Dr. Edita Čulinović Herc Andrej Galogaža

TRANSPARENCY AND DISCLOSURE IN CROATIA – A BRIEF REVIEW

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Dr. Edita Čulinović Herc[1] Andrej Galogaža[2]

TRANSPARENCY AND DISCLOSURE IN CROATIA – A BRIEF REVIEW

List of abbreviations:

SA	Securities Act
CA	Companies Act
TA	Takeover Act
CROSEC	Croatian Securities And Exchange Commission
BA	Banking Act
AA	Accountancy Act
AuA	Auditing Act
ZSE	The Zagreb Stock Exchange
GSM	General Shareholders Meeting

INTRODUCTION

Croatia is a transitional country which gained independence from the former Yugoslavia in 1991, and was internationally recognized in 1992. With the intention of transforming the countries economic system from a communist model characterized by dominant state ownership disguised as "social ownership" to capitalism primarily based on private property, a new Companies Act was adopted in 1993 and came into force on January 1st 1995. It is closely modeled on the corresponding German legislation.

[1] Ms. Čulinović Herc is Assistant Professor at Law School of University of Rijeka

[2] Mr. Galogaža is General Counsel of The Zagreb Stock Exchange

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Corporate governance is a new field, not well known or widely understood in Croatia. Due to difficulties in translating the term "corporate governance" into Croatian, it is commonly mistaken for a discipline which provides an answer to the question "How to run a company?" (i.e. management). The corporate veil is still heavy and thick, and the development of a culture of transparent conduct of business, investor relations and disclosure of material facts is lead by companies listed on the ZSE or abroad.

Note on term "Board" or "Board of Directors" – in common law countries, (UK, USA), under the so called one-tier system, the GSM elects the Board of Directors. Outside directors are members of the board that are not involved in day-to-day operations of the company. Inside directors are top managers of the company. The CEO may or may not be President of the Board. In Croatia, a different (German) model was adopted. The GSM elects members of the Supervisory Board. The Supervisory Board appoints top management (one or more natural persons referred to as "directors") who legally represent the company, make decisions on behalf of the company and conduct the company's day-to-day operations. Directors are not allowed to be members of the Supervisory Board. Therefore, it is usually referred to as a two-tier system. The term "director" in a two-tier systems does not apply to members of the Supervisory Board, whereas in one-tier system there is only one Board and all it's members are referred to as directors. To avoid confusion we shall use terms "member of Supervisory Board" and "director" in the sense attributed to them within the "two-tier system", as explained above. If a company has more than one director, they will be collectively referred to as the "Management Board".

REQUIREMENTS FOR DISCLOSURE

Prospectus

When issuing securities to the public, the issuer must issue a prospectus (public invitation to subscribe for and/or purchase securities).

Mandatory content of the prospectus when shares in joint stock company are issued is regulated by article 17 SA and article 196 CA. Provisions of CA are applicable only if shares are issued when founding joint stock Company and therefore CA is less demanding then SA regarding contents of prospectus.

Mandatory content of prospectus in the article17 SA complies with mandatory contents of prospectus prescribed by EU Council Directive (89/298/EEC). Both SA

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and Directive group necessary information as to the issuer in identical categories: information on securities being offered, on the issuer; on the nature of the issuer's business on the issuer's assets and liabilities; on issuer's management and responsible persons. Substantial differences between Directive and SA as to mandatory contents do not exist. The same is true in regard to publication and distribution of prospectus. Before publication, an approval of the CROSEC is necessary. The prospectus must be published as a supplement in a daily newspaper sold regularly sold in Republic of Croatia or in the form of brochure available without specific payment. In addition, either prospectus or notice where and how it can be obtained must be published in National Gazette.

In case of private placement only abridged prospectus suffices. Contents of abridged prospectus and definition as well as other issues regarding private placement of securities are regulated by CROSEC Regulation on Contents of Abridged Prospectus and Issuance of Securities by Private Placement (1997). According to that Regulation, securities issued by private placement must remain with original purchasers for period of one year. In some cases (such as debt-to-equity swap), prospectus is not required in any form.

If bonds are issued, only SA applies. No prospectus is necessary in case of government bonds. However, with every bond issue, government prepared Information Memorandum containing relevant data.

Prior to publication, prospectus must be approved by CROSEC, and only in case when value of entire issue is below 200.000 Kn[3] (in case of public offering) or 2.000.000 Kn (in case of private placement) is such approval not necessary. Still, issuer must inform CROSC on relevant facts concerning the issue.

SA provides that issuer will be subject to fine in amount up to 400,000 kunas:

- if it does not apply for approval of the securities prospectus to the CROSEC;
- if it publishes prospectus with content different from the mandatory content;

[3] 1 € is worth approximately 8 Kn.

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- if it issues an abridged prospectus although not authorized;
- if it issues securities without public offering contrary to the conditions required by the SA;
- if it distributes a prospectus contrary to the law.

A member of the management board supervisory board can be subject to a penalty (not exceeding 8,000 Kn), if he is the person actually responsible with respect to the operations referred above. But if he or she commits serious violation of regulations in order to realize unlawful gain, the fine may be as high as 40,000 Kn.

Listed Companies

Listing Particulars

Information to be published for the admission of securities to official stock exchange listing (Listing Particulars) is described by article 58 SA. It corresponds to the mandatory content of the prospectus. It must be sufficient to enable investors to realistically assess the financial position, assets and liabilities and profits and loss of the issuer. Publication of the data must be approved by the CROSEC, and afterwards published in the same manner as that prescribed for the prospectus. When comparing provisions of the SA with the Annex of the EU Council Directive coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing from 1980, one can generally observe that the contents of the information sheet required by the Directive are far more exhaustive then the contents required by SA.

However, the ZSE Listing Rules require substantially more information than required by the law.

Disclosure requirements after listing

If securities are already listed on the official (or regular) quotation board on the stock exchange, issuers are required by ZSE Rules and SA to publish annual and semi-annual statements. Information referred to must contain: half-yearly report on

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the activities of the issuer indicating at least net turnover and profit and loss before or after deduction of tax, presented in table form; interim dividend as proposed or paid (if any); explanatory statement containing all information enabling investors to make an informed assessment of the trend of that particular company's activities and profits and losses together with an indication of any special factor which has influenced those activities and those profits and losses during the period in question.

In accordance with SA, CROSEC should have issued regulation dealing with content and time of publication of those statements. However, so far CROSEC did not do so.

Issuers of listed information must also disclose material (potentially price-sensitive) information.

Fines[4] are imposed on issuer and members of supervisory and management board:

- if an issuer of securities does not publish data which must be published, according to SA, when applying for listing on the exchange, or
- if an issuer of listed securities, does not publish data which must be published regularly,

Interestingly, a member of the management board of an exchange or organized market which allows listing of securities that do not meet the requirements set out in SA is committing a crime punishable by a fine of up to 600.000 Kn or imprisonment up to 2 years (3 if he caused substantial damages or obtained unlawful gain).

Mandatory periodic disclosure required from "issuers of securities distributed to the public"

In last revision of the SA (1998) a duty was imposed on the certain classes of joint stock companies to publish quarterly reports on a regular basis. The content of

[4] Same fines as described in relation to prospectus.

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these reports is stipulated by the CROSEC Regulation on Quarterly Financial and Business Reports (2000).[5]

The corresponding duty is imposed only on:

- joint stock companies classified as "large entrepreneurs";
- on the companies who have more then 100 shareholders;
- companies whose initial capital amounts to at least 30,000,000 kunas

except if single shareholder is Republic of Croatia.

Large entrepreneurs are defined by AA.[6]

For no apparent reason SA refers to above mentioned companies as "issuers of securities distributed to the public".

All these three categories of joint stock companies must deliver to CROSEC quarterly reports within 30 days of the last day of the quarter. CROSEC is under legal obligation to make these reports accessible to public. Therefore, CROSEC instituted a Public Reference Room where anyone may search for data on the computers of PRR, and obtain printouts for a modest fee. The data are also available via Internet and against consideration.

It must be noted that CROSEC does not allow access to the identity of shareholders of companies under obligation to publish quarterly reports.

According to the CROSEC at this moment information on approximately 600 companies is available.

In its recent report the CROSEC has stated that the duty to produce and deliver quarterly reports was implemented in order to encourage joint stock companies to apply for the listing of the securities at the exchange.

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[5] The accounts must at least include following data: net sales, profit or loss before and after taxes, any interim dividends proposed or paid, if any, and a statement containing all data essential to investors so that they can evaluate the trends with respect to business operation, profit or loss, and particular circumstances which have influenced the business operation and compare this data with data from the corresponding period in the previous financial year.

[6] AA classifies entrepreneurs into 3 categories (small, medium and large) in accordance with certain criteria such as: number of employees, yearly income etc. Banks, financial institutions, insurance and reinsurance companies are large entrepreneurs by definition.

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Contrary to these expectations, the number of listed companies did not increase pursuant to imposing the obligation to produce quarterly reports.

If a joint stock company does not act in accordance with the conditions set forth in article 73 SA (omitting to publish information or submitting contrary to it), it is liable to a fine.[7]

Moreover, according to article 36 AA, a legal representative of the entrepreneur who fails to publish or present the financial statement would be also fined.

Disclosure of ownership

Duty to disclose ownership pertain only to ownership of shares (and only these which carry voting rights on GSM) and is regulated partly by SA, and partly by TA.

Duty to disclose when a major holding in a joint stock company is acquired or disposed of (SA)

In article 74/1 SA it is prescribed that persons who, by acquiring or disposing of securities carrying voting rights in a GSM of the issuer crosses one of the following thresholds: 10%, 20%, 1/3, 50%, 2/3, or 75% of total number of votes that person must notify the issuer and CROSEC within seven days. Thresholds of 2/3 and 75% are mentioned in a corresponding EU directive as alternatives and one of them has entered the law by mistake.[8]

An issuer who receives abovementioned notice is under obligation to publish it in a Croatian daily newspaper within seven days. CROSEC may exempt the issuer from duty to publish such a notification (not for a period longer than three months), if publication of the notice would obviously be very detrimental to the issuer, provided it is not likely that non-publication would prevent the public from assessing facts and circumstances necessary in appraising the value of securities issued by the issuer.

[7] Same fines as described in relation to prospectus.

[8] In early draft both thresholds were mentioned as the Ministry of finance had to make decision which one to apply. Editors of text appointed by MoF forgot to delete one of them.

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The silence of the CROSEC upon issuer's request for exemption constitutes denial of exemption.

Legal person may be subject to fine if it does not notify the issuer and CROSEC on crossing abovementioned thresholds or if the report does not contain the required data (e.g. the class and series of shares, number of votes in absolute and relative terms etc.).[9]

However, if natural person fails to make abovementioned notification pursuant to the fact that he or she acquired or disposed of securities and crossed one of thresholds, it is committing crime punishable by fine up to 400.000 Kn or imprisonment of up to 1 year.

It is difficult to explain such draconic treatment of natural as opposed to legal persons.

In its most recent report, the CROSEC has stated that failure to report crossing of thresholds is most frequent example of violation of the SA.

Duty to disclose ownership (TA)

As a general rule, a legal or natural person who has by any means other than inheritance acquires shares that carry 25% of votes on issuers GSM must report the acquisition to the CROSEC and publish tender offer for the takeover within 7 days from the day of acquisition. Therefore, in addition to reporting thresholds mentioned above and imposed by SA, a supplementary threshold is imposed by TA. It must be noted that the overall structure of thresholds (imposed by the SA and TA) in unnecessarily complicated and may be simplified while still remaining in accordance with the corresponding EU Directive.

Fine in amount of 100.000 – 500.000 Kn is imposed on person which fails to notify CROSEC on crossing 25% voting rights threshold which triggers mandatory takeover bid.

[9] Same fines as described in relation to prospectus.

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Disclosure of structure of ownership

Structure of ownership is considered to be very important and valuable market information. Disregarding the abovementioned disclosures by persons crossings certain thresholds mandated by SA and TA, it seems quite obvious that one of requirements regarding transparency and disclosure is transparency of ownership (on daily basis) of the joint stock companies, particulary regarding shareholders with large holdings. Unfortunately, it seems rather difficult to get such information in Croatia, although such information should be technically easy to obtain due to dematerialization of the securities through Central Depository Agency. For example, one emerging market exchange (Tallin) in arrangement with the Estonian central depository publishes Internet list of substantial (more than 5%) shareholders for all listed companies on a daily basis.

CROSEC obtains information on the 10 largest shareholders for every company under obligation to deliver quarterly reports (see above), but refuses to reveal their identity to the public via the Public Reference Room, although SA clearly requires that all information collected should be disclosed. Croatian Central Depository Agency refused to deliver similar information to ZSE (exchange would publish it via Internet).

Duty of members of management and supervisory boards to report transactions

Members of management and supervisory boards and other equivalent bodies[10] of the issuer of securities are insiders by legal definition and must report every transaction whereby they directly of indirectly acquire or dispose of securities of that issuer (or the company which the issuer controls) (article 64 SA). They must report transaction to the issuer, as well as to the CROSEC and to exchange on which such securities are listed. A report is to be given within seven days from the date transaction takes place.

[10] Term "equivalent bodies" is used to cover members of governing bodies of public law entities (such as State Health Insurance Fund) that issue securities that bear different name from Supervisory and Management board but have similar functions.

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Duty to report transactions extends to transactions undertaken by companies controlled by members of management and supervisory boards.

Curiously, there are no specific sanctions imposed for breach of that duty, so requirement to report transactions appears to be just a decorative provision of the SA.

Rules of ZSE impose the same duty and may impose sanctions on the issuer (but not natural person which actually failed to report transaction).

Duty to disclose material information to the public

Issuers of securities traded on the territory of the republic of Croatia (it is not entirely clear what constitutes trading on certain territory in the age of electronic trading) must promptly disclose material information to the public (article 65 SA). But, if publishing of information would jeopardize issuer's legitimate interests, the CROSEC may exempt it from that duty, upon issuer's request, but not for period longer than three months. Regulation in SA that pertains to insider trading was implemented with taking into consideration Council Directive coordinating regulations on insider dealing from 1989.

A fine[11] will be imposed on the issuer of securities that omits to publish material facts it was required to publish.

Privileged information and insider trading

According to the SA (article 64), insiders (natural persons in possession of privileged information[12]) are prohibited from

- Using privileged information in Trading
- Disclosing privileged information to other persons
- Give advice related to investment in securities to other persons based on their access to privileged information

[11] Same fines as described in relation to prospectus.

[12] SA uses term "privileged information" for material information prior to its disclosure to the public.

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Insiders are allowed to disclose privileged information only if they are so authorized as a part of their professional activity or duty (article 64/2 SA). The concept of permissive disclosure in the normal course of business seems to be difficult to implement. The better solution would be that "authorization" is a necessary precondition for divulging privileged information.

Securities companies and are not authorized to disclose privileged information acquired through conduct of their business activities.

If a securities company acquires privileged information related to certain securities, it must refrain from entering into transactions with such security for their own account or giving investment advice with regard to that security.

Usage or disclosure of privileged information contrary to articles 63 and 64 SA is a crime punishable by fines in amount up to 400.000 Kn or imprisonment of up to one year (two if substantial damages are caused or the person committing it obtained unlawful gain). Attempt is punishable. It is rather difficult to explain why is usage of privileged information contrary to article 64 SA (by natural person) also listed as misdemeanor punishable by fine in amount of up to 400.000 Kn.

ENFORCEMENT OF DISCLOSURE REQUIREMENTS

Authority to enforce disclosure requirements

The Authority to enforce disclosure requirements lays primarily on the CROSEC (Securities CROSEC of the Republic of Croatia). It is a permanent independent government agency established to regulate and oversee the securities market and to protect investors. Members of the CROSEC are nominated by the Government of the Republic of Croatia and appointed by the Croatian Parliament.

The CROSEC is in charge of issuing regulations to implement disclosure requirements.

Oversight of securities market is realized through the CROSEC Surveillance Committee. Tasks of this Committee are defined by two main activities. Firstly, the committee collects information on the activities of securities market's participants from different sources: Reports by the Zagreb Stock Exchange and Varaždin

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securities market, questionnaires sent and received from the securities companies, daily press and professional publications etc. Secondly, in cases where there is a suspicion of violation of the pertinent laws, or that fraud of investors occurred or that any other violation of the rights of the participants at the securities market occurred, the CROSEC has investigatory powers. As a result of the surveillance of the CROSEC, a crime might be reported to the State Attorney Office or Investigating Judge or a misdemeanor may be reported to the Misdemeanor Court. Other branches of administration such as police, or tax authorities may cooperate with CROSEC in investigations. The committee oversees observance of pertinent laws, not only implementation of SA, but also TA, CA, Investment funds Act, Privatization Investment Funds Act etc.

Once a crime or misdemeanor is reported to the relevant authority, the Criminal Court and Misdemeanor's Court have the duty to establish perpetrator's culpability of a crime or misdemeanor. Consequently, the Criminal Court and Misdemeanor's Court have authority to impose sanctions against perpetrators.

Apart from proceedings opened at the Criminal Court and Misdemeanor's Court, the CROSEC is authorized to file a civil suit for damages against issuers (of securities), securities companies, investment funds, underwriters and other legal entities or individuals if those subjects have unlawfully offended rights of securities holders. In this "class action" the CROSEC has a status of an offended party, although it does not actually own of securities and has not suffered a loss. If the CROSEC has been successful in the suit, damages will be paid to all the injured owners of securities of the class on whose behalf the suit was filed. No such suit has been filed so far.

Are disclosure requirements enforced?

No reliable data exists which would allow us to categorically answer that question. General feeling among members of the financial industry is that enforcement is still at rather rudimentary level. CROSEC lacks experienced and well trained personnel, partially because potential staff which acquire acceptable level of knowledge and experience are able to easy find more attractive jobs.

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In its most recent report relating to a period from January 1st 2000 to June 30th 2001 the CROSEC has stated that 49 crimes and 154 misdemeanors were reported.

The Surveillance Committee has stated that the most frequent violations were made by: non reporting changes in ownership structure of joint stock companies (article 74 SA) and irregularities in the takeover of joint stock companies (not publishing mandatory tender offer for takeover).

Examples of enforcement

From report of the State Institute for the Statistic from 1995 –2001 reports on persons who were reported, prosecuted and sentenced for the crimes under CA, AA and SA. The report is not specific on the type of crime committed but refers only to the laws in which the crimes are prescribed.

In 1995 no crimes were reported.

In 1996 crime involved 5 persons. Three of the five were accused, and all were convicted and sentenced to conditional imprisonment.

In 1997 40 persons were reported for criminal offences under SA, 16 were accused, and 14 convicted. One person was sentenced to unconditional imprisonment, 9 were sentenced to conditional imprisonment, 3 were sentenced to unconditional fine and one was sentenced to conditional fine.

In 1998 two persons were accused for committing crimes under SA and two were sentenced. Both persons were sentenced to conditional imprisonment.

In 1999 8 persons were reported for criminal offences under SA, 7 persons were accused and 7 persons sentenced. Against all unconditional fine was pronounced.

In 2000 272 persons were reported for criminal offences under CA. 94 of them were prosecuted and 67 sentenced. Two of them, were sentenced to unconditional imprisonment, and 10 of them to a conditional imprisonment. Against 52 of sentenced persons an unconditional fine was pronounced, and against 3 the conditional fine.

In 2000 16 persons were reported for criminal offences under SA. 17 persons were accused. 15 persons were sentenced. Against 12 of them an unconditional fine

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was pronounced, and against 2 the conditional fine was pronounced. One person was sentenced to a conditional imprisonment.

In 2000 two persons were accused for criminal offences under AA. One person was sentenced to an unconditional fine.

In 2001 542 persons were accused for criminal offences under CA. 170 persons were prosecuted. 130 were sentenced. Against 95 persons an unconditional fine was pronounced. Against 8 persons a conditional fine was pronounced. One person was sentenced to an unconditional imprisonment and 26 persons to a conditional imprisonment.

In 2001 7 persons were accused of criminal offences under SA. 24 persons were accused. 11 persons were sentenced. Against 8 persons an unconditional fine was pronounced. Three persons were sentenced to a conditional imprisonment.

No enforcement case decided by Court of Law and related specifically to transparency and disclosure is known to the authors (although such cases may exist).

However, CROSEC had forced certain disclosures in prospectuses by threatening issuers with refusal to authorize prospectus. Same applies to ZSE with regard to listing particulars. ZSE also enforced by threats of trading halts and delisting disclosure of certain information (last example was when major listed company tried to avoid disclosure of contracts with members of management board prior to GSM).

Role of the stock exchange

The Zagreb Stock Exchange's Surveillance department monitors trading for any suspicious price and volume movements and conducts its separate investigation. In case of a breach of ZSE trading rules, the ZSE will start a disciplinary procedure against its member(s). If a breach of legal provisions is likely to have happened, the whole case is reported and handed over to the CROSEC.

The ZSE may impose the following sanctions: private reprimand, public reprimand, suspension, delisting (for listed securities), monetary fine and revocation of membership (for member brokerages). The ZSE may also cancel individual

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transactions. In certain cases ZSE may use trading halts for a single security or group of securities.

ZSE has authority to inspect documents and premises of its member firms, interrogate staff and obtain documents from auditors and accountants.

The most frequently used measure was canceling transactions. In a few cases, private reprimands were issued and in one case suspension of membership (for 3 months) was imposed on a member. On several occasions, reports were filled with CROSEC when customers reported cases of misconduct over which the ZSE did not have jurisdiction.

Role of the judiciary

As explained above, in cases of criminal offences and misdemeanors, the ultimate decision lies with Courts of Law. Problems observed are general ineffectiveness of Courts (proceedings last for years) and shortage of competent judges due to lack of training in areas of law completely new to them (such as securities law). The same observation may be repeated for staff of the State Attorney's office.

A weak and inefficient judicial system is identified as one of the largest Croatian problems with serious negative influence on economic activities.

It must be added that many important pieces of legislation are very badly written and therefore extremely difficult to implement even by competent lawyers.

As one would expect, less important but simple cases are preferred by enforcers (CROSEC, State Attorney). Anecdotes on apparently incompetent persons spending days or even months investigating business activities of financial firms without understanding them are quite numerous and sometimes amusing.

It seems that industry professionals have far more advanced knowledge of market related activities than their supervisors.

ROLE OF THE BOARD IN OVERSEEING THE FINANCIAL AND NON-FINANCIAL DISCLOSURE

As mentioned at the very beginning, according to Croatian company law, functions of the board in joint stock companies are divided between the management board

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and supervisory board. While the management board is in charge of conducting business operations of the company on adaily basis and to represent the company, a primary task of the supervisory board is to appoint and supervise the management board.

Function of management board and duty to inform supervisory board

GSA may decide on adoption of annual financial reports only upon presentation of the separate report on the part of the supervisory board of the company, concerning supervision exercised by the supervisory board concerning work of management board.

Moreover, the management board has a duty to inform the supervisory board about all aspect of company business. It has to present reports on business policy and other principled questions regarding future performance of business activities; on profitability of the company business, particularly the profitability of employment of the company’s own capital funds; on course of business operations, particularly the revenues and position of the company; and on business operations which might be of great significance for the profitability and solvency of company business.

As to the frequency of reports, the management board must submit reports on business policy at least once a year (unless a change of the position or some new issues may require immediate reports). Reports on profitability of the company and on the allocation of capital are to be made at the supervisory board meeting when the agenda includes annual financial reports. Reports on current business operations and on the position of the company are to be made at least once in three months. Reports on business operations which might be of great importance for the profitability and solvency of the company are to be submitted in intervals allowing the supervisory board enough time to take attitudes regarding these issues.

There is no specific rule as to form of reports, but they should be in written form as a rule (especially in cases when law itself requires submission of these reports). Exceptionally, in urgent cases reports made orally might be sufficient. In drafting

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reports statement of facts should be presented separately from the standpoints of the management board.

Reports prepared by management board must be accurate and true (article 250/4 CA). If not, members of the management board would be culpable for a crime "False presentation of company assets". If a member of the management board in his reviews or surveys of assets makes a false presentation or fails to disclose the complete state of affairs in the company, including its relations with the joined companies or in his explanations and information presented to the auditors does the same, will be punished by a fine or sentenced to imprisonment up to two years.

Controlling function of supervisory board

The supervisory board is not only authorized to demand reports (at any time) on issues relating to business operation of the company but it has a right to review and inspect books and documents of the company, its treasury, securities and others. Inspection can be exercised by members of the supervisory board or specialized experts. This seems to be a bit outdated, considering the role of auditors today.

However, some companies introduced internal auditors that bypass management board and report directly to the supervisory board.

The supervisory board submits to the general assembly written report on the surveillance exercised. The supervisory board report must state whether the company is acting in accordance with the law, internal acts of the company and decisions made by the general assembly. It has to specifically indicate whether annual financial reports correspond with figures stated in company books and whether they present true financial and business position of the company. In its report it must also express its standpoint concerning the proposal of the management board concerning the profits and loss of the company.

In addition to submission of reports required by the law itself, the supervisory board may at any time ask the management board for information about the matters related to business operations of the company which either have great influence on the position of the company or whose influence may be reasonably expected.

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Moreover the supervisory board may require from the management board to be notified about some other issues bearing significance for business affairs and the position of the company.

It should be pointed out that members of supervisory board may be also culpable for crimes: false presentation of company assets, infringement of the duty to keep secrets.

Still, in most cases, the supervisory board only formally exercises its surveillance duties.

In order to illustrate the real level of responsibility of supervisory board, we refer to the case of one of most solvent and liquid Croatian companies, which went into bankruptcy (Tisak). The president of its supervisory board was thereafter appointed President of the Constitutional Court Of Republic of Croatia and is still at that position as we write this article.

Duty of the management board to demand initiation of insolvency procedure

If, during elaboration of annual or other financial reports, or otherwise, a loss in the company is discovered, its amount being as much as one half of the initial capital, the management board shall immediately summon the general assembly and notify it about the aforementioned loss. If the company is insolvent or financially incapable, the management board shall, with no delay and certainly not later than three weeks after the occurrence of the insolvency cause, demand that insolvency procedure or reorganization within insolvency procedure be initiated. After an insolvency event occurs, the management board must suspend all payments.

A breach of that duty amounts to a crime named: "Infringement of duty in case of loss, financial embarrassment or insolvency", as prescribed by CA, for which an offender might be sentenced for imprisonment up to 2 years, or punished by a fine.

Obviously, in such cases shareholders are already suffering losses and basic function of corporate governance rules, which is to prevent and avoid such situations, is not fulfilled.

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Audit committees

Although CA prescribes that supervisory board may appoint committees and entrust them with preparation of board resolutions and supervision of their implementation, this is not very common.

One firm that is listed Zagreb Stock Exchange and parallels on LSE has audit committee.

Auditors are appointed at GSM.

Qualifications of board members to oversee company accounts

CA does not require any special qualification for a member of management board. Any sane physical person may be appointed as a member of the management board.[13]

A research was conducted recently by Čolaković,[14] analyzing various aspects of position of managers in Croatia. The research was conducted with a method of anonymous questionnaire, and a sample was selected (1000 Croatian firms) on the basis of figures of the highest gross profit in last financial year. Complete answers were attained from 232 companies (consisting of 54 small enterprises, 141 medium-sized enterprises and 37 large enterprises). In this sample, resulting from 232 persons interviewed opinions of 138 presidents of the management board were evaluated, 48 members of the management board and 46 managers-owners. A research was not limited to joint stock companies but included limited liability companies as well.

As to level of education, 86% of interviewed persons have university degree; 9% of them have master of science/ doctor of science degree; 2% of them have high school and 3% of them secondary school. As to the professional profile 66,6% are technically educated with university degree, 20% of economists with university

[13] There is a general prohibition on appointing members of the board if they were sentenced for committing long list of commercial crimes, or against who is banned from performing certain activities.

[14] Esad Čolaković, Menadžerski ugovori: modeli, savjeti i praksa, Croma, Zagreb 2002.

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degree. The remaining number of questioned persons lawyers and political science profession are prevailing.

It has also been stated that top managers in large sized (sometimes publicly owned) joint stock companies, are persons whose whole carrier is tied to same company, and there is practically no fluctuation as to position of top manager. On the other hand, in smaller and medium sized companies fluctuation is approximately three times bigger, with a trend of engaging younger experts. But in comparison to developed European countries there is evidence that horizontal and vertical fluctuation of managers is very low in Croatia, which induces conclusion that there is no managers' market in Croatia.

There was a radical shift in top management in Croatian companies within the last 10 years, because 80% of managers were replaced by new management staff. Political interventionism and changes in ownership structure of companies have largely contributed to that shift. According to Čolaković, as a result of those changes a new generation of top managers now appears, with better qualifications and with a substantially higher level of technical knowledge. This sample of managers is not substantially backward in comparison to sample of managers in member states of the EU with same biographic characteristic. However, according to Čolaković this parallel cannot be drawn when comparing efficiency, professional self confidence, and application of specific techniques and skills.

No such research exists for supervisory board members, but it is generally acknowledged that a seat at the supervisory board is too often regarded as sinecure and that members are on average not sufficiently qualified.

Independence of board members when it comes to monitoring and overseeing the firm's financial activities

In Čolaković's research, when managers were asked to spell out key problems in regard to their responsibilities, an observation was made on the evaluation criteria for the work of the management board. It has been stated that they depend more

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on cooperativeness of management with supervisory board and assembly then on objective assessment of company's business results.[15]

It seems that both supervisory and management boards are in many cases de facto influenced by major shareholder or shareholders.

In many of Croatian "medium sized" joint stock companies, owners of controlling interest in joint stock companies are at the same time members of the management board (presiding member). In that case, it is reasonable to conclude that supervisory board plays less supervisory role, then envisaged by the law. This conclusion has to be seen in the light of the fact that the general assembly of the joint stock company is a body that appoints and recalls members of the supervisory board.[16]

Also, the Statute may allow certain shareholders (or any holders of certain special shares) to appoint a certain number of supervisory board members, but they cannot appoint more than one third of the whole supervisory board. Employees may have a right to elect certain number of members of the supervisory board, and the Labor Act requires employee participation in companies with dominant state ownership.

Disclosure requirements for board members

Apart from duty to disclose transactions (described earlier), and to disclose information on facts that would make them non-eligible for their function of the board member, supervisory and management board members are not legally required to disclose other circumstances such as conflicts of interest.

In rare cases are such duties imposed via statute or other acts of the company.

[15] Čolaković, p.31.

[16] CA does not require any special qualification for members of supervisory board except from being sane, although the statute may prescribe the conditions (article 255/1 CA).

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Other internal control or monitoring mechanisms

Banks ought to have internal audit and internal control department (article 76/1/3 BA). It is common that large sized publicly owned companies have internal audit departments, as well as some large sized privately owned companies. Internal auditors are organized as a special section in one of the two associations of Croatian accountants. Internal auditors are mostly appointed by and responsible to the management board.

As we have already mentioned, some companies introduced internal auditors that bypass the management board and report directly to the supervisory board.

ACCOUNTANTS AND AUDITORS

International Accounting Standards are applicable in the Republic of Croatia and translation thereof is published in Official Gazette. The Croatian board for Accountancy and accounting standards is a professional body whose duty is to follow the changes in those standards as well as to provide for its adaptation and interpretation in implementation. This board has 15 members, initially appointed by the Croatian government on proposal of Ministry of Finance. Nowadays, members of this board are appointed by Croatian Association for accounting professionals authorized by Ministry of Finance.

Apart from AuA, the audit profession is to be exercised in accordance with International Auditing Standards.

Licensing of accountants and auditors

In order to be licensed *an auditor* should satisfy certain requirements: citizenship of the Republic of Croatia, university degree in economics, he has to pass exam for the authorized auditor, he should not be convicted for business crimes, he has to be honorable and honest person and should behave in accordance with Professional code of honors for auditors. The auditor might be foreign natural person if audit is exercised by foreign audit firm (but notification of certificate for the licensed auditor is required).

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The candidate is allowed to apply for an audit exam if experienced in accountancy (minimum 3 years of practice). Exams are held before and according to the program of the professional association of auditors. The program must be approved by the Ministry of Finance.

Licensing of accountants is not provided for by Law on Accountancy, and Croatian law does not recognize the concept of certified or chartered accountant *stricto sensu*. It is possible for a company to outsource accounting. Still, AA does not provide the possibility for a professional association to license accountants, as it is provided for auditors. Presently, two existing associations of accountants *de facto* license accountants, although there is no such authorization implied in the law. Still, the responsibility for improper accounting lays primarily on entrepreneur, as can be seen from AA.

Regulation of the auditing profession has not been changed since the Law on Audit was adopted in 1992 and since then, never changed. In fact there are two competing associations of auditors in Croatia, both approved by Ministry of Finance, and both authorized to license auditors.

Civil and criminal liabilities of auditors and accountants

Auditors

There are various types of offences as far as auditors are concerned.

Civil liability of auditors is prescribed in article 11 AuA. Liability of the auditing firm is limited to the amount of 50.000 DEM per one audit, payable in kunas according to the exchange rate fixed by National bank of the Croatia. The auditing firm is obliged to insure itself from that liability. In case it is not insured from liability the audit firm is guilty of an offence relating to business matter and may be liable to a fine.

Obviously, such strong limitation of liability (auditors are hardly liable at all, considering compulsory insurance) is not stimulating responsibility among auditors. In combination with the fact that many auditing firms are competing on small market, results are predictable.

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An audit firm commits a felony and can be liable to a fine if it does not perform the audit in the manner as provided by the law or International Auditing Standards, or if it performs an audit without a license (audit firm must employ at least one authorized auditor), or if it performs an audit of an entrepreneur with whom it is related party.

Criminal liability of auditors is prescribed in article 628 CA. Said provision imposes criminal liability for the auditor or his assistant who makes false report on audit or does not disclose important facts therein. Offender may be sentenced by fine or imprisonment of up to two years (five years If crime was committed with the intention to provide unlawful gain or cause damage to another party).

As far as Law on Accountancy is concerned from year 1995 – 2001, only one person was sentenced for the crime prescribed in article 34 AA. A provision of article 34 provides that a person representing an enterprise (i.e. member of the of directors in joint stock companies) sentenced for imprisonment up to 3 years, or a fine may be pronounced against him, if the financial report falsely states the status of assets, capital and duties, provided that false information was put in the report with the aim of illegal acquisition of assets for himself /another person or with the aim of causing damage to another party.

According to the author's knowledge several disciplinary cases were initiated at Croatian Association of Auditors.

Infringements relating to accounting

All crimes and misdemeanors related to infringements of the AA, are directed towards legal representatives of the entrepreneur, and not towards accountants. [17]

As to criminal liability, if financial statements give false representation of the state of assets, liabilities and capital, the legal representative of the entrepreneur is deemed to be responsible for a crime, if false statement was produced with intent

[17] However, their personal liability can be derived from Criminal Code directly for example: forgery of document (311. CC); forgery of an official document (article 312. CC); fraud in the performance of a duty (article 344. CC); Illegal collection and payment (article 350. CC).

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to acquire assets illegally for someone's account or with intent to cause loss to someone (article 34 AA).

AA specifies several misdemeanors, also directed towards legal representatives of the entrepreneur. If in business books, bookkeeping events are based on unreliable documents, legal representatives would be liable for misdemeanor and would be punished with a fine in amount corresponding to 50 per cent of the amount expressed in such documents (Art. 33 LAA).

The legal representative is also liable for misdemeanor if he does not keep business books according to the principle of the double entry bookkeeping system; if he does not preserve the business books (10 years the ledger and the journal and 5 years auxiliary books); if he does not draw up basic financial statement; if he does not comply with the principles and methods of evaluation[18]; does not prepare the annual report. However, it should be emphasized that the duty to prepare the annual report concerns only so called large entrepreneurs in sense of article 16 AA.

Voluntary usage of external auditors

External auditors are used on very rare occasions if it is not specifically required by the law. The ZSE has its financial statements audited by one of the big five auditing firms since 1995 even though it is not under legal obligation to do so.

Mandatory audits

Yearly audit by external auditor is required by virtue of AA for all large entrepreneurs and medium entrepreneurs if they are joint stock companies. Joint stock companies classified as small entrepreneurs must go through simplified audit procedure every three years.

[18] For the preparation of financial statements there are some basic accounting principles to be obeyed. Business changes must be recognized in the moment they occur, there must be consistence and carrying on business on going concern basis. In preparation of financial statements there are some general principles to comply with when evaluating items (of balance sheet and the profit and loss account): caution, priority of substance over form, value characteristics, individual evaluation, and interconnection of balance sheet items with respect to time. See, article 26 AA

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Also, banks are subject to mandatory audit to be performed in accordance with additional requirements imposed by the central bank.

External auditors are also required to perform an audit in few specific cases regulated by CA.

External audit on the foundation of joint stock company is mandatory by article 182/2 CA in certain situations: if one of the members of the management or supervisory board is at the same time the founder of the company; if stocks for the account of a member of the management or supervisory boards were subscribed in the foundation of the company; if a member of the management or supervisory boards was given a special privilege in the or has received an indemnification or compensation for the foundation; and if foundation of the company was accomplished by investing assets other than money.

External audit on mergers is also mandatory. This is regulated by article 515 CA. Thereby it is stated that one or more auditors for each company involved in mergers should examine the merger agreement. They are appointed by management boards of respective companies. There is also the possibility that the same auditors perform an audit for all companies involved if the court appoints them on the grounds of the joint request. Written reports on the performed audit are required, and a statement regarding adequacy of the proposed ratio of exchange of shares must be part of the report. A written report must indicate which methods were applied in determining the ratio of exchange, criteria justifying the application of these methods and ratio of exchange which would be established if different methods were applied.

Independency of external auditors

In some cases, due to strong competition on small market and extremely limited liability, there are doubts expressed on the independence of auditors.

Recently a big Croatian bank almost ended in bankruptcy after it was discovered that the chief forex trader has been cumulating and hiding losses for 4 years. According to domestic and foreign press reports, cumulated losses amount to € 1.000.000. The bank had a foreign majority shareholder (German bank), an

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internal audit department, and was audited by one of big five global auditing firms for the last four years.

Quality of information provided in external audit reports

In cases when the audit is performed by a truly independent auditor and particularly if dominant shareholders and supervisory board members are requesting unbiased assessment of company position, there is no doubt that external audit is more than useful.

However, if auditors are too close to management, and when dominant shareholders or members of the supervisory board successfully exercise pressure on the auditor to bend its report in a certain direction, such a report may actually not serve the interests of other investors who may even suffer substantial losses by relying on it.

The liability of auditors must correspond to importance of their role as independent and highly competent professionals with a mission to primarily give assistance to investors other than insiders (members of the boards, top management, large shareholders).

In view of recent scandals related to highly reputable international auditing firms, additional efforts must be applied in order to reestablish the credibility of the auditing profession.

FINAL REMARKS

A lot remains to be improved in Croatia regarding corporate governance in general and transparency and disclosure requirements in particular.

Providing incentives for companies to list on the stock exchange would be a quick and welcome shortcut to improve the transparency and disclosure of Croatian issuers (in the experience of the ZSE, a major obstacle to listing is the reluctance of management boards to lift the corporate veil). Other than that, improvements in the quality of regulation and the competence of institutions involved in surveillance and enforcement in order to enable them to handle complex cases is of paramount importance. Assistance and encouragement that may be provided by international

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organizations and institutions in developing all aspects of corporate governance culture can not be overestimated.

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