accounting Law, the Law on Capital Markets and International Financial Reporting Standards. Listed companies that are listed on a regulated market have an obligation to prepare annually, semi-annual and quarterly financial and operating reports. Publication of the public financial reports is regulated by the articles 438 to 441 in Capital Market Law under which the listed company is obliged to submit reports: on the ZSE in the Central Register of Prescribed Information and through the media (HINA) and HANFA.

The 70, 23% of the listed companies have fully and in deadlines submitted annual financial statement for 2010 in Central Register of Prescribed Information (SRPI) according to the Capital Market Law. The 5,12% of the listed companies has not submitted their financial reports at all, while 24,65% of the listed companies is not fully met the legal requirement for the following reasons: they submitted their report after deadline (18,14%), they provided incomplete or incorrect report (6,51%). The five listed companies or 2,30% failed to submit proof of publication of reports in the media in accordance with Article 441 paragraph 9 of the Capital Market Law.

External mechanisms

The market for corporate control

In accordance with best practice solutions in the OECD countries, shareholders must not be deprived of the rights deriving from the dynamism of the market of corporate control, where the managerial groups are struggling to gain control over the company, whether it is about the fighting the voices in the General Assembly (by agent) or it is about tender offer. In Croatia, the market for corporate control is limited with the ownership concentration of the listed companies. Only slightly more than 5% of companies have the largest shareholder with less than 10% of the share in the ownership structure. The largest shareholder with less than 20% of the share have only 12,6% of the listed companies, while the largest shareholder has a majority ownership in almost 53% of listed companies. In almost 70% of listed companies major shareholder has a package owned by at least 30% of the shares. (Tipurić 2008, 70)

Legal and regulatory framework of corporate governance in the Croatia gradually evolved over the past twenty years. Today we can say that Croatia, in the normative sense, has established the highest European and international corporate governance standards. The legislation has been adopted, institutions established, as well as all the essential components of the financial markets and corporate governance infrastructure. Upgrading and fully meeting all the set norms and standards is a long-term task for Croatia.

Protection of minority shareholders

Protecting the rights of shareholders, especially those who have a minority package of shares is an important external mechanism of corporate governance. The protection of shareholder rights in Croatia over the past twenty years has sought to follow the EU legislation. Apart from legislation, Code of Corporate Governance has strengthened the principle of "one share-one vote", but unfortunately only for one-quarter of the listed companies, which are in accordance with statutory provisions become publicly traded companies and are obligated to apply best practice as defined by Code (Tipurić et al., 2008, 79).

The 13,4% of the listed companies has decided to pay dividends during 2010 for a total of 32 different stocks (1,4% of the listed companies have made a decision to pay dividends for ordinary and preference shares), 16,9% of the listed companies has decided to pay dividends during 2009 for a total of 45 different stocks (2,1% of the listed companies has decided to pay dividends for ordinary and preference shares). Out of 208 companies which are obligated to apply best practice as defined by Code, according to the rules of Zagreb Stock Exchange in 2010, 148 listed companies filled the questionnaire about the Code of Corporate Governance (till the 31.07.2011.), and for 2009 just 91 listed companies, what is the incensement for 31.41%. Only 125 listed companies have provided an answer about the percentage of compliance with the Code recommendations. 66% of them answered that in average they do compliance with the Code recommendations.

Competitive condition

The foundation of the economic system in Croatia is a free market and free entrepreneurship. Openness to the world market is daily checking the quality of the business activities including corporate governance in Croatia. Accordance to the survival or destruction of public companies their managers survive or perish. In this sense competitive conditions are an important mechanism of corporate governance in Croatia. Corporations will adopt those models of corporate governance that are in a satisfactory manner connected with the business efficiency. The market will force them to do so (Tipuric et al., 2008, 82).

CONCLUSION

Today's system of corporate governance is normatively aligned with the best practice of the European legal system. Legal and regulatory framework of corporate governance in the Croatia gradually evolved over the past twenty years. Today we can say that Croatia, in the normative sense, has established the highest European and international corporate governance standards. The legislation has been adopted, institutions established, as well as all the essential components of the financial markets and corporate governance infrastructure. However, despite great achievements, compliance with all legal regulations as well as the monitor of laws implementation is not yet at the satisfactory level and there is still a great deal of work to be done. Upgrading and fully meeting all the set norms and standards is a long-term task for Croatia.

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CORPORATE GOVERNANCE CHALLENGES IN MUNICIPALLY OWNED COMPANIES - CASE OF CROATIA

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Abstract

Municipal ownership refers to the city's ownership of public utilities. The importance of providing a high quality, efficient, accountable and safe service is the highest priority of municipally owned company (MOC), while at the same time it has to perform on an efficient and effective way in order to be able to satisfy the increasing infrastructure requirements of ever growing cities and expand its supply in new services.

On behalf of the city authorities, a municipally owned company is entitled to govern and perform operation over city's property, services, and systems which raise a question of responsibility and control of its management. Consequently, a high-quality corporate governance, understood as a multifunctional set of processes affecting the way a company is administrated and controlled, is as much needed in public ownership as it is in private. Moreover, as a category that shape company behaviour, good corporate governance system makes the platform for sustainable economic growth, increases economic efficiency, stakeholders' satisfaction and availability of capital sources.

Unlike privately owned companies, municipally owned companies, as well as state owned ones, usually are ones that have to obey market and non market logics, particularly a political one. They also cope with the lack of knowledge and motivation as well, due to the employment of eligible instead of professional management, which all challenge and have influence on company's reputation. On the contrary, since municipal services inevitably are natural monopolies or tend to become monopolies, there is a wide range of privileges that municipally owned companies face and could rely on in fulfilling their economic and social mission and responsibility.

This article is aiming to highlight the governance challenges in Croatian MOC. Reviewing the conditions under which corporate governance issues are relevant to MOC, we excel the core governance differences of municipal companies: multiple and conflicting objectives, excessive political interference, and sometimes ambiguity of vision and directions. Applying the corporate governance theoretical perspectives, especially the stakeholder-agency theory, we aim to provide a framework for more effective governance practice of MOC. By introducing the special case of largest Croatian MOC, Zagreb City Holding, we represent most important implications of corporate governance in such companies in general.

Keywords: corporate governance, municipally-owned companies, Zagreb City Holding, Croatia

Introduction

Corporate governance is to give answers to questions about who supervises the corporation and why (Kaen, 2003), how the corporation is managed and in whose interest (Blair, 1995) and in which manner changes in corporate control positions occur (Tipurić, 2011). Corporate governance encompasses the mix of internal and external factors that build the relationship among owners and professional managers who have mutual responsibility for the corporation and for the stakeholders. Since it provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performances (OECD, 2004), corporate governance thus can be defined as a kind of management of the management or meta-management (Tipurić, 2011, p 1).

Although the elements of corporate governance are increasingly applied to other forms of ownership, beside purely private, by companies which are formally not present at the capital market (Tipurić, 2008, pp 22-23), the field literature is very parsimonious upon the theoretical conceptualization and is lacking the practical cases, especially at the municipal level. This paper is aiming to fill this important gap.

The implementation of a good corporate governance practice in forms of established supervisory mechanisms used to control the management and administration of the corporation in the Croatian business environment is to be shown in the case of the municipally-owned company Zagreb City Holding.

Corporate governance in municipally-owned companies

The main issues of corporate governance refer to questions of power, authority and responsibility in accomplishing main companies' activities (Mitchell et al, 1997; Tipurić, 2008). Hence, we argue that the adopting corporate governance mechanisms can be helpful in resolving core governance difficulties of municipal companies – setting and achieving company goals due to political interference (eg. Wong, 2004). Moreover, the preamble of the "OECD Principles of Corporate Governance" declares that corporate governance should be considered as a key element in improving economic efficiency and growth as well as enhancing investor confidence (OECD, 2004), all highly important areas for MOC performance and governance. Building on transparency and board independence as two of the prime corporate governance mechanisms identified by OECD (2004), the same organization has published the OECD Guidelines on Corporate Governance of State-Owned enterprises which can be applied on City-Owned companies as well.

Aside many benefits for the national institutional framework and improvement of the management system quality, corporate governance practice in MOC confirms also the existence of direct unspecified yet present political interests which can significantly define, direct or undermine the efforts of the MOC Managing Board.

Among two basic mechanisms of control: external and internal, MOC generally applies the insider control model, in which the influence of internal control mechanisms prevails. A characteristic of MOCs, as is that of the State owned companies, is that they do not imply the existence of a corporate control market. Thus the possibility to supervise the success of the company by following the price of shares does not exist.

MOC apply all established internal control mechanisms: boards, management compensations, ownership concentration, relationship to stakeholder groups, corporate reporting, while only one external: legislative and regulatory framework (Tipurić, 2008).

Although the market for corporate control does not usually exist for MOC, the political opposition is acting like one in the arena of the City Assembly. The City Assembly appoints among its members the Municipal company Assembly proxies. They form and act as the legal representative body of the founder-owner member. The MOC Assembly than appoints the Supervisory board members and the Managing board members of MOC, which imply a dual model of corporate governance.

Internal mechanisms and their interrelations are to be included in the Code of Corporate Governance. Since MOCs are not required to declare its own Code, but are encouraged to conform to State one, they most commonly adhere to the Rules of Conduct of Assembly and Boards that define the major internal and external governance relationships and competencies. The main internal processes refer to the financial and organizational aspects, while external factors include international and national standards, legal framework and ethical rules.

External impact is mainly observed from the national level perspective or from the perspective of belonging to a corporate governance system and the existing valid legal and institutional frame. Due to single ownership, the supervisory boards, especially their structure, have the key role in the corporate governance of MOC.

Systems and mechanisms of corporate governance in Croatian MOCs

Croatia, like majority countries in transition, has prevalently adopted an insider control system characterised by high ownership concentration (Tipurić et al, 2007). A high ownership concentration for MOC means actually a public ownership, whose defining characteristic is the existence of the corporation for fulfilment of the interests of multi-stakeholder groups, not only of its owner.

Consequently, the Croatian MOCs are often 100 percent owned by the Cities, represented by the authority of the City Assembly and the Mayor. The City Assembly is the representative body of the citizens of the City, elected on the basis of universal suffrage in direct elections by secret ballot in a manner specified by Law on Local and Regional Self-Government. The Mayor is elected directly too, according to Law on Elections of Municipal Heads, Mayors, County-Prefects and Mayors of Zagreb. The mentioned laws are declared by Croatian President on a submission by the Croatian Parliament.

The Companies Act of the Republic of Croatia anticipates the situation in which the City as the legal entity performs the founder-owner role for the companies dealing with municipal and other kind of businesses. Corporate governance mechanisms work for this situation too.

In the context of the Croatian legal framework, the Companies Act of the Republic of Croatia is the lex generalis for the corporate governance area. The term “corporation” corresponds to the term joint-stock company and implies a legal subject, transferability of ownership, limited liability and no temporal limitations of business activities. On the other side, the limited liability companies are actually the legal form corresponding to MOC. Such a kind of a company is not obliged to obey to the National Code of Corporate Governance as are listed companies, or to the Code of Corporate Governance of Companies whose shares or stocks are owned by the Republic of Croatia, but are encouraged to, since the municipal ownership is also a form of public ownership. The later Code, introduced lately in 2010. prescribes the same basic framework and corporate governance bodies as for joint-stock companies, which are the executive board, the supervisory board and the general assembly. Both Codes have brought a great shift in standardization of corporate governance in Croatia, since they include the general principles and specific legal, financial and ethical framework for top level managers in private and public sectors.

Zagreb City Holding Ltd. - company profile

Zagreb City Holding Ltd. (Holding) is a municipal company founded by the City of Zagreb. It is in 100 percent ownership of the City of Zagreb. Pursuant to the Companies Act, in 2005 occurred the transfer of shares of 23 municipal companies owned by the City of Zagreb to the Holding company, named City Municipal Services, with the aim to the expansion and improvement of municipal services in Zagreb. In 2007, the company changed its name to its actual one, Zagreb City Holding Ltd. and operates under that title ever since.

The idea of organizing all the municipal companies and the city-owned enterprises of the City of Zagreb in one company – Holding, emerged for improvement of the conditions and standard of living of citizens. Constantly listening to the needs of its citizens, Holding shapes its services accordingly, since its scope of work includes some very important aspects of the life of the City, such as cleanliness, water and drainage, waste disposal, the gasworks, markets, public transport, graveyards, the coach terminal, good terminals, management of sporting facilities and many others.

Actually, Holding consists of 18 branches which perform the work with a total of around 12,000 employees. Holding is also the owner of four companies and one institution with about another one thousand employees.

The business areas of the Company are grouped into three pillars:

- Municipal functions
- Transport functions and
- Market functions

City Waste Disposal, Digital City, City Graveyards, Zagreb Markets, Water Supply and Drainage, Zagreb Roads, ZGOS, Zrinjevac (Čistoća, Digitalni grad, Gradska groblja, Tržnice Zagreb, Vodoopskrba i odvodnja, Zagrebačke ceste, ZGOS and Zrinjevac) are the branches included in the area of municipal functions.

Transport functions are performed by the branches ZET and Zagrebparking.

The business area of market functions consists of the branches AGM, Sports Facilities Management, Vladimir Nazor, Zagreb Fair, Zagreb Bus Station, GSKG, Goods Terminals, and Housing Construction (AGM, Upravljanje sportskim objektima, Vladimir Nazor, Zagrebački velesajam, Autobusni kolodvor, GSKG, Robni terminali, Stanogradnja).

The parent companies are: Zagreb City Gasworks Ltd., Zagreb City Gasworks – Supply Ltd., Zagreb plakat Ltd. and Zagreb Arena Ltd. (Gradska plinara Zagreb d.o.o., Gradska plinara Zagreb – Opskrba d.o.o., Zagreb plakat d.o.o., Zagreb Arena d.o.o.). The special institution is Zagreb City Pharmacies (Gradske ljekarne Zagreb). The commercial companies listed above and the institution, whose founder or co-founder is Zagreb City Holding Ltd. form the Zagreb Holding Group.

The basic duty of Holding is the effective and long-term performance of municipal service, with maximum protection of the environment and protection of the public interests of the local community. In the course of this work, particular attention is paid to continuously raising the satisfaction of beneficiaries of the Company's services and employees. Alongside the high standards of business practice that it aims for, the Company also has a clear commitment to improve the relationship with the environment. In line with the principles of sustainable development, in the City of Zagreb, Holding carries out and develops environmental management policies. The quality management system and management of the environment are founded on the demands of the international standards HRN EN ISO 9001:2000 and ISO 14001:2004.

Corporate governance mechanisms in Zagreb City Holding Ltd.

Good corporate governance depends on balanced relations between diverse internal and external mechanisms used to ensure effectiveness of management and to assist in solving problems and conflicts in corporate structures. The main challenges of corporate governance in Holding have been determined by the full municipal ownership, its heterogeneous business activities portfolio and the structure of legal framework, as well.

Holding, as most companies in Croatia, belongs to the insider control model, due to its form of concentrated ownership and prevailing influence of internal governance mechanisms. As a limited liability company, it is governed according to its Constituting Statement that contains all the mayor organs, their relation and responsibilities.

There are five internal governance mechanisms applied in Holding's governance: ownership concentration, supervisory board and sub boards, management compensations, corporate reporting and relationship to stakeholders.

Ownership concentration: It is assumed that large ownership concentration enables efficient supervision of management by the owners, with low agency costs. The supervision is performed through a Supervisory Board. Therefore, corporate governance can be seen as a means of finding the best way to discipline the management and it actually refers to institutionalized practices that result in manager's optimal performance.

City of Zagreb performs its role of Holding owner via the organs of the company: the Assembly, the Supervisory Board and the Board. The City is represented in the Holding Assembly by eleven councilors, elected from the City Assembly representatives' pool that includes existing political parties, on the proportion of their representation. By the Act of Resolution of the Constituting conference, the City Assembly appoints the Common agent representative member, acting as a President of the Holding Assembly. Other elected councilors act as the Assembly members. The appointment of Supervisory Board members was carried out by the Assembly pursuant to the Conditions for members of Supervisory Boards. It is an obligatory Act for Companies whose shares or stocks are owned by the Republic of Croatia, but MOCs mostly adhere to.

Holding Assembly appoints the Head of the Board. The Supervisory Board concluded an Employment Contract with the Head of the Board in which the mutual rights and obligations of the Company and the Head of the Board are established.

The City as owner is not included into everyday management that enables the company to have business independence, but through its bodies: the City Assembly and the Mayor, it sets its objectives and strategic goals and priorities of City's municipal activities and publishes them as its ownership policy through Zagreb Courier. In this way the City as one and only one owner of Holding provides for clear understanding of its goals by all stakeholders, the Company itself, the market and the wider public. In this role, the City acts as any shareholder who needs to protect its ownership and optimise its value. In the actual well determined and organized governance and institutional frame, the administration of Holding serves as a quite good example of MOC governance.

The problem occurs in situation when a Mayor and the City Assembly majority start to disagree in some city-vital issues. Conflicts arise from the distribution of power between two entities, that generate interest and a fund allocation divergence, all causing difficulties in managing of Holding. In such an occasion the important strategic decisions might not be delivered as optimal, but through political prism of intentions, and sometimes may even be conflicting and not transparent.

Supervisory Boards: Supervisory Boards are the crucial element of the corporate governance system as they set the policies and strategies determining the future of the corporation and are in the closest relationship to the management. For all reasons stated the issue of the role and structure of Supervisory Boards is the key issue in the discussion on corporate control (Tipurić, ed., 2008). As Supervisory Boards are responsible for the implementation of the corporate governance system, the owners are responsible for appointing qualified and efficient Supervisory Board members (Cadbury, 1992).

Holding practices a dual governance model. The Supervisory Board consists of five members. The four of them were appointed by the Holding Assembly. The fifth member is to be appointed by the Holding Works Council, but this leverage has not been activated yet. The president of the Supervisory Board and the vice president are appointed by the decision of the majority of votes at the Supervisory Board Constituting Conference.

The members of the Holding Supervisory Board are professionals with the highest education (three members have a PhD). Regarding transparency of work of the Supervisory Board, the Rules of Conduct are complied. According to mentioned Rules, the Supervisory Board rapports to the Assembly on a quarterly basis. On the occasion of the periodic rapport of the Board, the Supervisory Board issue its recommendations and requests for the next period. Board disseminate them through corporate departments, while a particular activities regarding business level changes or improvement are performed through Teams, constituted of insider management specialists.

An appropriate compensation for work is the basis for the independence of Supervisory Board members. Compensations to Holding Supervisory Board members are regulated by a Supervision Contract.

We have already stressed that Holding arise by joining all City businesses in one company. Some of its business architecture has been adopted successfully, bat some areas were not transformed completely. Since the Holding structure has not been fully integrated yet in a coherent manner, the Company does not perform all of its business efficiently and effectively. Therefore the Supervisory Board has undertaken the additional measures out of its available and legitimate range of acting and has established two specialized sub boards: one for restructuring and strategic development, other for audit, pursuant to anti corruption programme Guidelines. Both of the Boards have the external professionals engaged.

The members of the Restructuring and Strategy Board are two members of the Supervisory Board plus four external collaborators, the multidisciplinary experts needed for such a heterogeneous business system as Holding is. The Restructuring and Strategy Board was established for the purpose of Holding business model improvement and the provision of further strategic direction of the Company. The rules and the scope of activities of the Restructuring and Strategy Board are defined in the Rules of Conduct of the Restructuring and Strategy Board.

The members of the Audit Board are two members of the Supervisory Board plus three external collaborators, audit experts. The Audit Board was established for the purpose of better surveillance of financial reporting, accountancy activities and support to the internal audit department of the Company. The rules and the scope of activities of the Audit Board are defined in the Conduct of Procedure of the Audit Board.

Another important corporate governance instrument in Holding is the engagement of independent external auditors. Their basic function is to assert that financial reports adequately convey the actual state of the entire Company.

Management compensations: The area of the management compensations and bonuses is an internal governance mechanism which is generally assumed to be a good motivational instrument used to harmonize the owner's with the management's interests. The income level of members of the Board is usually defined in negotiations with the particular managers and in accordance with the particular conditions.

Holding has a very transparent compensation policy. The Holding Managing Board consists of four members, among one is the Head of the Board. Mutual rights and obligations between the Company, the Head of the Board and members are regulated by the Employment Contract. The contract contains fixed direct and indirect compensations. So there are no usual form consisting of the basic salary and the reward.

Although familiar with the most important reward criteria, such as achievement of plans, fulfilment of strategic goals, amount of the profit earned and success in the business field for which the individual member of the board is responsible, the Supervisory Board does not reward the Board member contribution individually. It asses its performance and gives or gives not the clearance to the acting Board member, all according to the Board Rules of Conduct and partly complying the State Code of Corporate Governance (of companies whose shares or stocks are owned by the Republic of Croatia).

The lack of formal reward is surely impacting the quality of corporate governance in Holding. But there are other, implicit mechanisms present that definitively correct the lack of former one: they are reputation and political credibility.

The maintenance of both respectable and credible position in public is as important for executive individuals as it is for firms in municipal ownership. Since the Holding's Boards consist mostly of City Assembly councilors, i.e. political parties members or independent proxies elected on the occasion of local elections, they have to show a strong commitment, act credibly and perform competent and responsibly in order to build a kind of professional reputation the public will asses as worth enough for providing another mandate.

While reputations often summarize a good deal of information about firms and shape the responses of its main stakeholders groups: customers, suppliers and employees, its main value is external, which is the extremely important area for the municipal firm (Teece et al, 1997, p 521).

Corporate reporting: Corporate reporting can be understood as obligatory and voluntary publishing or as reporting of information regarding financial and operational issues. In addition to its actions, conduct and communication, companies influence the opinion of themselves and thereby their reputation by information transparency in the relationships with their stakeholders, i.e. by reporting. Therefore, business annual or periodic reports of companies have been extending in the recent years beyond financial and investment results to environmental reports, reports on social responsibility and other value profiles and contributions of the company intended for different stakeholders (eg. Zabala et al., 2005).

The Company's web pages provide access to all obligatory reports and voluntary published information that Company find relevant for its consumers and other stakeholders.

Relations with stakeholder groups: Holding recognizes its consumers, suppliers, employees and labor unions, financial institutions, the City and the media representatives as its main stakeholders groups. As the utility company, Holding is very aware of the importance of relations with all stakeholder groups and has thus established a Contact centre for this purpose.

The Company is operating under a high safety standards of employees. Protective measures are regularly implemented to reduce or completely remove the risks that arise during work, both for the health of employees and for the working environment.

At the same time Holding enables its workers to gain new, advanced knowledge and skills, and pays attention to the well-being and legal rights protection, as well. Therefore, in Holding and its dependent companies there are 52 unions at work. All unions are included in the adoption and monitoring of the Basic Collective Agreement, which establishes in detail the rights and obligations of all employees. Bearing in mind the quality of life of its employees when they retire, in cooperation with the coordinating committee of the Unions who operate within the Company, since 2008 a closed-ended voluntary pension was established. The foundation of the fund and the company's personal financial incentives stimulate employees to save long-term.

Out of four acknowledged external mechanisms of corporate governance: corporate control market, legislative and regulatory framework, protection of minority shareholders and competition conditions (Tipurić, 2008). Holding governance is related mostly to legal and regulatory framework, but deals also, though partly, with other mechanisms. Due to already explained reasons of sole ownership, there is no need for activating the protection mechanism of other shareholders.

Competition conditions: Owed to the mostly natural monopoles of utilities, Holding has privileged position in its municipal and transport services, but has got a fear competition in its market service sector. The Restructuring and Strategy Board is dealing with the issues of market business remodelling.

On the occasion of Croatian accession to EU, some regulations and the City-funds transferring processes will be modified, which all embody a change in utilities that Holding is aware of. So the Company has already started with the preparation for the new business and institutional environment. To sustain and increase its investment capacity in the infrastructure and new services, it has submitted over 50 projects for EU financing.

Corporate control market: One of the most efficient mechanisms of corporate control is the manager market, forcing the management to operate effectively as they could always be replaced. Since Holding operates in an insider control system, this role is performed by the Supervisory Board of the Company. Besides, we have emphasized that the market for corporate control does not exist for Holding, but the political opposition is acting like one during the City Assembly meetings, on the occasion of adopting the Company's annual rapport. If the rapport is not adopted by the majority of votes, Boars could be recalled and suspended.

Legal and regulatory framework: The leading legal Act related to governance, surveillance and control of Holding is already stressed Companies Act, while the area is framed by the Law on Local and Regional Self-Government and the Utilities Act. The Company is obligated to comply with the Law on Public Procurement too. If decide to issue further notes, the Company is to comply with the national and selected market stock exchange regulations.

Since Holding is a highly diversified company that performs municipal, transport and market services, in parallel, there is a basket of business area laws, operating as lex specialis for a particular area, which determine the Company operations. They regulate municipal, water, gas, cemetery, property and traffic business activities.

Beside the mentioned Acts, the governance of Holding is characterised by the Constituting Statement, the Basic Collective Agreement, the corporate Ethical Code and the Anticorruption Programme, while Company complies to State Code of Corporate Governance to a great deal.

Holding has incorporated ethics in its organizational values and organizational culture as an important goal of corporate governance. Therefore, in 2010 has passed a Code of Ethics with the aim to guide the company's organs and employees in running the company. Furthermore, the Code regulates conflicts of interests, gifts and donations, compliance with laws and regulations, confidentiality of information and reporting of unethical behaviour. The Code emphasizes appliance of behaviour relating to protection of property and confidential information and the way of submitting complaints on behaviour opposed to the ones prescribed by the Code and sanctioning violations of the Code. For those activities, according to the State Anticorruption Programme requirement, the Company has appointed its Ethical Commission.

Conclusion

In the last couple of years Holding governance system has been fully established. Nowadays it operates as transparent and efficient one. These late governance changes were driven both by shifts in Croatian government and local and regional policies, and also by financial crises that has revealed the presence of corruption and the unethical behavior of big corporations' management.

Today, all the basic principles of the Code of Corporate Governance of companies whose shares or stocks are owned by the Republic of Croatia are being respected in Holding governance system: legality, transparency and publicity of business operations. Besides, the Company is administrated by clearly established procedures for the work of Supervisory Boards, the Board and other decision-making bodies. The prevention of conflict of interest is regulated, the efficient internal control is established and the strengthening of personal responsibility and responsible business operations are achieved.

Moreover, in the improvement of public services transparency, a great effort is being made. The Company conducts its business activities in an ethical, economical, more effective and efficient way, in conformance with laws, regulations, policies, plans and procedures. Holding Boards submit a timely financial reporting and publish regularly its business results and related auditor's rapport.

By adopting a Code of Ethics, the Company complies with legal and internal acts and the general principles of ethical behaviour in the working environment. It has established a zero level tolerance for unacceptable forms of behaviour.

All mentioned and applied mechanisms help and successfully protect Holding Board of conflicting political interest and a variety of conflicting goals, that all disturb the efficient managing of the company. As much as the corporate governance system continues in its further implementation and practical improvement, the Company's bodies will perform more professionally and consequently become more success oriented, so the overall company performance will be improved, as well.

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FIRM-LEVEL FACTORS INFLUENCING DIVIDEND POLICY

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Abstract

On the basis of previous empirical works profitability, stability of earnings, growth, debt level, ownership concentration and size are isolated as factors influencing dividend policy. Using cross section regression this paper shows their influence on level of dividends in 5 European countries, Australia, Japan and United States of America. We find profitability significant in each analyzed country with positive effect on dividend level. Stability of earnings is statistically significant in half of analyzed countries with negative sign. Similarly, we find negatively significant coefficients for growth variable in half of the analyzed countries. The impact of debt on dividend size is significant in 6 countries, but the signs of the coefficients are mixed. When it comes to ownership concentration regression analysis yielded 3 negatively significant coefficients. Size coefficient appears to be significant in half of the countries but its sign is inconsistent.

Key words: dividends, dividend policy, factors

Introduction

Black (1976) wrote: "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together''. Almost 4 decades passed since his famous claim, numerous theoretical and empirical investigations made by different scientists did not change much. Universal truth and solution to dividend policy has not been found and there is high possibility it will not be found soon. One of the main reasons for that is complexity of factors that influence dividend policy not just on firm-level but also on the country-level. The intention of this empirical investigation is to add a small piece to the famous dividend puzzle by trying to identify firm-level factors influencing dividend policy in different countries.

The paper is organized in following way: after introduction, second part summarizes the most known dividend theories focusing on Miller and Modigliani irrelevance proposition, tax-differentiation, information effect of dividends and agency problem. Third part gives overview of previous empirical works on firm-level factors influencing dividend policy. Fourth part presents data used in empirical investigation. Fifth part presents results of empirical investigation and sixth part concludes.

Dividend theories

Yield a shareholder may achieve can come in two different forms, as dividends and as capital gain. According to the classic theory of Miller and Modigliani (1961) on a perfect market characterized by information symmetry, rational behavior, no taxes and other frictions investors should be indifferent between dividends and capital gain. Their reasoning comes from investor's possibility to substitute one for the other by selling or buying shares. In that way it is possible for investor to reach any desired level of cash dividends. As a consequence on a perfect market, dividends do not matter and are irrelevant both for the investor and the company. However, real companies do not operate on a perfect market. Question that arises is can same conclusion of dividend irrelevance be applied in the real world marked with taxes, information asymmetry, agency problems etc. Observed interest in dividends of both investors and companies clearly speaks against dividend irrelevance argument. Without question dividends matter in the world in which real companies operate and their relevance is direct consequence of the characteristics of imperfect market.

Taxes arise as a first argument against dividend irrelevance proposition on the imperfect market. Dividends are typically taxed at a higher rate compared to the income from capital gain. As a consequence investors should prefer capital gain and it should be possible to increase the value of a company by decreasing dividends. Empirical investigation of Litzenberger and Ramaswamy (1982), and of Rosenberg and Marathe (1979) speak in favor of this reasoning, but not the one of Black and Scholes (1974). Connected with taxes is also a clientele effect. Although dividend tax rate is typically higher then capital gain tax rate the tax treatment of shareholders differs. As a result they will form clienteles with specific preferences for particular levels of dividends. Changing the dividend level, according to Miller and Modigliani, leads only to a change in the clientele of shareholders without influence on a share price.

Second explanation of the dividend relevance is based on the information asymmetry. Corporate insiders, managers and/or large shareholders have far better access to information regarding the current situation and future prospects of the company then small shareholders. Dividend choice is one of the key instruments they can use to convey information to the market. Empirical investigations of Bhattacharya (1979) and Miller and Rock (1985) show price reaction on dividend change and see it as confirmation of dividends as a signal of future cash flows. Other authors like Lang and Litzenberger (1989) emphasize dividends as a signal of the severity of overinvestment or free cash flow problem (Jensen, 1986). According to the overinvestment hypothesis, confirmed in their empirical work, a dividend increase signals reduction of the possibility of wasteful investments thereby increasing share value. If information content of dividends is observed from the perspective of a company with large, controlling owner, they can also be seen as signal of severity of the conflict between him and small, outside shareholders (Gugler, Yortoglu (2003)).

Third argument why dividends matter is based on the agency problem. In a company with dispersed ownership managers control the firm and may invest in projects which benefits them but not to small shareholders. Dividends take away free cash flow from them and reduce the possibility of such behavior. In a similar way dividends can be used in companies that have large, controlling shareholders. In that case high dividends show its unwillingness of rent expropriation of minority shareholders. Although there are numerous studies of dividend policy consensus on the connection of dividends and taxes, agency problem, information asymmetry and other market imperfections is still not reached. As previously mentioned since both investors and companies pay serious attention to dividends and their changes they are clearly relevant in the real world.

Previous empirical works on firm-level factors influencing dividend policy

First empirical study of dividends was provided by Linter (1956) and based on a survey of corporate managers. His work was followed by other empirical investigations that used either results of surveys of managers or secondary data from financial statements of companies. On the basis of them as factors that influence dividend policy are isolated profitability, stability of earnings, growth, debt level, ownership concentration and size.

Dividends as distributions to shareholders are paid out after all payments to suppliers, creditors, employers and tax authorities are made. Although company can use debt to finance dividends, debt level cannot grow indefinitely. As a consequence dividend level should be under strong influence of the company's profitability. The higher the profitability of a company, other things equal, the dividends should be higher. Empirical investigations based on secondary data from financial statements of companies of Fama and French (2001) in United States, Aivazian, Booth and Cleary (2003) in United States and 8 developing countries (Jordan, Pakistan, Zimbabwe, Turkey, India, South Korea, Malaysia and Thailand) , Bebczuk (2004) in Argentina, DeAngelo, DeAngelo and Stulz (2006) in USA, Baker, Mukherjee and Paskelian (2006) in Norway, Stacescu (2006) in Switzerland, Ben Naceur, Goaied and Belanes (2006) in Tunisia, Denis and Osobov (2007) in United States of America, Canada, Japan, Germany, France and Great Britain and Kowalewski, Stetsyuk and Talavera in Poland (2007) confirm positive influence of profitability on dividend level.

Companies are reluctant to dividend cuts because of negative signaling effect that usually follows them. Moreover, dividend omissions, especially in companies with long history of dividend payments, are especially unattractive because the investor could and probably will see their managers as the first managers in many years unable to generate suffucient funds to pay dividends. In the same manner, managers avoid dividend increases if they are not sure they can keep higher level of dividends in future. These facts lead to the conclusion that the management decision on the dividend level will be under strong influence of the earnings stability. It is therefore to expect that higher stability of earnings will be followed by higher dividends. Results of empirical investigation based on data from the company's financial statements and done by Bebczuk (2004) confirm positive influence of stability on dividend level but the results in Aivazian, Booth and Cleary (2003) are mixed. Empiricial investigations based on the management surveys show earning's stability as important factor when deciding on dividend policy (Brav, Graham, Harvey, Michaely (2005) in USA, Baker, Mukherjee and Paskelian (2006), Bancel, Bhattaycharyya and Mittoo (2005) in 16 European countries and USA).

The faster the company grows the more financial funding will be needed. Growth of a company can be financed by using funds a company generated by itself or by issuing additional debt and/or shares. Since there is a direct connection between dividends and retained earnings it is to expect that the dividend level will be under influence of the company's growth rate. Rapidly growing firms should have lower dividends than slow-growing firms. DeAngelo, DeAngelo and Stulz (2006) show that increase of sales growth significantly decreases the probability a company will pay dividends. Still, results of empirical investigations of Aivazian, Booth and Cleary (2003), Stacescu (2006), Ben Naceur, Goaied and Belanes (2006), Denis and Osobov (2007) are mixed.

Usage of debt in a financial structure determines part of the company's future cash outflows, those ones needed to cover interest and balance repayments. That, together with the usual increase of interest rates with debt increase, decreases company's financial flexibility. Moreover, higher level of debt means smaller amount of free cash flow at disposal to managers and/or large, controlling shareholders that act as agents for small shareholders. In that way debt itself will serve as a way of disciplining managers and large shareholders and decrease the need of dividends as control device. As a consequence significant influence of debt-level on dividend policy can be expected. It is expected for companies with higher financial leverage to have lower dividends. Empirical investigation of Gugler and Yurtoglu (2003) conducted in Germany, Aivazian, Booth and Cleary (2003), Bebczuk (2004), Stacescu (2006), Bena and Hanousek in Czech Republic (2006), Ben Naceur, Goaied and Belanes (2006) and Kowalewski, Stetsyuk and Talavera (2007) show as expected significant negative relationship between debt and dividend level. Managers questioned as part of survey conducted by Bancel, Bhattaycharyya and Mittoo (2005) in different European countries and United States of America so as the Norwegian managers in the survey of Baker, Mukherjee i Paskelian (2006) show the same direction of connection between debt and dividends. Still, empirical investigation done by Chen, Cheung, Stouraitis and Wong (2005) covering 412 companies in Hong Kong shows positive correlation between debt and dividend level.

Bigger companies should have easier access to capital markets and lower cost of debt financing. Moreover, they are usually more diversified and their cash flows are easier predictable and less volatile. As a consequence it seems reasonable to expect bigger companies will be able to pay and will pay higher dividends. Results of different empirical investigations differ significantly. Empirical investigations done by Bebczuk (2004), Bena and Hanousek (2006), DeAngelo, DeAngelo and Stulz (2006), Denis and Osobov (2007) show significant positive influence of company's size on dividend level and/or on the probability a company will pay dividends. On the other side, investigation of Gugler and Yurtoglu (2003) in Germany shows significant negative influence of size on dividend level, so as the one of Bena, Naceur, Goaied and Belanes (2006) in Tunisia. According to the last ones, the reason of negative relationship between size and dividends are low level of investor protection and high concentration of ownership that forces smaller and riskier companies to increase dividends in order to attract new shareholders. As in case of stability, results presented in the work of Aivazian, Booth and Cleary (2003) showed mixed results.

Ownership concentration as a factor influencing dividend policy should be observed in the context of agency-principal problem. Agency problem arises from the separation of ownership and control. In companies with dispersed ownership structure managers act as agents and should run a company in the best interests of their shareholders. Still, there is a possibility they will use company's funds also to conduct projects that benefit them but not to shareholders. To show their unwillingness of expropriation managers will need and shareholders will demand payment of dividends. In companies with concentrated ownership main agency problem is possible expropriation of minority shareholders. Since large, controlling shareholder has at disposal different means of fund distribution to himself without inclusion of small shareholders he is less interested in distributing dividends. It is therefore reasonable to expect decrease of dividend level with the increase of ownership concentration. Empirical investigations conducted by Maury and Pajuste (2002), Gugler and Yurtoglu (2003), Harada and Nguyen (2006) in Japan, Bena and Hanousek, Dragota (2006) in Romania confirms negative influence of ownership concentration on level of dividends and/or on the probability of dividend payment. Investigation of Harada and Nguyen (2006) also shows other facts that speak in favour of connection of dividend policy, ownership concentration and agency problem. Namely companies with large shareholder are more likely to increase dividends when company has high debt level and less likely not to pay them when debt increases. That shows their readiness not just to expropriate minority shareholders but also debt holders.

In spite of high number of empirical works consensus regarding the influence of different factors on dividend policy is still not reached nor did the scientists found formula for setting optimal dividend policy for each and every company. Reason for that should probably be searched in numerous differences among the companies but also among the surrounding in which they operate. Nevertheless, effort toward discovering new information regarding dividends, factors that influence them and the way they influence shareholders wealth should not be stopped. This empirical work tries to add small part to it.

Data

The firms in the sample cover eight countries (5 European countries, Australia,Japan and USA). Data for dividends and firm-specific variables are collected mainly from Bloomberg data base. The companies included are the biggest ones listed on the stock exchanges in each country included in the investigation. Financial firms and utilities are excluded because of their special characteristic (e.g. debt level). Whenever needed, various other sources like financial statements available at the Web sites of the companies are also used to collect any missing data. It is still impossible to obtain data for each and every variable from all 984 companies. As a consequence some companies had to be excluded from the analysis. Sample period covers 2010.

Table 1 provides summary measures of dividend policy as well as basic data to assess the financial situation of the analyzed companies. It also shows percentage of market capitalization of analyzed companies in each country.

Ratio of dividends to total assets of each company is taken as a dividend measure. As possible alternative measures of dividend one may take are dividend yield, dividend payout ratio, ratio of dividends to earnings and ratio of dividends to the book value of equity. Dividend yield is not chosen as a dividend measure because its reflection of pricing effects that are beyond management control, dividend payout ratio because of its instability and nonnormality as earning get close to zero, ratio of dividends to earnings and to book value of equity because their high sensitivity to accounting distortions (Aivazian, Booth, Cleary, pp. 378).

In table 1 profitability of companies is measured using return on assets, stability of earnings using standard deviation of return on assets during the period of 2006-2010, growth by using index of sales growth from 2009 to 2010, debt level using ratio of debt to total assets, ownership concentration by measuring the percentage of ownership of first shareholder in each company and size by calculating logarithm of sales.

Table 1. Cross-country summary statistics of dividends and other firm-specific variables

	DIV	ROA	SDROA	GROW	DEBT	CONC	SIZE	N	% of MC
AUS	0,0332	0,0429	0,0850	1,2355	0,4122	0,1659	2,8064	105	NA
FIN	0,0310	0,0552	0,0482	1,1462	0,5337	0,1714	2,7530	93	55,32
FRA	0,0184	0,0509	0,0199	1,0965	0,6270	0,1815	4,3509	32	57,01
JAP	0,0092	0,0299	0,0212	1,0791	0,5886	0,1392	6,0433	98	25,02
NTH	0,0331	0,0779	0,0700	1,2113	0,5725	0,1845	4,0693	19	84,38
POL	0,0038	0,0308	0,0682	1,2044	0,4655	0,3851	2,4229	150	30,43
USA	0,0218	0,0768	0,0420	1,1368	0,5694	0,0902	3,9356	419	72,68
UK	0,0279	0,0843	0,0464	1,1388	0,5694	0,1302	3,8701	68	57,92

This table presents mean values of dividends and other firm-specific characteristics from 10 countries. The firm-specific variables are as follows. DIV: defined as aggregate dividends over value of total assets; ROA defined as return on assets; SDROA defined as standard deviation of return on equity in period 2006-10; GROW defined as sales growth from 2009 to 2010; DEBT defined as total debt over total assets; CONC defined as percentage of ownership of largest shareholder; SIZE defined as logarithm of total sales.

Results of empirical investigation

To test the influence of profitability, stability of earnings, growth, debt level, ownership concentration and size on dividend level we run ordinary-least squares regressions with ratio of dividends to total assets as the dependent variable and firm-specific factors as explanatory variables for each of the eight countries in our data set. Equation used is:

$$DIV_{i,j} = \mathrm{a}_j + \mathrm{b}_{1,j} ROA_i + \mathrm{b}_{2,j} LGSD_i + \mathrm{b}_{3,j} LGGR + \mathrm{b}_{4,j} DEBT_i + \mathrm{b}_{5,j} CONC_i + \mathrm{b}_{6,j} SIZE_i + \mathrm{e}_j$$

where i denotes and individual firm and j denotes a country. Hypotheses are: positive effect of profitability, stability and size on dividend level and negative effect of growth, debt level and ownership concentration on dividend level. The results of regression presented equation are reported in Table 3.

Table 3. Regression results

	C	ROA	LGSD	LGGR	DEBT	CONC	LGP	Adj-R2
AUS	0.0176	**0.3654**	**-0.0212**	-0.0045	-0.0046	**-0.0359**	**-0.0077**	0.7185
	(0.0219)	*(0.0000)*	*(0.0000)*	*(0.7826)*	*(0.6787)*	*(0.0081)*	*(0.0017)*	
FIN	0.0659	**0.1729**	0.0029	**-0.0637**	**-0.0573**	**-0.0089**	-0.0023	0.5371
	(0.0000)	*(0.0000)*	*(0.6197)*	*(0.0044)*	*(0.0000)*	*(0.0945)*	*(0.3075)*	
FRA	-0.0459	**0.2862**	**-0.0079**	**-0.0873**	**-0.0339**	-0.0110	**0.0146**	0.7223
	(0.0056)	*(0.0023)*	*(0.0282)*	*(0.0314)*	*(0.0135)*	*(0.1855)*	*(0.0000)*	
JAP	0.0216	**0.1158**	**-0.0037**	-0.0013	**-0.0175**	**-0.0186**	**-0.0020**	0.9302
	(0.0000)	*(0.0000)*	*(0.0000)*	*(0.7021)*	*(0.0000)*	*(0.0944)*	*(0.0000)*	
NTH	-0.0333	**0.5432**	**-0.0115**	**-0.1965**	-0.0121	-0.0232	0.0071	0.6909
	(0.2599)	*(0.0003)*	*(0.0952)*	*(0.0107)*	*(0.4821)*	*(0.5831)*	*(0.1467)*	
POL	-0.0036	**0.0658**	**-0.0039**	-0.0003	**-0.0048**	0.0008	**0.0015**	0.2816
	(0.0381)	*(0.0543)*	*(0.0329)*	*(0.9039)*	*(0.0995)*	*(0.7229)*	*(0.0290)*	
USA	-0.0216	**0.1567**	-0.0023	-0.0277	**0.0269**	0.0267	0.0022	0.1223
	(0.0236)	*(0.0000)*	*(0.3597)*	*(0.1968)*	*(0.0022)*	*(0.4493)*	*(0.2766)*	
UK	-0.0212	**0.2837**	-0.009	**-0.0561**	**0.0355**	0.0112	-0.0021	0.5663
	(0.1289)	*(0.0000)*	*(0.0793)*	*(0.0986)*	*(0.0016)*	*(0.3172)*	*(0.4282)*	

This table presents regression results of dividends on firm-specific variables for 8 countries using annual data of 2001. All variables are defined in Table 1 (variables LGSD and LGGR are logarithms of variables SDROA and GROW. P-values are reported in parentheses. White heteroskedasticity adjustment is used. Adj-R2 is the value of adjusted-R2 for the regression.

We find profitability statistically significant at 10% significance level in each analyzed country and consistent with theoretical proposition. In all analyzed countries dividends increase with the increase of profitability as expected. Stability of earnings measured as logarithm of standard deviation of return on assets is statistically significant in half of analyzed countries. In all of them coefficient is negative showing inverse relationship between dividend size and instability of earnings. Similar to stability results, we find four negatively significant coefficients for growth variable. The finding in half of the countries in our sample is in line with the hypothesis that firms with higher growth rates have pay lower dividends. We observe that the impact of debt on dividend size yields significant coefficients in six countries. However, unexpectedly two of six significant coefficients are positive. The cross-sectional regressions yield as many as three negatively significant coefficients for ownership concentration showing dividend decrease with increase of shareholdings of the largest shareholder. Size coefficient appears to be significant in half of the countries but its sign is inconsistent. According to the regression results hypothesis regarding positive influence of profitability and stability so as of negative influence of growth and ownership concentration on dividend level are confirmed on 10% significance level. The same cannot be said for the influence of debt and size. Direction of their influence on dividend policy differs among countries.

It is important to point out the limitations that this so as any other empirical investigation has. The number of countries so as companies in them covered with this empirical investigation is limited. If the limitations of data, especially number in each country, can be overcome, one might find even more significant result regarding firm-level factors influencing dividend policy. Moreover, period covered in presented investigation is only one year. It would be interesting to extend investigation period to longer period and to use panel techniques as addition to regression analysis. Further, it is worth of thinking about different measure of growth and ownership concentration then the one use in this paper. Regarding variables it is worth to mention some other variables like industry that are not included in analysis presented in this work. Their inclusion could give additional value to the analysis.

Conclusion

In spite of numerous empirical and theoretical works on dividend policy dividends still remain one of the most important unsolved problems in finance. On the basis of them as factors that influence dividend policy are isolated profitability, stability of earnings, growth, debt level, ownership concentration and size. Using cross section regression this paper tries to show their influence on level of dividends in five European countries, Australia, Japan and United States of America.

At 10% significance level we find profitability significant in each analyzed country with positive sign of coefficient as expected. Stability of earnings is statistically significant in half of analyzed countries. In all of them coefficient is negative showing inverse relationship between dividend size and instability of earnings. Similar to stability results, we find negatively significant coefficients for growth variable in half of the analyzed countries. That result is in line with the hypothesis that firms with higher growth rates pay smaller dividends. We observe that the impact of debt on dividend size yields significant coefficients in six countries, but the signs of the coefficients are mixed. When it comes to ownership concentration, the cross-sectional regressions yield three negatively significant coefficients showing dividend decrease with increase of shareholdings of the largest shareholder. Size coefficient appears to be significant in half of the countries but its sign is inconsistent.

This empirical investigation has certain limitations. Number of countries so as number of countries analyzed in each country could be higher, period covered could be expanded to more years, better measures of some variables could be used and additional variables could be added. Solving these limitations certainly presents possible field for new empirical work. Although each of them adds small piece to the famous dividend puzzle lot of work is left to be done before we see the whole picture instead of numerous small parts of a big puzzle.

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THE USE OF CONJOINT ANALYSIS IN ORDER TO FORM ATTRACTIVE CREDIT OFFERS IN BANKS OF BOSNIA AND HERZEGOVINA

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Abstract

Formation of attractive credit offers is one of the objectives of all commercial banks, including banks in Bosnia and Herzegovina. Commercial banking sector is constantly facing the problem of equity loan, which is especially emphasized in conditions of financial crisis. Commercial banks, like all companies, strive to continually increase their market value and to better position themselves. One way to succeed in doing so is to increase the income. Given the specificity of commercial banking, their aspiration is achieved, among other things, through improving equity loans. In order to increase income on this basis, very important prerequisite is the formation of attractive credit offers, where the respect of clients` views on this issue is of great importance. Many banks, in order to retain existing clients, but also to attract the new ones, are aware that they must take into account their preferences. To respect and value their views means to identify the key factors and adjust the offer to them. The power of conjoint analysis is that it allows us to get the answer to this problem.

The algorithm of conjoint analysis is a multivariate procedure to measure the preferences of bank clients in connection with the attributes of the loan. This analysis relies on a survey of bank clients with the representative set of attributes that are ranked according to clients` preferences. The representative set is formed with the procedure called orthogonal design. Conjoint analysis then uses quantitative information that can be used to model client preferences for any combination of attributes. In the example of conjoint analysis, a commercial bank in Bosnia and Herzegovina is interested in forming a new attractive loan product and wants to study the influence of five factors (attributes) on the preferences of clients.

Keywords: Credit, conjoint analysis, orthogonal design.

Introduction

Conjoint analysis is an extremely powerful and useful tool for statistical analysis. This analysis is a multivariate procedure for measuring clients` priorities, in conjunction with some attributes of a product or service (Vasić and Rajić, 2007, p 205-215).

The use of this analysis is multiple, because in the real world consumers do not make the decision to purchase a product or a service solely on the basis of one characteristic, but consider large number of characteristics:

- when purchasing a car, customers look at a variety of performance, among which the key ones are: price, warranty, colour, possibility of deferred payment, type of engine etc.
- in development of e-commerce companies must focus on many segments, on which potential clients are paying attention, and among them are: a guarantee on product, delivery, the ability to return the purchased product, web-site presentation and many other things
- when choosing a hotel, tourists pay attention not only on price, but also on the location of a hotel, quality of service, local entertainment, schedule of flights to this destination etc.

Hesitation, doubt and uncertainty in decision making are just some of the characteristics that also apply to the banking sector. The key problem of this paper is how to establish a loan offer, so that the value of loans being placed is on higher level than previously. It is clear that this does not depend on one factor only. Having in mind this problem, in our study we analysed the banking sector in Bosnia and Herzegovina, where we tried to decipher this issue. The reason for selecting commercial banking sector in Bosnia and Herzegovina lies in the fact that this sector is of great importance for the entire economic system of the country. This refers primarily to the impact of the banking sector on the overall economic development and improving the functioning of financial markets.

The aim of this paper is to point out how important is each factor to the client in the evaluation of adequate long-term general purpose loan. Thus, establishing the quantitative relationship between all factors that affect the client in deciding on a loan, on one hand, and the decision on the loan, on the other. Taking into account this information, it is clear that all these factors are explanatory variables, whereas a decision or client preference is a dependent variable. By classification we have come to the factors that are important for the decision making, and those are:

1. the loan repayment period
2. the loan rate (expressed in the level of interest rate)
3. the number of guarantors (as a kind of loan guarantee)
4. the amount that bank charges on credit
5. the possibility of early repayment.

Of course, these are not the only factors. Clients` decision can also be affected by other factors (whether the rate is fixed or variable, whether the loan is taken with or without participation, whether in domestic or foreign currency and many other factors), but those mentioned earlier are defined as key factors.

Relying on this powerful multivariate procedure, we can offer a concrete mode that will accurately indicate which attribute is dominant and to what extent. In addition, commercial banks will be able to create such loan offer that is more adapted to the needs of potential clients and therefore banks will create conditions to advance their business, which may consequently result with the growth of aggregate demand.

Problem formulation and designing of survey

Conjoint analysis, like any other analysis or procedure, consists of certain steps. These steps give us the opportunity to plan, implement and effectively analyse the results of conjoint studies. These are the following steps:

1. Formulation of problem
2. Construction of stimulus
3. Deciding on the form of input data
4. Selection of procedures and application of analysis
5. Interpretation of results
6. Assessing the reliability and validity

In formulation of conjoint analysis problem, factors (or attributes, how the factors are often called in this analysis) must be defined, as well as their levels, which will be used to construct the stimulus (i.e. formation of cards, which will be discussed later). Levels of attributes indicate the category or attribute values. From the theoretical point of view, attributes that are selected should significantly influence consumer preferences and choices and to be acceptable in a sense that they can be influenced on . Attributes can be identified in various ways, such as:

- through discussion with management and some experts
- analysis of secondary data
- qualitative research
- pilot surveys.

Typical conjoint analysis contains five, six or a maximum of seven attributes.

After defining the attributes (factors), the next step is a selection of appropriate levels. Number of attribute levels affects the number or parameters to be evaluated and will also affect the number of stimulus or cards that clients (respondents) will assess. In this section, the utility comes into play, and when choosing the level this must be taken into account. Specifically, the selected levels can be critical in forming preferences . Therefore, the interviewer should take into account the levels of attributes that dominate the market and subject matter. The use of attribute levels that are beyond the scope of those that exist in the market will reduce the credibility of assessment, but will increase the accuracy with which the parameters were evaluated. The general guide is to distinguish the level of attributes so that the range is somewhat larger than those that dominate the market, but not so large to adversely affect the assessment task on which we can rely. It is recommended that the number of levels is two or three, maximum four.

Specifically, based on the key issues of paper, and taking into account aforementioned assumptions, five attributes have been identified. In order to answer the problem and accordingly create the attractive credit offer and to create conditions to increase the income, the following attributes have been selected.

1. Time (repayment period)
2. Price (price of loan expressed through the level of interest rate)
3. Guarantee (number of guarantors as a guarantee for the loan)
4. Commission (expressed as a percentage of approved credit)
5. Credit closing (possibility of early repayment of loans).

On one hand, the selected attributes are essential for the formation of client`s preferences (as dependent variables, where all selected attributes are explanatory variables), while on the other hand, all attributes are characterized by the fact they can be influenced by banking management, that is to have the control over them. Selection of these factors was preceded by prior preparation, which was based on the interview with the competent bank officers, i.e. employees who are daily confronted with these and similar problems.

After determining the attributes, selection of appropriate levels is next. In the listed example, attributes have different number of levels, but also the levels on different scales of measurement . The number of levels, then a description of each attribute and characteristics of relationship between levels is listed in the Table 1.

For stimulus construction of conjoint analysis, two approaches are available:

- paired approach
- procedure of full profile

In the paired approach, which is also called two-factor assessment, the respondents evaluate two categories of attributes until all possible attribute pairs of categories are evaluated (for each pair, respondents evaluated all combinations of levels of both attributes), while in the full profile approach, also called multi-factor evaluation, full or complete profiles were constructed for all attributes. Usually, each profile is described on a separate map.

Conjoint analysis uses full profile approach, where clients rank different types of options, in this case long-term general purpose loans, as defined by specific levels of all factors.

Even after careful selection of all factors and levels of analysis, the total number of possible combinations is often too large for clients to evaluate. For example, five previously mentioned factors (of which two factors have three levels, and three factors have two levels) the number of different combinations is 54 (3 x 3 x 2 x 2 x 2). To solve this problem, full profile approach uses partial factorial design, as suitable fraction of all possible combinations of factor levels (Vasić and Banićević, 2007) The algorithm of conjoint analysis in order to form attractive housing loan. A special type of partial design, called orthogonal field, provides a successful assessment of all main effects. Each card selected is a different version of the product in the study and should be presented to respondents in form of individual product profile. This helps the subjects to concentrate on the product version currently evaluated. In other words, use of orthogonal design drastically reduces the number of cards. Each of these cards should include all the attributes, i.e. to be comprehensive but to give different characteristics of each attribute.

Table 1 – Selected attributes and their levels

Ord. no.	Attribute	Description of attribute	Level of attributes	Measurement scale
1.	Time	Repayment period	1="7 years"; 2="10 years"	Nominal
2.	Price	Level of nominal interest rate	1="7.99%"; 2="8.99%"; 3="10.49%"	The scale of relationship
3.	Guarantee	Number of guarantors required to guarantee a loan	1="two guarantors"; 2="one guarantor" 3="no guarantors"	Nominal
4.	Commission	Amount of commission that ba ank charges during loan processing	1="1.00%"; 2="1.50%";	The scale of relationship
5.	Credit closing	Possibility of early loan repayment	1="YES"; 2="NO"	Ordinal

The software package SPSS (owned by 'IBM SPSS Statistics Family') with its wide application allows us to solve this problem adequately. The fact that the conjoint analysis is an integral part of any new version of this software package (latest version is 20.0) itself speaks of its importance and current value. Unlike most of the SPPS analysis, the active file is not a prerequisite for initiating this review. As details regarding start-up and generating analysis are not subject of this paper, we list only the output table in the appendix (more on the creation of orthogonal design and other analysis can be found on the main menu Tutorial / Help of the aforementioned software). Please note that the orthogonal design (often referred to as the plan) is required as a starting information for the conjoint analysis of data. So you would want to save your design as a SPSS database. Once you create orthogonal design, we can use it to create product profile that respondents will evaluate. It can be given in the form of table listing the profile, and it can also be displayed for each profile separately. Which way will be selected depends primarily on practical reasons and selection of researchers. In this paper we have opted for a complete view on one page (more accurately the first variant).

That output (Table 2) is the 'rough' version of a questionnaire filled out by respondents. When we learn to generate orthogonal design and display profile (either separate or individual) we are on the right way to start analysis. However, to start conjoint analysis we also need the input data.

Input data

Input data is provided by respondents, based on the offered cards. The respondents give a rating or rank offered cards in terms of their preferences or intentions to purchase.

In selecting the sample we have opted for four commercial banks in Bosnia and Herzegovina (all from Banja Luka), as follows: 'NLB Razvojna Banka', 'Intesa San Paolo Bank', 'Hypo Alpe-Adria Bank' and 'Komercijalna Banka, joint stock company, Banja Luka'.

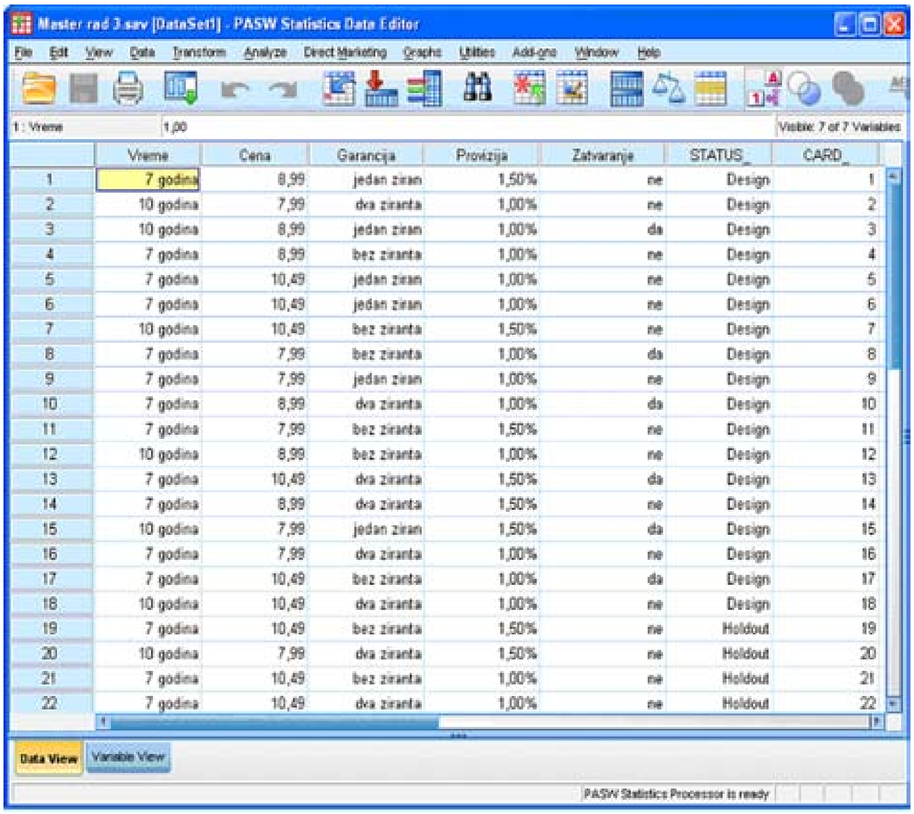
In each bank, we interviewed five respondents (potential clients of all commercial banks) which makes twenty respondents. They were asked to rank all offered profiles according to their preferences.

Specifically, in our case, the respondents ranked each proposed concept (card) from the standpoint of overall acceptability, i.e. from the standpoint of intent on "taking credit". Data collected on the affinities of the subjects are kept in the database . The data consists of responses of twenty respondents (size of our sample) where each respondent is identified by unique value of variable "Identification". In this way they make ranking list of their preferences to this bank product, ranking all offered concepts from favourite to least favourite. Respondents were asked to rank 22 credit profiles.

Table 2 – Output layout in the SPSS software (creation of orthogonal design)

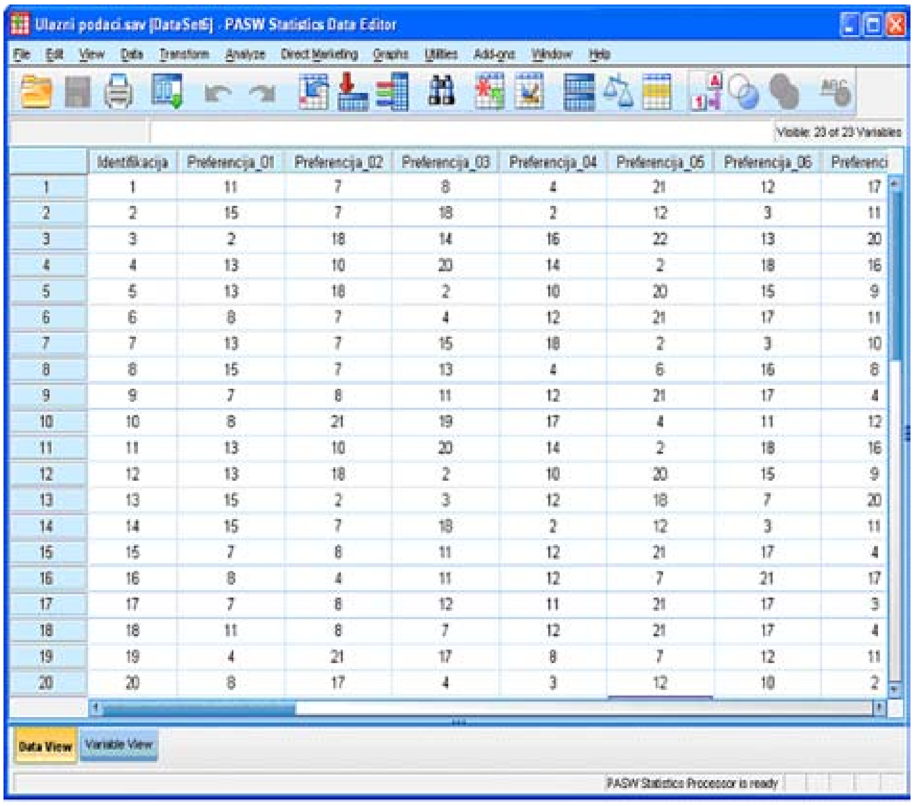
Card List						
	Card ID	**Period of loan repayment**	**Level of nominal interest rate**	**Nuber of guarantors required for a guarantee**	**Level of bank commission**	**Possibility of early repayment**
1	1	7 years	8,99	one guarantor	1,50%	No
2	2	10 years	7,99	two guarantors	1,00%	No
3	3	10 years	8,99	one guarantor	1,00%	Yes
4	4	7 years	8,99	no guarantor	1,00%	No
5	5	7 years	10,49	one guarantor	1,00%	No
6	6	7 years	10,49	one guarantor	1,00%	No
7	7	10 years	10,49	no guarantor	1,50%	No
8	8	7 years	7,99	no guarantor	1,00%	Yes
9	9	7 years	7,99	one guarantor	1,00%	No
10	10	7 years	8,99	two guarantors	1,00%	Yes
11	11	7 years	7,99	no guarantor	1,50%	No
12	12	10 years	8,99	no guarantor	1,00%	No
13	13	7 years	10,49	two guarantors	1,50%	Yes
14	14	7 years	8,99	two guarantors	1,50%	No
15	15	10 years	7,99	one guarantor	1,50%	Yes
16	16	7 years	7,99	two guarantors	1,00%	No
17	17	7 years	10,49	no guarantor	1,00%	Yes
18	18	10 years	10,49	two guarantors	1,00%	No
19[a]	19	7 years	10,49	no guarantors	1,50%	No
20[a]	20	10 years	7,99	two guarantors	1,50%	No
21[a]	21	7 years	10,49	no guarantor	1,00%	No
22[a]	22	7 years	10,49	two guarantors	1,00%	No
a. Holdout						

Table 3 – SPSS



	Vreme	Cena	Garancija	Provizija	Zatvaranje	STATUS_	CARD_
1	7 godina	8,99	jedan ziran	1,50%	ne	Design	1
2	10 godina	7,99	dva ziranta	1,00%	ne	Design	2
3	10 godina	8,99	jedan ziran	1,00%	da	Design	3
4	7 godina	8,99	bez ziranta	1,00%	ne	Design	4
5	7 godina	10,49	jedan ziran	1,00%	ne	Design	5
6	7 godina	10,49	jedan ziran	1,00%	ne	Design	6
7	10 godina	10,49	bez ziranta	1,50%	ne	Design	7
8	7 godina	7,99	bez ziranta	1,00%	da	Design	8
9	7 godina	7,99	jedan ziran	1,00%	ne	Design	9
10	7 godina	8,99	dva ziranta	1,00%	da	Design	10
11	7 godina	7,99	bez ziranta	1,50%	ne	Design	11
12	10 godina	8,99	bez ziranta	1,00%	ne	Design	12
13	7 godina	10,49	dva ziranta	1,50%	da	Design	13
14	7 godina	8,99	dva ziranta	1,50%	ne	Design	14
15	10 godina	7,99	jedan ziran	1,50%	da	Design	15
16	7 godina	7,99	dva ziranta	1,00%	ne	Design	16
17	7 godina	10,49	bez ziranta	1,00%	da	Design	17
18	10 godina	10,49	dva ziranta	1,00%	ne	Design	18
19	7 godina	10,49	bez ziranta	1,50%	ne	Holdout	19
20	10 godina	7,99	dva ziranta	1,50%	ne	Holdout	20
21	7 godina	10,49	bez ziranta	1,00%	ne	Holdout	21
22	7 godina	10,49	dva ziranta	1,00%	ne	Holdout	22

Table 4 – SPSS



Ulazni podaci.sav [DataSet6] - PASW Statistics Data Editor

Visible: 23 of 23 Variables

	Identifikacija	Preferencija_01	Preferencija_02	Preferencija_03	Preferencija_04	Preferencija_05	Preferencija_06	Preferenci
1	1	11	7	8	4	21	12	17
2	2	15	7	18	2	12	3	11
3	3	2	18	14	16	22	13	20
4	4	13	10	20	14	2	18	16
5	5	13	18	2	10	20	15	9
6	6	8	7	4	12	21	17	11
7	7	13	7	15	18	2	3	10
8	8	15	7	13	4	6	16	8
9	9	7	8	11	12	21	17	4
10	10	8	21	19	17	4	11	12
11	11	13	10	20	14	2	18	16
12	12	13	18	2	10	20	15	9
13	13	15	2	3	12	18	7	20
14	14	15	7	18	2	12	3	11
15	15	7	8	11	12	21	17	4
16	16	8	4	11	12	7	21	17
17	17	7	8	12	11	21	17	3
18	18	11	8	7	12	21	17	4
19	19	4	21	17	8	7	12	11
20	20	8	17	4	3	12	10	2

Data View | Variable View

PASW Statistics Processor is ready

Variables 'Preferences 01' to 'Preferences 22' contain the ordinal numbers of profile cards of products from the profile database. In our example the respondent under the number one most preferred profile of 11, so 'Preference 01' has a value of 11, next on his list is profile 7, then 8 and so on until the end. Database with input data given by all respondents is provided in Table 4.

In this way, we come to another key database that serves to start the analysis. In addition to the base where the factors are defined (attached to the paper), this database is of great importance, as will be later explained.

Analysis start-up

Conjoint analysis uses specially tailored version of regression analysis on ranked preferences of respondents. After applying conjoint analysis we will be able to find out which factors are important to clients, as well as which levels of a given factor are particularly preferred. In order to apply conjoint analysis, it is necessary to establish its model, and then introduce the method of evaluation of unknown model parameters, as well as standard errors. This procedure allows the calculation of all sizes that are used in conjoint analysis through specially adapted methods of ordinary least squares.

Statistics model of ri score for the i-card (from the respondents) is:

$$r_i = \beta_0 + \sum_{j=1}^{p} u_{jk_{ji}}$$

(1)

where:

b_0 is constant

$u_{jk_{ji}}$ is a partial value of contribution or utility connected to

kji-th level of j- th attribute (j = 1,2, ... p) of i-card.

Start-up of conjoint analysis in the SPPS requires use of command syntax, since for this analysis communication windows have not yet been made. The command syntax, which is combination of two previous basis is illustrated in the appendix.

Obtaining the output data (results and interpretation)

Running the command syntax, which is explained in the previous section, is introduction to final stages-getting the output data. More accurately, an adequate set of syntax, then connection to database, as well as defining all factors is preliminary condition for obtaining the final results of the analysis.

Analysis results can be interpreted from different stand points. We can be interested to every respondent individually (his impressions and preferences to individual factors and levels of each factor) or to aggregate result (when the analytical value of results is much greater).

Table 5 shows evaluated scores of utility statistics (i.e. statistics of partial value) and their standard errors for each factor level. Higher level of utility statistics show higher affinities. As expected, there is a reverse relationship between the level of interest rates and high commissions for loan processing. Larger negative values indicate lesser utility. In addition to higher values indicating a greater tendency it is important to bear in mind that all utilities are expressed in common units. This means that they can be summed up to get the total utility for any combination. This way the total utility of any long-term loan and with any performances may be established.

For example, the total utility of long-term general purpose loan with the following characteristics:

- payback period (time) 10 years
- the interest rate (price) 8.99%
- a loan guaranteed by one guarantor
- 1 % commission and
- the possibility of early repayment is

utility(10 years) + utility(8,99) + utility(one guarantor) + utility(1,00%) + utility(yes) + Constant =

4,825 + (-0,900) + 2,183 +

(-0,300) + 3,025 + 3,383 =

= 12,216

The scope or range of utility value for each factor allows to measure how important was each factor for the overall affinity (preference) of the respondents. Factor with the larger range of utility is more important than those with a smaller range. However, in order to give the answer to the question which of these factors is the key, i.e. on which factor the respondents were the most sensitive, we will not rely only on the range from the smallest to the largest value. For this purpose it is necessary to look at the results concerning the importance score for each factor. Importance score for the i-th factor is listed below:

$$IMP_i = 100 \cdot \frac{RANGE_i}{\sum_{i=1}^{p} RANGE_i} \qquad (2)$$

where $RANGE_i$ represents the difference between maximum and minimal value of utility parameter for i-th factor.

Table 6 shows the averaged value of utility statistics. On its basis, it can be clearly seen which factor is more or less significant. This information is essential for the bank management, as it gives them the opportunity to better understand the market, and based on that to better prepare and position themselves. Averaged values indicate the relative importance of each factor known as the importance or value score.

Table 5 – Rating scores of utility statistics

Utilities

		Utility Estimate	Std. Error
Time	7 years	2,413	,860
	10 years	4,825	1,719
Price	7,99	-,800	3,970
	8,99	-,900	4,467
	10,49	-1,000	4,963
Warranty	two guarantors	1,092	,496
	one guarantor	2,183	,993
	no guarantor	3,275	1,489
Commision	1,00%	-,300	,860
	1,50%	-,600	1,719
Closing	No	1,513	,860
	Yes	3,025	1,719
(Constant)		3,383	5,004

Table 6 – Averaged values

Importance Values

Time	18,552
Price	7,994
Warranty	49,691
Commission	11,464
Closing	12,300

Averaged Importance Score

Values are calculated by taking the utility range for each factor separately and dividing the amount of utility value for all factors. Thus, values are percentages and their sum is 100 %. The calculation was made separately for each potential client and hence the results are the average of all potential clients. It is clear from this table that the most important factor is warranty, and that the price is the least important factor, which is even better illustrated in Figure 1.

It should be taken into consideration that these are averaged values, i.e. that they do not reflect the preference of each subject individually, but on average. The figure that is attached to the paper indicates the individual attitudes of respondents in terms of preference for these factors .

Review of conjoint analysis

In the following table (Table 7) two statistics have been calculated, Pearson`s R and Kendall`s ,which allow measurement of the relationship between observed and estimated preferences.

Similarly Table 7 also shows Kendall` statistics for highlighted profiles. To remind you that respondents ranked highlighted profiles (there are 4 in the example), but they have not been used in conjoint analysis for the assessment of utility statistics. Instead, conjoint analysis calculated the correlation between observed and estimated rankings for highlighted profiles in order for validity check of utility statistics. In these cases, correlations for highlighted profiles can give better indication for quality model. It should be noted that highlighted cases will always have lower correlation of coefficients.

Figure 1 – Averaged value of utility statistics

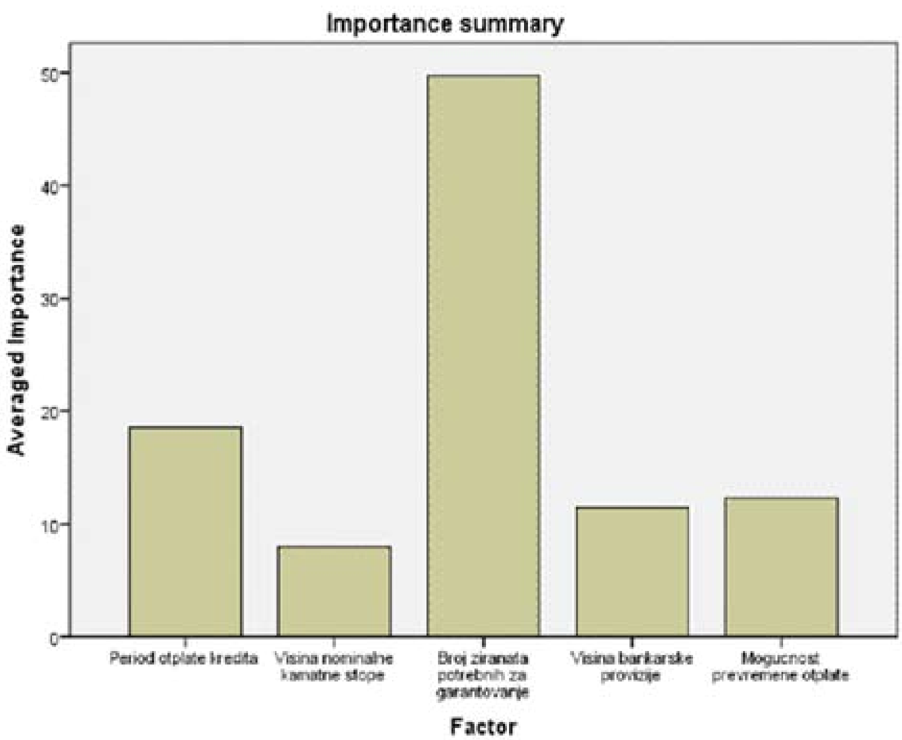


Figure 2 – Individual subject importance

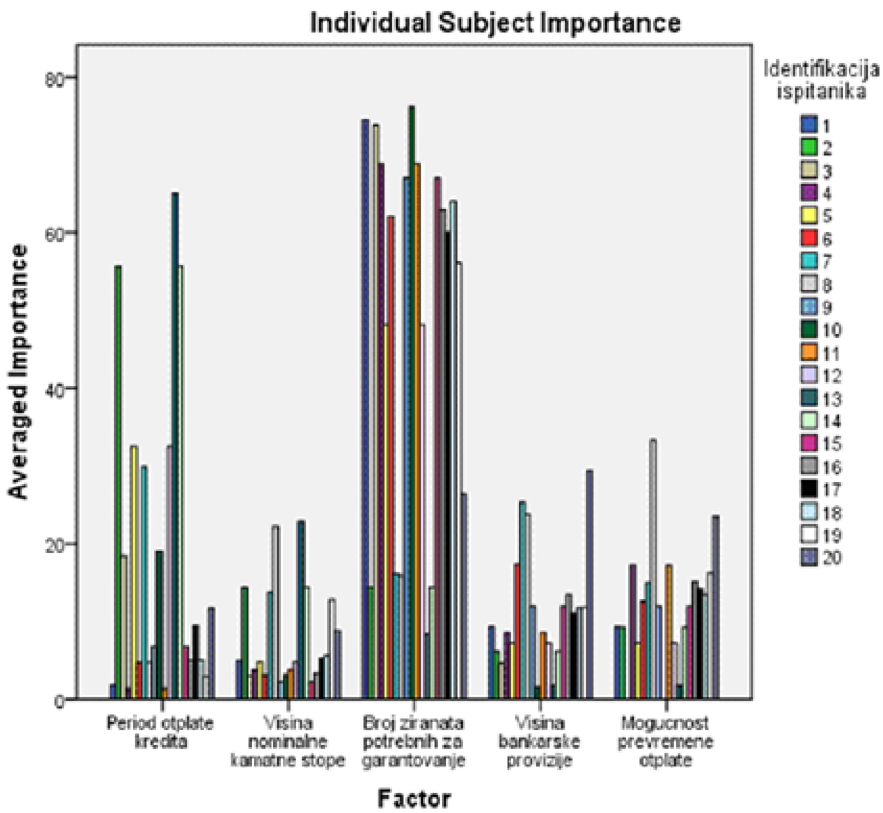


Table 7 – Values of correlation coefficients

Correlations[a]

	Value	Sig.
Pearson's R	,756	,000
Kendall's tau	,630	,000
Kendall's tau for Holdouts	,000	,500

a. Correlations between observed and estimated preferences

Coefficient of simple linear correlation, as a relative measure, takes values from -1 to +1. If it takes positive values, correlation between occurrences is direct or positive (both occurrences show direct variation) and vice versa. When correlation coefficient in absolute value is closer to 1, there is a stronger correlation between occurrences. In contrast, when it is closer to zero linear relationship is weaker.

In our case, this coefficient is 0.756, which indicates stronger correlation. As the significance is .000, it is clear that the correlation coefficient is significant.

Conclusion

Conjoint analysis has experienced a "boom" in the last twenty years, when it comes to its use. Its use in no longer associated with the marketing and management of the market only (as was previously the case), but it has multiple use. Thus, the analysis found its place in the banking sector.

The issue of equity loan is in the focus of banking problems. In times of crisis and great competition that characterizes this sector, banks were forced to fight for each client in order to survive on the market. Bank management should be well aware of its potential clients in a sense that they have to feel what the clients want from the bank. Therefore, conjoint analysis comes into focus, because it gives very important and sensitive information, based on which banks can better position themselves on the market. This information comes from the respondents, because analysis is based on the survey in which the respondents properly evaluate selected factors that are considered to be of importance.

Conjoint analysis comes to key answer, and that is which factor should be put in the fore during the formation of credit offer, and which factor can be partly neglected because the clients do not consider it critical when making a loan application.

The results of our analysis showed that factor Warranty (number of guarantors) has the greatest impact on overall customer preference in applying for long-term general purpose loan and bank selection. This means that there are big differences in preferences between loans that include preferred number of guarantors (for clients) and the profile that contains the least desirable number of guarantors (higher number). The significance of this factor is so dominant that it has relative importance almost as much as the other four factors together (i.e. 49,691 %). The fact that the subject of analysis are long term loans, which are mainly related to large amounts of money, this has a logical justification due to the difficulty of finding an adequate person as a guarantor.

The results also show that other important factor is Time. Excluding these two factors, other factors (price, commission and closing of credit) have a minor role. However, this does not mean that they will be excluded in the formation of our strategy. On the contrary, this information has a multiple importance. In fact we know that the credit offer formed by the bank should have as few guarantors as possible because clients are extremely sensitive to that, whereas fixed commission for loan processing is not as the important, nor is interest rate . In practice this means that the bank can increase the amount of loan processing to an acceptable market levels without fear of significant influence on the clients` preference to opt for this bank.

Conclusions and recommendations regarding the formation of credit offer in the future should not be viewed from one aspect only. The guidelines that this paper foregrounds definitely have a wider social significance. All interested parties benefit from formation of such credit offers of long-term general purpose loans. When it comes to interested parties, we can classify them into three groups:

1. clients, as borrowers,

2. bank, as the institutions that provide loans,

3. general public.

Bank clients are interested in having available loans that best suit their preferences, which may result in greater degree of loyalty. On the other hand banks, taking into account the preferences of their clients may be in position to significantly increase their credit loans, which is one of the main goals of every commercial bank. In this way, banks are coming into situation that increases the number of their clients, and they become more attractive from their point of view, which as a final result has a better position of banks in the market. However, in this scenario are interested not only banks. Wider public and economy also have the interest, because in this way the whole environment is upgraded to a new level. When the population and economy can easily get loans, which they believe are very attractive, it can be a good signal that the whole community is on an upward trajectory.

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http://consulting.ajjan.com/conjoint.htm

Endnotes

1. For example, while selecting the car brand, we should have the essential characteristics (price, fuel consumption, interior space, colour). On the other hand it will not be helpful if we tell the manager of some auto-shop that buyers prefer sports car comparing to more conservative one, unless sports car characteristics and conservatism are not defined in terms of attributes over which management has control.

2. The utility does not have to be a linear function, because respondents sometimes value more medium car models than small or large ones, and on the other hand they are often more sensitive to transition from medium to high cost, than low to medium cost ect.

3. If the price of car brand varies between 14 000 €, 16 000 € or 18 000 €, the price will be relatively unimportant, but if the price varies between 10 000 €, 20 000 € or 30 000 €, it will be extremely important factor.

4. It refers to the fact that some levels are on nominal scale of measurement, while others are on other scales.

5. This database as the previous one (which is related to the formation of the plan) serve as a basis for analysis star-up.

6. The table represents the output from SPSS, which is copied in its original form in the paper.

7. For example, a respondent number two does not consider the number of guarantors as a key factor.

8. If the range between the rates was higher, this component would be omitted in the conclusion. However, when determining the level of interest rates market conditions were taken into consideration, i.e. these rates correspond to market ones at the moment of this research.

INTERDEPENDENCE OF CONTROLLING AND CORPORATE GOVERNANCE IN TRANSITION COUNTRIES

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Abstract

The issue of ownership and management is the prevailing topic of the modern business world. Small and medium enterprises in all countries are the backbone of social peace necessary for any economy. On the other hand, large companies carry the volume of capital growth and market sharing in global economy. In case of large companies, the functions of ownership and management are separated for the sake of successful business. That separation, aimed at better management, produced corporation, for which professor Candler says it may be the most important social innovation today (Chandler, 1990).

The question is what is the crucial importance of corporation? The answer is simple, and can be found in management, which is on one hand free of any burden with the aim to focus on business results, and on the other hand the imperative of sustainable and responsible business requires corporations to reconcile the interests of all stakeholders. That way corporation created a complex system of relations, both within and out of it. The issue of cognitive skills of management, which should answer the growing demands, emerges in this complex system of corporate governance. It certainly became mission impossible! The risk of decisions made by managers exceeds the limits of human and managerial capabilities.

This complex system of corporate governance initiated the growth of new forms of assistance to manager, with internal audit and controlling standing out. While internal audit means legality of business for manager, controlling encompasses a number of functions which are too demanding for the manager, and without which his key decisions exceed the allowed limit of business risk.

Keyworlds: corporate governance, economies in transition, controlling, success of corporate governance, future development

Introduction

For the purpose of studying the efficiency of corporate governance, being analyzed in the European context, it is necessary to recognize important differences between economies in transition and the developed ones. Therefore, the subject of this study is corporate governance in transition economies, as well as the introduction of controlling that helps manager reduce the risks of his decision-making.

The aim of this study is to clarify the status of corporate governance in transition countries, and its positioning, i.e. the achieved level of controlling and its implementation. This kind of research is quite rare, and in Croatia it is one of the first such studies.

The goal is to point to the most important factors of corporate governance in transition countries, and to indicate the level of development of controlling as a partner in management in the field of reducing the risk in decision making to the acceptable degree. This issue is explored in the developed economies in Europe, especially Germany, and can serve as a model, but it should not be copied, as it is proven that copying brings negative effects (Mesaric, 2002, p 10).

Corporation and corporate governance system

The concept of corporation comprises an economic entity in which owners are neither personally nor with their property responsible for company duties, or for any other obligations related to the system of company management (Berle, 1933). Accordingly, there is a separation of ownership from the function of administrating company resources.

In setting up the system of corporate governance, whose main goal is to make stakeholders wealthy, there is a need to define basic postulates of sustainable business: be ethical, responsible, and profitable (Stainer and Stainer, 1998 p 5). Each of the three postulates has its own issues. Therefore, in 2004, OECD set the Principles of Corporate Governance (OECD, 2004), which position the corporation in the global economy system.

The interests of shareholders, i.e. stakeholders and managers, in the circumstances of lack of confidence and erosion of business ethics, have gradually come down below the level necessary to ensure continuity of development. Thus, socially responsible governance which is the heart of corporate governance is at stake.

In the time of deep, global crisis which is based on the lack of trust, the reconciliation of conflicting interests is the biggest problem of corporate governance, meaning that socially responsible governance is in crisis.

National or Multinational Corporation is the capital pillar of developed economies, and it promotes a State that occurs as an entity which has to support the resolution of this problem in accordance with the surrounding on macro level. The problem of surrounding, especially on a macro level is neglected in the strategic governance. Significant differences between the macroeconomic models of States are neglected by the world's leading financial institutions that assumed responsibility to solve this problem, especially in transition economies. This refers to the World Bank and IMF (Mesaric, 2002, p 15).

In developed countries, governments have become more active, so for example Germany amended the law on the protection of investors „Gesetz zur Kontrolle und Transparenz im Unternehmensbereich“. According to this law, enacted in 1998, the control of business activities, as well as the transparency of business and its results, in the sector of economic entities is legally bounding. This law raises the level of protection of shareholders and investors through the following:

- all share holding companies are required to organize risk management, to explore the upcoming risk, to set the risk strategy transparently, and to announce whether and why the management will accept the upcoming risk
- the company must define, organize, and develop certain types of risk management
- if investment fails, provided that the creditor constituted at least 10% of investment in relative value, or 1 million euros in absolute value, then the refund is provided from the owner's private funds.

Thus, in developed economies the state has defined its role, and it imposed strict criteria of corporate social responsibility on corporations. Consequently, socially responsible governance was protected from any other type of management.

Corporate governance in transition countries

Taking into account the definition of corporate governance, as well as the concept of basic model of corporation where ownership is separated from management, researches show a significantly lower level of participation of corporations in national economies of transition countries. At the same time, American corporations make almost three thirds of national production, and hire approximately one third of the total number of employees (Tipuric, 2006. p 1). The situation is similar in developed economies in Europe. In transition countries, according to Croatian example, about 70% of large companies function as corporations and they hire about 25 % of total number of workforce. In this case it should be taken into account that there are significant differences in the criteria of classification of small and medium enterprises in transition and developed economies. In the field of employment the same criteria are applied, but in the classification of small and medium enterprises the criteria differ. Criteria relating to company assets and income are significantly different (Lukovic, 2008 p 6). The difference between Germany and Croatia is 7:1 in favour of Germany. The reason for this lies in the policy of each country in terms of realization of social aspects of entrepreneurship, according to which 60-65% of total number of employees are hired in small and medium enterprises. So, both in absolute and relative numbers, corporations are much less common in transition countries. The link between ownership and management in transition countries is much more pronounced. There are many reasons for that, but the most important is motivation which arises from the symbiotic relationship of investment and business results. Also, State plays an important role in transition countries. Unfortunately, State administration in transition countries is disorganized, susceptible to economic crime and corruption. Fighting corruption means hunting the perpetrators, but without anti-corruption mechanisms (Lukovic and Piplica, 2011, p 61). Such macro surrounding resulted in four basic features of business environment for entities in transition countries (Lukovic, 2008, p 9):

1. non-payment
2. incompetence of managers
3. insufficient knowledge of e-technologies and foreign languages
4. inefficient judicial system.

In transition economies, in corporate governance, two-tier system prevails, i.e. (1) supervisory board and (2) management board (Tipuric, 2006, p 60). Without going into a deeper analysis of this model of corporate governance, it is necessary to point to the main purpose of corporate governance which is effective corporate social responsibility. “Without efficient system of governance, there is a chaos in human relationships. Governance brings order to chaos.” (Colley et al, 2003, p 2). The most important question whether a glass is half full or half empty remains to be explored, i.e. to which extent is corporate governance in transition economies (in)efficient.

Based on a two-tier system of corporate governance in transition economies, the role of supervisory board is to control and guide strategically, and it could be specified as (Tipuric, 2006, p 62):

1. Analysis and targeting of corporation strategy
2. Monitoring the effectiveness of management
3. Intervention in management when necessary
4. Linking the income of management with the company
5. Ensuring transparency
6. Solving conflicts between management and stakeholders
7. Ensuring the integrity of accounting, finances, audit and control systems
8. Supervising the process of informing and communicating.

This specification of operational functions of supervisory board is comprehensive. Considering the competence and cognitive skills of members of Supervisory Board is usually focused on the assistance of the supporting services of corporation Management.

Starting from the need for effective corporate governance, we can say that, at all levels, it is the biggest problem in transition economies. There are many repercussions of ignorance at all levels of management, from corporation to state. Apart from ignorance, there is a domination of shareholders which indicates underdevelopment of wider social model of external corporate surrounding.

The question is how to ensure transparency, reduce the risk of management decision making to the acceptable level, manage the risks, set up the information and communication system to support management, compensate for a lack of management competencies, solve the problem of limited cognitive competences of management, raise the market competitiveness of corporations, etc. One of the fundamental answers to these problems is controlling!

Controlling and its position in management

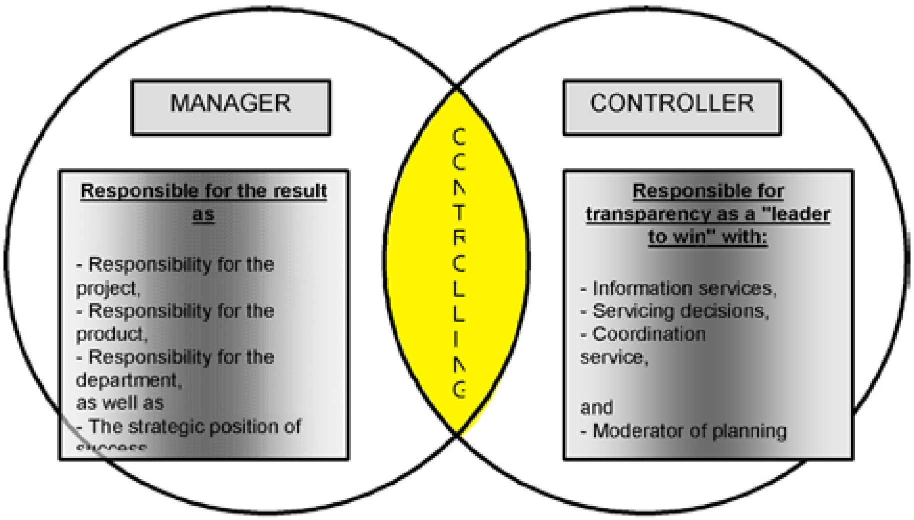
There are different definitions of controlling, but since corporate governance deals with managing structures and processes in business systems, the appropriate definition is: ‘Controlling is the process that occurs as a result of harmonized efforts of management and controllers in order to achieve the specified goal of economic entity.’ (Lukovic and Lebefromm, 2009, p 5)

Table 1 Differences of interest between the three main influential groups of subjects

	Areas of expectations	Stockholder	Stakeholder	Manager
1	The objectives of existence	Production	Quality of life	Maintaining a position of profit based on
2	Ecology	exploitation of resources	The preservation of life and harmony with nature	Exploitation of resources with environmental rules, if possible
3	Marketplace	Commercial bases	Partly social control in market decisions	Increasing market share
4	Resources	The economic return of resources	Balanced economic and social return of resources	Preservation of resources in mandate time
5	The level of interest	individual interests	Coordination of common interests of people	Individual interests with the interests of supporting the "stronger"
6	State	Small role of the state	The active role of the state	The active role of the state as support of business result

Source: by author Lukovic, T.

Figure 1. Controlling as process between the controller and manager



Source: Luković, T. & Lebefromm, U.: „Controlling, concepts and cases“, First book, University of Dubrovnik, 2009

Main characteristics of controlling are (Lukovic and Lebefromm, p 6):

1. Closely oriented and focused (on the problem) on the way of thinking and working
2. Complete orientation and focus in thinking and working towards the realization of the specified goal of the company
3. Complete orientation of thinking and working towards the realization of company gain, assuming that long-term successful business is ensured
4. Focus on thinking and acting towards the future of the company.

Controlling is a process developed through common work of managers and controllers, thus, that cooperation is a key factor to successful controlling. Cognitive skills and compatibility of managers and controllers are basic preconditions for controlling to develop within the system of corporate governance. It must be pointed out that there are two main types of controlling in corporations regarding its implementation: (1) total controlling which is incorporated in entire company and all its functions, and (2) controlling which is being introduced.

It has to be said that controlling has five key functions related to its basic sources:

1. Accounting and computing function

2. Audit function (internal audit)

3. Joint work and cooperation with external audit

4. Tax function

5. Function of interpreting results and information.

The role of controller, as a subject related to manager, is advisory in terms of several forms of cooperation and development of controlling. As Elmar Mayer says: ‘Controller is, or will become, the one who learns more than others, comprehends, thinks and acts oriented to future so as to manage the company successfully.’ (Mayer, 1986, p 33). Thus, it is evident that a large portion of tasks is transferred to controller. Still, it should be noted that the responsibility of controller is related only to one area: design and management of the information and communication system of the company. Controller offers solutions and Albrecht Dayhle calls him ‘seller of objectives and plans’ (Dayhle, 2003, p 9) while explaining the methodology of his work and design of suggestions presented to manager according to the ‘if…then’ system.

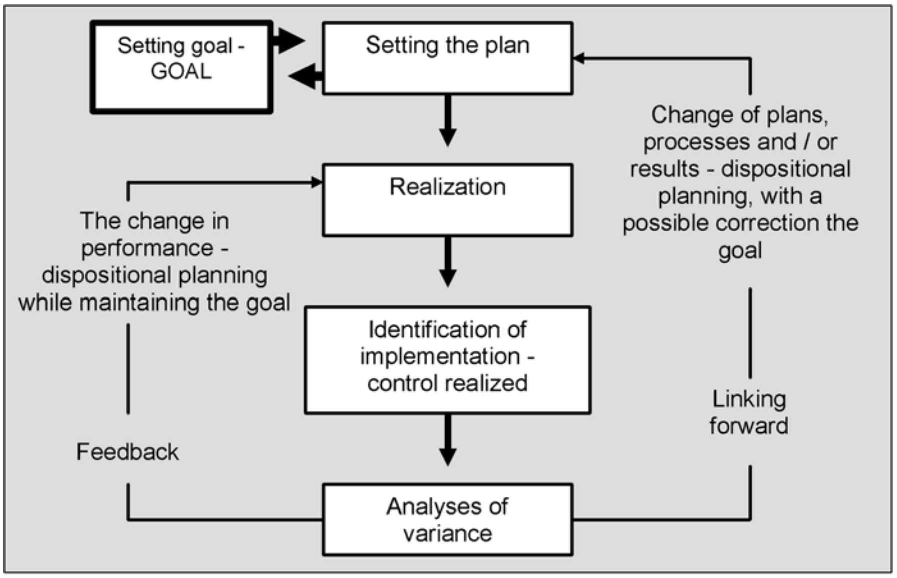
In corporate management controlling is present in operational and strategic planning. He transforms all tasks into measurable values, distributes them to holders, and creates different measuring systems. Accordingly, departments within corporation are organized as profit centres and their performance is checked on daily basis.

Rewards system is related to efficiency, so for example in corporations in Germany the variable part of salary is not only much higher than a fixed pay, but it is a precondition and an important factor in keeping the job.

Regarding the functioning of controlling in the system of corporate governance, total controlling runs by the circular flow scheme.

Starting point of circular flow of controlling in corporations is a target established by stakeholders and implemented by top management. The role of controllers is to ‘grind’ and divide it in sectors and departments. Planning transforms goals into specific strategic and operational tasks, delegating them to lower levels of management. Four basic elements of management are delegated to those in charge of tasks: (1) powers, (2) tasks, (3) authority and (4) responsibility. This process of fragmentation of one goal to sub-groups and their transfer to the lower levels of personal goals is interesting in practice because the main goal is lost on the way, especially in complex corporate systems. When it gets to the lowest level of management and work, while advancing step by step according to the top-down approach, then the main goal simply gets lost. So one of the skills of controller is ‘to transfer main goal to the lowest levels, to make sub-goals measurable, and then manage their implementation.’ The role of analysis of discrepancies between realized and planned values is to estimate the achieved differences and the reasons for that are examined through the ‘telling why system’. That phase of circular flow of controlling is very important as it is followed by decision-making. The decision related to goal exceeds the level of managers in corporate governance. It is made with ‘commitment’ which solves the dilemma whether to keep the main goal with change of plan, process and dynamics of results, or to give up on the main goal and divide it into higher or lower levels.

Figure 2. Typical circuit controlling the flow



Source: adapted by the author Luković, T. (according to Weber, 2000, p. 8)

Single-loop-learning or double-loop-learning is a source of lack of rationality in corporate governance with 'a firm hand on the tiller'. This occurs because information from environment is insufficiently connected with planning and control. Experienced and self-confident manager imposes his ambitious plan to members of management, in spite of controller's warnings, thus harming the importance of commitment. It results in irrational decision-making. While single-loop-learning prevails in operational management, double-loop-learning is 'sine qua non' of strategic corporate governance. Adopting the changes in environment as part of double-loop-learning is key factor of successful strategic planning. Single and double-loop-learning should be connected in order to have harmonized functioning of circular flow of controlling. That means that operational and strategic planning, as well as managing and controlling should also act jointly. Main prerequisite for this is cognitive competence of managers, controllers, and all task holders. Since corporation is a complex organization, circular flow of controlling is exposed to an unconnected functioning, and therefore to a higher degree of irrationality. This problem is harmful for circular flow of budget where a 'budgetary slack' can occur, leaving an empty space in the budget, and it can be harmful when the items of budget 'intersect' because of the upcoming deficit. Both solutions are irrational. Controllers and all task holders are in charge of this problem which is increasingly common in corporations, as the process of informing, planning and controlling refers to everybody. Controller develops a system of dispositive planning which reduces the risk of possible contingencies (Lukovic and Lebefromm, 2009, p 295). That fact drives the integrated controlling system of entire company and not just of the top of the pyramid of corporate governance.

Introduction and scope of controlling in transition countries

On the European level, there are significant differences in the development of countries. Generally speaking, two economic and political worlds can be distinguished: (1) economies emerging from the state-planned (communist) model, and (2) those from market-entrepreneurial model. The first group consists of transition economies, while highly developed economies of Western Europe form the second.

To study the form and level of implementation of controlling in corporate management in transition economies it is necessary to be familiar with the surrounding.

Surrounding as key factor of implementation of controlling

As mentioned earlier, controlling is a process that occurs between entities of controlling, which means its success depends on the entities' cognitive skills that are the result of the surrounding within which they are formed. Surrounding is crucial for the controlling in corporate governance in transition economies. This surrounding is best described by the Nobel laureate Joseph Stiglitz and summarized by M. Mesaric (Mesaric, 2002, p 15), and we shall mention the basic features of surrounding of corporations in transition economies.

So, state-planned economies, called transition economies, at the beginning of the third millennium, go through important political and economic changes. Market- entrepreneurial model, without any alternative, was imposed on them. The question was how to implement it. That question divided the transition economies. How? Powerful financial institutions as International Monetary Fund and World Bank occurred as support to transition countries in their economic and political changes. They offered the transition model with financial help. They used shock therapy instead of gradual approach (Mesaric, 2002, p. 19). That led to division among countries into those that introduced market-entrepreneurial model by means of shock therapy and those that used gradual approach. Countries that implemented gradual transition, taking their objective circumstances into consideration, gave positive results and started their development (except China and Poland), while those that used shock therapy and succumbed to large financial institutions gave bad results (ex. Russia and Croatia). The latter nearly halved their GDP in less than ten years, increased employment, compromised payment system, became corrupted, caused stratification of population, and other negative effects. Fast and unprepared privatization proved to be devastating, and those economies still cannot repair negative consequences. The privatisation proposed by IMF was intended for foreign capital, believing that modern managerial and technical knowledge would come with it, leading to faster flow of new financial capital and easier access to foreign markets, and resulting in faster development and higher employment. The result was just the opposite. So, psychology and mentality were at issue. Lester Thurow explained this aspect of transition and the advantages of using the gradual approach (Thurow, 1983). He challenged the basis of liberal economic doctrine, i.e. its wrong perception of man and his behaviour. Basic anthropological, i.e. behavioural premise of that doctrine is a rational man, famous homo economicus, who makes rational decisions that maximize usefulness. This problem, substantiated by shock therapy, cut down two pillars of every national economy, (1) small enterprises, which are pillars of any national economy, and (2) corporations which are pillars of capital. Distress was created instead of social peace, and corporations encountered the problem of socially responsible business.

Position of controlling in corporate governance system, case study of Croatia

When positioning of controlling is analysed in transition countries, for which we can take Croatia as example, it is necessary to take into consideration two basic areas of its implementation:

1. Business sector and
2. Education and creation of human resources.

In the economic sector, when we analyse the implementation of controlling, its application is present in the system of corporate governance, i.e. where the problems of making risky decisions are most common.

In 20 years, modern European corporations were role model for Croatian corporations, but there are few authors who deal with them in their scientific work. These corporations, as entire economy, applied European standards, so Croatian corporate governance, together with national system of corporations, can be compared to all developed European economies. In 20 years of development of corporate governance in Croatia, supervisory boards, as key segment of corporate governance, went through positive changes and slowly became "real" supervisory boards (Tipuric, 2006, p 249). They gradually resume responsibility for the corporation strategy and its implementation. Second entity of corporation, management, is changing.

There are two sets of problems in Croatian economic and political environment:

1. Problems at the state level:

- Insufficient competence in market-entrepreneurial model and work and life in those circumstances
- Malfunctioning of judicial system and protection of debtors rather than creditors
- Saving companies that should go into bankruptcy and liquidation, and thus supporting adverse business
- Corruption.

2. Management problems:

- Low level of education and cognitive skills
- Lack of knowledge of e-technology
- Lack of knowledge of foreign languages
- Independent risky decision-making
- Business in circumstances of non-payment.

In Croatian economic and political circumstances corporations do well. If we leave out the problems and development of supervisory boards, management intensively uses internal audit and controlling due to pressure caused by duties in turbulent circumstances. Internal audit survived, positioned itself in corporate governance and became essential entity. Controlling, as support to corporate governance, is being implemented, which is connected with high level of misunderstanding resulting in a number of problems. The biggest problem of implementation of controlling in corporate governance lies in its psychological and mental nature. The basic premise of its introduction is mental compatibility of management and controllers. Without that, controlling is just a door plate in the corporation building.

Another problem is dependence of controlling on good information system and its handling by all users, without which there is no high quality controlling. Third problem is education. Fourth problem is positioning of controlling and adapting the entire corporate system to the controlling concept.

Introduction of controlling in corporate governance brings a number of changes. Corporate governance adapts to it step by step because controlling is a shock for entities not used to such type of management. It is gradually implemented in the corporate value system, covering them partially.

Controlling, seen as coordination of all segments of corporations, entered Croatian corporations with the introduction of information system. Although the introduction of information system is dynamic, controlling is a support to accounting, thus fulfilling its original accounting and computing function. In all Croatian corporations controlling has satisfied this and it slowly meets the second one, internal audit. The remaining three functions are still not covered in Croatian corporations. The first two phases were carried out through information systems which internally satisfied the needs of Croatian corporate management, i.e. in circumstances when it was not market oriented. That type of information systems satisfied four basic, classic, internal functions (Panian and Spremic, 2007, p 22):

- Planning and organization
- Acquisition and implementation
- Delivery and support
- Monitoring and assessment.

Still, it should be said that it is a system that meets four internal functions on the level of ERP (Enterprise Resource Planning) of first generation. ERP I is a software based on a common data base and user interface, which ensures free flow of information among segments of the organization and provides a comprehensive informative view on business system. Therefore, planning and market oriented corporation remained out of the system. Introduction of ERP III supports the view on the position of corporation on the market, there is communication with the market, and benchmarking is becoming a reality. That is also a beginning of a new role of controlling in Croatian system of corporate governance. The controlling concept, which is being introduced in almost all Croatian corporations, with the support of global crisis, introduced the so-called value-oriented controlling.

Education in transition countries is limited; Croatia is a good example for that. In private sector short courses are organized to introduce the basic concept of controlling. There is an increasing number of doctoral students who wish to do their thesis on the subject of controlling, but there are practically no mentors for that subject in Croatia. The biggest problem is lack of understanding and knowledge, so because of their ignorance people ask: ‘Who is that controller? Is he God who would solve the problems of managers? And if he does all that, then what does the manager do?' Since controlling is a support to accounting and finances in Croatian corporate governance, the question is if it is part of accounting or management department. Lack of understanding is significant, which means that the educational sector does not meet the demand of economy, primarily corporations. Still, when it comes to education, development of controlling in developed European economies has positive effect on transition countries due to globalization. Education regarding controlling is quite common and life-long learning is supported in science and in practice. It creates a highly valuable intellectual property which contributes to development of corporate governance. The difference between Germany and Croatia in the presence of controlling in education and its implementation in corporate governance is significant. Germany already needs a new generation of controllers (Weber, 2000, p 15), while Croatia struggles with the understanding of controlling. But, we have to believe in future, as it is the way controlling goes.

Conclusion

Corporate governance is inconceivable without controlling in developed European economies. Requirements that management has to meet make the decisions too risky. In corporate governance, the mistakes arising from risky decisions are measured in amounts that cannot be forgiven. Therefore, the role of controlling and good controller is sometimes more important than the role of manager. Controlling system of thinking is incorporated into entities on both macro and micro levels, thus creating new environment which contributes to development of corporate governance and corporate value system.

In transition economies controlling occurs in the first phase of development, accounting, and then extends to finance. Controlling is first and best implemented in corporate governance system, and almost all Croatian corporations have some kind of it. The lack of professional controllers is common, and systematic training of controllers in all transition countries does not exist. This is substantiated by lack of understanding on the level of the most responsible ones, the universities.

European market of developed and economies in transition needs controllers, which is impossible to satisfy in current circumstances. Human resources do not offer educated controller that Croatian corporations need. That demand is an important impetus, so we must hope that educational centres will get reorganized so as to meet that demand and produce the first generation of controllers.

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MANAGERIAL CONTRACTS – SOLUTION(S) IN BOSNIA AND HERZEGOVINA

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Abstract

Managerial contracts represent a tool through which relations between shareholders and professional managers are being defined in all forms of business in which managerial function is separated from ownership. Managerial contract should, in a win-win manner, balance relations between shareholders and professional managers, while treating professional managers as key carriers of strategic and operational business, who provide the biggest contribution to the business effectiveness. It is obvious that the concept of managerial contracts in this region is not treated adequately, nor is the concept of professional management promoted as the key factor of organizational effectiveness, which is largely a result of the logic of the previous social-economic system's mind-set. This paper promotes the importance of professional managers and managerial contract, and highlights an understatement and apsurdity of specific legal (and practical) solutions in Bosnia and Herzegovina in areas which are related to the problem of managerial contracts.

Keywords: managerial contract, corporate governance, organizational effectiveness, compensations

Introduction

This paper considers the problem of managerial contracts worldwide and in the context of Bosnia and Herzegovina. It is obvious that the concept of managerial contracts in this region is not treated adequately, nor is the concept of professional management promoted as the key factor of organizational effectiveness, which is largely a result of the logic of the previous social-economic system's mind-set. Purpose of this paper is to highlight the fact that professional managers are key factor of organizational effectiveness, and that a managerial contract is a tool which should create a framework within which professional managers will be (highly) motivated to manage the business successfully, which is a precondition for fulfilment of shareholders' interests (as well). Therefore, this paper critically summarizes existing legal and practical solutions in regulating relations between shareholders and professional managers in Bosnia and Herzegovina, which are contradictory to the highlighted logic of relations between shareholders and professional managers, shaped through a managerial contract.

The paper is structured as follows. Part one summarizes the historical context of managerial contracts' evolution, or historical context in which separation of managerial function from ownership happened, accompanied by the term "managerial contract". Part two highlights basic assumptions of the theories (agency theory and service theory) which regulate relations between shareholders and managers. Part three identifies the purpose of a managerial contract (which is balancing the relations between shareholders and managers through the win-win approach), as well as its content through the mechanisms which should secure a balance between (confronted) interests of shareholders and professional managers. First three parts pragmatically summarize what managerial contracts should be. Part four summarizes corporate context of Bosnia and Herzegovina, as well as the way in which the issue of professional management and managerial contracts is treated in this region. Part five highlights an understatement (and aspurdity) of the legal infrastructure and practical solutions which are contradictory to the logic of a status of professional managers and managerial contracts elaborated in first three parts of the paper. Concluding part of the paper recognizes a set of recommendations whose application could contribute to the affirmation of the concept of managerial contracts and professional managers in a way in which managerial contracts (and professional managers) are treated in a highly developed countries. There is no doubt that it is necessary to change existing mind-set of shareholders and law-makers who obviously mistreat the issue of managerial contracts (and professional management).

Managerial contract(s): historical context and meaning of the term

The very start of modern capitalism usually is being related for 1932, a year in which one of the most influential articles, tractates in history of management has been published. It is the tractate written by the founders of modern corporation Adolf A. Berle and Gardiner C. Means under the title Modern Corporation and Private Property, in which they argued that the management function should be separated from ownership. By separating managerial function from ownership, institution of professional managers is being created, who in the name and on behalf of an shareholders of a business strategically and operationally manage the business (Martin, 2009).

In the second and the third decade of the twentieth century, great entrepreneurs such as Rockfeller, Mellon, Carnegie, Morgan, Boeing, Siemens, ... who have established and managed first big businesses, are being replaced in those same businesse by professional managers. By separating managerial function from ownership, or by engaging professional managers in order to in the name and on behalf of shareholders professionally manage business, preconditions for introducing managerial contracts, which, logically, aim to regulate relations between shareholders and professional managers, are created. From this point of view, professional managers are hired connoisseurs, experts, professionals who have the knowledge and skills for successful management of a business. No matter what their craft and skills are, professional managers de facto have a status of „hired workers“ who are engaged by shareholders in order to in the name and on behalf of them manage the business. There are no doubts that the effectiveness of the business itself depends on skills and craft of professional managers.

In terms of separation of managerial function from ownership, a managerial contract represents a tool, a document which regulates relations between shareholders and professional managers who on behalf of shareholders operationally manage business processes within (specific) business entity. Managerial contract is applicable in all forms of business organizations in which managerial function is separated from ownership, meaning that the institute of managerial contract, hypotheticaly speaking, could be applied even in a small craft shop if a craftsman finds it appropriate to hire a professional manager. The more complex a business is, the more demanding a form of the managerial contract is, which leads to a conclusion that a managerial contract within a corporation as the most complex form of organizing a business has the most demanding form. Within corporations, managerial contracts are legally shaped and very formalized, with detailed definition of all the aspects of relations between shareholders and professional managers.

Theoretical framework for regulating the relationship between the shareholders and the manager: Agency theory and Service theory

For the purpose of analyzing and regulating relations between shareholders and managers, two significantly different theories have been developed (Tipurić, 2008):

a. Agency theory

b. Service theory

Agency theory

According to the agency theory (Tipurić, 2008), one partner in joint venture hires another one and authorizes him/her to, in the name and on behalf of the shareholders, conduct certain activity. The first one is called principal, while the other one is called agent. Therefore, the principal is a party (partner) which entrusts conducting of certain doing to an agent. The principal opts for this step when he/she has no necessary knowledge and skills to conduct this doing or when he/she does not have enough time to finish it in a given deadline. The agent accepts the engagement, expecting, in turn, adequate compensation. The compensation, as a rule, is being agreed in advance and the principal is obliged to disburse it. Principal's interest is to maximize his/her benefit, while minimizing agent's compensation, while agent, of course, strives to maximize his/her own benefit.

'Agency theory assumed that, by itself, the wealth of the principal will not be maximized because agent and principal: (1) have different goals, (2) have different approach to information (principal is in no position to oversee the actions of the agent and know the information he/she has) and (3) do not have the same risk affinity.' (Tipurić, 2008). Problem actually comes up because the principal cannot fully monitor the actions of the agent. Considering the fact that both the principal and the agent are striving to maximize their own benefit, there is a good reason to believe that the agent will not always work in the best interest of the principal. It often happens that the agent puts no more efforts than necessary for his/her own benefit maximization, even if it means a harm for the principal (opportunism). Due to the lack of information, monitoring the agent becomes somewhat difficult for the principal. Disparate approach to information for the principal and the agent represents so called information assimetry. Managers are present in the corporation 24/7 and have all the information in their hands, while shareholders or board, as a body in charge for monitoring manager, has occasional meetings. As this assimetry grows larger, the probability of the opportunistic behavior of the agent also becomes larger.

Central problem according to the agency theory is (Tipurić, 2008) "acting of the manager as an agent contrary to the stated goals and interests of the owner as a principal." Manager's natural behavior is directed towards maximization of his/her own benefit; therefore, the goal of the agency theory is to answer the question on how should "selfish" managers act according to the interests of owners (Figure 1).

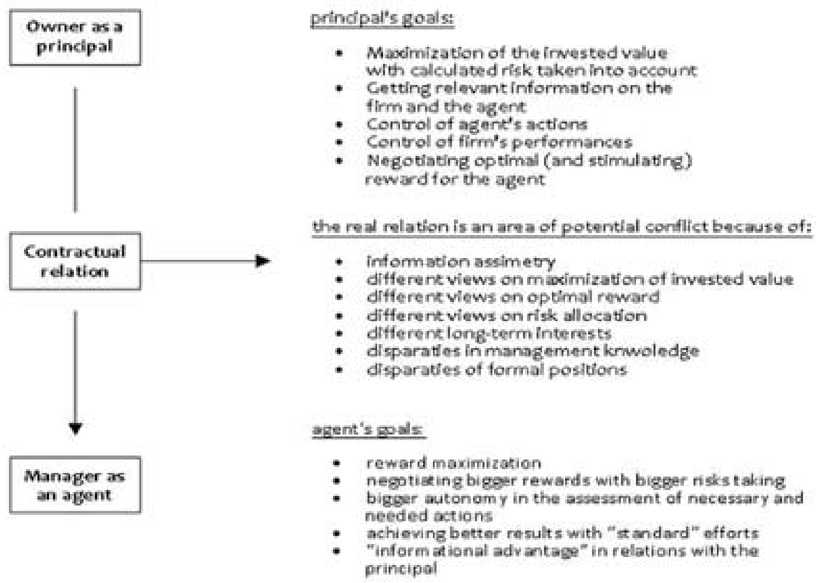
Service theory

Service theory is another theory on relations between owners and managers, and it completely differs from agency theory, by offering a concept in which hired professional managers behave as servants who put the stress on interests of owners. This theory is based on a sociopsychological model of human behavior and focuses on a motivation of managers in running a business. According to this theory, manager is stimulated non-material motives, such as success of the business entity he/she runs, which produces a feeling of satisfaction of the manager. Therefore, an issue of choice of a professional manager and his/her sociopsychological characteristics is crucial.

In the core of the service theory is establishment of the harmony between manager's goals and owner's goals, keeping in mind that the compatibility of the interests of these parties will depend on psychological traits of the manager and the situation in which the business is. Psychological traits are a source of motivation, identification with the organization and use of power, while situational factors are managerial philosophy and culture. Sources of motivation are numerous non-material factors, such as growth and development, promotion, recognition, desire for the success of the whole organization. Through the trait of the identification with the organization, the manager equalizes himself/herself with the organization and feels that he/she is its important part. He/she us committed to the organizational values and perceives organizational goals as his/her owns. Unlike agency theory which prefers institutional power, service theory is based on the use of individual power by manager.

According to the service theory, managers are those who guard interests of business entity, customers, and all the stakeholders, giving the advantage to the long-term rather than short-term goals. Service theory does not imply control of the manager and his actions, as the control is perceived as counterproductive and demotivating for manager's work. Essence of this theory is that the manager is trustworthy and thus the control is not needed.

Figure 1-Relations in the context of the agency theory: shareholders (owners) and managers



Agency theory vs Service theory

Focus of the agency theory is control of the manager's work, starting from the assumption that the shareholders' interests and manager's interests completely differ, and that in terms of lack of control, managers favour owns interests and goals, harming the interests of the shareholders of th corporation (Table 1). Unlike agency theory, service theory emphasizes autonomy in manager's work. This theory assumes that constant monitoring over manager's work is not necessary, as their goals and interests are identical to the goals of the shareholders. It is obvious that those two theories are each other's alternative, one excludes the other. However, both of them are very useful and applicable in practice, but within different contexts, and dependent on the way the relationship between shareholders and manager is being perceived and the level to which mutual trust is being built. Generally speaking, agency theory has (significantly) more followers.

Managerial contract(s): purpose and content

No matter whether the relation between the shareholders and the manager is based on the assumptions of the agency theory or the service theory, the institute of managerial contract is certain.

The purpose of the managerial contract is the regulation of the relations between the shareholders and professional managers. Aim, ideal is to adequately balance their mutual relations and highly conflicted interests, by pursuing the win-win logic. Balancing the relations and conflicted interests assumes great craft and business knowledge, adequate mindset of the shareholders (as well), and their negotitations ability, but over all their ability to make optimal choice of professional manager. In any case, managerial contract is being created through the process if negotiations between the (representatives of the) shareholders and professional managers, which assumes that the shareholder is adequate partner who knows and understands business and managerial tools through which it is possible to estavlish wanted win-win balance.

Table 1- Agency theory vs Service theory

	AGENCY THEORY	SERVICE THEORY
Manager	agent	servant
Management approach	economic approach	sociological and psychological approach
Behavior	individualistic opportunistic self-orientation	collectivistic pro-organizational trustworthy
Motivation	own goals	principal's goals
Manager's and principal's interests	divergent	covergent
Organizational structure	structure of monitoring and control	structure of support and authorization
Owner's approach	aversion towards risk	affinity for risk
Foundation of the principal-manager relation	control	trust

Source: Tipurić, D. (2008) Korporativno upravljanje. Zagreb: Sinergija, p 148

As the relations between shareholders and professional managers are very complex, the managerial contract, contentwide, is complex as well, keeping in mind above stated note that as the business entity is more complex, the managerial contract is more complex too. Although there is no theoretical consistency in terms of the content of a managerial contract, integral managerial contract should include following elements:

1. Formal and legal status of the professional manager and the managerial contract (this part of the contract includes the question of the duration of the contract)

2. Scope and authorities of the professional manager's work(scope emerges out of the demarcation between the managerial function and the ownership, assuming that the manager strategically and operativonaly runs the business)

3. Effectiveness (performances) of the business entity (and the manager)

4. Managerial compensations

5. Dissmisal before the contract expires

(this part of the contract defines when and under which circumstances the dismissal before the contract expires is possible, with shareholders' holy right to terminate the contract when they assess that the manager is not fulfilling his/her tasks adequately, including the dimension of a violation of organizational values and ruining organizational identitiy and integrity)

As the parts of the contract which are related to the effectiveness (performances) of the business entity and the manager (third part) and managerial compensations (fourth part) are key elements of the contract through which it is possible to reach the wanted win-win balance, further in this paper possible ways of regulating the relations between shareholders and manager, especially in terms of above highlighted parts of a contract, will be briefly addressed.

Effectiveness of a business entity (and the manager)

The issue of effectiveness standards of a business entity and effectiveness standards of individual businesses is a key question when it comes to achievement of adequate balance of interests of shareholders and interests of the manager. The issue of organizational effectiveness is, without a doubt, one of the most complex issues in theory of business (Box 1).

Box 1-Peter Drucker on performance

Neither the quantity of output nor the bottom line is by itself an adequate measure of the performance of management and enterprise. Market standing, innovation, productivity, development of people, quality, financial results – all are crucial to a company's performance and indeed to its survival. Just as a human being needs a diversity of measures to assess his or her health and performance, an organization needs a diversity of measures to assess its health and performance. Performance has to be built into the enterprise and its management; it has to be measured--or at least judged--and it has to be continuously improved.

Source: Drucker, P. (1988) Management and the World's Work. Harvard Business Review, Sept -Oct., pp 65-76

Theory of business has developed a wide variety of effectiveness standards, but a tool for measuring effectiveness promoted by this paper, which already became universally applicable tool for measuring organizational effectiveness, is so-called Balanced Scorecard.

Balanced Scorecard, as a universal and widely accepted tool for measuring effectiveness in all types of businesses and organizations (profit and non-profit and governmental institutions – Box 2), examines effectiveness through four mutually connected perspectives (learning, internal processes, customers, financial – Figure 2).

Box 2-Applicability of the BSC

According to some surveys, 88% of the companies which have already implemented BSC in their organization, believe that the BSC have provided them with increase in operational performances (Gerald DeBusk i Aaron Crabtree, 2006). Also, 60% of the companies from the Fortune magazine lists already have BSC. Applicability of this concept goes from industrial companies, banks all the way to the state institutions and healthcare organizations.

This popularity of the BSC concept is present due to the fact that it assures solution for the basic problem: inability to implement strategy. One study has come up with the result that the improvement in strategy implementation for 35% for an average company leads to an increase in stock value for 30%, which further confirms that the strategy implementation significantly improves financial situation.

BSC is in a great manner being applied in public sector organizations as well, and in non-profit organizations within developed economies. The city of

Charlotte (USA), U.S. Ministry of defense, U.S. Ministry of energy, Cockbum and Melville (Australia), Singapore district, U.S. National Reconnaissance Office (NRO) with its three programs (Air Force, Central Intelligence Agency and Navy), are just some of the examples of public sector organizations which successfuly use balanced scorecard concept for realization of their strategies and achieving their missions.

Source: Babić, M., Simić, Šunje, A. and Puljić, M. (2008) Korporativno upravljanje – principi i mehanizmi. Sarajevo: Revicon.

Without further examining the logic of a Balanced Scorecard as a tool for measuring organizational effectiveness, we would like to note that this tool has developed a whole set of instruments which starts from the organizational vision and mission, and which translates organizational strategy into strategic map through which, in a causal-consequent relation, strategic goals within four mentioned perspectives are identified (strategic map as an instrument of this tool). Starting from the strategic goals, set of parameters are identified (not more than three or four parameters per perspective) with desired level for each of the parameters, as well as a set of actions neccessary to conduct so this system could come to life (Figure 3). Continuous measuring whether the projected parameters for all the perspectives are at the desired level is the best possible way for measuring organizational effectiveness which lies beyond the organizational vision and organizational strategy.

It seems logical that the strategic map with its set of parameters and desired level for each of the parameters becomes additional element (an annex) of a managerial contract with a clear note that if the desired levels of parameters are not achieved, adequate corrective actions could be taken.

Figure 2-The concept – the logic of a Balanced Scorecard

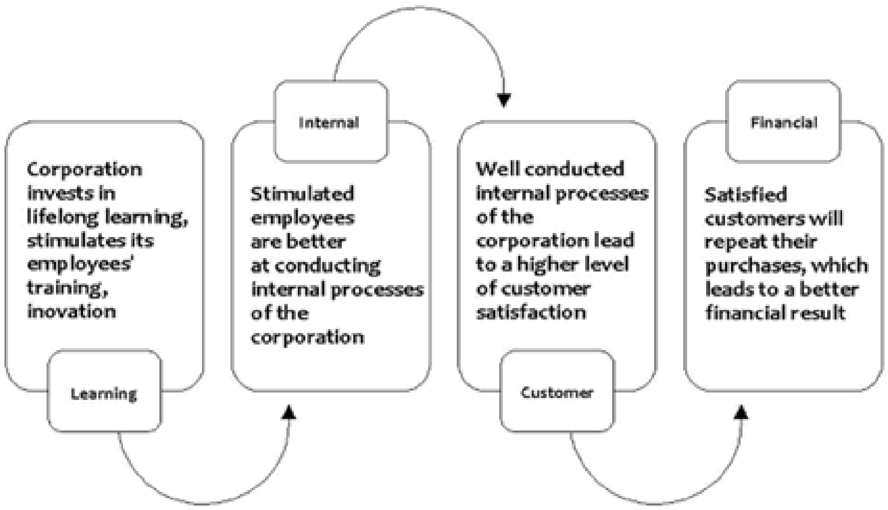
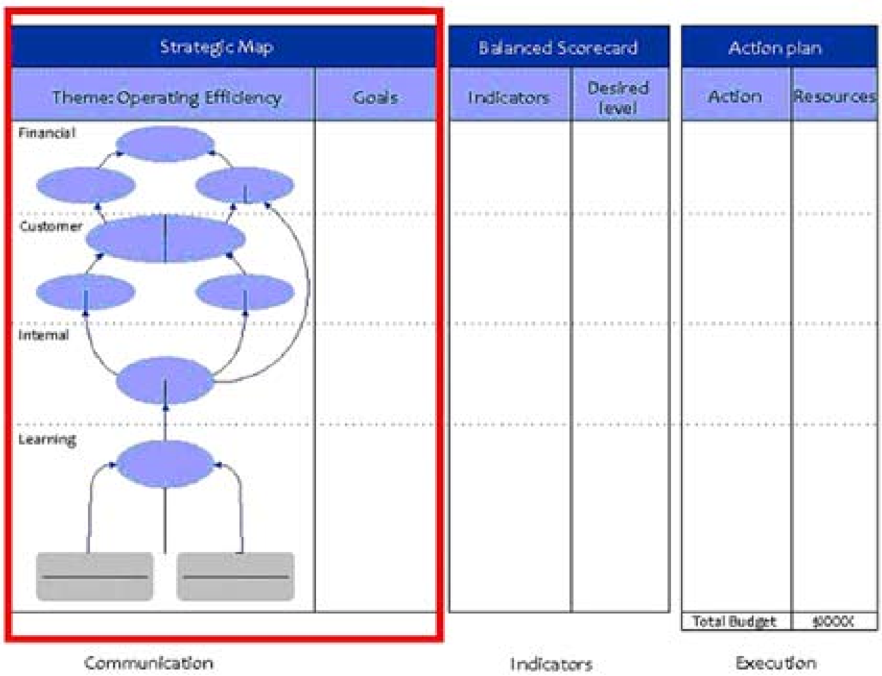


Figure 3-Strategic map and a set effectiveness indicators



Additionally, stimulative managerial compensations should be connected to the fulfillment of projected parameters. A system of parameters established in this manner is a good way for balancing the interests of shareholders (business effectiveness) and the interests of professional managers (compensations).

Managerial compensations package

Without further explaining this part of a managerial contract, it is important to note that a widely accepted idea of a good managerial compensations package includes following components (Tipurić, 2006):

- basic salary,
- short-term incentives,
- long-term incentives,
- severance pay (compensations related to an early termination of the contract),
- programs of retirement and life insurance,
- special programs of extraordinary benefits.

The height of managerial compensations is conditioned with a whole set of factors, including historical and cultural traits. Irrespective to significant differences in size of managerial compensations in different parts of the world, there are no doubts that professional managers should be highly paid as they are key factors of organizational effectiveness (Figure 4). Moreover, corporate top-managers of big corporations are highest paid people on Earth. This is for reason, as on their competence mostly depends corporate effectiveness.

Good practice of managerial contracts relates most components of compensations package with the previous element of a managerial contract – organizational (and managerial) effectiveness. The use of Balanced Scorecard concept of measuring organizational effectiveness related to short-term and long-term incentives is a good way of balancing the interests of shareholders and managers in a desired, win-win manner (Figure 5).

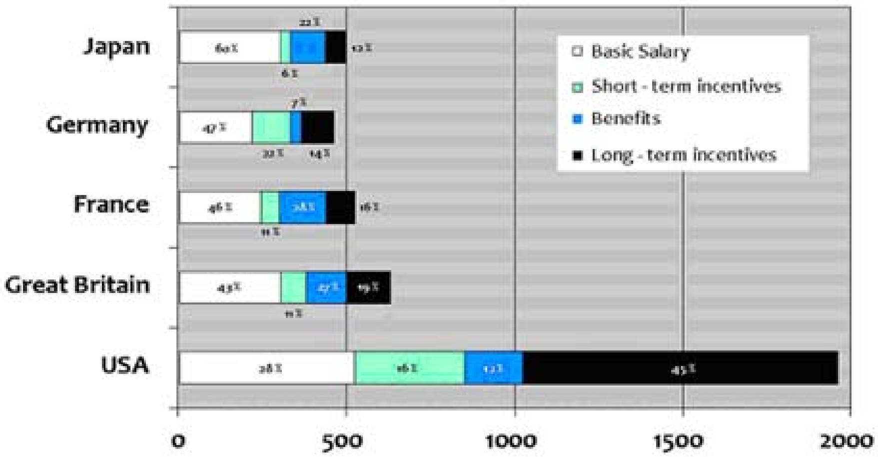
Corporate governance in Bosnia and Herzegovina and managerial contracts

In order to get a grip about the corporate context in Bosnia and Herzegovina, it is necessary to give a short introduction on Bosnia and Hezegovina as a state and its specificities.

Bosnia and Herzegovina is a highly complex country. It is a parliamentary republic, with a bicameral legislature (has two legislative or parliamentary chambers) and a complex three-member Presidency composed of a member of each major ethnic group. The central government's power is highly limited, as the country is comprised of two autonomous entities: the Federation of Bosnia and Herzegovina and Republika Srpska. The third region, the Brčko District, is governed under local government.

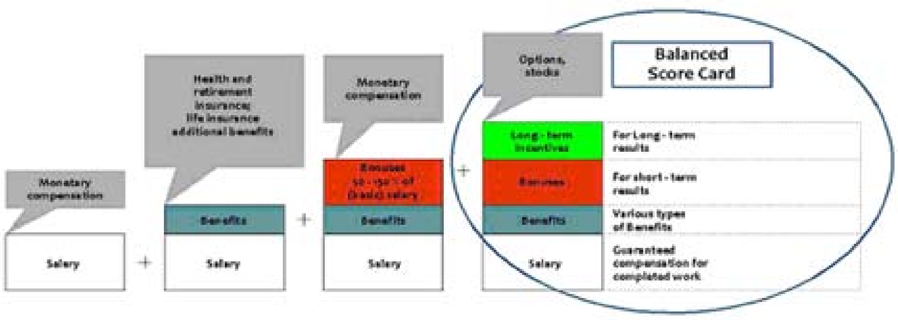
As the issue of corporate governance (Box 3) is within jurisdiction of two mentioned entities, in Bosnia and Herzegovina there are two separate and completely differentiated concepts of corporate governance, with different solutions. Institutional and legal framework of the corporate governance in Bosnia and Herzegovina is being established since 1998 and is still under construction and far away from a desired stage. Relevant assessments of the quality of corporate governance in Bosnia and Herzegovina point out the fact that the quality of the corporate governance in Bosnia and Herzegovina is not at a very high level.

Figure 4-Compensation packages for the top-managers worldwide



Source: Goldman Sachs Research (2007)

Figure 5-Managerial compensations and organizational effectiveness



Box 3- Corporate governance – OECD's definition (2004)

"Corporate governance involves a set of relationships between (1) a company's management, (2) its board, (3) its shareholders and (4) 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."

The purpose of this paper is not to compare given concepts of corporate governance, but to explore the place and the role of managerial contracts in the corporate context.

In the corporate context, boards are responsible to, by using wide set of so-called internal mechanisms and accepting external mechanisms of corporate governance, which have a character of "the systems of a higher rank" (Box 4), ensure harmonious relations between specified key corporate players (shareholders, boards, management, stakeholders).

Box 4-External and internal corporate mechanisms

External mechanisms

- Market for corporate control
- Legal infrastructure

- Protection of minority shareholders
- Competition terms   Internal mechanisms
- Separating managerial function from the ownership
- Professionalization of the managerial function
- standards (norms) of manager's performance
- measuring and evaluating the efectiveness of manager's work
- system for rewarding of managers
- concentration of ownership
- boards of the shareholders, th woners of the corporation
- relations with stakeholders
- financial transparency... publishing

Source: Babić, M., Simić, Šunje, A. and Puljić, M. (2008) Korporativno upravljanje – principi i mehanizmi. Sarajevo: Revicon.

Within given context, integral managerial contracts should regulate relations between shareholders and professional managers (first two internal mechanisms of corporate governance) in a manner which includes following three so-called internal mechanisms of corporate governance: (1) standards (norms) of the manager's performance, (2) measuring and evaluating the efectiveness of manager's work, and (3) system for rewarding of managers.

In every corporation, shareholders, through their representatives, select professional manager (selection of a manager is by all means one of crucial tasks of a corporate board as a key corporate authority) and with him/her regulate mutual relation through a managerial contract, with respect to external mechanisms of corporate governance. "Legal infrastructure", as an external mechanism, through regulating bodies and wide set of legal acts, defines a framework, limitations within which a corporation autonomously defines relations with its management.

Even though the legal infrastructure, as an external mechanism, is in entities of Bosnia and Herzegovina very different, and promotes different models of corporate governance, and different forms of corporate architecture, still (almost) all issues in the domain of the legal infrastructure related to the area of managerial contracts are almost the same.

Managerial contract(s) in Bosnia and Herzegovina: understatements (and apsurdity) of legal infrastructure – solutions in Bosnia and Herzegovina

As it is already stated, even though there are two different "legal infrastructures", two different concepts of corporate governance, issues in domain of managerial contracts are regulated in the same manner. When it comes to practice of corporate governance, solutions are also almost identical in all parts of Bosnia and Herzegovina: same unresolved issues, misunderstanding of the concept of corporate governance, non-understanding of the meaning and the role of professional managers and managerial contracts, and lack of true understanding by shareholders of the logic of how business is actually functioning.

In next few paragraphs, we will pragmatically look through the legal solutions and practice of corporate governance associated with the regulation of the relations between shareholders and managers.

Formal and legal status of professional manager and managerial contract

In areas covered by this part of managerial contract confusion and understatement are present, with many unresolved issues. What is the character of a managerial contract: is it a classical working contract for a determined or indetermined amount of time, or is it some other sort of contract? Maybe experiences of some other countries (for example, Germany) would help in finding adequate treatment of managerial contract. In Germany managerial contract has a character of a „contract of service".

Other questions whihc are related to the status of a manager are equally understated. The question is whether a top-manager has a status of an employee, and whether he/she after contract's expiration or early termination still stays an employee of the corporation. The practice of the corporatce governance in our country treats top-managers as employees, which is contrary to the logic of treatment of professional managers. This kind of approach only reaffirms the conclusion that the institute of professional managers is not recognised, nor it is sufficiently acknowledged in Bosnia and Herzeovina

Scope and authorities in work of professional manager

Legal acts on business organizations in both entities deal with an issue of the scope of manager's work, but mostly in terms of legality of doing business, without sufficiently defining authorities and responsibilities of professional managers.

There are no doubts that professional managers are authorized to run the business of a corporation on behalf of the shareholders, as well as to take the full responsibility for running the business activities, including the aspect of legality of doing business. More precise determination of the scope of manager's work with a focus on responsibility of professional managers for the actings of the corporation could be a subject of legal regulations. This approach would additionally promote the institute of professional managers and their role in strategic and operational management of business processes within the corporation. Even though that this part of a managerial contract arises out of the concept of separating the managerial function from ownership, it is necessary to more precisely define authorities, and especially responsibilities which are taken by professional managers.

Effectiveness (performance) of a business entity (and the manager)

Given aspect of a managerial contract is not commented in any of the legal acts, even though this part of a managerial contract covers two internal mechanisms of corporate governance (standards (norms) of manager's performance; measuring and evaluating the efectiveness of manager's work). There are no doubts that this part of a managerial contract is by all means its key part.

Existing practice also confirms that the issues of standards (norms) of manager's performance and effectiveness of a business are not treated in adequate way. Even if some standards are developed, then in almost all cases those standards are dominantly, sometimes exclusively, tied up to some typical financial indicators. We have no information on a sigle case of a managerial contract which ties up organizational effectiveness to, in this paper recommended, balanced scorecard concept of measuring organizational effectiveness.

Lack of understanding the concept of separation of the managerial function from ownership, is also obvious in a recently adopted Draft of the Act on state equity management in business organizations in Federation of Bosnia and Herzegovina. This Draft specifies that in case of loss (in accounting terms) of state-owned enterprises, salaries of the management team, and even the salaries of all the employees, should be reduced. Following the basic logic of the separation of the managerial function from the ownership, the only possible consequence in case of unpreceded loss is a dismissal of the top-manager, or an early contract termination, and selection of a new one which will be able to run the business successfully.

Managerial compensations

The way in which this part of a managerial contract is treated, is best confirmed by the lack of understanding of the place and the role of professional managers in our business environment.

The legislators in both entities of Bosnia and Herzegovina treat only issue of managerial compensations in so-called state-owned enterprises, and limit the earnings of our top-managers in an outmost apsurd way. This is in a complete contradiction to the logic of professional management, thus slaughtering the meaning, the place and the role of professional managers in achieving organizational effectiveness. In state-owned enterprises in the Federation of Bosnia and Herzegovina, total monthly income of a top-manager cannot exceed the level of five average monthly salaries in the Federation (around 2.000 EUR), while annual bonus for outstanding results cannot exceed the level of two average monthly salaries in the Federation (around 800 EUR). Somewhat drastical solution is provided in Republika Srpska, where, by the ruling of the government, a monthly salary of a top-manager in a state-owned enterprise cannot exceed 1.533,87 EUR. Any additional comment would be redundant. These kind of measures are not only retracting and demotivating professional managers, but also put state-owned enterprises in an uneven competitive situation relative to a privately owned enterprises in a same industry.

The practice in privately owned and privatized enterprises for which, logically, there is no a legal limit in terms of the height of top-manager's earnings, leads to a conclusion that compensations packages of top-managers in Bosnia and Herzegovina are mostly comprised of basic salary solely, with inadequately elaborated other elements of a compensations package. Even though there are no relevant studies in Bosnia and Herzegovina on earnings of our top-managers, one could easily get an impression that shareholders are not really demonstrating the readiness to pay the top-managers adequately, and that the organizational effectiveness is insufficiently tied up to the standards and measures of organizational effectiveness.

An early termination of the contract

An early termination of the contract again implies previously mentioned issues of top-managers status as an employee. Contrary to our legal solutions and solutions from the practice, a manager whose contract has been early terminated could not stay as an employee of the organization in which he/she performed as the top-manager. This issue once again deals with the above nentioned issue of the formal and legal character of a managerial contract, which could in no case have a status of a classic working contract.

Conclusions – Recommendations

As a concluding remark, we opted for a following set of recommendations which could, if applied, improve our legal infrastructure as wel as our business practice related to the issue of managerial contracts and professional managers:

- Paradignatic shift of the mind-set related to the place and the role of professional managers in organizational life (professional manager, and not working man as the ground stone of the organizational effectiveness)
- Introducing the institute of a managerial contract into the legal infrastructure
- Promotion of successful managers and development of a market for professional managers in Bosnia and Herzegovina
- Training for shareholders to „make choices" in a procedure of professional managers selection
- Training for shareholders to, parallel to development of the awareness that professional managers are partners without whose help shareholders could not reach their goals, make competent managerial contracts and improve their negotiating skills
- Corporitization of so-called state-owned enterprises in a way that „the state" is the owner which fulfills its ownership rights through corporate boards (without interference in other aspects of the corporate life)
- Promotion of holistic concepts of organizational effectiveness
- Associating compensations packages of top-managers primarily with the organizational effectiveness
- Promotion of the modern concept of the corporate governance, through positioning the boards as a key corporate bodies which, together with professional managers, run the corporate business.

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