DISCLOSURE OF RELATED PARTY TRANSACTIONS IN SOME EAST EUROPEAN COUNTRIES

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ABSTRACT. This paper purpose is to analyze how are respected the disclosure requirements under OECD Corporate Governance Principles and also under the 24 International Accounting Standard about reporting related party transactions in some East European countries, knowing that a strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders’ ability to exercise their ownership rights on an informed basis.

Keywords: related parties, compulsory and voluntary disclosures, East European countries

1. Introduction

1.1. Generalities

Related parties are common characteristic of commerce and business. Many companies develop activities through subsidiary or associated enterprises. Also a company can control or exercise significant influence on the financial and operating decision of other company. Between a company and its controlled or significant influenced companies usually are developed different relationship and commercial transactions.

It is essential for the market to know if a company perform her activity alone, independent on normal markets terms or the company is in a related party position with other companies.

A related party relationship could have an effect on the financial position and operating results of the reporting enterprise. Related parties may enter into transactions, which unrelated parties would not enter into. Also transactions between related parties may not be effected at the same amounts as between unrelated parties.

Accounting recognition of the transfer of resource is normally based on the price agreed between the parties. Between unrelated parties the price is an arm’s length price. Related parties may have a degree of flexibility in the price-setting process that is not present in transactions between unrelated parties.

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The importance of related parties, transactions with related parties and disclosure is underlined by international organizations like Organization for Economic Co-operation and Development (OECD), International Accounting Standards Committee (IASC), Committee of European Securities Regulators (CESR), and EU Commission.

Related parties and reporting related party transactions represents disclosure requirements under the OECD Corporate Governance Principles and also under the 24 International Accounting Standard and related parties transactions are current debates at European and international level.

1.2. OECD principles of Corporate Governance

Adopted in 1999, OECD's principles represent the worldwide guideline in the area of corporate governance. The Principles represent a common basis that OECD Member countries consider essential for the development of good governance practice. They address to the specific problems that result from separation of ownership and control.

The OECD Principles are fully relevant for the publicly traded companies and may be useful also in improving corporate governance in privately held or state-owned companies.

In most corporate governance codes, disclosure plays a central role: companies disclose, in their annual report, how they deal with corporate governance issues. This information should conform to the code’s provisions. Disclosure therefore is a key element in all code driven governance systems, while conversely markets will strongly influence the governance practices. Imposing disclosure, the codes expose a company and its board to justification, outside criticism and most importantly to market assessment. In general, board members will protect their reputation and will voluntarily adhere to good governance practices, even in the absence of formal codes.

Companies respecting the disclosure and transparency principle ensure timely and accurate on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

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2 The Organization for Economic Co-operation and Development
3 www.ebrd.com - Law in transition, Strengthening corporate practices, 2006
4 www.oecd.org- Principles of Corporate Governance 2004
5 Disclosure should include but not be limited to, material information on:

a. **Major share ownership and voting rights.** One of the basic rights of investors is to be informed about the ownership structure of the enterprise and their rights vis-à-vis the rights of other owners. The right to such information should also extend to information about the structure of a group of companies and intra-group relations.

b. **Remuneration policy for members of the board and key executives,** and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.

c. **Related party transactions.** It is important for the market to know whether the company is being run with due regard to the interests of all its investors. The company must fully disclose material related party transactions to the market, either individually, or on a grouped basis.
About the methods to use for price the transactions between related parties, OECD and IASC recommend the same methods: comparable uncontrolled price method, resale price method or cost plus method. Sometimes no price is charged or transactions would not have taken place if the relationship had not existed.

1.3. International Accounting Standards 24 - Related Party Disclosures

A key element of accounting regulation current evolutions in Europe is to provide financial investors with more accurate and precise information about entity's activity.

The objective of IAS 24\(^6\) is to ensure that financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. IAS 24 present the related party concept, related party transactions, the related party issue with the methods used to price transactions between related parties and the disclosures requirements regarding the nature of the related party relationships as well as the type of transactions and the elements of the transactions necessary for an understanding of the financial statements.

In most east European countries, annual reports are currently prepared following national accounting standards, which even when meant to be consistent with IFRS do in fact differ substantially from them on specific issues. This is especially the case regarding inflation accounting, undisclosed liabilities, and valuation of assets and reporting of related parties transactions. This situation is changing with the adoption of full International Financial Reporting Standards (IFRS) by listed companies from EU members or future members. In this sense a special attention should be given to consolidation requirements and related party rules, because these countries haven’t developed a practice for it.

1.4. European Directive on Minimum Transparency Requirements for Listed Companies

In December 2004 The European Council and Parliament have approved a new Directive\(^7\) on minimum transparency requirements for listed companies, which will be applied by EU Member States within two years of its publication in the EU’s Official Journal.

The Transparency Directive establishes a general obligation for all issuers of shares, whether they have to prepare the half-yearly report in accordance with IAS or not, to include in the interim management report disclosure the major related party transactions.

\(^6\) www.ifac.org- IAS 24
\(^7\) The Directive completes a package of Financial Services Action Plan measures adopted over the last period– including the IAS Regulation, the Market Abuse Directive, and the Prospectus Directive – to establish a common financial disclosure regime across the EU for issuers of listed securities.
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In CESR’s opinion the following information must be disclosed about major related party transactions:

(a) The nature and extent of any transactions, which are as a single transaction or in their entirety material to the issuer. Where such related party transactions are not concluded at arm’s length, provide an explanation of why these transactions were not concluded at arm’s length. In the case of outstanding loans including guarantees of any kind, indicate the amount outstanding.

(b) The amount or the percentage to which related party transactions form part of the turnover of the issuer.

CESR believes that a reference should instead be made to IAS 24, which already provides appropriate definition of related party transactions.

The half-year financial report should instead describe the most significant events that have an impact on the financial position and performance of the issuer since the last annual report. In this sense is used the term “major related parties transactions”

2. Methodology

Knowing that a strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders’ ability to exercise their ownership rights on an informed basis, the aim of our article is to research the status of reporting related party transactions in some East European countries.

We intend to find answers at following questions by a transnational comparative approach:

- How ‘related parties’ are understood in each country? For this purpose we intend to analyze the concept of related parties in each countries legal framework: companies law, accounting law, fiscal law, competition law and others laws to find how are defined related parties and related parties transactions.

- How ‘related parties’ are regulated by national laws? For this purpose we intend to analyze the reporting requirements legal framework, companies Law, accounting law, fiscal law and others laws to find the compulsory disclosure requirements.

- The existing legal requirements for reporting related party transactions and the manner in which they are implemented are capable of ensuring appropriate transparency and disclosure? For this last purpose we analyze the reports of OECD and Word Bank for each countries regarding the corporate governance implementations and the conformity with OECD Corporate governance principles, Securities Commissions reports, financial statements of companies via internet.

A initial version of this study was presented at Emerging Issues in International Accounting and Business Conference, 2006, under the patronage of Department of

8 The Committee of European Securities Regulators
3. Related parties concept

3.1. Related parties
Under IAS 24 parties are related\(^9\) if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions. Parties are not related\(^{10}\) in follows case:

- two enterprises simply because they have a director or key manager in common;
- two persons who share joint control over a joint venture;
- financers, trade unions, public utilities, government departments and agencies in the course of their normal dealings with an enterprise; and
- a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

OECD defines related parties more condensed. Related parties\(^{11}\) can include entities that control or are under common control with the company, significant shareholders including members of their families and key management personnel.

3.2. Related parties transaction
A related party transaction\(^{12}\) is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.

Transactions\(^{13}\) involving the major shareholders (or their close family, relations etc.), either directly or indirectly, are potentially the most difficult type of

\(^9\) IAS 24 art.9: A party is related to an entity if:
(a) directly, or indirectly through one or more intermediaries, the party:
(i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
(ii) has an interest in the entity that gives it significant influence over the entity; or
(iii) has joint control over the entity;
(b) the party is an associate of the entity; (IAS 28)
(c) the party is a joint venture in which the entity is a venture\(^9\); (IAS 31)
(d) the party is a member of the key management personnel of the entity or its parent;
(e) the party is a close member of the family of any individual referred to in (a) or (d);
(f) the party is an entity that is controlled, jointly controlled or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or
(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

\(^{10}\) IAS 24 art.11

\(^{11}\) www.oecd.org - Principles of Corporate Governance, 2004

\(^{12}\) IAS 24 art.9

\(^{13}\) idem 14
transactions. In some jurisdictions, shareholders above a limit as low as 5 per cent shareholding are obliged to report transactions.

3.3. Findings about related parties’ concepts in East European countries

The laws of the countries analyzed contain references regarding ‘related parties’. In fiscal laws there are some references at ‘related party transactions’ concept like transactions between related parties. In some countries, transactions between related parties must be reported only if a number of additional conditions are met.

Definitions of ‘related parties’ exist in both corporate laws, securities, fiscal and accounting regulations, but in some countries the definitions are different from one regulation to other, adapted to the purposes of the relevant piece of legislation.

Accounting rules, respecting IFRS or harmonized with international standards or/and European directives, regarding related parties present in notes to financial statements reporting requirements.

We can conclude that the concept of ‘related parties’ is defined in similar manner in the laws of the countries under examination.

Generally\(^\text{14}\), legislators have taken two different and successive standpoints:

(i) firstly, there are certain categories of persons (legal entities and individuals) qualified by law as ‘related parties’;

(ii) secondly, a general wording is inserted to allow any person capable of exercising an influence over another party in the making of decisions to be qualified as a related party.

There are classes of persons qualified by law as ‘related parties’ common to all the countries investigated but there are others specific to the legislation of only one country.

Classes of persons qualified by law as ‘related parties’

The main classes of persons (physical or legal) qualified as ‘related parties’ in the national legislations examined can be grouped as follow:

- **persons involved in the management of a company**: members of management, key executive officers are qualified as related to the company in whose management they are involved.

- **persons with participation towards the company’s share capital**: shareholders who own more than the prescribed threshold of a particular company’s shares. A shareholder is considered as a related party if he have direct or indirect at least a significant interest (but this is not necessary in all cases), even if holding disclosure requirements apply to lower levels of shareholding (e.g. holdings of 5%).

- **persons with ‘control’ direct or indirect**: persons exercising control over another party and that other controlled person; persons controlling together a third party; persons under the control of a third party.

\(^{14}\)www.oecd.org - Reporting related party transactions and conflict of interest by Luputi L, 2004
• **persons with family relations**: spouses and relatives; there are differences as regards the degree of kinship and affinity. Generally, this criterion is also used for determining indirect involvement in management, indirect participation towards the share capital or indirect control.

• **persons with other existing relations**: The regulations qualify as ‘related parties’ the persons between whom certain relations, other than family relations, are established: employer and employee, commercial agent and beneficiary, commercial partners, donor and donee, etc.

• **cross shareholding**: companies with cross-shareholdings also qualify as related parties.

*Persons qualified based on the general wording*\(^{15}\)

The general wording in the definition of ‘related parties’ allows any person capable of exercising an influence over another party in making decisions as a ‘a related party’. Since the qualification as ‘related parties’ in reliance on this general wording involves a process of interpretation, transactions between related parties which do not fall within any of the categories specifically set out by law are the least disclosed, there being no clear basis on which to claim or prove that a transaction between related parties has taken place.

### 3.5. Concept of ‘related parties’ under national laws

#### 3.5.1. Concept of ‘related parties’ under Romanian law

Provisions regarding the concept of ‘related party’ exist in the Romanian securities regulations, competition law, privatization law, banking law, accounting law and fiscal law.

*In Romanian Company Law*\(^{16}\), there is no clear definition of ‘related parties’. In the last published law version there are introduced some articles\(^{17}\) treats aspects about related party of a company: the founder/shareholder – regardless of the shareholding in the first two years of the company’s business, the director, the executive manager, the spouses and relatives of the director or the executive manager, up to the fourth degree of kin, the company wherein the director or the executive manager holds, by himself or together with the spouse or relatives at least 20% of the subscribed share capital, the director of a company and a company controlled by the company where he acts as director, as well as the company controlling the company it administers also seem to qualify as related parties.

*The securities regulations*\(^{18}\) contain definitions for ‘person involved’:

a) persons who control or are controlled by an issuer or which are under joint control;

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\(^{15}\) www.oecd.org - Reporting related party transactions and conflict of interest by Luputi L, 2004

\(^{16}\) Companies Law no. 31/1990, adopted in November 1990, amended several times, and finally published in revised form in the Official Gazette in November 2004

\(^{17}\) Company Law no.31 art. 143,145,148,265

\(^{18}\) Emergency Ordinance no. 28/2002, as subsequently amended  and Capital Maket Law no. 297/2004
b) persons participating directly or indirectly in the conclusion of agreements for the joint exercise of voting rights, if the shares forming the subject-matter of the agreement ensure a controlling position;

c) individuals having managerial or control powers within the issuer;

d) spouses and relatives of the individuals under a), b) and c) up to the second degree of kinship;

e) persons who can appoint the majority of members to the Board of directors within an issuer.

A significant shareholder is the person or group of persons who action in common and who have direct or indirect more than 10% of share capital or vote rights, or a part of shares sufficient to influence significant the decision taking process.

In Capital market law and in accounting law are defined terms associated with related parties: mother company, group of companies, subsidiaries, and control.

3.5.2. Concept of ‘related party’ in Bulgarian law

Bulgarian legal framework (Commercial Act and securities regulations) relevant to related parties defines several categories of related parties, with some differences between the definitions in the Commercial Act and those in the securities regulations.

Under the Commercial Act, related parties are defined as follows:

- ‘spouses, lineal relatives up to any degree, collateral relatives up to the fourth degree of kin, and relatives by marriage up to the third degree of affinity inclusive;
- employer and employee;
- any two persons, one of whom participates in the management of a corporation of the other;
- partners;
- a corporation and a person which or who holds more than 5 percent of the voting interests and shares issued by the said corporation;
- any number of persons, whose activity is directly or indirectly controlled by a third party;
- any number of persons, who or which jointly control a third party, whether directly or indirectly;
- any two persons, one of whom acts as commercial agent for the other;
- donor and donee of a gift.

“Related parties” furthermore means any person that participates, whether directly or indirectly, in the management, control or capital of another person or persons and therefore may agree among themselves on terms other than the customary ones.”

A holding can be: a joint-stock company, a partnership limited by shares, or a limited liability company purpose to have share participation or manage other companies and having no a partnership limited by shares, or a limited liability company

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19 The Bulgarian Commercial Act was adopted in 1991, last amended at the end of December 2005.
purposed to have share participation or manage other companies and having no further obligations to perform commercial activity itself.

At least 25% of the holding capital should be invested in its subsidiaries. A subsidiary is a company wherein the holding either possesses or exercises control over, directly or indirectly, at least 25% of the shares or has the power to appoint the majority of the managing body members.

In the Bulgarian securities law\textsuperscript{20} there is a definition of related parties\textsuperscript{21}. Related parties are:

\begin{itemize}
  \item [a)] The parties, where one of them controls the other one or is a subsidiary company thereof;
  \item [b)] The parties whose activities are controlled by a third party;
  \item [c)] The parties that jointly control a third party;
  \item [d)] Spouses, lineal relatives up to any degree, collateral relatives up to the third degree of kin,
  \item [e)] and relatives by marriage up to the third degree of affinity inclusive.
\end{itemize}

A party is deemed to have control\textsuperscript{22} over a company if it:

\begin{itemize}
  \item [a)] Possesses, inclusive through a subsidiary or under an agreement with a third party more than 50% of the votes in the General Assembly of a company; or
  \item [b)] Can appoint directly or indirectly more than a half of the members of the Governing Body of a company; or
  \item [c)] Can otherwise decisively influence the making of decisions relevant to a company’s activities.
\end{itemize}

The possession of more than 50% or the largest number of shares or stakes shall mean the possibility to control the taxpayer.

3.5.3. Concept of ‘related party’ in Serbian law

Under Serbian law, companies may become related by means of equity or agreements. Related companies include: holding and subsidiary companies (joint-venture, trust), cross-share companies, and holding companies. Competition regulations may bar companies from becoming related.

If a company has a majority (50%) or significant (25%) holding in another company or if, under an agreement with another company, it has the right to appoint the majority or at least a quarter of the members of the Board of Directors of the other company, or if it has a majority or at least a quarter of the votes in the General Meeting, it is treated as a parent company, with the other company deemed to be its subsidiary. A holding company is a company that owns shares or stock in a subsidiary

\textsuperscript{20} The primary laws governing the Bulgarian capital market are the Financial Supervision Commission Act (the “FSCA”), which came into force in March 2003 and was last amended in May 2005; the Law on Public Offering of Securities (the “Securities Law”), which became effective in January 2000 and was last amended in May 2005. The Commercial Code, entered into force in 1991 and amended more than 20 times, most recently in May 2005.

\textsuperscript{21} Supplementary Provisions of the Public Offering of Securities Act, Clause 1, point 12

\textsuperscript{22} Supplementary provisions of the Public Offering of Securities Act, paragraph 1, point 13
company, its business being primarily to exercise control, acquire an interest in other companies in the form of shares, stock or convertible debentures (formation, lasting investment, purchase, swap), as well as to manage the securities. A holding company may be incorporated as a general partnership, limited partnership, joint-stock company, limited liability company, socially owned company and public company.

A related party is a company or an individual who can significantly influence a company’s business decisions. Owning 50% or more of the largest proportion of a company’s shares is considered a significant influence. A related party is also a company in which, as in the other company, the same employees or management bodies conduct management, exercise control or own capital.

3.5.4. Concept of ‘related party’ under Croatian law
Related companies are legally independent companies whose mutual relationships are as follows:
• ‘a company that has the majority holding in another company or has the majority right where decision-making is concerned
• dependant and main company;
• a company of concerns;
• companies with reciprocal shares;
• companies joined by entrepreneurial contracts.’

3.5.5. Concept of ‘related party’ under Albanian law
In Albanian law the following are regarded as related parties:
• a legal entity and any person who owns, directly or indirectly, at least 50% of the shares or voting rights in that entity; and
• two or more legal entities if a third person owns, directly or indirectly, at least 50% of the shares or voting rights in each entity

3.5.6. Concept of ‘related party’ under Montenegro law
A related party is a company or an individual that can significantly influence a company’s business decisions.

3.5.7 Concept of ‘related party’ under Hungarian law
The companies Act qualifies an entity as related, if at least one person of the taxpayer plus another individual holds a controlling majority share in each other or a third person in both of them. A controlling majority – which may also be indirect – means a voting right in excess of 50 percent, or the right to appoint or dismiss the majority of leading office-holders and supervisory board members. Parties are defined as related if:

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23 Croatian Company Law art. 473 – 477. Adopted in 1993, is based mainly on the German and Austrian company laws, and incorporates the applicable directives of the European Commission.
24 The new Companies Act will take effect on 1 July 2006. This is the third revision of the Hungarian Companies Act and it is hoped that it will provide regulations that are better harmonized with the EU regulations.
• they are connected by direct or indirect majority shareholdings;
• they are able to appoint or dismiss the majority of the key management or the
  supervisory board;
• they have a common direct or indirect majority shareholder.

4. Reporting related party transactions – compulsory disclosure

4.1. Disclosure requirements content

In many countries the laws require financial statements to give disclosure about certain categories of related parties. A special attention is accorded to:

- relationships between parents and subsidiaries\textsuperscript{25}. Regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so must also be disclosed.

- management compensation. Disclose key management personnel\textsuperscript{26} compensation in total and for each of the following categories\textsuperscript{27}: short-term employee benefits; post-employment benefits; other long-term benefits; termination benefits; and equity compensation benefits.

- related party transactions. If there have been transactions between related parties, disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. These disclosure\textsuperscript{28} would be made separately for each category of related parties and would include:
  • The amount of the transactions.
  • The amount of outstanding balances, including terms and conditions and guarantees.
  • Provisions for doubtful debts related to the amount of outstanding balances.
  • Expense recognized during the period in respect of bad or doubtful debts due from related parties.

IAS 24 give some examples of the kinds of transactions that are disclosed if they are with a related party: purchases or sales of goods, property and other assets, rendering or receiving of services, leases, transfers of research and development, transfers under license agreements, transfers under finance arrangements (including

\textsuperscript{25} IAS 24 art.12
\textsuperscript{26} IAS 24 art. 9: Key management personnel are those persons having authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including all directors .
\textsuperscript{27} IAS 24 art.16
\textsuperscript{28} IAS 24 art.17-18
loans and equity contributions in cash or in kind), provision of guarantees or collateral, settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

A statement\(^{29}\) that related party transactions were made on terms equivalent to those that prevail in arm's length transactions should be made only if such terms can be substantiated.

Disclosure requirements\(^{30}\) include the nature of the relationship where control exists and the nature and amount of transactions with related parties, grouped as appropriate. Given the inherent opaqueness of any transactions, the obligation may need to be placed on the beneficiary to inform the board about the transaction, which in turn should make a disclosure to the market. This should not absolve the firm from maintaining its own monitoring, which is an important task for the board.

Companies are encouraged, and in some countries even obliged, to provide information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company. Disclosure may include management/employee relations, and relations with other stakeholders such as creditors, suppliers, and local communities.

There are also a lot of national regulations who reclaim reporting related party and related party transactions: Company Law, Capital Market Law, Competition Law, Fiscal Law, Bankruptcy law and others.

In countries like Czech Republic, Hungary, Poland, Slovak Republic, Slovenia, Romania, Bulgaria, Croatia who adopt Corporate Governance principles, in them national Code of Corporate Governance exist requirements about disclosures and transparency, about reporting related parties and related parties transactions.

4.2. Findings about reporting related party transactions – compulsory disclosure in East European countries

The ‘forms’ of disclosures vary from country to country and depending on the transaction. The most common forms of reporting are:

- reporting to the General Shareholders Meeting – in most cases the approval of the General Shareholders Meeting being necessary,
- reporting to the Securities Commissions and further to the shareholders, publishing in the Official Gazette,
- reporting to all users in notes to financial statements.

There are cases in which the reporting requirements apply only if the related-party transactions meet a number of additional conditions (e.g. transactions whose value exceeds a specified threshold, etc.).

In Romanian Company Law there is an exception from the rules governing the reporting of related-party transactions, because the relations between employer and employee are not considered like related parties. Opposite, in accounting

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29 IAS 24 art. 21
30 www.oecd.org - Principles of Corporate Governance 2004
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regulations the companies are obliged to present in notes to financial statements some elements regarding employees, treated like related parties.

In each law there are sanctions for noncompliance with its. Recognizing the importance of reporting related parties transactions, the laws who contains prohibitions to related-party transactions carry severe sanctions\(^{31}\) (e.g. the deeds constitute criminal offence and carry fines or prison terms, and from the standpoint of civil law the transactions are considered null and void). The sanctions for acting in breach of requirements for the reporting of related-party transactions vary from immaterial to severe sanctions. The applicable sanctions may be: civil sanctions\(^{32}\), administrative sanctions\(^{33}\) and criminal sanctions\(^{34}\). Generally, the applicability of a sanction for breaching related-party transactions does not depend on whether the transaction caused any damage to the company.

4.3. Reporting requirements under national laws

4.3.1. Reporting requirements under Romanian law

Until the OMFP 94/2001\(^{35}\) the Romanian disclosures requirements can be characterized by follows\(^{36}\):

- historical financial statements requirements did not require full disclosure
- historical use of financial statements discouraged full disclosure
- resulting mentality/understanding issues regarding purpose of financial statements.

And about related parties disclosure\(^{37}\):

- disclosure not required under existing frameworks
- lack of understanding of what a related party is
- purpose behind transaction may be designed to be hidden
- lack of available adequate information to conform related party relationships

\(^{31}\) www.oecd.org - Reporting related party transactions and conflict of interest by Luputi L, 2004

\(^{32}\) Civil sanctions consist mainly in the cancellation of the transaction or the possibility to claim in Court the cancellation of the transaction performed in breach of the relevant legal provisions.

\(^{33}\) Administrative sanctions are applied by Securities Commission to cases in which the related party acting in breach of the rules governing related-party transactions. Administrative sanctions can go all the way to withdrawal of the authorization.

\(^{34}\) Criminal sanctions apply mainly to breaches of clear prohibitions against the performance of related-party transactions. However, there are cases when criminal offences apply to violations of rules governing the reporting of related-party transactions.

\(^{35}\) The OMFP 94/2001 “Harmonization of Accounting Regulations with the European Union 4\(^{th}\) Directive and International Accounting Standards” has introduced a requirement for certain Romanian entities to prepare financial statements that reflect the Standards issued by the IASC and interpretations by the Standing Interpretations Committee of ISAC and to be in accordance with the requirements of the European Union 4\(^{th}\) Directive.


\(^{37}\) idem 38
Romanian accounting regulations\textsuperscript{38}, especially the Order 94/2001 introduced, among other items, accounting requirements for Romanian financial accounting and reporting regarding disclosure of related party balances and transactions. But disclosure\textsuperscript{39} of "related party" balances at the period end or transactions during the period although required for disclosures are in cases limited in what is included. In addition no consolidation concept exists where one entity has a majority ownership or control in/over another.

Romanian tax regulations\textsuperscript{40} prescribe certain rules for transactions between related parties (e.g. the requirement of transactions at arm’s length).

Both Romanian Company Law and Capital Market Law\textsuperscript{41} contain reporting requirements and provide rules regarding the control mechanisms aiming to monitor and prevent abusive related party transaction.

The most important requirements under Romanian Company Law are set out below:

• ‘The acquisition\textsuperscript{42} by a company of a good from a founder or a shareholder:
  
a) in a period of maximum 2 years from the incorporation of the company or from the date when the company was authorized to start its activity; and
  
b) in return for an amount or other consideration accounting for at least 10\% of the subscribed share capital must be submitted for approval to the Shareholders General Meeting, after a valuation performed by an independent appraiser, be published in the Official Gazette and in a wide circulation newspaper. Acquisitions performed in the normal course of business of the company, as well as those made in on the basis of a decision by an administrative authority, or based on a court ruling, or made on a regulated stock exchange do not fall under the above provisions.”

• The sale -purchase agreements\textsuperscript{43}, the loan agreements and the rental agreements standing for more than 10\% of the net assets value, concluded between the company and one of its directors, have to be approved in an extraordinary shareholders general meeting. The same rule applies if the agreement is concluded between the company and one of the following persons (related parties): (i) the board member’s spouse; (ii) the board member’s relatives down to the fourth degree, or the relatives of his/her spouse down to the fourth degree; (iii) the commercial or civil company where the board member or the persons mentioned at

\begin{footnotes}
\footnotetext[38]{OMFP 94/2001}
\footnotetext[39]{www.ey.com- Financial reporting in Romania, 2005}
\footnotetext[40]{Profit tax Law 414/2002, Decision 859/2002 for the approval of the Instructions regarding the calculation methodology of the tax on profit, Fiscal Code Law 517/2003}
\footnotetext[41]{Capital Market Law no. 297/2004, entered into force on 28 July 2004. The Capital Market Law unifies the previous regulations contained in different acts into a single piece of legislation and transposes a number of EU directives.}
\footnotetext[42]{Companies Law no. 31/1990, art.143}
\footnotetext[43]{Companies Law no. 31/1990, art.145}
\end{footnotes}
(i) - (ii) are board members, directors or hold at least 20% of the capital, unless a company is a branch of the other company.

- It is forbidden to grant compensations or any other amounts or advantages to directors and managers, or other related parties other than under a resolution by the Shareholders General Meeting. Similarly it is forbidden for a company to make loans to its directors or executive managers in respect of any kind of transactions, if the amount exceeds Euro 5,000 and the transaction is performed other than in the normal course of business.

The securities regulations lay down the following main reporting obligations:

- Any acquisition, sale, swap or collateral posting operation involving the assets of a publicly-held exceeding during a financial year individually or cumulate 20% from the total assets less accounts receivables may be concluded by directors or executive managers only after they have obtained the approval of the Shareholders General Meeting. Paragraph 2 of the same article states that the loan of company assets worth more than the 20% threshold to a related party is subject to prior approval by the Shareholders General Meeting;

- Internal and financial auditors of publicly-held companies are responsible for checking the management of the company, and the accuracy and appropriateness of transactions or acts/documents concluded by the company with its directors, employees, company shareholders or affiliated persons or persons involved therewith;

- The holdings of two related parties in a publicly-held company are always considered together (i.e. as the sum total of their individual holdings – for any trading operation, it is the aggregate percentage that is taken into account);

- The following reporting obligations are regulated:

  (1) The directors of a publicly-held company shall be bound to present to the NSC current reports, which shall be compulsorily published in the Commission’s Bulletin, wherein they shall state any juridical act concluded by the company with its directors, employees, majority shareholders of the company or persons involved or affiliated thereto worth jointly at least the ROL equivalent of 50,000 euro.

  (2) In the case that the company concludes juridical acts with the persons under paragraph (1), these shall be concluded in compliance with the company’s interest in relation with the offers of the same type existing in the market.

  (3) The reports shall contemplate in a special chapter the juridical acts as concluded or the amendments thereto and shall specify the following: the parties that concluded such juridical act, the date of execution and the nature of the act, a description of the object thereof, the aggregate value of the juridical act, the

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44 Companies Law no. 31/1990, art.148
45 Capital market law, art. 115, par. 1
46 Capital market law, art. 113
47 Capital market law, art. 123
amount due by the parties to each other, the security, as well as the terms and modalities of payment.

(4) The reports shall also mention any other information needed to establish the effects of such juridical acts on the financial situation of the company and any other information required in accordance with the NSC regulations.’

Under the Law on judicial reorganization and bankruptcy procedure there are the following relevant provisions: ‘(2) The following trading operations, concluded during the year preceding the opening of the procedure, with persons having legal relations with the debtor, may also be cancelled and the services recovered if they prejudice the interests of the creditors:

a) with an active partner or a partner owning at least 20% of the trading company's capital, in case the debtor is a limited partnership company or, respectively, a general partnership company;

b) with a shareholder owning at least 20% of the debtor's shares, in case the debtor is the respective joint-stock company;

c) with an administrator, director or member of supervising bodies of the debtor, joint stock company;

d) with any other natural or legal person having a dominant position over the debtor or over its activity;

e) with a co-owner over a common asset.’

4.3.2. Reporting requirements under Bulgarian legislation


Effective 1 January 2005 entities subject to the preparation and presentation of financial statements on the basis of IAS are:

• companies performing their business activities on the basis of special laws (banks, insurance companies, investment and insurance companies, etc.) for which mandatory audit is required by a law;

• enterprises issuing securities under the Bulgarian Public Stock Offering Act;

• companies, which do not meet the criteria for small and medium-sized companies; and

• companies, which have prepared and presented annual financial statements for 2004 under IFRS.

So all there companies must provide information about related parties and transactions with related parties under IAS 24.

Bulgarian company and corporate governance laws are relatively effective but need to impose restrictions on transactions involving shareholders in conflicts of interest situations and there are not any checks to guarantee that a transaction price is fair.

The Bulgarian\(^{49}\) corporate and securities law does not prescribe a systematic legal treatment of activities involving related parties. However, there are many provisions imposing restrictions on the appointment of related parties to certain corporate bodies or on transactions involving related parties. In generally, related parties transactions are forbidden and as far as there is any need for reporting, it is for reporting that the parties are not related. However there are cases in which additional conditions have to be met. An example\(^{50}\) is the contracts between a company and the single shareholder of that company (who or which represents it) shall be made in writing.

*Company law* imposes in some cases various forms of reporting. The members\(^{51}\) of the Managing Board or Board of Directors should inform the Managing Board, respectively the Board of Directors if they or parties related to them enter into contracts with the company, when these contracts are out of the scope of the customary activities of the company or differ substantially from the market conditions. These contracts shall be concluded only upon a decision of the Managing Board, respectively the Board of Directors. Contracts required to be reported to the Managing Board or Board of Directors are those that fall outside the scope of the company’s objects or that differ substantially from the customary market conditions.

According with *Securities law*\(^{52}\) transactions by the publicly held company with an interested party\(^{53}\) shall be approved in advance by the Managing Body of the company.

Under the Bulgarian law, there are no specific requirements as regards the form of the reporting. However, any approval by the Managing Board or Board of Directors of the joint stock company must be in writing, with protocols signed by all the members of such Body or Board to be prepared for all the resolutions passed.

There are also many cases in which prohibitions to the performance of related-party transactions are regulated, as below:

- revocatory actions\(^{54}\) for the annulment of certain transfers of assets by the debtor subject to bankruptcy proceedings to related parties, executed before the opening of the bankruptcy proceedings.
- the trustee\(^{55}\) in bankruptcy proceedings shall not enter into contracts in the name of the company either with himself or with a party related to him.

49 www.oecd.org - Reporting related party transactions and conflict of interest by Luputi L, 2004
50 Company Act, art. 235-a
51 Company Act art. 240-b
52 POSA art. 114, par. 2
53 Art. 114, par.5 POSA defines interested parties as the members of the managing or Supervisory Bodies, the procurators, and the persons holding more than 25% of the votes in the General Meeting.
54 Company Act, art. 647
55 Company Act art. 662 par.1
A shareholder of the stock exchange shall not possess, directly or through related parties, more than 5% of its shares.

The members of the Managing or Supervisory Bodies of the managing company or the members of the Managing or Supervisory Bodies of the investment company shall not invest Company assets in securities issued by them or by parties related to. These are the two types of governing bodies of the joint-stock companies in Bulgaria.

The investment company shall not invest in securities issued by persons controlling the investment company or by parties related to them.

The main acts governing the competition prescribes the restrictions on commercial entities aiming at ensuring the regular operation of the free market and the consumers’ protection. At present the law fully complies with the European standards. There are some references at reporting related parties and practices and agreements are prohibited under the protection of competition.

Analyzing the implementation of corporate governance in Bulgaria, in 2004 there were a lack of public information on:

- total remuneration received during the year by the members of the management bodies of the corporations;
- acquired, possessed and transferred company shares and bonds by the members of the committees during the year;
- the committee members’ rights to acquire company shares and bonds;
- the committee members’ participation in trade companies as unlimited liability partners, the possession of more than 25 per cent of the capital of another company, as well as their participation in the management of other organizations as prosecutors, managers and board members.

Unfortunately the situation is almost similar in 2006, continued lack of transparency.

4.3.3. Reporting requirements under Serbian law

In Serbian regulations there are references at reporting related parties in fiscal law. The taxable person is required to report in the balance sheet transactions between related parties. The taxable person is also required to state the value of the transactions by reference to the to prices that would have been charged for the same transaction between unrelated parties. The transactions are stated in the Corporate Profit Tax Return Form.

56 POSA art. 23, par.2
57 POSA art. 172, par.1
58 POSA art. 176, par.2, p.3, “b”
60 Keremidchiev S- Towards modernization of the corporate governance in Bulgaria, 2004
62 Corporate Profit Tax Law art 60,
Under the Corporate Law, shareholders can request any information concerning the business of the company. There is no specific provision to prescribe the obligation of the company’s General Manager or other (management) body to report (state) the related-party transactions in their regular reports to the shareholders. Nevertheless, having in mind the company’s obligation to report related-party transactions (and transfer prices) in accordance with the Corporate Profit Tax Law, such transactions should be reported in the official documents presented to the tax authorities. These documents furnish shareholders (as well as public authorities) with information on related-party transactions. Our experience so far is that companies do not report related-party transactions.

There are no specific conditions to be met for a company to be under an obligation to report related-party transactions (e.g. transactions exceeding a certain threshold, etc.).

A subsidiary may acquire shares in the parent company and exercise its voting rights carried by the shares already at its disposal, pursuant to the Law on cross-share companies (i.e. the acquisition of significant, majority and mutual capital share has to be transparent, e.g. entered in the Register and published in the Official Gazette).

Cross-share companies are related companies, each holding shares in the other. If the cross-shares are of relatively equal value, each company shall reduce its share in the initial capital of the other one by 10%.

If a company holds shares making up more than 10% of the initial capital of another company, the cross share of the latter company may not be greater than 10% of the initial capital of the former company. A company that acquires a share in the capital of another that is greater than 10% shall notify the latter accordingly forthwith. Starting from the date of receipt of notification, the notified company may not buy shares or stocks of the company, which has acquired more than 10% of its initial capital. If the notified company holds shares accounting for more than 10% of the initial capital of the company from which it has received the notification, the capital share of one company in the capital of the other shall be reduced to not more than 10% by mutual agreement. In the event of such an agreement, the company having a smaller share in the capital of the other shall transfer its shares up to 10% of the initial capital of the other company within a year from receipt of the notification. The right to vote may not be exercised on the basis of shares, which a company has to transfer.

4.3.4. Reporting requirements under Croatian law

There were founded reporting requirements in Croatian Securities Market Law, the Law on the Take-over of Joint Stock Companies, the Law on Companies, the Law on Investment Funds.

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63 The Securities Market Law of 2002 replaced an old law, which was criticized for a lack of clarity on the objectives of securities regulation and for not giving sufficient legal authority (e.g., enforcement powers) to the Securities Commission of the Republic of Croatia (the “CROSEC”).
Under Croatian Company law, there are several forms of reporting:

- when a company acquires over 25% of stocks or shares in another company having its headquarters located in the Republic of Croatia, it shall notify that company of this fact, in writing and without delay;
- unless a contract on the conduct of company business operations has been signed, within the first three months of the financial year the managing board of the dependent company shall make a report on the relations between the company and the related companies. The report will present all legal operations carried out by the company in the previous year, with regard to the main company or to the companies related to the main company or according to the instructions following the interests of these companies, as well as all other operations conducted or not conducted in the previous year in accordance with the instructions received from these companies.
- whenever the company’s annual financial statements need to be audited, the auditor shall be provided with the abovementioned report together with the annual financial statements and the report on the state of the company.
- the management board shall submit to the supervisory board: the report about relations with the related companies, the auditor’s report and, if annual financial statements need to be investigated by the auditor, the auditor’s report as well. The supervisory board shall examine the report on relations with the related companies and present a written report on the issue to the general meeting.
- if requested by one of the stockholders or by a member of the limited liability company, the court may order a special investigation into the business relations of the company with the main company or with a related company.
- The management board is required to provide information on the legal and business relations with related companies to each shareholder, at his/her request, at the general meeting.
- The supervisory board is at any time entitled to request the management board to report on the legal and business relationships with related companies.

In OECD expert’s opinion for Croatia, particular attention should be paid to improving the disclosure and transparency requirements concerning company operations. For example, while the Law on Companies has provisions regulating actions taken by a person who has influence in a joint stock company and causing damages to the company, the requirement for interested parties to timely disclose conflicting interests in transactions with the company should be strengthened. In

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64 Company Law art 478
65 Company Law art 497
66 Company Law art 498
67 Company Law art 499
68 Company Law art 500
69 www.oecd.org Survey Corporate governance in South East Europe - OECD 2003

94
addition, the way that audited financial statements are disseminated should be improved. Oversight of auditors' work also needs to be enhanced.

The 2004 Report on the Observance of Standards and Codes ("ROSC") issued by the World Bank and the International Monetary Fund observed that Croatia needed to improve its disclosure of share ownership and control structures, and the independence of auditors. For example, shareholders still lack appraisal rights or mandatory cash buy-outs upon take-over; take-over disclosure is less extensive than prospectus disclosure requirements; and directors and senior management are not required to disclose compensation or personal benefits they would receive in a takeover.

5. Reporting related party transactions – voluntary disclosure

5.1. European brief elements

For the beginning it is interesting mention some respondents answers at a CE survey about transparency in intra group relations and transactions with related parties:

- 60% of respondents answer that Community law should provide a common definition for related party transactions.
- 49.5% of respondents answer that material transactions with related parties that are directly or indirectly controlled by the parent company of a group or that are significantly influenced by board members of the parent company or any other company of the group should be disclosed, more than 50%.
- 55% of respondents agree that the corporate governance statement should inform about shareholder rights in the case of cross-border investments.
- 59% of respondents agree that the corporate governance statement should contain information on controlling other companies.
- 52% of respondents agree and 44% don't agree that the statement contain an overview of significant transactions between the controlling shareholders and the company in case they are not disclosed in the annual accounts or group accounts.

We can conclude that the opinions are shared almost equal between providing and not providing voluntary disclosure about related parties in EU countries.

5.2. East European situation

In East European countries like around the world, OECD realizes regular survey of implementing corporate governance. For SEE countries OECD experts recommends countries in 2003 to accord a special attention to fair and transparent evaluation for share issues, squeeze-out procedures, major and related party transactions.

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70 www.europa.eu - Consultation on board responsibilities and improving financial and corporate governance information, 2005, survey made on 208 companies from all European countries, members or not members of UE

because the issue of pricing is also critical in major transactions and related party transactions as the valuation of assets may also be very complex in the transition environment, and this is the most obvious avenue for abuse. Also it is a responsibility of a company’s board of directors for assuring the fairness of transactions involving share new share issues or related parties.

Another issue regards the accounting system, the adoption of full International Financial Reporting Standards (IFRS), which should be pursued and fully implemented for listed companies, and a special attention should be given to consolidation requirements and related party rules.

Now in some east European countries, annual reports are currently prepared following national accounting standards, which even when meant to be consistent with IFRS do in fact differ substantially from them on specific issues. This is especially the case regarding inflation accounting, undisclosed liabilities, valuation of assets and reporting of related parties transactions. Last but not least, consolidation was not traditionally required in most national accounting standards and this constitutes a major and crucial divergence between IFRS and prevailing national standards.

The accountancy profession in south east Europe has decided on a practical approach to the corporate governance debate, by focusing on accounting and audit reforms, with the overall purpose of improving financial disclosure — one of the key elements of the OECD principles of corporate governance. The professional accounting and audit associations have aligned themselves along two regional and the South Eastern European Accounting Reform Initiative

Most SEE countries have however adopted or are in the process of adopting IFRS for large enterprises. EU accession is a principal driving force in this process but harmonizing with EU directives regarding accounting practices is still in its infancy. It is important that this process be accelerated and that all SEE countries take the necessary steps to adopt and implement full IFRS for at least all publicly listed companies. But after having an good regulation it is important to put in practice in a proper way.

Even excellent laws can suffer from poor implementation. Most transition countries need to upgrade their commercial laws to standards that are generally acceptable at an international level. Even more importantly, they must make those laws fully effective, particularly through strengthening their court systems, tackling corruption and adopting appropriate measures to strengthen the rule of law.

Knowing from practice the Romanian situation we think that we can extrapolate the conclusion of a study made in Bulgaria at whole east European countries. In Bulgaria in 2000 the managers of enterprises indicated that they are

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73 Pohaska M Tchipec P- Establishing Corporate Governance in an emerging market: Bulgaria, 2000 Center for the studies of democracy, Sofia
very reluctant to submit information in the state and operations of their companies and do it only if they are compelled by the existing legal obligation.

Related-party transaction reporting is rather an undeveloped exercise in the region. Checking via internet the financial statements of some listed companies from our target countries it seems that not all existing provisions on the reporting of related-party transactions are currently implemented. Additionally, when undertaken, the reporting of related-party transactions is done in a ‘formal’, non-creative manner, only to ensure conformity with the legal provisions, rather than to provide legitimacy to transactions.

In general there is little confidence, if any, in the countries under review, that existing procedures ensure full transparency and disclosure of related-party transactions. This compounds the lack of confidence in the ability of the relevant authorities to lay down and implement adequate procedures.

The information reported\(^{74}\) to relevant authorities is not always relevant (e.g. the information on beneficial owner is not reported) and the authorities have no resources/possibilities to check it. Sanctions imposed by law and/or relevant authorities consist in civil penalties or administrative sanctions. Rarely are criminal sanctions imposed. The sanctions are imposed by the relevant authorities, rather than by a corporate body/judicial court. There are few cases in which minority shareholders brought a claim for the company’s failure to meet its reporting obligation.

5.3. Reporting related parties’ practices in Romania

In 2003-2004, the EBRD benchmarked the relevant Romanian corporate governance legislation against the “Principles of Corporate Governance” published by the OECD. A main issue mentioned is that significant transactions are not subject to specific approval procedures and related party transactions are not sufficiently regulated. Another issue is that the law is very general on board duties and responsibilities and is silent on issues such as that of the independent director, remuneration and compensation or audit committees.

In the same trend, Ernst & Young Romania\(^{75}\) warning foreign investors about:

- Disclosure of “related party” balances at the period end or transactions during the period though required for disclosure are in cases limited in what is included. In addition no consolidation concept exists where one entity has a majority ownership or control in/over another;
- No details on business relationships or remuneration of senior management is provided and/or no details of transactions with relations or related companies;

In Romania, public-held companies, under securities regulations are obliged to respect National Securities Commission\(^{76}\) (NSC) related-party transaction

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\(^{74}\) www.oecd.org - Reporting related party transactions and conflict of interest by Luputi L, 2004

\(^{75}\) www.ey.com - Financial reporting in Romania,2005
reporting procedure. The related-party transaction reporting to NSC is confidential. Public companies must disclose any contracts above €50,000 between the company and its directors, employees, majority shareholder, and affiliated or related parties. The NSC monitors how publicly held companies respect their reporting obligations and imposed sanctions on noncompliant companies. Therefore, companies have started to implement the legal provisions on reporting, including provisions governing the reporting of related-party transactions. But the National Securities Commission does not currently have the technical capabilities to verify the accuracy of such reports. Therefore, there is no practice as regards, for instance, incomplete reporting.

In addition, as Romanian firms move towards implementation of IFRS, companies will have to report related party transactions in notes to the financial statements, according to the requirements under IAS 24. Also the Code of Corporate Governance recommends monthly disclosure of related party transactions.

Analyzing the official web site of public-held companies more than a few companies are complying with this requirement in 2004 and 2005.

A next steps good guidance for the Romania, regarding the reporting of related parties should be the OECD expert’s recommendations:

- the harmonization of securities law requirements with the requirements and definitions of related party transactions under IAS 24, and the inspection of related party transactions by an independent audit committee of the board.
- the revision of the company law provisions on boards of administrators of joint stock companies to require that all sales and transfers of assets be conducted at “market” or “arm’s length” prices.
- the revision of the securities legislation to extend the definition of ownership to include indirect control relationships and to require disclosure of direct and indirect control relationships.

6. Conclusions

If 1990-1995 period, the related parties concept was without any correspondent in the practice of east European countries, now we can say that related parties became a real issue for financial information producers, market analysts, investors and economic environment of these countries.

In the studied countries exist a legal framework, which contains important provisions regarding related parties and related parties transactions. In some countries (Romania and Serbia) the existing legal framework is not fully adequate

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76 The National Securities Commission of Romania (Comisia Nationala a Valorilor Mobiliare or “CNVM”) is the securities market regulator. CNVM was established in October 1994 as an independent regulator, accountable to the Parliament, with the authority to impose fines and issue legally binding regulations.

77 Capital market Law, art 225

as to support and impose an appropriate transparency and disclosure of related parties transactions.

The reporting related parties transactions currently are made just for compliance with existing provisions, in a formal manner, without any voluntary disclosures in generally.

We can conclude that the existing regulatory framework governing the reporting of related-party transactions is not sufficient or appropriate. The tax provisions are considered too vague, with no further guidance for implementation.

Currently in Romania, all the listed companies prepared the financial statements according to the international regulations (IAS and/or EU Directives).

The main problem is that the capital market institutions do not verify whether the information provided in the financial statements and in the appropriate notes is complete or not. National Securities Commission intensified its efforts to determine the Romanian issuers to report the financial statement. In this sense a large number of sanctions were imposed and as a result, more and more issuers are reporting the financial statements.

Finally, we must note the progress registered by Bucharest Stock Exchange where a wide majority of BSE issuers comply with disclosure obligations and the reports are most of the time complete and accurate.

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