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COPROPRATE GOVERNANCE IN CROATIA

Quality Evaluation of Corporate Governance in Croatian Joint Stock Companies via SEECGAN methodology

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The book "*Corporate Governance in Croatia*" (*Korporativno upravljanje u Hrvatskoj*) is the first genuine edition on corporate governance practice in Croatian joint stock companies listed at the Zagreb Stock Exchange. It originates from the idea of developing the South East Europe (SEE) specific customized measure of corporate governance quality and is one of the accomplishments of the large-scale international joint project, undertaken by the members of the *South East Europe Corporate Governance Academic Network (SEECGAN)*.

The book is committed to the evaluation of corporate governance quality by using the newly developed and applied *SEECGAN methodology*. The methodology is designed and systemized under the supervision of the book's lead author and editor, Professor Darko Tipurić. The *SEECGAN methodology* is SEE business ecosystem specific and inherent to the market, with institutional, cultural and social particularities of the selected group of countries participating in the research: Croatia, Bosnia and Herzegovina, Serbia, Montenegro, Slovenia and Macedonia. The main measurement tool of this undertaking is the *SEECGAN index of Corporate Governance (hereinafter SEECGAN Index)*, aimed at quantification, and consequently, the improvement of the corporate governance practices. Moreover, the Index allows for the comparison/benchmarking of a firm's corporate governance characteristics with those governance provisions

that form the best practice platform. The Index also allows for corporate governance benchmarking among countries.

The quality of the corporate governance system is a complex issue: it is difficult to measure and explain in an unambiguous manner. The rationale behind it is that corporate governance is a form of meta-management, since it embodies a set of relations between the management, board, shareholders and stakeholders of a firm. Hence, it defines the framework for setting goals and determining the means to achieve them, and consequently shapes the contextual outline that enhances or diminishes the firm's performance. Having in mind the significance of the corporate governance practice quality for firms, in order to build and sustain the corporate governance excellence, the author and coauthors elaborate the research content through three chapters: the conceptualization of the methodological frame is explained in the first, the application of the methodology and the research results for Croatia are presented in the second chapter, while the concluding remarks, as well as the recommendations for annulations of the spotted weaknesses of Croatian corporate governance practice are suggested in the third chapter.

The first chapter introduces the review of the most frequently used significant corporate governance indices (i.e. *Gamma Score S&P-a*; *ISS Governance QuickScore Index*, *IFC Scorecard of Corporate Governance Standards*, etc.) and continues with the detailed explication of the initiative for the SEE customized methodology, necessary for measuring the firms' differences with respect to governance quality. Since all the available indices vary considerably in the spectrum of dimensions taken to evaluate a firm's corporate governance, which is considerably related to the national business context that nuances the significance of the sufficiently important areas to be included in the measurement tool, they are not aligned with the particularities of the SEE business context, governance structure, value and culture. Moreover, the authors do not find them suitable for the insider control governance system that is commonly practiced in the area.

For all these reasons, as well as to enable the comparison of different firms across the entire range of relevant corporate governance quality context dimensions, the *SEECGAN Index* has been designed as the

composite measure of seven segments, distilled through the empirical research conducted in 2014 on the joined stock companies listed at the national stock exchanges in the selected SEE countries (Croatia, Bosnia and Herzegovina, Serbia, Montenegro, Slovenia and Macedonia) participating in the research, so that the Index could become the benchmarking tool for the corporate governance practice quality, both between the firms and among nations. Seven selected segments of the *SEECGAN Index* are as follows: (1) Structure and Governance of Boards; (2) Shareholders' Rights; (3) Transparency and Disclosure of Information; (4) Audit and Internal Control; (5) Compensation/Remuneration; (6) Corporate Risk Management; and (7) Corporate Social Responsibility.

The first segment assesses supervisory and management boards and their commissions' roles, or the board of directors' roles, board organization and performance. The second evaluates shareholder's rights and their participation in the corporate decision-making process. The third segment assesses the transparency and disclosure of regulated information. The fourth evaluates the system of external audit, the work of the audit commission, as well as the internal auditing and controlling activities. The fifth segment scores the compensation and remuneration system of board members and top management team, as well as the policies of remuneration. The sixth segment evaluates the risk prevention system and enterprise risk management, while the seventh assesses the corporate social responsibilities and the existence of the formalized corporate procedures and praxis of the social responsible performance.

These seven segments are represented by a total set of 98 questions, mapped in a scorecard matrix. It is worth noting that the questionnaire is adapted particularly for companies practicing a one-tier corporate governance model. Each segment could be considered independently or grouped with other segments, forming an overall *SEECGAN Index* score. The maximum score for each segment is 10 (best possible practice) and the minimum is 1 (worst possible practice). The overall *SEECGAN Index* score is interpreted as the average value of all seven segments with 1 being the lowest value, and 10 being the maximum index value, that reflect the corporate governance quality of the particular company via a single calculate rating.

With respect to the score achieved, corporations are grouped in four clusters, labeled and marked as: Premium (A); Good (B); Unsatisfactory (C); and Poor (D) corporate governance. The author and coauthors emphasize that the *SEECGAN methodology* conveniently allows each company to interpret its overall and composite scores in two consistent manners: the first is an overall gained mark (A, B, C or D); the second is the composite gained score of each segment of the *SEECGAN Index*. For example, a company with premium corporate governance (A), might score a set of segment indices (A – A – A – B – A – A – B), which can be understood as a need for the improvement of the corporate governance praxis related to the fourth and seventh segment of the *SEECGAN scorecard*.

For „A“ scored companies, the index value ranges between $7.5 \leq 10$, which indicates that the governance processes and practices applied assure high protection from possible value devastation and other harmful activities that might not be in the best interest of the corporation, shareholders or important stakeholder groups involved. The corporation governance system quality pertains minimal to zero weaknesses with respect to the seven evaluation dimensions. „B“ scored corporations have gained the index value ranging between $5 \leq 7.5$, which indicates that the governance processes and practices applied assure a medium protection from possible value devastation and other harmful activities that might not be in the best interest of the corporation, shareholders or important stakeholder groups involved. The corporation governance system's quality exhibits several weaknesses with respect to some of the seven evaluation dimensions. „C“ scored corporations have gained the index value ranging between $2.5 \leq 5$, which indicates that the governance processes and practices applied do not assure sufficient protection from possible value devastation and other harmful activities that might not be in the best interest of the corporation, shareholders or important stakeholder groups involved. The quality of the corporate governance system exhibits notable weaknesses with respect to the majority of the seven evaluation dimensions. „D“ scored corporations have gained the index value ranging between $0 \leq 2.5$, which indicates that the governance processes and practices applied assure low protection from possible value devastation and other harmful activities that might not be in the best interest of the corporation, shareholders or important stakeholder groups involved. The quality of the corporate governance system exhibits notable shortcomings and weaknesses in all the seven dimensions of evaluation.

The second chapter presents the results of the empirical research, which was conducted on 32 joined stock companies out of 162. The research results reveal that the Croatian overall *SEECGAN index* scores 3.91, which implies unsatisfying quality of the national corporate governance practice, and it scored lower than for example Slovenia (5.59) or Macedonia (4.09). According to the study findings, only three Croatian companies were scored with premium corporate governance quality. The 28.1% of the companies have good governance practice, while 40.6% of them were evaluated as unsatisfactory and the remaining 21.9% as having poor governance practice quality. The leading author and his associates further elaborate the analysis of the scores gained in details, by using the segment group's codification, the cluster and factor analysis, and link them to the size and ownership of the sample companies.

The final chapter conveys important insights consolidated in concluding remarks and recommendations for the Croatian corporate governance practice improvements. Generally, as the research results highlight, the existing practice is oriented towards legal and regulatory compliance and the regularity of disclosure, as well as towards shareholders rights, audit and internal control obligations. Notably, the importance of remuneration and compensation issues are yet not recognized as the core contributing elements to the quality of corporate governance practice, neither is the board performance and operating mode. Moreover, the integrated risk management and the corporate social responsibilities dimensions are found to be rather neglected areas in Croatian governance practice, although they undoubtedly contain the core ingredients of use to sustain overall excellence of corporate performance.

The recommendations offered explicitly point out to those governance provisions needed for elevating the present governance quality level, thus spanning the space for the elimination of the existing weaknesses. A good starting point, as suggested by authors, might be the strengthening of the role, independency and competences of the board members. The long-term strategic orientation, as well as the alignment and empowerment of shareholders' and other important stakeholders' activities in the corporate decision-making processes enable the strategic direction of the company to become wealth-generating and better fitting within the ecosystem it operates. Consequently, by becoming more collaborative, companies'

strategies turn into even more competitive. Besides, as professor Tipurić and his colleagues advise, all the mentioned recommendations are not relevant only for the joined stock companies; they pertain to the state and municipal owned companies alike.

The book "*Corporate Governance in Croatia*" (*Korporativno upravljanje u Hrvatskoj*) has improved the contemporary and holistic governance platform, which is able to sustain the best governance practices. Moreover, it has offered the missing, SEE region-specific tool for corporate governance practice benchmarking. Since the *SEECGAN index* indicates, besides strong, also the weak areas of performance by focusing on their improvement, it allows for building and sustaining the corporate governance practice excellence. Being understood as the virtue of balancing the shareholders' and stakeholders' expectations and company's interest, long term goals and legitimate competitive behaviors, in the scope of this research the corporate governance practice affirms its decisive impact on the overall corporate performance in complex and ever-changing business reality.

This work sheds important new light on the corporate governance practice. The pragmatic side of the governance discipline, despite the vast scientific and commercial elaboration, has somehow remained neglected until now, so it merits to be considered as the genuine book value. By combining theoretical propositions and practical throughputs and outputs with a robustly conceptualized methodological framework to be applied as part of the conducted empirical research, significant sets of recommendations have been brought to the fore. Hence, the book could serve as an excellent navigator for the scholarly and business community alike. Moreover, the fact that the inaugurated *SEECGAN Index* allows for the comparison of the domestic and international companies' corporate governance practices is particularly noteworthy, since it underpins the fundamental issues of interest for private and institutional investors, as well as for financial and legal actors.

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