

THE HAGUE UNIVERSITY OF APPLIED SCIENCES  
FACULTY OF MANAGEMENT AND ORGANISATION  
EUROPEAN STUDIES

# THESIS

## CORPORATE GOVERNANCE MECHANISMS IN THE BANKING SECTOR

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Less Fraud, More Transparency



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## EXECUTIVE SUMMARY

The collapse of the Corporate Commercial Bank in 2014 is the biggest financial fraud case that occurred in Bulgaria since it joined the European Union. The prosecutors' indictment defines it as a pyramid scheme case. It had a great impact on Bulgarian economy and politics, as its measurable impairment losses are as high as 5% of the GDP and continue to rise.

The focus of the current thesis is to examine corporate governance mechanisms and theories, and their applicability in the banking sector. Hence, the key objective is to answer the following central question: „*What are the corporate governance mechanisms that can help prevent corporate fraud from happening again?*” In order to do so a mixed research methods' approach was used to gather the necessary data. This approach includes qualitative and quantitative research.

The Theoretical Framework and Literature Review provides an in-depth research of the theories related to corporate governance mechanisms and practices, corporate trustworthiness, service quality and control, fraud detection, prevention and investigation. This regulatory framework covers a wide range of provisions from the establishment of financial institutions throughout the decision-making process, to insolvency procedures. Thus its application can contribute to minimizing the human factor, the principal-agent conflicts and other related flaws. This would be of substantial importance for stability and predictability.

The Case Study data was collected through the examination of the official indictment, official financial and institutional reports, and a variety of news media sources. These documents revealed poor governance practices within the bank and governmental regulators. Additionally, five interviews were conducted with representatives of some of the largest public companies in Bulgaria to substantiate the analysis and the conclusions.

The Analysis uncovers several main findings. Firstly, fraudulent behaviours and corrupt practices can be reduced through transparency, truthful accounting, independent auditing and corporate control mechanisms. Secondly, the main challenge for governmental regulators appears to be the restoration of confidence. This can only be achieved through institutional transparency, the adoption of tough control measures, the selection of qualified executive officers and adequate remuneration. Lastly, corporate governance mechanisms are only effective in a less fraud-oriented and more transparent environment with governmental supervision.

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**LIST OF ABBREVIATIONS**

ABIRD	Association of Bulgarian Investor Relation Directors
BACCOM	Bulgarian Association of Credit Cooperatives and Organizations for Microfinance
BDIF	Bulgarian Deposit Insurance Fund
BFTB	Bulgarian Foreign Trade Bank
BICA	Bulgarian Industrial Capital Association
BNB	Bulgarian National Bank
BNSI	Bulgarian National Statistical Institute
CEO	Chief Executive Officer
CCB	Corporate Commercial Bank
CG	Corporate Governance
CGM	Corporate Governance Mechanisms
CGIX	Corporate Governance Index
CPI	Corruption Perception Index
EBA	European Banking Authority
ECB	European Central Bank
EC	European Commission
EIOPA	European Insurance and Occupational Pensions Authority
ESA	Joint Committee of the European Supervisory Authorities
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FSI	Freedom of Speech Index
GAAP	Generally-accepted accounting principles
GSA	General Shareholders' Assembly
GDP	Gross Domestic Product
GMS	General Meeting of Shareholders
LMC	Liquidity Management Committee
MF	Monetary Fund
NCGC	National Corporate Governance Committee
OECD	Organization for Economic Cooperation and Development

## **1. INTRODUCTION**

For many years, researchers have studied the drive, consequences, and diverse aspects of corporate governance mechanisms and fraud. It has been established that the European Union (hereafter referred to as the 'EU') loses between €179bn and €990bn annually to fraudulent and corruptive practices, especially those related to public procurement projects (RAND, 2016). Such practices create inefficiency and hinder fair competition.

These researchers' findings have shed light on the nature and seriousness of corporate fraud. Most importantly, they have helped agencies and governments create strategies to detect, investigate and prevent fraud to a substantial extent. It is important to point out that in order to grasp the entirety of fraud one must not only examine it from a managerial perspective, but also from a humanistic and cultural perspective.

The purpose of this thesis is twofold. Firstly, it will introduce the available and most relevant research in the field of corporate governance, including the principal-agent relationship within the theoretical context of Barry Mitnick's and Stephen Ross' research; it will discuss corporate governance mechanisms; and, it will present the specifics of fraud theory. And secondly, it will attempt to identify a pattern to determine the most efficient manners to fight fraud. This will be achieved by examining a recent fraud case that occurred in Bulgaria in 2014, involving the 'Corporate Commercial Bank' (hereafter referred to as 'CCB').

### **1.1. Problem Definition**

The investigation of corporate governance and fraud theory is crucial for the development of strategies to fight fraudulent acts, such as the case of the CCB. It was one of the biggest banks in Bulgaria and had the highest percentage of state funds and state-owned companies' funds deposited in it. Many journalists, economists and analysts, both foreign and Bulgarian, speculate that the CCB case is a typical Ponzi or a pyramid scheme. Certainly, it is a combination of bad corporate practices (or the lack of good practices) that led to the bankruptcy of the CCB.

Studying this particular bank case in terms of its corporate governance practices – the internal and external mechanisms that in some way at some point in time were applied (or not applied) – will result in recognizing the most effective instruments for the investigation and prevention of fraud.

## 1.2. Scope of Research

The purpose of my thesis is to better comprehend corporate governance mechanisms from a managerial perspective, and their role in the prevention and detection of corporate fraud. It is of great importance to examine the existing European and Bulgarian legislation, to compile SMART (specific, measurable, achievable, relevant and time-bound) instruments, and to conclude by recommending the most efficient of these.

This will be helpful in the prevention of cases such as the CCB, which are very harmful to the normal functioning of market economies, people's trust in institutions, the banking sector and political stability. The CCB case portrays how the combination of external pressure, unrealistic audits, the lack of properly applied internal corporate governance mechanisms, and the lack of governmental support can lead an entire country into an unprecedented debt spiral.

The central research question is as follows: *What corporate governance mechanisms can help prevent corporate fraud from happening again?*

In order to accomplish the purpose of a bachelor degree thesis and to answer the central research question, the following research objectives were formulated:

1. Examine corporate governance theories and mechanisms since the emergence of the agency dilemma, and also, fraud theory, its motives and consequences,
2. Explore the effects of fraud on corporate governance and appropriate prevention mechanisms, in respect to the specifics of the case study,
3. Study the opinions of highly positioned managers, experts and other relevant stakeholders regarding the effects of fraud on corporate governance and the applicability of corporate governance mechanisms,
4. Identify the most efficient corporate governance mechanisms that can prevent and fight fraudulent activities within corporations.

The following sub-questions will be addressed in order to respond to these objectives:

- What are the relevant corporate governance theories and mechanisms?
- What are the facts behind the case study?
- What were the internal mechanisms which were applied/not applied in the case study?
- What were the external mechanisms which were applied/not applied in the case study?
- What actions did governmental agencies undertake?



- How do experts describe and analyse the CCB case?
- What can be learned from the failure of the CCB?
- What legislative changes occurred?
- What has changed in the functioning of financial corporations?
- Are these amendments considered sustainable, efficient and effective?
- What mechanisms could prevent such scenarios from happening in other banks?

### **1.3. Thesis Structure**

The thesis is divided into five informative chapters. Chapter 1 (Research Methodology) describes the research methods chosen for this thesis and presents the sources accessed during the research process. The applied methodology follows a mixed approach using both qualitative and quantitative research methods. The quantitative research includes thorough desk research and five elite interviews. The qualitative research includes the study of statistics and indexes.

Chapter 2 (Theoretical Framework and Literature Review) has two core purposes. The first is to provide the reader with a comprehensive theoretical foundation of the relevant concepts of corporate governance, its mechanisms and interconnectivity to corporate fraud. The second is to review all relevant literature, both available in online and printed publications. Therefore, Chapter 2 addresses the first two research objectives.

Chapter 3 (Case Study) serves as a descriptive narrative of the economic, political and social context due to which the case study was possible. It then describes all the facts related to the case, such as internal and external corporate governance mechanisms, and the causes and consequences of the collapse of the bank. The analysis of the case study narrows down the theory to one specific context, thus addressing the second, and part of the third research objectives.

Chapter 4 (Analysis) addresses the last objective by intersecting the reviewed literature with the specifics of the case study complemented by the interviewees' answers.

Lastly, Chapter 5 (Conclusions and Recommendations), summarizes the research results and answers the research question. In addition, it offers several recommendations of plausible improvements to corporate governance mechanisms in light of the outcomes of the case study.

## 2. RESEARCH METHODOLOGY

Corporate governance mechanisms entered the Bulgarian business environment relatively recently. They represent a new development in terms of legal framework, and there is little empirical research conducted in Bulgaria investigating their birth and evolution. Therefore, the analysis and conclusions draw upon the expertise of the interviewed professionals.

For the purposes of this thesis, I studied a wide range of publications – journals and textbooks in the fields of management, finance, accounting, and psychology; online sources, including interviews with specialists available on news websites. Additionally, I studied both European and Bulgarian legislation – documents available either on the official institutions' websites, or as hard copies in the institutions' archives.

Due to the CCB case being rather complex, the research methodology needed some restructuring. It was planned to conduct a number of elite-interviews with professionals related to the case study. Overall, about 80 highly positioned executives, governmental experts and academics were contacted. However, the intricacy of this particular fraud case, its *sub rosa* connections to politicians, oligarchs and media moguls, meant that many remained silent. As a result, five interviews were conducted with highly-positioned executives selected based on their expertise.

### 2.1. Research Strategy

The initial methods chosen for this thesis were: desk research, case study research and semi-structured interviews. Qualitative research methods were considered most appropriate given the complexity of the topic and the CCB case, as both the central question and the sub-questions required extensive analysis (O'Leary, 2004).

Desk research was essential to the preliminary findings. It resulted in the accumulation of theoretical data which the interviews later further contributed to. The interviews connected the theory to experts' practical experiences and professional opinions. In order to compile the information necessary to clarify the case study, two stenographic records were used. These records are available in Bulgarian on the website of the President of the Republic of Bulgaria. They were the best source of reliable and accurate information for the evolution of the case study. Furthermore, essential parts of the official indictment were accessed. The document is under special selective restriction of access within the premises of the Courthouse requiring a lengthy procedure for the authorization for its study.

Semi-structured interviews were conducted. They consisted of one section with ten theoretical questions and another section with seven practical questions about the financial sector and institutions. However, due to interviewees giving either vague or interesting answers, questions were added in the process of the interviews. Transcripts in Bulgarian were written for each interview, and were later translated into English. All responses were grouped into categories, answering a particular sub-question or objective. The interview questions and the translated transcripts can be found in the Appendix.

In order to systematically answer the central research question a specific fraud case was also chosen as a research method, studying a specific fraudulent situation that occurred in the corporate banking sector. Through it the theory could be adequately tested – validated or refuted. Moreover, it allowed narrowing down the research of the thesis. Though it did not allow answering the central question completely, it gave a number of indications that could further be elaborated via the interviews, allowing the creation of a number of hypotheses. The essence of this case study was that it verified corporate governance theories and mechanisms against the real business environment in Bulgaria.

It was of utmost importance to accomplish a more credible, transferable, yet reliable and objective research, thus some secondary analysis of data was undertaken. A number of indexes were used, such as the Corruption Perception Index, the Freedom of Speech Index, and others, and also some economic data was accessed on the website of Eurostat, and also on the websites of the Bulgarian National Bank and the Bulgarian National Statistical Institute.

## **2.2. Sampling**

The interviewees, being professionals on a managerial level, were selected for their profound knowledge of the mechanisms, added values and complexities of corporate governance practices. More importantly, they were chosen for their familiarity with the corporate banking sector and in particular with the case study.

Professionals were identified and contacted at all stages of the research process. When the persons confirmed that conducting an interview was feasible it was established whether this would happen face-to-face or over the phone. All five interviewees were well informed about the objectives of the thesis, and also, prior to conducting the actual interview they were informed of the requirement to record the process.

Three persons are representatives of the largest public companies in Bulgaria and two are senior management experts in the field of corporate governance and corporate law. One of the interviewees, Mr. Mithankin, is an active participant in the development, discussion and adoption of the National Code of Corporate Governance of Bulgaria. In addition, the holding corporation that he represents is part of the definition of the Bulgarian Index for good corporate governance standards and assessment.

Figure 1 offers a list of the interviewees, their education and professional expertise.

Mrs. Bilyana Katsakova	Jurist
Shareholder and Partner, International Consulting JV and Austrian Investment Fund Golf Imobilien LLC	
Mr. Dimitar Djutev	Jurist
Shareholder and Partner, Transvagon JSC, Italian Enterprise Luxinvest LTD, Eurolex LTD, Agro 5 LTD, Agro 7 LTD, Etter LTD, BB Unionsport LTD	
Mr. Galin Petrov	Engineer
Shareholder and Board of Directors Member, Sunny Beach JSC, DIDKO Limited JSC, Gimel JSC; Owner, Total Engineering LTD, Transcontinental Business Consulting LTD	
Mr. Nikolai Mithankin	Economist
Shareholder and Director for Investor Relations, Stara Planina Hold PLC; Board of Directors Member, Association of Investor Relations Directors in Bulgaria; Member at the Union of Economists in Bulgaria	
Mrs. Svetlana Georgieva	Jurist
Corporate Attorney at Law, Supreme Bar Association	

**Figure 1. Professional Profiles of Interviewees**

It is important to note that the interviewees have on average more than 20 years of professional experience. Their opinions are the fruit of their expertise. Sampling error may be present due to the lack of representatives of the academic and institutional spheres, and also, professionals who had been involved in the evolution of the case study. Thus, it is possible that external validity may be hindered to some extent. In order for this to be avoided, a large number of academic resources were consulted during the desk-research, as well as documents, such as the financial statements and reports of the bank, reports from institutions and the official indictment.

### **2.3. Data Analysis Framework**

The “web of meanings” came as a result of putting together two key ingredients, namely the theoretical background and the cognitive map, and constructing a network of valid connections. Additional literature was sought out when necessary in order to have a meaningful analysis (Strauss & Corbin, 1990). The chapter’s objectives were reached by:

1. Preparing an exhaustive interview questionnaire by compiling all important principles of corporate governance during the theoretical study,
2. Conducting interviews with experts, shareholders and members of Board of Directors who responded to the approved questionnaire,
3. Writing an analysis of key features by combining all interview results with the theory and also the instruments that are put in place already. The analysis was done gradually in terms of the topics that arose. It compares theoretical data to the real business environment and also to the case study when applicable.

Prior to creating the homogenous text all interviews were transcribed, translated and analysed in order to uncover and categorise patterns. This was the only efficient way to make a comprehensive order of the themes to be discussed.

### **2.4. Ethics**

Applied social research requires high ethical standards, especially when it involves the participation of people. It is crucial that these principles protect the rights, dignity and privacy of the interviewees when requested (Bryman, 2008). These norms were applied throughout the interviews, the *post factum* transcription and translation (Davidson, 2009). When initially contacted, the interviewees were not only presented with the research topic and interview questions, but also with an Informed Consent Form (see Appendix 8.2.). Where anonymity or confidentiality was requested, or off-the-record comments were made, interviewees were respected. Transcripts and translations were sent for their review prior to their submission to the supervisor of the research process.

### **2.5. Limitations & Potential Issues**

The chosen research design had the purpose of strengthening the validity of findings by eliminating or mitigating potential limitations. Despite these efforts the conclusions and recommendations were victim to certain issues (Shipman, 2014).

First of all, the CCB fraud case consists of multiple layers, behind-the-scenes connections between oligarchs, politicians and the management of the bank. Secondly, it portrays diverse corporate governance mechanisms giving the researcher the freedom to elaborate on a wide spectrum of topics. Lastly, it has had an immense impact on the Bulgarian economy, political and social environments. However, it represents only a single fraud scenario.

Due to the complexity of the issue and its characteristics, many specialists, academics, stakeholders and shareholders who were initially contacted refused to be interviewed. The final interviewees represent non-financial institutions. This allows them to elaborate to a greater extent on the first section of the interview questions.

Further constraints arise from the fact that the case study required thorough research, which was also a complicated process as data was scarce and difficult to access. Initially, it was possible to construct a potential storyline only based on online news media. This later needed validation through the use of the indictment, stenographic records and stakeholder interviews. This was important as media are increasingly being bought by a single media group, making them biased and censored.

The stenographic records were in a format and length suitable for the purposes of this research, while the indictment consisted of close to fifteen thousand pages. This further complicated the evaluation of the hypotheses and potential working mechanisms that could be applied in the future. Nevertheless, multiple attempts were made to confirm the hypotheses.

Though these are all valid concerns a critic can comprehensively evaluate the validity of this study's outcomes given that the research process was very well documented.

### 3. THEORETICAL FRAMEWORK & LITERATURE REVIEW

The theories that explore the essence of corporate governance have emerged in the context of the theory of the corporation. They provide an understanding of the development of corporate issues such as the agent-principal problem, the role of shareholders and Board of Directors etc. Moreover, the theories explain the complex connections with the market environment in which a corporation operates (Padgett, 2011 ).

Empirical projections of corporate governance theories are important to the development and effective operation of corporate agents. There are two main groups performing special functions. The first group are the internal agents – the shareholders, who have ownership control, and also, the Board of Directors and executives with coordinative and executive functions. And second, the external agents – the stakeholders, who have monitoring and controlling responsibilities, and the stock exchange, which in its essence is the public performance evaluator.

#### 3.1. Fundamentals of Agency Theory

The theory of agency, also called the Principal-Agent theory, reflects one of the oldest discussions in corporate theory mainly related to the division of labour by leadership from the subject's property. It will be incorrect not to mention that the principal-agent relationship has been noticed by the classics of economics theory – Adam Smith, Alfred Marshall and Karl Marx.

The theoretical perceptions of agency theory or the contract between the principal (the owner) and the managing manager (representative-agent) appear in the late 1970s' on the scientific arena. Two scholars – Stephen Ross and Barry Mitnick, propose an economic theory of agency and an institutional theory respectively. Ross regards agency theory through the prism of *compensation contracting*, wherein in its essence it is a problem of the distribution of incentives (called the Economic Theory of Agency) (Ross, 1973). Whereas, Mitnick regards it as a system encompassed by institutions that evolved in order to adequately handle agency's imperfect relationships. These institutions were created by society not only to manage or buffer these imperfections, but also to adjust to them or sometimes even become distorted by them (Mitnick, 1975). Hence, in order to thoroughly comprehend the entirety of agency theory, we have to study both the incentivization and institutional perspectives.

An agency relationship, as Ross writes in his earliest papers on the topic, “is one of the oldest and commonest codified modes of *social interaction*” (Ross, 1973). Qualifying agency theory as society's generic issue Ross' work is set apart from the already available research by scholars, such

as – William Baumol, Robin Marris, Oliver Williamson (the modern originator of the theory of transaction costs), Armen Alchian and Harold Demsetz, on topics related to theory of the firm. Moreover, his work contrasts with the work of researchers like Kenneth Arrow, Michael Spence and Richard Zeckhauser, Jacob Marschak and Roy Radner, who all examine the connections between action, uncertainty and information.

Ross suggests that agency theory arises between two or more parties “when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal, in a particular domain of decision problems” (Mitnick, 1993). All relationships that are contractual (as between an owner and manager, creditor and debtor, landlord and a tenant, etc.) in their essence illustrate key agency relationship elements.

Focusing the attention on a specific problem, namely the characteristics of the contract between the principal and the agent, is the merit of Michael Jensen and William Meckling in their 1970s’ work, which has had influence in further literature. It is based on the presumption that the company’s activities can be seen as a set of links formalized by contracts between the holders of resources of diverse kinds (Jensen & Meckling, 1976). This occurs when the owner (or group of owners), called the principal, hires other individuals called agents to perform an activity for which they delegate their decision-making power. The research over the dangers of a moral conflict between shareholders and corporate managers, derived by Jensen and Meckling, is highly fruitful, allowing for subsequent study that can be defined in three main areas: the implementation of an optimal contract; the effect of the contract on the managers; the effect of managers’ actions on the company’s performance (McColgan, 2001).

The first time Mitnick’s agency appears in a political science context is in 1984’s *The New Economics of Organization* by Terry Moe. Moe explores the implications of the principal-agent model onto public organizations intersecting it with the theory of competition and decentralization on the basis of neoclassical economics (Moe, 1984). Then, in 1987 the theory is first reviewed in a sociological manner in light of its implications of personal relationships, trust and fidelity, and the post factum problems created (Shapiro, 2005). Despite the fact that Mitnick’s work had been cited throughout the years in many researchers’ papers from a wide span of fields; and also, despite the fact that he laid the foundations of the essential concepts and logics of the theory, his work remained relatively unidentified as the originator of the theory of agency along with Ross’s economics-related application.



### **3.1.1. Institutional Agency Theory**

As a political science student with a distinct interest within the realm of public choice, Mitnick viewed agency theory through an institutional perspective, opposed to Ross' econometric analysis. He believed that there are both social and institutional methods by which the "ice-cream cone problem" could be solved.

In his 1973 work, he was the first to identify the fiduciary norm as a social one, and also, define its boundaries. The norm asserted that the agent has to strictly follow the principal's interests without taking even into slight consideration self-interest. In addition, the agent has to use the full capacity of his own skills, to put all necessary effort and time into the completion of the principal's expectations, and also, to minimize the competition risks that potentially could negatively affect the actions of the agent. The agent is expected to be scrupulous follower of the contractual (or verbal) promises that he has made. Moreover, all relevant actions and information must be kept confidential, except in the communication with the principal. In fact, the agent is supposed to keep the principal well informed, especially in cases when competing interests might be evident (Kolb, 2008).

The norm was intersected between three essential elements. The first element was the consensual relationship between the agent and the principal, that is, contractual agreement which may also not be formal. The second was the principal's vulnerability in regards to the agent's actions. The last element was the agent's degree of discretion over the benefits that the principal is ought to receive in return as a result of the agent's actions and choices, meaning, that the agent clearly has a strong impact on the principal.

The fiduciary norm gives guidance as to the behaviours of the agent and the principal. In accordance to it, the agent (the fiduciary) is expected to pursue with persistence and effort the principal's expectations and interests. Given the fiduciary's discretion degree, and also, the probable limited directions from the principles, the fiduciary is moreover expected to carefully evaluate and select appropriate acts so as to maximize the principal's outcomes. The greater the discretion degree of the fiduciary, that meaning, a greater dependency on the fiduciary, the more he or she has to abide to the norm. Agents who have principals highly dependable on them must in return put extra time and work to satisfy the principal's desires (Kolb, 2008).

There are, moreover, three sub-norms intertwined with the fiduciary norm, contributing to the principal's protection, namely: confidentiality, full disclosure and good conduct. Based on these the fiduciary is expected to withhold confidential information; to disclose all information that

might affect or oppose the principal's interests; and also, to behave professionally so not to impair affiliations with third parties, and to maintain good liaison with the principal.

### **3.1.2. Positive Effects of Agency Theory**

The theory allows for three positive projections to be defined. Firstly, the basic conflicts in the corporation are defined. They are driven by the ability of the agent to have almost unlimited rights over the management of the corporation. Conflicts arise between the principal and the agent (or the Board) due to differences in their goals and interests, the agent's assumption of financial risk, or because of large loans – a decision taken by the agent. The latter meaning that in general the interest of the creditors is to give a large credit, though the risk of bankruptcy remains for the principal. Secondly, a methodological basis is formed for the development of franchises, which is one of the modern forms of entrepreneurship. And lastly, proxy voting is introduced, by the means of which the direct participation of shareholders in the General Meetings' decision-making process is largely reduced.

### **3.2. Transaction Costs**

The Transaction Cost Theory is based on the study by Ronald Coase, who first focuses on the fact that the degree of rationality of the firm is directly dependent on the framework of the use of internal and external contracts (Coase, 1960).

O. Williamson, basing his work on Coase's, rehabilitates the idea of optimizing the structure of the firm when it is in the process of growth. He designates three focal points. The first is the specific structure of corporate governance as an alternative to market regulation. The second is corporate governance, based on relationships, contracts and transactions for their existence between the firm and the suppliers, the labour market, the capital market, the regions, etc. And the last, the management costs, which are public by nature for each individual investor and subject to regulation and control by the owners.

Williamson spends a significant amount of time and effort over his theoretical concept of the new position on the Board of Directors (hereafter referred to as the 'Board') and its role as a mediator in the corporate guide. He defines the following specific obligations: the holder of the function of a defender of interests of the shareholders; a mediator of the interests of the managers and the shareholders; mediator of the interests of the shareholders and the corporation as a whole; mediator of the interests of the corporation and the stakeholders.

The theoretical rationale for the function of a mediator of the Board has a particularly important projection over corporate practices. A similar understanding of the place and functions also defines his new vision of its composition and structure, which later became widely applicable in the practice of US corporations to attract the so called Independent (or External) directors (Williamson, 2007).

### 3.3. Stakeholder Theory

The stakeholder concept is a very old one dating back in Anglo-Saxon law. In its original interpretation it means an ‘individual who keeps the money, property or stake of other individuals in a particular place (stake) until their owner is established’.

The contemporary source of introduction of the term stakeholder (an interested party) in the corporate governance system should be sought in the Corporate Social Responsibility Theory (hereafter referred to as ‘CSR’). It emerged in the years after the Great Depression in the United States. Massive bankruptcies, the collapse of hundreds of funds and private investors revived the public debate on CSR.

It is considered that from then on the issue of stakeholders is relevant to the management and the economic theory and practice. Stakeholder theory emerged later in the early 1970s through the work of E. Fama and R. Freeman (1983) and M. Jensen (1984) in response to the expectations of increase in the social responsibility of modern corporations (Fama & Jensen, 1983).

The term includes individuals, groups and institutions that have no direct relation to the final financial result (and are not involved in its distribution) of the corporation’s activities. They have keen interest in social and financial outcomes of its activities, insofar as they affect the environment in which they live. The new understanding of the term is much wider and includes a set of versatile carriers of (indirect) interests in the corporation. Hereafter, stakeholders in a corporation are individuals, groups or organizations whose interests may be affected by the action (or inaction) of the corporation.

Stakeholder	Stakeholder’s interest	Stakeholder	Stakeholder’s interest
Owners/Shareholders	Profit, Execution of objectives, Direction	Trade unions	Working conditions, Minimum wage
Country/State	Taxes, Legal framework	Users	Quantity, Quality, Customer care
Board of Directors	Implementation, Goals, Remuneration	Creditors	Liquidity, New Contracts
High authorities	Remuneration, Work,	Local authorities	Work places,

	security		Inclusion in Social life
Employees	Remuneration, Security, Pension fund	NGO	Ecology, Information, Transparency
Stock exchanges	Reliability, Liquidity		

**Figure 2. Stakeholders and their interests**

### **3.3.1. Critiques of Stakeholder Theory**

The main focus of criticism against stakeholder theory refers to the necessity of corporation's profits reduction conditional to the increased social responsibility costs.

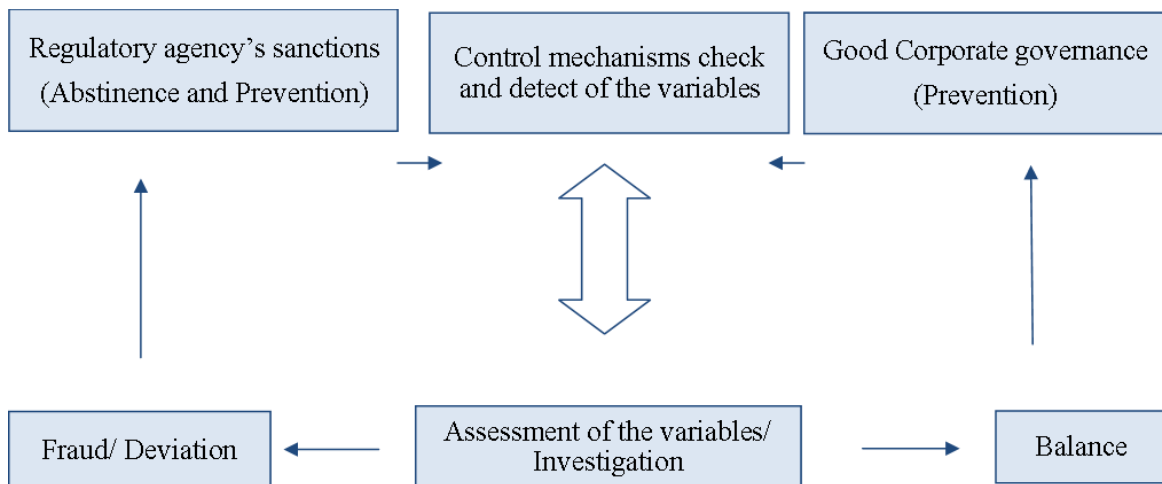
### **3.3.2. Positive Effects of Stakeholder Theory**

The most important positive effect of the theory relates to the creation of tools for external control of the activity of the corporation. The scope of their action is subject to lively discussion, but the most effective ones are: the external directors' institution, the minimum wage system, systems for direct and proxy voting, the disclosure of information, the inviolability of the pension fund, External independent audit, etc.

## **3.4. Control Mechanisms for Fraud Detection, Investigation & Prevention**

Historically, Montesquieu's "Spirit of Laws" (1784) is considered the first source that refers to the control mechanisms for fraud detection, investigation and prevention. The doctrine explained how the political sovereignty could be equally distributed and independently functioning as a mechanism against tyranny and in favour of liberty.

Control mechanisms, generally are methods that support better inter-agency management in a desirable way and guard against fraud and other adverse behaviour. These are widely known as the system of checks and balances.



**Figure 3. Control Mechanisms**

The correlation between agency theory and the system of checks and balances can be identified as separation of rights, duties and responsibilities among top management, directors, and employees. This helps with the reduction of expenses related to disagreement between agents and with determining the best incentives for desired action and behaviour.

The fundamental principal-agent problem occurs when agents use the power for their own benefit instead. Companies try to correct the deviation by instituting measures such as monitoring, watchdog organizations, incentives for good behaviour, and sanctions for adverse behaviour. Thus, the system of checks and balances minimizes mismanagement, conflict of interests, corruption and fraud.

Recently, the separation of power became an element of the concept of good corporate governance. The governance of corporations is like governing a sovereign state – it has policies, codes, management and employees; it intends to develop accountability and prosperity, to avoid failure, to eliminate problems before their occurrence, to address the needs and expectations of the members.

The system of checks and balances provides such control mechanisms that protect against internal problems due to negligence or deliberate unlawful actions. For example, banks execute financial transactions in their daily business – accept deposits, pay interests, provide loans, mortgages, pay checks, provide other financial services authorized by the local regulators. The power to make decisions and the duty to verify its proper execution is distributed among different departments. The system emphasizes interdependence of entities without interference and creates data for auditing.

By examining multiple Corporate Governance Codes, Heugens and Otten identify at least five mechanisms expected to correct the deviation, namely:

1. Organizational arrangements – control over executive agents through internal checks and balances. The creation of an appropriate organizational arrangement reflects the concept that the best way to control executive agents is to create an institutionalized structure. It defines the separation of powers that checks and balances the management activities. Each agent entity has to ‘check’ the other entity and to ‘balance’ the powers;
2. Ownership concentration – major deterrent to managers’ opportunism are large shareholders;
3. Legal protection of small shareholders – in case of scattered property;
4. Empowering management – an alternative view of control based on good stewardship model (Davis, Schoorman, & Donaldson, 1997);
5. Managers’ assessment – controls the flows of reprimand and encouragement directed at them.

The system of checks and balances establishes monitoring for proper implementation. It is important to ensure that no individual or structural unit will increase the risk of centralization over decision-making process (Demsetz, Saidenberg, & Strahan, 1997). Besides, the system of checks and balances serves to decrease mistakes, to avoid inappropriate activities, to prevent corporations’ collapses and bankruptcies especially of corporations that operate in transition economies (Heugens & Otten, 2005).

#### **3.4.1. Internal Control Mechanisms**

The primary control mechanisms for a corporation come from its internal monitoring, reporting and taking corrective measures when the risk climbs up and the liquidity goes off the track. Internal mechanisms include composition of the Board, clear distribution of duties and responsibilities, independent internal audits and controls, supervision of management and implementation of best practices.

The Committee of Sponsoring Organizations of the Treadway Commission (hereafter referred to as the ‘COSO’) identifies several factors that cause fraud in financial reports. COSO presents recommendations for decreasing the reasons for fraud – a common system with regulations on governance. According to the COSO model, internal control is a process influenced mainly by the Board, executive officers and personnel that is engaged in the maintenance of financial security of the corporation, consisting of:

1. Efficiency of operations;
2. Accountability of the financial reporting;
3. Implementations of the regulation.

Internal control in the public sector is regulated by the Financial Management and Control in the Public Sector Act (Promulgated State Gazette, 2013) applied in the following organizations (Council of Ministers, 2006):

- Budget organizations and municipal enterprises;
- Organizations that operate with funds guaranteed by the government of Bulgaria;
- Organizations that provide funds under the Programs of the EU;
- State and municipal enterprises and state-owned enterprises that are not commercial companies;
- Other organizations that operate with public funds by the statutory instrument.

The responsibility for financial management and control is a duty in the hands of the corporations. They are obliged annually by 31<sup>st</sup> March to provide information to the Minister of Finance for the functioning, adequacy, efficiency and effectiveness of the management and control system (Law for financial management and control in public sector, 2006).

It is important to note that managers can delegate their powers to other officials within the corporation. These delegated powers do not release the manager from his responsibility in case of failure.

The **double signature** is another special control mechanism. The signature of a person responsible for the accounting entries – a chief accountant, a financial director, supervisor or other person responsible for the finances and accounting, is required to express familiarity with business transactions and if necessary, prevent from mistakes. The System of Preventive financial control is established by an order of the Minister of Finance, specifying the financial quaestor, the type and volume of obligations and the expenses to be covered, the duration, liability and other matters (Law for financial management and control in public sector, 2006). It is a mechanism that controls the compliance, legality, effectiveness, efficiency and the economy (not just the lawfulness of the financial controller), applied by expressing the opinion of a financial quaestor before committing and incurring expenses determined by the Minister of Finance.

In Bulgaria, the auditing conforms to the international auditors' standards (ISA) and combines them to the Guidance on Audit and Ethics Codes, regulated by the International Audit Federation.

The **Structure of a corporation** provides further framework and stability. The set of chosen structures determines the organizational boundaries of leadership behaviour (Ensley, Hmieleski, & Pearce, 2006), limiting and controlling internal interrelationship. The strategic vision, objectives, and guidelines for best practices can be achieved by setting up committees to the Board working in the interest of shareholders (Gedajlovic & Shapiro, 1998), namely:

1. A Nomination Committee – guaranteeing a fair and balanced selection of new members of the Board with relevant competences;
2. An Audit Committee – providing reliable information on the state of fineness and perpetuity of the corporation;
3. A Remuneration Committee – responsible for defining the rules of remuneration for senior management so to ensure the possibility of attracting and retaining capable cadres, but such that would be relevant to their contribution to the corporation.

Moreover, the corporate governance structure may vary based on the shareholder or stakeholder models. In the US, UK, Australia and Canada, the shareholder-oriented model in terms of the concept “increasing the shareholder wealth” is widespread. The stakeholder model, including employees, tends to be common in Continental Europe and Japan. It increases the wealth of the corporation and protects the jobs. Corporations of either models or having a combined hybrid model with elements target to implement good governance practices protect the investors and ensure profitability.

The **Board of Directors** has to be bound by agreements so that the roles and duties of the chairperson and executives are truly independent – for example, representative of the shareholders and representative of customers. **Statutory responsibilities of directors** are an important mechanism that ensures honest and open communication with all stakeholders (investors, top management, employees, and customers).

**Revision** is a process that determines whether the data presented by the financial reports correspond to the criteria.

**Internal audit** is an important ongoing internal control mechanism regulated by the financial institutions. The principles of the Corporate Governance Code recommend establishment of an internal control department that will monitor the banking activities and reports its observation such as:

1. Detect fraudulent activities,



2. Monitor operating results,
3. Verify financial reports,
4. Identify adverse management,
5. Provides recommendations,
6. Report to audit committee and top management.

Banks are also required also to establish an **Audit Committee**. Its members are appointed by and report to the General Shareholders' Assembly. Its main duties include monitoring, control of the information in the annual financial report and presenting recommendations to the management in compliance of the internal control mechanism. Transparency of information and the disclosure of Audit Committee's activities are considered restricted, and their reports do not unveil whether they are playing any effective control role in the banking sector or not.

**Transparency and mandatory disclosure** are important elements of a bank's regulation and good corporate governance. For examples, annual financial reports have to be verified by independent auditors and publicly disclosed. There is a range of bank decisions that are listed for immediate disclosure. These include information and decisions that may have financial consequences on the share price. Mandatory disclosure provides shareholders with confidence to continue their investments.

**Internal rules and code mechanisms** ensure accountability, fairness and transparency in the corporation relations with shareholders, executed by the Board.

**The codes of corporate governance** recommend guidelines accepted by the management and employees to conduct their actions in accordance with their contractual liability and moral values such as trust, good behaviour, and fairness. For example, guidelines recommended by the UK's Cadbury Committee describes corporate governance as a system by which corporations are "directed and controlled" ('Code of best practices' of 1992) and present recommendations for the executive directors and agents responsible for monitoring, reporting and control. Although, they are not mandatory, the London Stock Exchange expected all publicly listed corporations to declare whether they comply with them, if not, why.

Corporate regulations enforce a range of duties on directors, including fiduciary duties. Directors have to exercise highest degree of loyalty and care in preservation of principal's assets (cash, property, bonds, options, and shares), information or opportunity. The deviation occurs when directors operate for their own private benefit.

**Incentive stock options for senior executives** provide the right for directors to buy or sell a corporation's ordinary shares at a fixed cost and for a certain period. Initially, the role of incentive stock options is to encourage high level management (CEO, VP, executive directors, high level executive officers, high level financial officers, and other) to operate in favour of shareholders. It is included in their executive compensation package.

Deviation occurs when directors manipulate the market price and backdate stock options. In such occasions they have substantial financial benefits. Financial experts criticize stock options that can be directed to short-term capital cutting (liquid funds or assets), as the corporations will suffer from shortage of assets in the future.

**The compensation package mechanism** includes direct (salary, bonus, commissions) and indirect benefits (pension plan, insurance, trainings) provided to senior level executives who serve the owners' interests. It also includes dividends (a share of after-tax-profit). The amount and distribution of the dividends is within the responsibilities of the Board. It is considered that a compensation package reduces senior level executives' intention to take risky-investment decisions. Additionally, managerial moral hazard based on illegal motivation can be reduced.

Moral hazard circumstances increase the probability of losses. They can be regulated by strict sanctions such as 'recommended interest-rate-ceilings' (established by the market or as a governmental requirement), banking reserve and liquidity, asset restrictions and license segregation of commercial banking from insurance and investment banking. The positive effects of law regulations narrow the scope of authority delegated by the principal (in the frame of their contractual relationship) to agents to deal with highly risky markets.

**Reduction of agency cost mechanism** is a process of monitoring, supervision and removal of agency cost (consulting, taxes, and trainings, etc. non-operating expenses) to boost profits. These costs are associated with nomination of trustworthy Board and skilled employees that will benefit to the prosperity of the corporation. The Nomination committee has the duty of identifying the skills needed and evaluating the candidates for the Board and also, whether they would be able to achieve the desired goals. Nominated candidates need to be approved by the central regulatory institution to proceed further with required activities.

**Deposit insurance** provided by the central bank is mandatory and pays demands from the pool of funds. On one hand, depositors rely on the government to guarantee their deposits from adverse corporations. They are comfortable to give their assets to banks with the highest rate of interest. On

the other, banks rely also on the governmental deposit insurance. In order to grow, they pay highest possible rate of interest to attract maximum cash.

Deviation occurs when banks depart from the risk-based capital requirements (to have more money on hand) and execute risky capital investment and spending.

Shareholders possess the exclusive right to manage the corporation and to construct control mechanisms. However, most shareholders in the banking sector are investors with small portions such as individuals and institutional depositors. Minority shareholders have the right to call a General Shareholders' Assembly (GSA), to propose topics for discussion to the agenda, and to nominate board members. In case of capital matters, shareholders are endowed with general assessment and blocking rights. They have no enough resources to constantly monitor, observe, inform or control the implementation of principals and the performance of agents.

Financial institutions (depository and non-depository corporations) are obliged to provide shareholders with notifications and materials for the growth of the corporation. Due to its dynamic nature, the disclosure of bank operating statements (monthly report on deposits, withdrawals, checks, earnings, transactions) is very costly (Bhattacharaya, Boot, & Thakor, 1998). Though, financial affairs are considered as confidential that narrow the scope of the publicly available information.

A **derivative action** is a statutory procedure (a lawsuit) that provides shareholders with the right to take action on behalf of the bank against its directors or employees for breaking their fiduciary duty, for mismanagement or other serious violation. It is an important control mechanism that restrains executives from negligence and moral hazard (Bainbridge, 2009).

#### 3.4.2. External Control Mechanisms

External control mechanisms are such executed by external supervisory institutions located outside the corporation. These include state regulators, sector organizations, revenue institutions, external audit institutions, other corporations and political governments. They have the exclusive right to provide recommendations as well as sanctions upon implementation of certain standards, legal regulations and guidelines of good governance compliance. These external supervisors report to shareholders and other stakeholders through direct and indirect means of communications.

The **Independent Audits** operate as the 'guardian' of the regulatory accounting. Auditors provide systematic examination and verification of annual financial reports, prepared by the internal audit department, transactions reports, and books of account. Their specific objective is to determine

whether the accounting reports are correct and true; whether they correspond to the regulations of the Generally-accepted accounting principles (hereafter referred to as 'GAAP'); and also, whether they present actual financial operations.

They provide independent accounting based on their professional accountability. If the financial reports are incorrect, with mistakes and adverse practices, the external audit has duty to advise appropriate measures, including recommendations on how to solve the problems. Additionally, auditors notify other external stakeholders (state regulators, investors, employees, shareholders).

Any qualified independent auditor can identify strengths and weaknesses of systemic risk practices in the banking sector, pushing banks to reform. The lack of professional attitude therefor leads to failures, which require more regulations such as rotations of auditors, consulting limits, etc.

Deviation occurs when independent audits are de facto not independent and become ineffective, not adding value to the economic sustainability. Instead, they act as social parasites that consume resources, increase agency costs and bankruptcy risk.

Government administration has to be committed and encouraging to independent audits that report weaknesses in corporations. However, the recent collapse in the banking sector in Bulgaria has revealed 'simulated accounting' practices and political negligence.

In Bulgaria, the independent audits are exercised by accountants registered in the Institute of Certified Public Accountants in Bulgaria.

**Credit rating agencies** rank corporations issuing bonds. They are a very influential control mechanism that has played a significant role in the most recent global financial crisis. The rating agencies in the United States, for example, exploited their regulatory status to profit from the booming mortgage market (Reiss, 2010).

Consequently, various countries are now introducing rules regulating credit rating agencies, for example, the SEC has proposed that rating agencies are required to disclose 100% of their rating actions in a publicly accessible format (Hunt, 2009).

There have also been suggestions that the rating companies should be held liable to the investors in residential mortgage backed securities that have lost large amounts in the recent financial crisis (Nelson, 2009).

**Corporate Governance Index** (hereafter referred to as ‘CGIX’) was chosen as a name of the index. It was also decided that the original technical calculation and the dissemination of the information will be made by the Bulgarian Stock Exchange-Sofia.

The index was defined to consist of seven companies, weighted by their market capitalization adjusted for free float of each one of them. Its base value was set at 100 points and the date of calculation was determined on 19<sup>th</sup> September 2011.

According to the rules adopted to calculate the index, the included companies are subject to periodic review in June each year, while the coefficients of free-float are reviewed every three months by analogy with the indices of the Bulgarian Stock Exchange-Sofia.

The National Corporate Governance Committee has included in the index as of June 2012 the following companies:

1. Stara Planina Hold AD-Sofia
2. Monbat AD-Sofia
3. Sopharma AD-Sofia
4. Industrial Holding Bulgaria AD-Sofia
- 5. Corporate Commercial Bank AD-Sofia**
6. Kaolin AD-Senovo
7. Enemona AD-Kozloduy

**External control agencies** examine the implementation of best practices in corporate governance. They are very useful due to exchange of information through seminars and other activities. In Bulgaria these include:

The **National Corporate Governance Committee** (hereafter referred to as ‘NCGC’) was established in September 2009 on the principle of public-private partnership for consultations and cooperation at a national level on matters of corporate governance. NCGC is the successor of the Working Group on Corporate Governance – author of the Bulgarian National Corporate Governance Code.

The NCGC’s main activities, set out in its ‘Rules for the Structure and Activity’ include:

- Encourage the implementation of best practices in corporate governance,
- Monitor the implementation of the Bulgarian National Corporate Governance Code,
- Reviewed the Code every 18 months or initiate changes where necessary,

- Develop mechanisms to monitor the implementation of the Code,
- Follow and comply trends of corporate governance at the national and international level,
- Prepare recommendations to regulators to improve corporate governance,
- Development and presentation of guidelines for best practice in specific areas of corporate governance,
- Prepare and publish annual assessment of the state of corporate governance in the country,
- Cooperate with similar institutions in other countries and their associations, and international organizations.

With regard to the decisions passed by the National Corporate Governance Commission, BSE published on its website a Corporate Governance Assessment Scorecard, which was adopted by the Commission.

The **scorecard** is a tool that assists companies with applying the basic principle of the National Corporate Governance Code ‘comply or explain’. Thus it enables the companies to carry out self-assessment on the extent to which they implement the principles and recommendations set out under the code in their operations.

As a result of the campaign undertaken by BSE to promote the Scoreboard, most of the companies which had declared observance of the National Code of Corporate Governance principles, presented a completed Scorecard to the Exchange. Based on the completed questionnaire and a quantitative examination undertaken in order to satisfy the predefined requirements on the companies’ liquidity, a number of interviews were conducted with those companies qualifying for inclusion in the Index.

The **Bulgarian Industrial Capital Association** (hereafter referred to as ‘BICA’) was founded in 1996, mainly with the responsibilities to:

- Protect the interests of its members before the executive and legislative authorities at national and European level,
- Influence the preparation of regulations and policies of good corporate governance,
- Make systematic efforts for improving the competitiveness of Bulgarian enterprises, creating favourable business environment and enhancing the Bulgarian economy in general,
- Support the implementation of policies to ensure macroeconomic stability and budget discipline, improving the business climate and the sustainable economic growth,

supremacy of law and implementation of contracts for business security and property inviolability.

The **Association of Bulgarian Investor Relation Directors** (hereafter referred to as ‘ABIRD’) was established on July 8th 2005, mainly with the responsibilities to:

- Integrate the achievements of the EU countries in the field of capital markets and corporate governance in the regulatory framework,
- Elaborate legal framework regulating the development of the activity,
- Protect the rights and interests of the members of the Association before the financial supervision authorities and any other entities and institutions – participants in the capital market,
- Support the creation of a favourable economic, cultural and public environment for the local and foreign capital as well as for attracting foreign investments in the country;
- Improve the qualification of the IR Directors,
- Improve the statute of investor relations as a strategic corporate function,
- Raise the standards for information disclosure intended for investors.

The **Bulgarian Association of Credit Cooperatives and Organizations for Microfinance** (BACCOM) was established in 1999. Its mission is to support the development of ethical finance in Bulgaria by introducing ethical financing of small entrepreneurs, the realization of objectives in the field of regional development, social support, reducing differences and also, it works for an approval as an equal partner of the European and world organizations for implementation of joint projects, programs and other initiatives.

#### **3.4.3. Governmental Control Mechanisms**

The law regulation and supervision mechanism in the banking sector requires not only a special compliance of corporate governance principles and guidelines but also involvement of the political sovereign through law regulations. Principals and agents are subjects to special law regulation system in the banking sector. Banking legislation emphasizes on stability and reliability of the market system. These specific regulations are enforced by governmental regulatory agencies mandated to supervise the enforcement of regulations.

The **governmental regulatory agencies** are also agents, dedicated to the public interest that can enforce regulations themselves. Such agents are outside the contractual relationship either with the principal or with the banking organizations because of different interests. For example, the roles of

regulatory agencies in the financial sector expand through government's intervention limiting the degree of risk decisions; harmonization of national practices; in pricing and credit policy, supervising financial institutions.

The governmental regulatory agencies play an important role in the operation and enforcement of corporation's rules. The external bank control is exercised by:

- 1) The National central bank, special agencies (committees) and the European supervisory agencies within the bank supervision framework,
- 2) The Financial Investigation Agencies, which check on money laundering facts or evidence, usage of the banks by organized criminal groups for financing terrorist or other illegal activities.

The governmental regulatory agencies in Bulgaria are as follows:

- 1) The **Bulgarian National Bank** (hereafter referred to as 'BNB') – established immediately after the autonomy in 1879. It is an independent issuing institution of the state, reporting directly to the National Assembly, playing a crucial role in the development of the Bulgarian contemporary market economy. It maintains the stability of the financial market and of the Bulgarian currency and, observes the bank and credit system. Since 2007, the BNB is a full-fledged member of the European System of Central Banks and participates in the decision-making process within the banking and financing institutions in the EU.
- 2) The Bulgarian National Bank is the main regulatory agency in Bulgaria, which is responsible for banks and insurance companies.
- 3) The **Central Depository AD** (CDAD) – established in 1997, under art. 91 of the Securities, Stock Exchanges and Investment Intermediaries Law. CDAD shareholders are the major Bulgarian commercial banks that play an active role in the securities' market. The Bulgarian National Bank and the Minister of Finances control all activities of the CDAD. Its main activities include:
  - Dematerializing shares book-entry registration,
  - Maintaining shareholders' registry of the companies traded,
  - Maintaining a registry of the securities traded,
  - Immobilizing share certificates that are a matter of public trading.
- 4) The **National Registry** – consisting of all 1053 joint-stock companies, privatized under the Mass Privatization Program. It is updated automatically when the trade or the transfer of shares is fulfilled.



- 5) The **Council for Bulgarian Capital Market Development** – established in 2016 on the initiative of the Central Securities Depository, the Financial Supervision Commission (FSC) in partnership with numerous Non-governmental organizations.
- 6) The Ministry of Finance
- 7) The **Bulgarian Stock Exchange Sofia** (hereafter referred to as ‘BSE’) – a public company that was officially licensed by the State Securities and Exchange Commission to operate as a stock exchange on October 9, 1997 and is currently the only functioning stock exchange in Bulgaria. The scope of the Exchange activity includes the following:
  - Organizing trading in securities and other financial instruments,
  - Operating and maintaining information systems for trading in securities,
  - Establishing and maintaining a clearing system guaranteeing the obligations assumed under securities transactions executed on the Exchange.
- 8) The National Revenue Agency,
- 9) The Public Financial Inspection Agency,
- 10) The Financial Supervision Commission – established in 2003 as an independent institution reporting directly to the National Assembly. It is a regulatory institution that controls the non-banking financial sector. Its goal is to ensure the protection of the consumers of financial services and products.

**Securities** are investment instruments (bonds, debentures, notes, options, shares, stocks) issued by a regulatory agency (or private) as evidence of a debt, a right to share, or to distribute a property. The securities’ laws provide a set of rights and obligations. The positive aspect of such mechanism appears to be in reducing transaction costs and preventing of moral hazard. For example, they may be traded in financial stock exchange. Bank employees should not exercise insider trading, nor use internal information for benefit (upcoming deals or adverse results) that could affect the financial situation of the bank. A deviation occurs when law cannot be enforced properly.

The **Reputation mechanism** is important to boost corporation assets. Law regulations in the banking sector determine that financial institutions must publish their corporate governance documents (statutes, internal regulations, and financial statements). Providing internal information on how the corporations operate to stakeholder, including media vehicles (specific print or electronic) improves the image and increases confidence in the corporations’ activities.

**Markets** are very influential mechanisms to corporations as they:

- Determine traded price,

- Mediate transactions,
- Broadcast price information, etc.

**Conflicts and fraud** could be controlled by instituting rules against potential adverse behaviour of ownership and employees. For example, the company might draft a conflict of interest statement that top executives must sign, requiring them to disclose and avoid potential conflicts, such as awarding contracts to family members or contracts in which an executive has an ownership interest. The company might also forbid loans to officers and family members or the hiring of family members.

**Effective insolvency procedures** are often forgotten but important monitoring mechanism. If the law empowers liquidators to conduct effective investigations of corporate collapses it may lead to the uncovering of misconduct and resulting liability. Recent research shows that the legal provisions concerning the creditors' control rights in the insolvency process are a strong predictor of the average growth rate.

In Bulgaria, the effectiveness of this mechanism has increased as litigation funders are now permitted to operate. They have provided the funding required for instituting class actions on behalf of investors against companies and directors who have contravened the law. The reward for the litigation funders is a share of the damages if the action is successful.

#### **3.4.4. European Control Mechanisms for Fraud Detection, Investigation & Prevention**

The **European System of Financial Supervision** (hereafter referred to as 'ESFS') – established as a decentralized, multi-layered system of micro- and macro-prudential authorities to ensure a consistent and coherent exercise of financial supervision in the EU, is currently undergoing major changes due to the introduction of a banking union.

The 'de Larosière' report of 2009 recommended its creation in the form of a decentralized network, made up of European and national supervisors. The micro-European level pillar consists of the European Banking Authority (hereafter referred to as 'EBA'), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (hereafter referred to as 'EIOPA'), working together in the Joint Committee of the European Supervisory Authorities (hereafter referred to as 'ESA'). Macro-prudential supervision is conducted by the European Systemic Risk Board (hereafter referred to as 'ESRB'). The relevant competent national supervisory authorities in the Member States are also part of the ESFS.

The objectives of the ESFS include the development of a common supervisory culture and the facilitation of a single European financial market. As part of the legislative initiative procedure, the Parliament adopted a resolution on the review of the European System of Financial Supervision of 11 March 2014, which made detailed recommendations to the Commission. The establishment of the banking union also changed the shape of the European supervisory framework.

The EBA, EIOPA and ESMA are the **European Supervisory Agencies**, responsible for micro-prudential supervision carried out at national level. These are EU agencies with their own legal personality and represented by their respective presidents, independent and generally acting solely in the interest of the Union.

- I. The **Joint Committee** is responsible for overall coordination and coordination between the different sectors in order to ensure cross-sectoral consistency between the supervisory authorities.
- II. The **macro-prudential supervision** at European level is carried out by the European Systemic Risk Board, based in Frankfurt, Germany. Its aim is to prevent and mitigate the systemic risk to the financial stability of the EU in the context of the macroeconomic situation.
- III. **Banking union** is proposed to be established in 2012 by the European Commission. The financial crisis has shown that the simple coordination of financial supervision through a European System of Financial Supervisors is not enough to prevent the fragmentation of the European financial market. Banking union includes the Unified Supervisory Mechanism (already created), the Unified Restructuring Mechanism (already in place) and a General Deposit Guarantee Scheme (proposed as a European Deposit Insurance Scheme) supplemented by the Unified supervisory manual.

## **4. CASE STUDY**

### **4.1. Bulgaria: Economic, Social & Political Background**

This year Bulgaria celebrates a decade as a member of the European Union. Despite this, it still is the poorest Member State with a minimum wage of only €235 (in comparison to Romania with €318, Lithuania – €380, Latvia - €380, and Estonia - €470 (Eurostat, 2017). According to Transparency International's Corruption Perception Index (hereafter referred to as 'CPI'), Bulgaria stands in 75<sup>th</sup> position alongside countries like Bahrain, Ghana, and Turkey – making it the last in the ranking of EU Member States (TransparencyInternational, 2016). On this ranking Romania is listed as 57<sup>th</sup>, Lithuania 38<sup>th</sup>, Latvia 44<sup>th</sup>, and Estonia 22<sup>nd</sup>. Bulgaria also lags behind all other EU Member States in terms of freedom of speech. Reporters without Borders' Freedom of Speech Index (hereafter referred to as 'FSI') lists Bulgaria in 109<sup>th</sup> position. The FSI places Romania in 46<sup>th</sup>, Lithuania in 36<sup>th</sup>, Latvia in 28<sup>th</sup>, and Estonia in 12<sup>th</sup> position (ReportersWithoutBorders, 2017).

This is a brief overview of the socio-economic state of Bulgaria and other Member States. For the sake of brevity, it does not take into account recent indexes on innovation, media sustainability and happiness, despite their interconnectedness and dependability. The combination of these variables can demonstrate that higher scores imply overall better living standards, genuine market economy, objective media, trade and growth opportunities. The study of these factors does not count among the objectives of the current thesis.

#### **4.1.1. Political Specifics in 2013 & 2014**

In 2013 and 2014 Bulgaria faced turbulent economic, social and political challenges. Riots began early in 2013 and continued till the end of the year. Protesters expressed scepticism as to the direction of the national economy. They also condemned the apathy of the political elite, the lack of justice, the concentration in the electricity market and monopolies, and the ineffectiveness of governmental measures to create a favourable economic and social environment (Thorpe, 2013).

These protests marked the beginning of a political crisis. The problems which had accumulated throughout the "transition" and the population's general sense of defencelessness grew into unprecedented dissatisfaction. Self-immolation was used by many in protest against the Parliament. In March, the government (called the 'Borissov I') stepped down and an ad interim government was set up.

Months later, after early parliamentary elections, a coalition government (the ‘Oresharski’ cabinet) came to power. It united the Socialists and the Party for Rights and Freedoms (predominantly supported by Bulgarian Muslims and ethnic Turks). In July 2014 this government also stepped down, due to continuing anti-governmental protests. A second ad interim government was then set up. In November 2014, for the second time, the leading liberal-conservative political party GERB came to power together with the Reformist Bloc (centre-right coalition) and a newly formed centre-left party (called ‘Borissov II’).

#### 4.1.2. Economic Specifics

In 2013, the Bulgarian economy recorded modest economic growth (0.9% in real terms), owing to the financial sector, insurance, social activities and agriculture. Industry, construction, trade, transportation and tourism did not significantly contribute to the GDP. The minimum wage increased to €158 as of January 1, 2013, but the socio-economic situation continued to stagnate.

As a result of the volatile economic and political situation in the country in 2014, the international rating agency Standard & Poor’s Global lowered Bulgaria’s long-term credit rating in foreign and local currencies to “BB+ with a stable outlook” (Heinz & Ejgel, 2016).

	2013	2014	2015	2016
<b>Real GDP (MN euro)</b>	42 010,8	42 761,3	45 285,6	47 363,5
<b>Real GDP growth rate – volume (%)</b>	0,9	1,3	3,6	3,4
<b>Gross External Debt (MN euro)</b>	36 935,6	39 338,4	33 947,3	34 642,5
<b>Gross External Debt (% GDP)</b>	87,9	92	75	73,1
<b>Trade balance (MN euro)</b>	-2 932,7	-2 776,6	- 2 622,4	-1 844,8
<b>Foreign direct investment (MN euro)</b>	1 383,7	1 160,9	2 534,8	701,7
<b>Foreign Direct investment (% GDP)</b>	3,3	2,7	5,6	1,5
<b>Net external debt (MN euro)</b>	14 368,3	13 732,7	6 561,9	2 521,9
<b>Net foreign debt (% GDP)</b>	34,2	32,1	14,5	5,3

**Figure 4. Bulgarian Economic state (2013-2016) Source: Bulgarian National Bank [website](#)**

Stability in the banking sector was the Borissov II government’s main challenge. In order to tackle it, a framework for state aid to support the liquidity of banks in Bulgaria was agreed upon with the

European Commission in June 2014. Bulgaria's foreign debt grew by 76.6% in 2014, as a result of the issuance of Eurobonds of almost €1.5 billion in international markets. In December, the government took a short-term bridge loan of €1.5 billion from one local and three foreign banks, which resulted in an increase in foreign debt of €984 million. Both the proceeds of the issued bonds and the loan were used to finance the state budget deficit and to provide a loan to the Deposit Insurance Fund of banks.

In 2015, the Bulgarian economy started to recover, but at a weak and uneven pace. The events linked to the CCB remained the focus of attention for both citizens and investors. In June 2016, the Parliament ratified two loan guarantee agreements from the European Bank for Reconstruction and Development (hereafter referred to as 'EBRD') and the World Bank for deposits of €300 million, again needed as an injection to the unstable economy. Interestingly, Borissov resigned in November, after having heavily lost the presidential elections. This thrust the country into the hands of another ad interim government.

In the same period of time (2013-2017), despite the country's severe financial issues, the government spent close to 77.4 million leva on early parliamentary elections, due to the complex political situation (as a comparison, Austria – a country with 6,35 million voters in 2013 – spent only €13 million on the September 2013 elections, accounting for €2,04 per person (DiePresse, 2013); whereas Bulgaria had 6,8 million voters, accounting for €1.57 per person. These two countries have completely different standards yet similar public expenditure (CentralElectionCommission, 2017). 26.5 million leva were spent in 2014 and close to 30 million leva in 2017 (OpenParliament, 2017). For the period 2009-2017 taxpayers have paid 285 million leva for elections and referendums).

#### **4.1.3. Social Specifics**

In 2013, the Bulgarian civil society organised numerous protests in many large towns' main squares, especially those located in front of institutions. The #DANSwithme riots (an acronym from the State Agency for National Security, hereafter referred to as 'SANS'), were a phenomenon that united hundreds of thousands of people from all kinds of backgrounds. Rioters gathered to express their discontent with the numerous problematic developments which had taken place, mainly in the political arena (TheEconomist, 2013).

The tipping point was reached when a media tycoon, ex-deputy minister, and corruption convict was nominated as the Head of SANS. His media empire, the "New Bulgarian Media Group Holding", was backed by the CCB. It is widely considered an unreliable news source which

supports any government in power (SEENPM, 2017), allegedly due to public procurement projects (Dhambazova, 2012).

In October, students joined the “moral revolution” occupying Sofia University indefinitely as a motion of no confidence, “due to the loss of any kind of legitimacy of the governance practices in Bulgaria” (Naudet, 2013). Other universities throughout the country were also occupied as a sign of support and protest (Mediapool, 2013).

As a result of this unrest, many formal and informal civil society groups were established as platforms for debate and common action. Their purpose was to unite citizens and experts in order to find smart and sustainable solutions for Bulgaria’s societal, cultural, green and digital development (among these are the ‘Greens’, ‘Protest network’, ‘MoveBG’, the initiative ‘Justice for everyone’, and many others).

#### **4.2. Case Study Specifics**

CCB was an heir of the Bulgarian Foreign Trade Bank (hereafter referred to as ‘BFTB’) – one of the biggest banks in Bulgaria post-1989. The BFTB was created in 1964, to serve international commercial activities of the Central Committee of the Bulgarian Communist Party. In 1988, BFTB and External Economic Bank of Russia merged to create a joint venture. In 1994 the joint financial institution with the Russian bank was renamed to Corporate Commercial Bank AD. In the period of the privatization process (in 2000), the CCB was purchased by a brilliant entrepreneur – Mr. Tsvetan Vassilev (the majority shareholder of capital through Bromak LTD) and a dozen other legal entities (required by law).

The new ownership strategy was massively successful. The CCB became famous in handling successful risk investment, as well as for its willingness to finance the largest infrastructural and trade projects. In April 2007, the Financial Supervision Commission confirmed its decision that the bank could offer 1 million leva ordinary public shares with a nominal value of 10 leva per share. The CCB published a prospectus for an initial public offering of ordinary shares in which it provided detailed information on its activities and its organizational structure. As of 2007, the bank registered share capital of 50 million leva (AlixPartners, 2015).

Toward the end of CCB’s life, the majority shareholder was praised for his company’s strategy, financial success and naturally became predominant steward of 51% of assets. Success was so phenomenal that the slogan of the company “Our customers are expensive” was formulated.

According to the Bulgarian Prosecution “in 2013 and at the beginning of 2014, there was no other natural person to manage solely and exclusively so much of the country’s economy”. The CCB was transformed from a small financial institution to the 4<sup>th</sup> largest bank in Bulgaria and the 24<sup>th</sup> world’s largest bank, according to the TOP SEE BANKS ranking in 2012.

In 2013, according to BNB data, the CCB is fifth based on the amount of assets, third in profits and first in terms of growth of deposits. On November 30, 2013, the bank is already the fourth largest bank in Bulgaria with assets accounting for 6.7 billion leva, with 10.04% share in deposits and 13.07% share of loans granted to businesses.

In 2014 as soon as some media provocations went viral through social media and alter in news media the CCB collapsed. Though insolvency and corporate governance failure can take place in any strong public or private company. Governmental regulators, creditors, investors, employees and other stakeholders can easily be attracted by the company’s reputation and high stock market indexes. If agents were good, honest and acted in accordance to agency theory and the fiduciary norm, such blindness would never have happen. Unfortunately for all stakeholders who carry the burden of losses, human behaviour is difficult to predict in the economic theoretical models.

#### **4.2.1. Early Associations with Poor Corporate Governance**

Initially, a dozen of hypotheses focused on the way and reasons for the monumental bankruptcy. These were also identified by the current research. The majority were external factors.

Stakeholders omitted the release of critical information about the CCB, complaining that it has only deposits of enterprises with a majority state ownership and that there is a transfer of state resources to the bank.

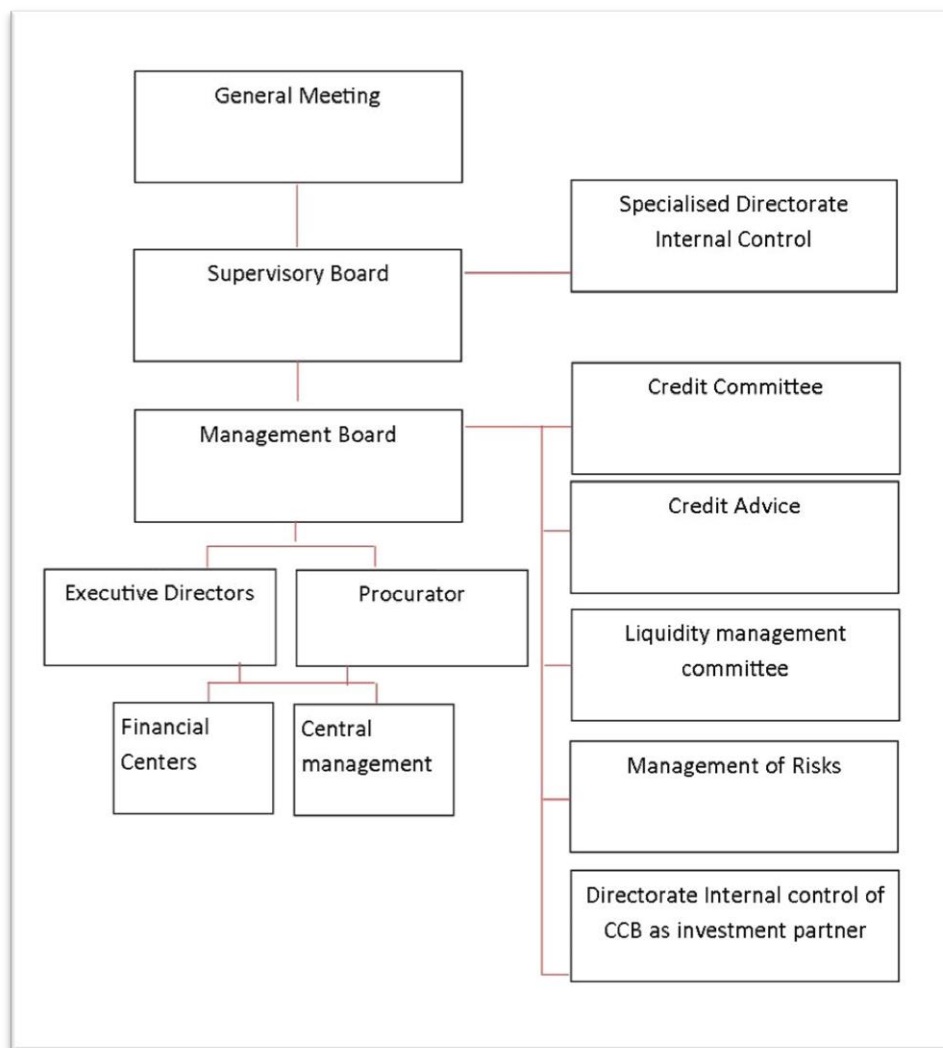
Early signs of ethical concern were identified in a letter to the Minister of Finance in August 2010 by Mr. Alexander Italianer (European Commission Secretary General since 2015). In his letter he stated that the European Commission (hereafter referred to as the ‘EC’), Competition Directorate General investigated a complaint against the bank’s practices of selecting its depositors from certain economic areas, such as the energy market, transportation and communications, tobacco trade, military industry, and state-owned enterprises. The complaint alleged that the political governance provided grants in favour of the bank. Moreover, certain media group and telecommunication companies were linked to the bank.

According to the inspection, after the bank was put under the special supervision, majority shares were distributed among three major shareholders, namely:



- 51% to Tsvetan Vassilev through “Bromak” LTD,
- 30% to the Sultanate of Oman, through its investment fund (bought their shares in 2009),
- 9% to VTB Capital (bought their shares in 2013).

The Bank’s Statute states that most of the shareholders’ decisions required a simple majority, giving “Bromak” control over the governance, although changes in the composition of the Supervisory Board required a majority of two third.



**Figure 5. Organizational Structure of the bank**

#### **4.2.2. Bodies of Management & Representation**

The governing bodies of the Bank are the General Meeting of Shareholders (hereafter referred to as the ‘GMS’); Supervisory Board and Board of Directors. The Supervisory Board and the Board of

Directors of the Bank carry out their activities in accordance with the law and adopted internal rules of banking operation.

The Supervisory Board is a collective body that exercises ongoing control over the activities of the Board of Directors and through it on the overall activity of the Bank. The Supervisory Board does not participate in the Bank's operational management. The members of the Supervisory Board are elected by the GMS for up to five years and can be re-elected without limitation. In 2007, the Supervisory Board consists of 3 individuals, Bulgarian citizens. An update of the CCB Founding Act is made in 2013, which states that the Supervisory Board consists of 5 members. After placing the bank under special supervision in 2014, the inspectors export data that the Supervisory Board consists of 5 members:

- Mr. Vassilev, Chairman;
- Mr. Zlatozar Sourlekov - Member;
- Mr. Abdul Salam Mohammed Abdullah al-Mourshidi-member. At that time he is Director of the Board of Bank Muscat, Sultanate of Oman.
- Mr. Faisal Amur Mohamed al-Riyami-member;
- Lubomir Denev - member.

### **Functions of the Supervisory Board**

A member of the Supervisory Board may be a natural person and a legal entity. A person cannot simultaneously be a member of the Supervisory Board and of the Board of Directors. He cannot participate in the management of the bank either. He represents the bank only in relations with the Board. The Supervisory Board adopts the financial reports followed by verification. When approved, the financial reports are submitted to the attention of the General Meeting for acceptance by them.

### **Functions of the Board of Directors**

The Board of Directors is a permanent collective management and representation body of the Bank, which exercises its powers under the supervision of the Supervisory Board. The Board of Directors exercises its rights and obligations in compliance with the provisions of the statutory instruments, the Articles of Association of the Bank, the decisions of the GMS and those of the Supervisory Board as well as those stipulated in the Rules of Procedure and other internal regulations of the Bank.

The members of the Board of Directors are elected by the Supervisory Board for five years. They may be re-elected without restrictions and may be dismissed or replaced at any time by the Supervisory Board.

The Board of Directors, with the approval of the Supervisory Board, employs at least two of its members, referred to as “Executive Directors”, who manage and represent the CCB jointly. In 2007, the Board consists of three Bulgarian individuals. According to the Founding Act of 2013, the Board consists of three to nine members and a legal entity cannot be a member. Conclusions on the number of members of the can be made from these signatures. The Founding Act is signed by 4 individuals who are Bulgarian citizens. After the bank was placed under special supervision, according to the inspectors, the Board of Directors consists of 4 members, namely:

- Mr. Orlin Roussev - Chairman and CEO,
- Mr. Ilian Zafirov - Member and Executive Director,
- Mr. Hristov - Member and Executive Director,
- Mr. Pantaleev - Member and Managing Director.

The members of the Board implement the operational management of the bank, safeguarding banking secrecy. Its main functions consist of the following: preparation of the financial reports and the annual reports on the Bank's activity; manages the activity of bank branches and accepts their accounts; resolves issues of credit and interest rate policy on the amount the bank collects; decides the termination of risk exposures classified as loss up to 10% of the capital; adopt internal rules of conduct; adopt rules of procedure; adopts rules for disclosure of conflicts of interest between bank administrators and its clients; empowers executive directors to represent the bank; resolves other matters that are not within the competence of the General Assembly.

The Board of Directors may only take decisions after the prior approval of the Supervisory Board when decisions concern substantial changes in the nature and organizational structure of the Bank, such as: expansion of the scope of the banking operations; opening and closing of branches; buying, selling or renting real estate; changes to the adopted business plan from 2010; changes in accounting practices and policies; making payments other than standard payments (including charitable or political endorsements), entering into new loan agreements on behalf of the bank or changes of the conditions of loan agreements already entered into; the adoption of decisions to form an exposure to one person or to economically related persons if it exceeds 15% of the value of the equity; providing guarantees; establishment of collateral; modification of existing contracts with a shareholder or a related party.

## Executive Directors

The Executive Directors represent the Bank and perform the operational management. Two of them are determined to sign the bank documents jointly. The Board, on a proposal from the Chairman, approves a distribution of the tasks for which each of the executive directors will be responsible.

According to the prospectus, executive directors are chosen among the members of the Board. At the moment of publication of the prospectus there are no registered procurators (commercial representative). It is stated that the CCB shall be represented by the Chairman of the Board in his capacity of an Executive Director.

The main functions of executive directors are to manage and represent the bank in front of third parties; organize the Bank's operations, provide its operational management, ensure the banking day-to-day activities and preservation of its assets; conclude and terminate employment contracts with employees of the bank; issue orders on current issues, post workers; perform functions assigned by the General Assembly or by the Supervisory Board. The support bodies to the Board were, namely:

- **Credit Committee** – a specialized internal body for monitoring, assessing, classifying and providing risk exposures of the Bank. The composition, powers and activities of the Credit Committee are governed by the Credit Committee's Operating Rules.
- **Credit Council** – a permanently functioning specialized advisory body of the Bank, which presents to the Executive Directors an objective assessment of the parameters of the offered credit transaction. The composition, powers and activities of the Credit Council are governed by the Credit Council's Rules of Procedure.
- **Liquidity Management Committee** (hereafter referred to as 'LMC') – the Central Liquidity Control Authority of the Bank. The composition, the powers and the activities of the LMC are regulated by the Bank's Rules of Procedure.
- **Risk Management Board** – an internal advisory body that assists the Bank's management to identify measure and control risks.
- **Specialized Service to identify customers and transactions and to control and prevent money laundering and terrorist financing** – a special unit that monitors the banking operations (CoM, 2006). The number and personnel of the SS are determined by an order of the executive directors. The main functions and activities of the SS are regulated by the Implementing Rules for Measures against Money Laundering and Financing of Terrorism.

#### 4.2.3. Internal Control Structures

The following separate structural units are presented in the structure of the Bank:

- **The Internal audit** – one of the main elements of the Bank's internal control system, is carried out by a Specialized Internal Control Service.
- **The Specialized internal control service** performs the internal audit in the Bank by performing independent, objective and impartial assessments regarding the effectiveness of the risk control and management systems, the organization of the operational activities, the compliance with the established laws and regulations.
- **Internal Audit Department at the Bank as an Investment Intermediary** – an autonomous structure in the Bank's system, which is subordinated to the Board. The activity of the Internal Control Department is regulated by Rules for the Organization and Activities of the Unit as an Investment Intermediary (Council of Ministers, Article 54, Ordinance 1).

#### Internal Audit

The internal audit, which is one of the main elements of the Bank's internal control system, is carried out by a specialized internal audit service with a manager. The specialized internal audit service performs the internal audit of the Bank by performing independent, objective and impartial assessments of the effectiveness of risk control and risk management systems, the organization of operational activities, compliance with established laws and regulations. The specialized internal audit service also performs constant monitoring of compliance by the persons entrusted with the operational management of the Bank and all other persons working under a contract for the Bank with the pattern-oriented software architecture and the acts for its implementation. The Head of the Internal Audit Service is elected and dismissed by the General Assembly of Shareholders.

#### 4.2.4. Structural Units in the Bank's Central Management

The structure of the Central Bank is made up of independent structural units which distributed offices report directly to CEOs; directorates report directly to Directors; as well as departments (refer to Appendix 4 for a schematic preview).

From the in-depth study of the Bank's official internal financial records, financial statements, audit reports, reports of the BNB, it can be concluded that the Bank has been operating in accordance with Bulgarian and European regulations as well as with the international regulations specific to banking sector. The Bank has implemented a development strategy that has contributed to the

growth of the Bank at the level of leading financial institutions both in Bulgaria and in the international arena.

The external factors affecting the internal governance of the bank to fail (notwithstanding strict subordination, allocation of liabilities and responsibilities and successful results) are explored by the current thesis to the extent connected with the specifics of the corporate governance in the Bank. The case study finds that the bank has operated under the conditions of a long-standing political crisis and an inadequate market economy. The Majority Shareholder, a talented financier and Maecenas, has worked in an unpredictable political and economic environment.

There are conclusions in the official reports of the Central Bank, as well as in other official documents, which state that external factors have caused deliberate panic among depositors and clients of the Bank, which has led to collapse of liquidity. Numerous media publications confirm the suspicion that the problems of the Bank come from being pressured by the political elite to provide unsecured loans as well as lending to large-scale projects with slow returns on profits. This leads to the conclusion that external factors are most probably the reason for the apparent poor practices of corporate governance that arose in 2013.

After the Bank was placed under special supervision, the Bulgarian accusation asserted that the Majority Shareholder was the main culprit for the failure of the CCB, arguing that he had applied internal and external control mechanisms incorrectly and manipulatively.

The Bulgarian Specialized Public Prosecutor's Office published a document defining the specificities of the practices applied in the operation of internal and external control mechanisms such as the "CCB Model".

#### **4.2.5. The Situation after the Special Supervision**

The Prosecutor's Office of the Republic of Bulgaria states (not proved yet) that, by its very nature, this "model is a functionally structured technological mechanism of social and control-management relationships, through which a group of persons, managed by the Majority Shareholder, succeeded in assigning the public funds, attracted and entrusted to them in the Bank".

The indictment refers to activities from a criminal-law point of view. The criminal charge is not the subject of the current thesis, but in the context of the detailed information on fraudulent behaviour it is possible to draw conclusions about corporate management and corporate governance of the Bank.

With the development of financial activity over the years, the Bank has formed a unit of people trusted by the Majority Shareholder to serve companies related to him. These trusted persons later turned out to be the main witnesses against the Majority Shareholder.

According to testimony, the meetings of the Supervisory Board are held in absentia, and a Bank's employee prepares the minutes of the council meetings. The protocols are signed first by the Majority Shareholder, and then signed by the other members of the Supervisory Board, regardless of the content.

Similarly, the Bank's Audit Committee functions - its meetings are held in absentia, the minutes are prepared by an employee of the Bank, signed first by the Majority Shareholder, and finally signed by the independent external member of the Committee.

With the rapid and dynamic growth of the Bank carried out in the years from 2002 to 2005, the Bank was practically run by the Majority Shareholder and his partner. After his departure, a single style of decision-making is introduced.

According to the accusation, the corporate management model looks like this: the Majority Shareholder decides to fund a certain investment or other (including political) project. However, he does not want to finance it directly because he does not want to expose publicly who the investor is.

For officers preparing the stooge (frontmen) documentation this is trusted transactions that resemble the popular fiduciary operation. A model in which the key question is who is responsible.

The response of the Prosecutor's Office is that the factual and beneficial owner and tenant of these deals is the Majority Shareholder. Although the stooges are very well aware of this - they know and understand that transactions with their commercial companies, although formally signed by them, are not theirs. Risk management is put in the hands of the Majority Shareholder.

The Prosecutor's Office assumes that the risk is managed successfully by the Majority Shareholder at one point, but this is precisely the threat - without diversifying the Bank's loan portfolio with its focus under sole control. Mistakes in this management lead to collapse and hardship of the whole system.

The accusation assumes that the poor management, poor banking practices, covering bad loan losses and pouring money into losing projects starts in 2009.

The duality of the Majority Shareholder is that, on the one hand, he is the real manager of a Bank with access to finance, on the other hand, the owner of a private company and a practitioner with excellent knowledge in banking.

Banking regulations and good banking practice, however, do not allow lending to ownership, as well as to related companies, as the concentration of loans to one person is considered to pose a risk to public resources.

Employees empowered to make decisions and sign Bank's documents (for example, a credit agreement where many signatures are required) have signed up without any hesitation that they could be accused in fraudulent behaviour.

The logical question is who can create such a sense of impunity? State authorities are the only ones that have the potential to answer this question hanging in the public space and blurring the credibility of the state itself.

According to the indictment, all this was well known to the executive directors of the Bank, the head of the Specialized Internal Audit Service, the responsible auditors of the specialized auditing company "KPMG Bulgaria" LTD and the BNB Deputy Governor in charge of the Banking Supervision Department.

The companies – borrowers without any real commercial activity (which are conventionally called “hollow companies”) and the companies of so-called related parties account approximately 70% of the credit portfolio of the Bank.

The scheme of "hollow" companies has begun to function from 2013. When preparing the documentation, each lawyer put his own signature at the bottom of the document. "Hollow" companies create a complete illusion of commercial companies, with all the necessary documentation, but – their purpose is not commercial. Instead – simulative.

### **Corporate Management Involvement**

According to the Bulgarian Prosecution, the executive directors and employees, responsible for accounting, internal and external auditing, along with the legal department have not working in isolations, but in constant contact with the Majority Shareholder. Furthermore, the Majority Shareholder ordered himself the finest details on the operational level. The employees were not forced to execute certain illegal actions. They have been part of the whole operation, providing professional expertise, dedicated to the fraudulent activities.



Such ignorance illustrates the importance of the social responsibility that carries out the agents, considered to be a good and moral people (by the agency theory).

The research on the current case study considers that the roots to ensuring the effectiveness of the corporate governance are within the corporate mismanagement. The executive directors are the obvious problem for the long-term banking operation due to their non-executive attitudes. The Board and superior employees at the Bank did not behave in accordance with the fiduciary norm. On the contrary, they were composed of people with poor ethical characteristics and ready to perform fraudulent activities.

If the conclusions of the Bulgarian Prosecutions are true, this is the root of the Bank's corporate governance failure itself. Because if the head is spoiled, how can the rest of the body performs its functions properly?!

#### **4.2.6. General Provisions on Central Bank Supervision Framework**

The Bulgarian banking system is subject to the legislative framework for the implementation of the new Basel III capital agreement in the EU.

With regard to the Bank, the banking supervisor and the official responsible for its functioning and the application of supervisory measures, the Deputy Governor in charge of the Banking Supervision Department did not carry out the necessary monitoring, the identification of bad banking practices and fail to apply adequate supervisory measures. In fact, the supervision of the Bank has been carried out formally, the offenses established have been disguised by the officials performing the on-field checks, and the official responsible for the implementation of supervisory measures - the respective BNB Deputy Governor has not applied them.

The main mistake of BNB Supervision is that it has not established and regulated by supervisory measures and giving prescriptions of corrupt practices of lending loans to related parties. It has turned credit operations into an apparent activity constituting a tool for misappropriation of public money from "hollow" and related companies.

Banking Supervisors are obliged to inspect and respectively apply supervisory measures in the presence of banking transactions which by means of frontmen thwart or circumvent the application of the provisions of this Act, the By-Laws and the BNB acts. This undoubtedly implies an obligation that requires the adoption and application of special rules, methodology and, respectively, control and investigation indicators. In other words, these bodies and officials of the

BNB are bound by the obligation to expose any possible frauds in banking. Obviously, such rules, methodology, and indicators simply do not exist (Council of Ministers, Article 103, par. 1, item 3).

At the beginning of 2014, the BNB approved the purchase of Credit Agricole by the Bank, which in practice provides a clear indicator that the Bank is in good standing condition and apply good banking practice and activity.

### **Central Bank Supervision on the Bank**

The Central Bank conducts regular checks on the Bank's activities in accordance with the regulations in the banking sector. In practice, it seems that the governing bodies of the bank, together with the Internal Audit Service and the external audit firm, conceal data about existence of large exposures to related parties and business group concentrations.

The prosecutor's office concluded that if this information had been found earlier, the Bank had to be placed under special supervision and its banking license to be revoked in 2012. This may be a very ambitious conclusion because the amount of loans after 2012 *de facto* is included in the mass of insolvency. These loans are devalued by the auditors after the Bank is placed under special supervision and calculated as economic damages.

#### **4.2.7. General Provisions on Specialized Internal Audit Service**

The internal organization and functioning of the SIAS is managed by the Rules on the Organization and Activities of the Bank's Internal Audit Service. The SIAS implements the provisions of the International Standards on Professional Practices on Internal Audit.

Generally, the construction of internal control systems in banks is subject to the requirement of economy, efficiency and reasonable sufficiency of control. Internal control systems in banks should ensure the approval of any expense and payment and execution of transactions and engagements in accordance with their authority, compliance with the business policy adopted by the management, effective management of the assets and liabilities of the Bank, their protection against losses caused by staff, officials and / or outsiders and their timely disclosure, provision and use of sufficient, accurate and timely information through the Bank's accounting and other reporting, timely identification not assess the risks of losses and their continuous monitoring and reporting, monitoring and timely reporting to the management of capital adequacy and liquidity of the Bank.

The second section of Ordinance No 10 on internal control in banks covers the so-called management control (Council of Ministers, Article 5). The Ordinance also stipulates that the senior management of the Bank, in the person of the executive directors, respectively of the Board, shall establish internal rules and procedures, which ensure the lawfulness of the Bank's activity and organization, including the risks stemming from them.

With a view to maintaining a modern level of internal control system, a special place is dedicated to the assessment and management of Bank risks.

The persons under the supervision of the senior banking management - the executive directors or the Board respectively approve the risk matrix of the CCB, which includes the type and amount of the risks and limits assumed by the Bank according to individual risks and levels of competence.

Each Bank maintains an accountability and information system which should at least provide rapid access to information in accordance with the powers of the officials and its movement:

- a) in ascending order - to inform the management of operations, risks and the current state of the Bank;
- b) in descending order, to inform employees of the objectives and tasks of the Bank as well as the policy, rules and decisions endorsed by management;
- c) in horizontal order - to provide and exchange the necessary information between the different structural and functional units of the Bank.

All banking transactions shall be recorded in a timely and comprehensive manner in chronological order. Banks keep electronic files and transaction files by type of transactions, customers and other criteria they choose.

The Bank files should contain an inventory of the documents in the file, internal Bank's documents, protocols, agreements, contracts, etc., financial and other customer and market information and other documents and information essential for the Bank.

The internal audit in the banks is carried out through the specialized internal control. It can be defined as an independent valuation activity that performs control to assist the bank's management on the legality and compliance with the internal regulations of the Bank transactions and related transactions entrusted to a specially established internal banking control authority.

## **5. ANALYSIS**

The major goals of the analysis are to address the particular constitution of the corporate governance in Bulgarian business environment, to identify which are the key mechanisms of CG to prevent fraud in the context of the specifics of the case study, which might apply in the largest public and private companies.

### **5.1. Bank Governance**

In essence, the banks have many stakeholders in comparison with the non-financial institutions. They have many shareholders and debtholders, the majority of them are depositors or holders of subordinated loans. Complexity of bank governance is based on the interaction between shareholders and boards of directors, along with the interaction between the bank and the governmental supervision. The governmental regulators approve bank's financial decisions, control reports and require supplementary information. In addition, the banks are subject to strict laws and specific governmental regulations. Some of the challenges for the governmental supervision are related to their independence, financial expertise and credibility.

#### **5.1.1. Benefits of Good Governance Practices**

The separation of power became an element of the concept of good corporate governance, where similarities alike governing a sovereign state could be identified – strategies, guidelines, policies, codes, management and employees. It intends to develop accountability and prosperity, to avoid failure, to eliminate problems before their occurrence, to address the needs and expectations of the investors and trust in the capital market.

In Bulgaria, most of the leading corporations (public, private, industrial, manufacturing) are not listed on the stock exchange market. The structure of corporate governance of non-public companies is reminiscent of the management of family companies. This type of management is based on the application of the “one-size-fits-all” principle. That is no longer a part of the guidelines presumed within the OECD policy.

The adopted National Corporate Governance Code did not take into account specificity of the Bulgarian microeconomic environment. Second, the management of non-public corporations is similar to the management model of the limited liability company. In their corporate management, based on a statute act, management, control and executive functions are constituted.

Mitankin pointed out that „as early as 2003, a program for internationally recognized standards for good corporate governance was adopted by Stara Planina Hold for the first time. Then, in 2007,

more precisely on October 30th, Stara Planina Hold became a co-founder in the adoption of the National Corporate Governance Code.”

The regulatory mechanisms for prevention of fraud will have to be aligned with the implementation of the principles of good CG, as the achievement of trust and transparency. Mithankin believes that “this is the company’s external assessment, that is, capitalization – the price of the shares”. On the other hand, Djutev states that “trust and the image are better, the partners we work with are glad that we are introducing a significantly higher standard than the one we are legally obliged to observe.”

Petrov points out that in his company “these practices have been implemented for 9 years. Certificates are not just a necessary ‘evil’. When your partners see that you have a full certificate in your area they trust you [...] my partners can trust us that whatever we do in the field, it will always be the same quality [...] Reasons for implementation are for internal compliance and for external trust.”

In moments of economic crisis, one of the corporations has executed a burdensome bureaucratic procedure in order to protect the interests of its minority shareholders. “Such a good practice is the redemption of our own shares. You will not see this practice anywhere written in any regulations, even in the corporate strategy.” Mithankin emphasized.

#### **5.1.2. Transparency & Disclosure**

The agency theory is associated with the occurrence of the asymmetric information. This segment is linked to the theoretical basis of the audit, as a scientific discipline. Increased exchange of corporate information and high-technology alternative spotted some controversial issues in fulfilment of standards of transparency and social responsibility.

The OECD principles have been designed to be adaptable to different properties and cultures (Chowdary, 2002). These principles are associated with protection the rights of shareholders; equal attitude toward all shareholders; the role of shareholders; disclosure and transparency; and responsibilities of the board (OECD, 2004).

Mithankin confirms that “good corporate governance practices could lead to greater trust in two directions. First direction comes from the customers and suppliers. As a result, stability of the market presence of the enterprise is ensured. Second, investors are looking for the securities of the holding. Thus, through good corporate governance, we provide more transparency about the

market capitalization of the company. As a result, this leads to the guarantee of the shareholders' investments and their profitability.”

Bulgarian companies use a variety of methods to provide regulatory and non-regulatory corporate information to their shareholders and to the society. The most common way is by posting this information on the Internet, on the corporation's websites themselves, as well as in the governmental trade register. In the case of public corporations, corporate information may be published on the website of the Bulgarian Stock Exchange, the State Gazette, as well as by spreading prospectuses with corporate information. Mitankin pointed out that “on the website of the holding [...] all internal regulatory documents, even the Code of Ethics for Employees, have been published”.

Only two of the interviewees confirmed that they have a special position at their corporations such as an Investor Relations Director. This is not a regulatory requirement, but is a part of the practices of good corporate governance and transparency of the corporation. According to Djutev “our goals were generally long-term – better accountability to our clients and better interactions with creditors; be clearly visible and understandable to them; knowing where our ship with corporate structure is moving. From an internal point of view – the idea was to grow the business and optimize the processes inside, raising profits”.

The CCB has also strictly obeyed the Disclosure and Transparency principle. It has regularly published information on its official website, on the Bulgarian Stock Exchange and has published prospectuses with corporate information and financial results.

## **5.2. Internal Corporate Governance**

ICG suggests best practices and regulatory guidelines that might influence decisions making process, board's effectiveness, structure and inter-company's acts that could affect stakeholders. One of the elements of the effective CG is related to the compliance of the boards to ensure that the company's activities are performing in good faith.

The analysis revealed primary that the Bulgarian business intentionally apply the principles of CG in order to meet the contemporary trends in the stock markets. Georgieva states “at the earliest, these standards are implemented by my client, who has realized the need for this, as their idea was to achieve transparency in business”. The managers expected significant economic growth of managed corporations.

The Bank was a distinguished member of the NCGC since its establishment as of 2009 on the principle of public-private partnership for consultations and cooperation at a national level on matters of corporate governance. It was included in the CGIX (in 2012) on the bases of its weight of market capitalization.

#### **5.2.1. Corporate Structure**

In essence, corporate structure responds to the benefits pursued by the corporations or to resolves relative issues. The structure depends on several elements that include organization, number of employees, capital, market, management controls, rules, procedures as well as their regulatory mechanisms. Thus, it involves interaction between management, boards, shareholders, stakeholders and their social responsibility.

All interviewees confirmed that they have limited employees at management and control positions because of the legislative freedom, an external accountancy and auditing firm to perform these functions. They agreed that it reduce the bureaucratic procedure in the corporation as well as the costs.

Managers confirmed that they are most innovative in their approach to satisfy both regulatory and non-regulatory (voluntary) requirements. It was verified by Mithakin's words that "it is a little bit specific to us because the appointed staffs consist of 4 positions, namely: Investor Relations Director, Development Director, Chief Financial Officer and Office Manager. That is all. And somehow to appoint individuals to be in charge of internal control - there is no logic. Nevertheless, we have certain rules for the internal control system that these employees apply. We also have an audit committee. We have an external auditor appointed by the shareholders".

#### **5.2.2. Board Structure**

Of utmost importance is the board composition so that it includes the right people with sufficient financial expertise, thus to carry out the management risks. The main structural principal-agent models are one-tier, wherein the management, representation and control functions of shareholders are carried out by a single governing body – the Board of Directors. Thus, two-tier system consists of the Board and the Supervisory Board. According to the agency theory, shareholders prefer the board to reimburse the CEO with special stock options due to their significance in executing the operational duties.

The analysis summarizes that the dominant system of management within Bulgarian corporations is the one-tier structure. It exists in all companies, except for those in which law regulates the two-tier system of governance; however, one-tier structure is preferred.

Mitankin elaborates that „this is dictated primarily by management costs [...] and almost everywhere the Board consists of 3 to 4 members. The two-tier governance structure has those companies that are required by law such as banks, insurance companies, and so on [...].for our local conditions, for our geographical latitudes, the one-tier structure is more practical”

According to Katsakova not the material cost but the non-material cost shall be consider when the principal decides on the structure “as in the cases where the owners of the corporation exercise the management then the risk of gaps and bad practices in the company's management and operations is considerably more observable”. Djutev elaborated on the dissimilarities stating that both the one-tier and two-tier structures of CG have their benefits and negative elements. According to him, “the one-tier structure is better for corporate structures of a smaller type, as the other – would make it more difficult for administrating. [...] Larger and more socially responsible corporations with a significant effect on the economy in a particular industry or in more developed countries are better at having a two-tier corporate structure, as it ensures better accountability, better governance and social involvement of this private enterprise”.

The case study reveals that the Bank has a two-tier governance structure, with four members in the Board. All of them were acting as executive directors.

Such finding can be interpreted as a minor criticism as the CG requires (on a voluntary basis) that more members of the board be independent of the corporation's operational activity in order to ensure transparency of information for the public stakeholders.

### **The Responsibilities of the Board**

Board members, the company's face, carry out many responsibilities, which are bounded by the laws and CG principles, as well as they shall be individuals that comprehend the geopolitical issues. Primarily, Board ensure the shareholders' interests, at least to the extent they are independent enough to enforce fiduciary norm, instead to engage in risky operations.

It may be acknowledged that the issue of board independence and the setting of principals' goals remain unresolved. Katsakova summed up that “the theory must be distinguished from the reality [...] good results depend on the goal the owner specifies himself”.



In the context of the decision-making process, the interviewees united that at their corporations, the Board are operationally independent from other superior agents. Decisions with the participation of all principals (owners) and with the participation of the Board are taken in terms of changes related to the corporate policies, business strategies, investments and other activities of higher level of importance.

### **5.2.3. Bank's Board**

According to the Bulgarian Prosecution, the members of the boards exercised the CEO functions have not working in isolations, but in constant contact with the Majority Shareholder. Furthermore, the Majority Shareholder ordered himself the finest details on the operational level. The employees were not forced to execute certain illegal actions. They have been part of the whole operation, providing professional expertise, dedicated to the fraudulent activities.

Such ignorance illustrates the importance of the social responsibility that carries out the agents, considered to be a good and moral people (by the agency theory).

The research on the current case study considers that the roots to ensuring the effectiveness of the corporate governance are within the corporate mismanagement. The CEO is the obvious problem for the long-term banking operation due to their non-executive attitudes. The Board could not convince the Prosecution that they behave in accordance with the fiduciary norm. If the accusations of the Bulgarian Prosecutions are true, the board is the root of the Bank's corporate governance failure itself. If there is a head spoiled, how can the rest of the body perform its functions properly?

### **5.2.4. Shareholders Position on Internal Audit**

Theoretically, the internal audit plays a significant role in risk assessment and verification of corporate reports. Audit committees in the lack of risk committee exercise its duties by evaluation of the risk investments. According to the agency theory, auditors are defined as agents.

Interviewees reveal their interest on the trends of agency theory and audit as well. Djutev considers it "as a wonderful tool [...] that can identify problems early [...] and before negative effects occur - be eliminated." Principals hire independent auditors to verify the work of managers (agents). However, the auditors are also agents. "The law is good and fair and yes- the external audit has an added value, as far as external control is independent and performs its function in good faith. The question is how it is used? Law is a beautiful tool that can do bad things in bad hands" Djutev points.

Furthermore, it shall be acknowledged that the interviewed Bulgarian managers show a high level of expertise regarding the development of the audit institute itself. Mithankin elaborated that “answer to the question whether the independent audit leads to good results and efficiency is - it leads! To some extent, it depends on the interaction between the independent auditor and the management or the owners, who have appointed him, especially if the owners are managers. It depends on their interaction”.

For example, in Bulgaria, before the adoption of the Law on the Institute of Chartered Accountants in 1931, there is no widespread audit practice (then an expertise). Upon the emergence of the audit in countries with developed stock capital, principals seek auditors; pay them to reduce the information risk and the risk of agent fraud.

#### **5.2.5. Corporate Ethics & Human Resources**

The interviewees viewed the corporate ethics as an important element in principal-agent relationship. It involves the standards of ethical behaviour of the principals and of the agents. The analysis confirms that an ethical stakeholder chooses to do more than the law regulates and less than the law insists. All of the interviewers indicate that the human factor cannot be omitted. The agency theory makes correlation as to the reward and incentives. Interviewees criticize it. Instead they emphasize on creating the opportunities for employee realization, as well as providing the opportunity to be shareholders, i.e. commitment to the success of the corporation.

#### **Failure of the Internal Audit of the Bank**

The proficiency of the Bank's internal audit activity has been exercised only formally as no cash inventory has been made in any of the audit commitments in relation to the Central Cashier. Similarly, none of the audit commitments to verify the loan process has examined the quality of the collateral and/or the existence of such collateral. If it is true, this is a clear case of fraudulent, manipulative and unethical accounting and internal auditing. Thus, poor corporate governance has been identified.

Due to lack of any evidence of action, nor of any reporting or judgment by the auditors on the wire balance sheets and financial reports, such ignorance could be defined as a purposeful support to the fraudulent management.

#### **5.2.6. Internal Audit & Fraud Prevention**

At the beginning of the twentieth century, the audit grew into verifying the financial reports. Thus, the importance of auditors increases as they are assigned the function of socially responsible, i.e. to

defend the interests of the whole society. Georgieva elaborates that “internal control ensures the observance of the internal company’s acts and the observance of the basic requirements from the legislative acts”. She argues that “fraud implies the intent of fraudulent action, but rather how the legislative provisions embodied in internal-company acts are observed”. Petrov consider that “fraud can happen in companies that are large enough to have no interest and no direct involvement of management as an owner or as a person to implement the policies of the company in which he is appointed. In practice, then, both internal control and internal audit are very important to be chosen by the owners. [...] The idea of internal control is important, it is very important to be realized”.

He disagrees on the subject that fraud can happen “because the structure is distributed vertically and there are no executive directors who can do anything like fraud”.

Does that imply if the fraudulent behaviour of auditors is encouraged by the owner himself due to the subordinate structure? Therefore, there is a contradiction between the theory and practice. Not to mention about the government regulators that performs the final supervision.

The legal provision for the application of a Committee of Auditors seems unacceptable to the interviewees. This Committee is directly subordinated to the Board. Their assumption is that the functions of Audit Committee and the functions of the Internal Audit are duplicated and do not lead to better authentication of corporate reports. In three out of five interviewed companies, there are no employees assigned to carry out the control. For two of the companies, there is no statutory provision for auditing due to the type of the companies. By decision of the management of these two companies, there are no employees appointed for the accounting activities because the accounting is outsourced to companies with which they have signed contracts for accounting services.

As established in the case study, the CCB auditors have not safeguarded the interests of society. However, according to the Bulgarian Prosecutor’s Office, they have defended their personal financial interests and have endangered their important public function to serve to the interests of the corporation.

### **Functions of the Independent Audit in Banks**

Bank reports are “checked and validated” by a specialized audit firm (Council of Ministers, Art. 76, Par. 1). Of course, the company itself does not perform the audit, that's what the auditors do (Council of Ministers, Art. 13, par. 5,2). The audit report is signed by the representative of the

Audit Company and registered auditor responsible for auditing, named by the law ‘key auditor’. In ISA 220 “Auditing of the quality of the audit of financial statements”, the registered auditor responsible for the audit is called the “engagement partner”, the latter being “responsible for the audit engagement and its execution, and for the auditor's report issued by company name”. The Prosecutor's Office argues that the responsible auditors of the specialized auditing company “KPMG Bulgaria” LTD have not fulfilled these obligations, although the baseline data collected by the on-field assistant auditors and senior auditors was collected objectively and in full. The external auditors have allowed significant weaknesses in the audits that led to the failure of their public-law obligations to notify the BNB in the identification of weaknesses in the Bank's operations.

Public oversight and control of the bank's business is based essentially on two pillars ensuring that the Bank's functions as a stable, reliable and secure financial institution (Council of Ministers, Art. 1, par. 1). The first pillar of this system is the supervision exercised by the Central Bank. The second pillar of the public-legal oversight system is carried out by the auditor of the Bank, aimed at supporting the Central Bank's supervisory activity (EC, 2014).

Generally, the registered auditor who audits the company, do so on the grounds of the independent financial audit in the implementation of International Standards on Auditing. Audit itself is actually “expressing an independent opinion on the reliability in all aspects of importance of the financial reports”, i.e. the auditor's work is to say yes, the financial report is generally reliable or not - it is not reliable. Inclusion of the concept of “credibility” is important because if there are non-important mistakes and deviations the auditor can still verify the reliability of the financial reports. The auditor is not expected to certify the 100% confidence of the report. This reflects the risk-based audit concept underlying the International Auditing Standards.

Therefore, if the banking supervision authorities and registered auditor conscientiously fulfil their commitments (related to supervisory reports to the Bank and not about financial ones), the Bank's activities would have been appropriately supervised and controlled. Providing false information to the BNB and its non-verification or confirmation by the registered auditor undoubtedly prevents the conduct of banking supervision activities.

### **Failure of the Independent Audit of the Bank**

The external auditor is in fact a “dependent” financial auditor, and he is financially dependent. The Prosecutor's Office found that the auditors received more than 6 million leva from the Bank

and related companies. Out of this amount, 1.5 million leva are remuneration for the audit of the Bank itself. The remaining funds are paid for audits of hollow companies or affiliated companies. The financial interest between the auditing and consultancy seems too much excessive and illustrates a clear problem of conflict of interest, in accordance with the agency theory, and not only.

The auditors issue the audit reports that are necessary for the functioning of the CCB Model - reports with a purely audit opinion showing that the Bank is functioning properly. At first glance, formally, the “bought” audit team abides by the audit methodology – checks are carried out, checklists filled in, and piles of audit documentation are created. Finally, the key auditor examines it with its “closed eyes”, sees no weaknesses, violations and misstatements, and again – the audit reports on the bank’s financial statements and supervisory reports are confirmed without reservations.

The temptation of money is most likely to be the extraordinary factor that could not have been overcome even by an internationally recognized audit institution.

In the context of the case study, however, was revealed that the Bank has a number of professional staff to perform accounting to carry out internal audit controls, as well as the existence of the Audit Committee. Bulgarian Prosecution considers that these employees have abused their expertise and assisted the illegal activities in the Bank. On the other hand, all bank statements that were supposed to be verified by an external independent auditor have passed the relevant verification procedure, but they have also “closed” their eyes by not reporting any irregularities in the corporate reports.

### **5.3. Bank’s Collapse**

The Bulgarian Prosecution is clear (but not proved yet) that the Bank’s management, including internal and external control audits caused the serious financial problems due to certain debtholders, debt contracts and illegal cash withdrawals.

Nevertheless, the sophisticated situation, there was a public perception that the Bank is “too big-to-fail” and it is a matter of political support. However, by the middle of September 2014, there was an understanding that the Bank has lost 4.2 billion leva. More than 18 lawsuits had been filed. The main accusations were charged with: wire fraud, money laundering, financial misstatements in the fake financial reports and organized criminal group, established with the self-material benefits, enrich oneself.

A severe lack of transparency in the Bank's balance sheets along with the indicated financial prosperity in the regular financial reports, verified by the external auditors, meant that stakeholder outside the particular cycle of trusted people was not aware of this off-balance liabilities until it turn into "to-big-to-be-saved".

The current research of the case study illustrates a clear picture of information asymmetry; with majority shareholder and principal (a Supervisory Board member) happen to be the insider executive manager (an agent).

#### **5.3.1. Poor Corporate Governance Impact**

Transparency is an essential element of the sound corporate governance. All the Majority Shareholders, the Board, employees at accounting and internal audit departments could be defined as being responsible due to their fraudulent behaviour. The CCB accounting, internal and external auditing was untrustworthy and anything but transparent. The research considers that the unethical, illegal and fraudulent behaviours caused the bankruptcy. Many employees lost their jobs and many people lost their savings.

#### **5.3.2. Costs of Fraudulent & Corrupt practices**

The costs of "bought" decisions, associated with fraudulent behaviour and corrupt practices by most interviewees result in two dimensions. The first, represent the amount of money paid in bribes or thievery of public assets. The second dimension is not measurable, because it would rather bring about the violence and the criminal operations. In countries with poor market dynamic, it would affect the process of improvements and would lead to economic inequalities and social injustice.

When fraudulent behaviours grow to a high level in the economy, the major governmental institutions would be aligned with the criminal groups. This suggests that governing institutions are weak and hardly deal with the public confidence or destabilization. For instance, charges of widespread public-sector corruption were at the heart of the public demonstrations in Bulgaria during the 2012-2014 political crises.

Good corporate governance principles can make it difficult for fraudulent behaviour to put roots into society. Its main counter mechanisms are through transparency, accountability and rule of law. Mitankin suggests that "the lack of good practices in state regulators is subject to much discussion. The good practice of a state regulator is when he puts forward his projects in advance. The draft amendments, because we are witnessing a lot of cases where a state structure that has the right to

rulemaking put somewhere in the “sixth debt hole”, regulation to change something and ... zero. Nor is it published in the media that there is such a project. Then we say, the 14-day deadline passed. This is a massive example of poor practice in a state regulator. Even see the Law on Legislation Acts. This is a law that was changed in the past 2007 and 2016 to reflect the European requirements.”

The logical question is who audit the auditors? In the banking sector, it is the Central Bank Supervisors. There are also other governmental regulators in the areas of taxes, revenues, licenses, etc. According to philosophy of the agency theory, governmental regulators can be defined also as agents of the principal as they fulfil objectives in their interest. The case study examination proved to certain extent the principal-agent dependency as all stakeholders such as internal and external auditors, along with the governmental regulator did not perform their duties in good faith. There were no signs of principal-agent conflicts. On the contrary, there was intentional collaboration (as Bulgarian Prosecution revealed).

### **5.3.3. External Influences**

The BNB and the government have decided that in the absence of incomplete information and insufficient data on the quality of CCB assets, the initial plan involving state participation in the capital of CCB was not justified. The prospect of being a state-owned bank with unclear asset quality and the resulting significant shortage of capital imply a high price and risk for taxpayers.

The BNB together with the government and experts of the main parliamentary parties have developed a new plan. The main idea of the new plan was to identify assets for which a “good condition” could be assessed and could generate income for the bank, as well as the CCB's liabilities, to move on the balance sheet of Victoria bank and thereby enable depositors to access their accounts.

Consultations were held with representatives of the European Commission (Directorate General Competition) in Brussels (8.07.2014) to determine the basic parameters of the plan, incl. with an option to cover deposits above the guaranteed amount of 196,000 leva. The aim is to prevent the spreading of uncertainty among depositors in other banks and to limit the negative effects for the entire banking sector.

The EBRD expressed its willingness to participate in such plan, if proved that the “good” bank (Viktoria) is in good financial condition and the main political factors together with the BNB agree on the strategy for resolving the situation with CCB.

At a meeting on the situation in the banking system and in particular on the CCB, under the President of the Republic of Bulgaria (14.07.2014), it became clear that the political forces could not reach agreement. No consensus has been reached as to whether or not the CCT case is subject to current legislation or to provide a new special law. After the meeting, the BNB announced that it continued work on the special supervision procedure in accordance with the requirements of the Credit Institutions Act.

#### **5.3.4. European Commission Supervision**

In August 2014, the DG “Internal Market and Services” to the EC sent a letter to the BNB. The letter expresses concern about the lack of access to deposits for 30 days and the prospect that this situation will continue. It is pointed out that under Directive 94/19 / EC, as amended by Directive 2009/14 / EC on Deposit Guarantee Schemes (Directive), Member States should be able to pay compensation within 20 working days of the date, to which the competent authorities make an establishment as an “unavailable deposit”.

An expert group of representatives of the EC, EBA, ECB, MF, BNB and BDIF was established in September 2014, which discussed the possibilities of providing full or partial access to deposits. The explanation of the Bulgarian side is that there are no legal provisions and procedures that authorize the BNB to make such a decision. There is no clear criterion for determining which deposits are to be paid and which ones do not. The Bulgarian legislature has not entrusted the BNB with powers to authorize or refuse partial access to deposits.

The EC launched a violation procedure 2014/2240 (September 2014) in respect to non-compliance with obligations for Bulgaria under Directive 2009/14/EC. Under the pressure of the European institutions, the bank's license was withdrawn and bankruptcy proceedings were initiated. Following the bankruptcy order of CCB, the Fund announced several commercial banks through which the clients of CCB (in bankruptcy) can withdraw the funds up to the guaranteed amount.

In summary, the analysis points out at the significance of the CG as a solution for preventing the financial crisis caused by the intentional fraudulent behaviour and “shadow” banking management. Comprehension of the reasons for failure, bankruptcy’s influences, flaws and potential future bank’s sound governance could most likely convince corporations in application of the control mechanisms accurately might be the answer.



## 6. CONCLUSIONS & RECOMMENDATIONS

In this chapter will be summarized the key control mechanisms of corporate governance that public and private corporations shall adopted to restrain the worst consequences associated with the internal interaction or influenced by the external environment.

However, the shareholder activity, the welfare of the society, and the protection of the interests of all the stakeholders can be adapted by not only force and sanctions. However, the major corporate structures with majority owners are the carriers of the risk taking and have the resources to take advantage from the weakness of the governmental regulators, further they are also carriers of phenomenon of opposing to changes and of maintaining the *status quo*. This effect might be correlated with the Newton's law that each physical object remains in peace, until an outside force does not bring it out of this state. A regulatory environment in relation with the corporate governance principles would be considering the liquid security market force to moves forward.

Corporate governance principles to some extent are uniquely correlated with the specifics of the business environment and principal's (owner) philosophy. The quality of largest public and private corporations has made it difficult for governmental regulators to analyse the proper implication, changes and timing of certain risks and control mechanisms.

In Bulgaria, the quasi-capital economy continues to function rather imitates the principles and standards of market mechanisms. The changes are clearly necessary thus it can be fostered concerning the governmental regulators but rather through increased interaction between all the stakeholders. Moreover, there are four specific research CG mechanisms: transparency of the owner's goals, social responsibility of the Board, the independence of internal and external auditors and the effectiveness of the governmental regulator, including policy that would lead to stimulation of ethical behaviour, which are considered to be the answer of the research question.

Competitiveness among large corporations is practically absent. The governmental regulators exercise asymmetric tailor-made pressure less to the largest corporations, more to the small and medium-sized businesses that have a limited quantity of documentation and business activities would be easy to control.

Effective corporative control is one of the tools in the regulatory environment to prevent the fraudulent activities. The major partner in the applied European model of the corporate governance on Bulgarian side is the governmental supervisory authority.

The regulatory frameworks work together with the National Code to minimize the mechanical appliance of the basic standards of the CG taking into account the specifics of the Bulgarian political, economic and regulatory environment. At the moment, it involves the main set of best practices and standard of the modern trends of CG guidelines. The symbiosis between regulated and voluntary practices would be appropriate for the Bulgarian economy because it would stimulate inter-company competition. Among the regulatory principles of the CG are toward disclosure of corporate information, volumes, toward timelines and deadlines, responsibilities, and the notion of insider information ban on trading at the stock market.

The Bank crisis of 2014, due to the weaknesses in its audits and governmental supervision, pointed out as a disadvantage the excessive risks-management by the principals. Therefore, the focus on material incentives, the high remunerations of the members of the senior management of the bank doesn't stimulate neither the ethical behaviour nor the public responsibility of agents.

Many of the CG issues in the Bank hang about unclear due to the lack of a valid court decision confirming the hypotheses of the Bulgarian Public Prosecutor's Office. Thus, the Bulgarian society attitude, observed in large number of media publications, criticizes the governmental regulators who have rushed the Bank's bankruptcy - a specific subject of commercial law that generates revenue from financial services. The lack of legislative and regulatory predictability in times of large-scale banking crises is one of the obstacles to market oriented stability.

Economic reforms and changing policies (after 2014) seems to leave oppressive questions and lessons learned in the difficult way about the need to introduce mechanisms to prevent fraud, to build up transparency and internal and external control practices.

To Bulgarian economy, the question of removing the source of weaknesses in the enterprises that were traded during the privatization in Bulgaria, control over their activity in accordance with the mechanisms of corporate governance and increasing the competitiveness among the largest capital sees the only reasonable attitude.

Business in Bulgaria and globally responds positively to achievements of the corporate governance control mechanisms. It contains the strongest anti-corruption expectations in attempt to deal with the grey segment of economy and the grey cardinals rather being able to operate in Bulgaria.

Shareholders must assume their responsibilities by choosing boards, organizational structures, proper distribution of responsibilities, ranges of incomes and risks, and ways to achieve the goals set.

The analysis found that the application of control mechanisms in the corporation is also important in terms of creating a competitive environment among corporations themselves. In essence, the dynamic capital markets keeps a small capital gap between small and large shareholders, but in the small economies there is a monopoly syndrome. A corporation that is not in an intra-corporate competition is able through its capital to operate in many sectors of the economy and thus becomes stronger than the state in which it operates. This syndrome affects political governance and the country-wide development.

Monopolistic corporations take advantage of the weaknesses of the political system, use corrupt models to manage their business, and very often it is also associated with abuse in corporate management. CG is a powerful tool for limiting these opportunities. Other CG mechanisms are also important and supplementary to the CG itself.

### **6.1. Recommendations**

The recommendations are associated with the Theoretical Framework and Literature Review and the Conclusion chapters.

All legislative measures, although implemented with delay, in their proper and responsible implementation, can increase the image of public companies as well as the interest of investors toward corporations with good corporate governance. Regulations – already in place – aim at avoiding fraudulent practices, such as the conditional raising of capital due to a decision of the General Meetings of shareholders. There are also regulations for the voting of shareholders through a proxy. Addressing the conflicts of interest is an important aspect of new amendments.

Thus, firstly control mechanisms limit the possibility of unethical conflict between principal and the agent by restraining the opportunities for drowning corporations and misusing the interests of small and individual shareholders. This reduces the flow of funds of uncertain origin, which is the main driver of corruption.

Secondly, by increasing transparency in decision-making and disclosure of information it would limit the scope of corrupt practices.

Thirdly, the introduction of good corporate control mechanisms in modern firms will limit the opportunities for “hollow” corporations, pyramid financial institutions and the implementation of “Ponzi” schemes. The proportion of these companies would be minimizing, or would completely disappear.

**6.1.1. Development of the capital market**

The Bulgarian capital market, which consists of the Bulgarian Stock Exchange – Sofia, the OTC Tariff and the Market of National Securities and Brady Bonds is still poorly utilized. The Bulgarian society is not too well informed about the opportunities offered by the capital market. In this context, it is important to implement a governmental policy in the sense of awareness and to orientate public limited companies to outsider shareholder structure with the participation of the smallest shareholders as an alternative to investing in real estate or simply the bank loans.

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## **8. APPENDICES**

### **8.1. Appendix 1. Interviews**

#### **8.1.1. Interview questions**

Please introduce yourself

#### **Questions in the Context of Corporate Governance Theory:**

1. Has the business enterprise you work at implemented the principles of good corporate governance? Why? For how long? What are the direct/indirect benefits/damages from their implementation?
2. What are the most important goals/objectives for your (or in principle) enterprise for having introduced good corporate governance practices? Have you achieved any of them?
3. Is a one-tier or two-tier governance structure embedded in your business enterprise? In your opinion, what are the advantages/disadvantages of the one-tier/two-tier governance structure? Which is more effective from the point of view of preventing bad practices and bearing higher public responsibility?
4. How is internal control in your business enterprise (internal audit, audit committee) (or in principle) organized? What is the meaning of internal control in the prevention of fraud?
5. Does your business have external control (a specialized independent auditor)? Do you consider that external control (a specialized external audit firm) is a 'bad necessity' because it is imposed by law or does it have real added value in the prevention of crises (fraud) within an enterprise?
6. Can the non-compliance with good corporate governance practices lead to bankruptcy of an enterprise or vice versa? I.e. does corporate governance fulfil the function of a pillar to tackle fraud, increase social responsibility and transparency of a business?
7. In your opinion, what are the three practices that most effectively contribute to the prosperity of your business (or in principle)?
8. What do you think are the reasons for bad corporate governance (or the lack of it)?

9. How do state regulators contribute to good corporate governance?

10. What are the specific good practices that contribute to restraint bad practices in your corporation?

**Financial Sector Questions:**

1. In general is there a conflict of interest, in your opinion, when of a member of the Board of Directors of a bank is also a member of the supervisory board and is also employed on an operational affecting the decisions on all levels? (Principal-agent theory)

2. To what extent can the internal audit or audit committee perform its supervisory functions in good faith, given that it is elected and remunerated by the governing bodies of the bank? Can he perform the inherent control functions in good faith?

3. To what extent can the external audit firm perform its control functions in good faith having been approved and paid by the bank's governing bodies? What are the mechanisms for deterring unlawful behaviour?

4. Can the state regulator foresee vicious management practices and counteract effectively?

5. In 2014 there was a financial crisis; did this reflect the political and economic situation in the country and to what extent? What is the significance of the financial sector for the Bulgarian economy?

6. What do you think are the most difficult effects to overcome after the crisis in 2014?

7. Is it possible to forecast financial crises and how? Are the Bulgarian legislative mechanisms adequate enough to do so?

8. Following the financial crisis in 2014, new standards and regulations were introduced in the financial sector. Would they be effective in the prediction and prevention of possible new financial crises before they arise?

Thanks for your attention!

### 8.1.2. Interview Transcripts

#### Interview 1. Bilyana Katsakova

*August 25, 2017 19:00h. Face-to-face at Garden Sofia*

1 Please introduce yourself!

2 Hello, my name is Bilyana Katsakova. I'm a lawyer. A significant part of my practice is dedicated  
3 to serving foreign investors in Bulgaria.

4 Why do corporations implement good corporate governance practices, according to you as an  
5 expert in this area? What are the direct benefits or disadvantages of implementing these practices?

6 What I can share as observations of the practice and the practice of realized investments in  
7 Bulgaria, is that the implemented system of management and control in the company itself is  
8 extremely important, in view of the successful realization of a specific project or completion of a  
9 specific contract. The management structure is of utmost importance, as in the case where the  
10 owners of the corporation exercise the management then the risk of gaps and bad practices in the  
11 company's management and operations is considerably more observable. In each activity and in  
12 each assigned project, it is a very important element. For example, in designing a building,  
13 supervision plays a crucial role; in the corporation - the control structure that the owner chooses to  
14 ensure good working practices and good results.

15 I.e. direct benefits would be the good results?

16 Absolutely, good results depend on the goal the owner specifies himself.

17 What are the most important goals or tasks for the corporation after the introduction of good  
18 practices in the management? Whether it is a financial gain; whether it is social responsibility or  
19 any other reason? Are these reasons being achieved through corporate governance?

20 Each of these reasons would be a motive for the introduction of corporate governance and would  
21 result in the benefits that meet the owner's requirements.

22 How has the distribution of competences and responsibilities in the structure of the corporation  
23 been achieved? Is it flatter or deeper?

24 Companies with owners who have an interest in monitoring the actual process of the activity - it is  
25 extremely important for them to control and be informed about the day-to-day activities and the

ways in which the activities are carried out. The whole organization depends on the structure of the company. As far as it implies a larger structure of subordination and staff, then organization of the governance structure will be deeper. It will lead to step-by-step control and the information can reach all levels of competence in both directions - from staff toward management as well as from management to executive staff. Hence, the clearer the structure is and the competences are distinguished, the control of the competent authorities is also clearer. Because in a clear structure, it is much easier to control and track where gaps are allowed that lead to a negative result. If the structure is clear, it makes it possible to identify the problem more quickly and fix it.

**Why in the corporation, where you work, you choose a one-tier or two-tier structure?**

In any case, the decision is taken by the owner of the company what control system they are needed to achieve the goals they settled. In this respect, this also depends on the volume of the company itself. Yes, a company could successfully be managed by a one-tier system without a follow-up control unit, without permanent supervision, and it could achieve its goals. As practice shows, and as practice implies, everything is a matter of trust and fulfilment of the taken responsibilities. As it gains popularity recently, institutions are not institutions by themselves, but they are what people are considered collectively. In this aspect, in the management, and in every other activity, it is as much successful to accomplish its goals, as the people inside it pursue these goals themselves.

**Information asymmetry, trust. Is trust a serious element and a decisive factor?**

Trust is a decisive factor because you cannot demand it in the vacancy notice as a requirement in organizing the structure or in hiring. It is a quality that builds up, exists and consolidates the execution of goals in a very stable way. In my practice, I can say that wherever there is a trust, and it is established over the time being, things happen even with a single look. One knows that can count on employees, that they can pursue the specific goals. If it is not clear what goals are being pursued, each one performs the functions assigned to him/her only. The ultimate goal is not attained, as everyone imagines.

If at the owner level, the goal is one, and at the management level - the goal is different. As a result a different understanding of the goal is considerate.

**According to you, how the trusted relationships between the two levels - principal and agent are being built up? Are there mechanisms that can be used to build up sound relationships?**

56 Creating trust is a practical matter. As long as some norms can be formulated, trust is a matter of  
57 personal attitude and concern.

58 The other way in which sound relationship can be build up is through motivation, through various  
59 bonus systems, additional remuneration in respect to the result?

60 This is the main motive for making a particular person involved in achieving the overall goal. He  
61 can see this goal at the moment he sees his own interest. Creating such incentives is for a person to  
62 recognize himself as part of the general goal because of his own interest. There is no way to  
63 acknowledge the owner's goal only in achieving the profit for the owner itself. In any case, the  
64 development of mechanisms that stimulate the employees at all levels to be empowered and  
65 committed to achieving the goals that are placed on them is crucial. In order to a person to be  
66 committed, to giving all of its knowledge and stamina, there must be personal commitment to it.

67 What is internal control and what does it serve to?

68 Both the composition of the management and the control system is the sole solution of the owner  
69 and, depending on the goals he / she settles, would make a structure that will ensure the objectives  
70 are achieved. It depends on what the owner needs. Whether he or she needs to guarantee the tasks  
71 he / she assign to or needs control to confirm to another external control authority that the activity  
72 meets certain regulatory requirements.

73 If we are talking about an internal audit and an audit committee, in this case, how can these internal  
74 authorities could be motivated to perform their duties in good faith?

75 The internal audit is entirely in the company structure. It would depend on the remuneration  
76 within the company. It depends on the owner how much he can motivate them to perform their  
77 duties.

78 The answer immediately appears itself: that everything depends on the will of the owner.  
79 Theoretically, the internal audit should definitely guarantee an objective checks on and objective  
80 status reports. In practice, practice proves that there is occur something different as a result.

81 What is corporate governance that leads to bad corporate results?

82 This is the lack of corporate governance, in practice. I.e. it is not as required by good trade practice  
83 and regulatory framework. Then the result, sooner or later, even for the owner will be negative or  
84 will not meet the expectations. Such corporate governance is manipulative management.

85 Would such corporate governance always lead to bankruptcy?

86 Practice shows that even the very good corporate governance leads to bankruptcy, depending on  
87 the goals set by the owner.

88 Can you share reasons for the emergence of practices that lead to poor corporate governance  
89 results?

90 What is a bad practice?! If the owner is aiming at bankruptcy - the result is good. The theory must  
91 be distinguished from the reality.

92 Do you consider that the external audit is a necessary “evil” or has its added value?

93 There is definitely added value! If it fulfils the obligations that are legally defined and the  
94 objectives for which it is legally binding, then there would be efficiency. We need to distinguish  
95 theory from practice. Where is the difference? In the practice there is formally used control to  
96 achieve other goals. For example, supervision of a construction activity and the realization of large  
97 investments, supervision play an extremely important role in achieving the objectives. If the owner  
98 allows himself to load the external audit with informal functions, the result is guaranteed - failure  
99 of the investment. This is a major problem in Bulgaria.

100 What are the good practices that most effectively contribute to corporate prosperity?  
101 At any moment in which they (practices) perform the functions assigned to them, which  
102 correspond to the objectives of the legal norms that they have provided, then there would indeed be  
103 good results. I'm talking about the intended controls and regulators.

104 What are the specific mechanisms that limit poor practices?

105 Effective control! Because, it is legally provided. Internal and external control can also be used.  
106 The question is - what is the purpose, they are used for?

107 What are the reasons for the bank's collapse in your opinion? Could this collapse be prevented?

108 In order to take a specific position, there is a need to be acquainted with the structure, function, and  
109 checks carried out. In particular, I cannot give a personal opinion about facts. But there are enough  
110 authorities in the state to find out what the gaps are. It would be interesting to the public to  
111 understand where the reasons for the state to fall into this situation. I say the state, because the state  
112 is an essential element of controlling the activity of a bank. This is state regulation, which also has  
113 its competencies and responsibilities.



114 Do you support any of the hypotheses that the breakdown is due to poor corporate governance,  
115 corruption, fraud, or due to private interest of dropping out of the currency board, personal  
116 revenge?

117 The reasons are complex. Reasons cannot be attributed to a single reason, and only for a bank of  
118 management or control mechanisms.

119 Do you know who the high-ranking managers in the bank are?

120 No, I have no observations. I have no idea if there is public information because I'm not interested.  
121 This information is of interest to people who have specific grounds of interest.

122 What are the reasons for the for the bank's rise in terms of corporate governance?

123 I have no direct impressions.

124 In the public there is a theory that this rise is due to relations with the country's elite?

125 Yes, there is a lot of information about this in the public media. I believe that we have very good  
126 regulatory mechanisms, as well as competent institutions, which can identify it and report it as  
127 information.

128 What are the internal and external circumstances of creating the model of the bank?

129 There are many factors that have led to this. As well as circumstances (contacts with the country's  
130 elite) are certainly available. There is no one factor, one reason to lead to this result. The omissions  
131 must have been a lot both at the level of internal control and at the level of external control and at  
132 the level of state regulation.

133 There are few auditing companies that have the capacity to perform audit of a bank. Some of these  
134 were involved in the annual audit reports and at later stage participated in the bank's inspection  
135 after the bank was placed under the special control. Is not it the conflict of interest?

136 The answer is assumed itself. You actually control something you've done yourself.

137 Is the State Regulator the authority that should supervise the conflict of interest or other authority  
138 in order to prevent the situation from negative results?

139 The State bears its responsibility for the control exercised in this case.  
140 Why did the Central Bank not respond to the financial statements and why did not support the  
141 bank?

142 I do not have objective information

143 Are there any good practices that could be used to prevent insolvency?

144 Definitely! Yes! Few examples and practices utilised, and from the very specific case, conclusions  
145 can be drawn that could serve to prevent insolvency.

146 Do you believe that legal amendments in financial sector legislation will help to better anticipate  
147 similar situations?

148 I very much hope that the experts will not remain impartial and will draw conclusions from the  
149 situation with the bank, which leads to a lot of damage. Let us hope that pre-notification practices  
150 will be established in the future.

151 In the case of the bank, it seems that a person performs all the functions as in the insider structure?

152 How does this affect the bank? Can it be seen as an intervention to achieve certain benefits?

153 As far as I do not know the case in detail, I cannot comment on this issue, as well as the presence  
154 of a conflict of interest.

155 In principle, in terms of mixing many features into one person this leads to a series of management  
156 errors. Even if this person in a certain way wants to direct the whole activity of a corporation, there  
157 is no division of competences and authorities, the problems are inevitable.

158 Did the case impact the political and economic development of the country?

159 It has definitely influenced the country's political and economic situation and we will still suffer  
160 the damage. Let us hope that sufficiently competent specialists will give their opinion and they will  
161 be taken into account in order to overcome the case with a positive change of practice and  
162 legislation.

163 Are management mechanisms effective for preventing centralization of power in corporations and  
164 why are these mechanisms important?

165 In my opinion there are enough mechanisms. The question is how they apply in practice. It is  
166 extremely important, because the effective control guarantees good results.

**Interview 2. Dimitar Djutev**

*August 29, 2017 19:00-20:10h. Face-to-face at Eurolex Office Sofia*

1 Please present yourself!

2 My name is Dimitar Djutev, a lawyer in education. I have a Master's Degree in European Private  
3 Law. I am currently a managing partner in a family group of commercial companies.

4 Is the commercial enterprises, where you work, have implemented the principles of good corporate  
5 governance?

6 The group of companies I manage are specialized in several directions. The main focus is  
7 providing legal services to corporations. We also deal with assessing the legal risk of decision-  
8 making by corporate management as well as in the field of renewable energy sources. In our  
9 activity, we have introduced such principles of good governance, although we are not legally  
10 required to do so.

11 Why have you decided to implement these principles?

12 My and my partners' belief is that this kind of good corporate governance principles will give: first,  
13 a better trust to our clients, to investors in our businesses, and a higher trust in our creditors. These  
14 principles help us make better decisions in our operations and avoid frequent mistakes in our work.

15 How long have you been utilizing these principles?

16 The principles we introduced at the end of 2006. It can be said that they have been effective with  
17 us since 2007.

18 What are the direct / indirect benefits / damages from their implementation?

19 Our image is better, the partners we work with are glad that we are introducing a significantly  
20 higher standard than the one we are legally obliged to observe.

21 I emphasize trust. Separately, in the way we make decisions within companies, we have order and  
22 this is very useful. It seems to be very good for our business.

23 What are the most important goals / objectives for your (or, in principle, commercial) enterprise  
24 after the introduction of good corporate governance practices?

Our goals were generally, long-term goals, better accountability to our clients and better interactions with creditors; be clearly visible and understandable to them; knowing where our ship with a corporate structure is moving. From an internal point of view - the idea was to grow business and optimize the processes inside, raising profits.

I.e. with the introduction of these principles, have you achieved these goals?

Most of them – yes! In terms of revenue growth, I dare to say that several economic shocks in 2008, 2009, 2014 have had a significant impact on ours and on the stock market at large. In this sense, we are feeling the perceptually good effect of these practices.

Is a one-tier or two-tier governance structure embedded in your business enterprise?

Our businesses are in the form of limited liability companies. We do not have this structure resembling a joint-stock company with a one-tier or two-tier governance structure. We do not use these governance tools, as we do not have the norm to do it.

In your opinion, what are the advantages / disadvantages of the one-tier / two-tier governance structure?

Both forms of corporate governance have their benefits and negative elements. I think the one-tier structure is better for corporate structures of a smaller type, as the other - would make it more difficult for an administration.

In my opinion, larger and more socially responsible corporations with a significant effect on the economy in a particular industry or in more developed country are better at having a two-tier governance structure, as it ensures better accountability, better governance and social involvement of this private enterprise.

Which is more effective in terms of preventing poor practices and bearing higher social responsibility?

The carriers of higher social responsibility are the large corporations with a great effect on society. In this sense, it is clear to me that the two-tier governance structure should take this risk.

Undoubtedly, the two-tier governance structure is more useful for preventing bad practices, as its tools are richer. The idea of this two-tier structure is to have an additional level of control by independent members. In this sense, some people who have a higher look can identify the problem much better than others who are involved in the activity themselves.

54    **How is internal control organized in your business enterprise?**

55    We have implemented internal control in two directions. We have direct operational control over  
56    what is being done, and it is done by both our managers and our internal auditors who are actually  
57    external independent auditors. Their reports and remarks are taken into account only by the  
58    managing partners.

59    The other control is ideological and it is implemented by the managing partners on the lower level  
60    managers.

61    **What is the meaning of internal control to prevent fraud?**

62    It can be very large. It's a wonderful tool. There are great achievements as long as it is used in the  
63    right way. Since internal control can identify problems early in their maturation and be eliminated  
64    before negative effects occur, whether only the corporation and its structure or the financial  
65    attitude or employees, etc.

66    **Do the companies you work at have external control?**

67    By law, there is no such obligation for our companies. We use external auditors ad hoc. We have  
68    projects on which we work and use external auditors as this is a guarantee of the high quality of the  
69    service we provide.

70    **Do you consider that external control is a necessary “evil” as it is imposed by law or has real added  
71    value to prevent crises (fraud) in the commercial enterprise?**

72    It could be. Presumably, the law is good and fair and yes- the external audit has an added value.  
73    The question is how it is used. Law is a beautiful tool that can do bad things in bad hands. As far as  
74    external control is independent and performs its function in good faith. This tool is wonderful and I  
75    am very glad to have it. In cases where it is not well used, so-called independent auditors become  
76    dependent on corporate interests - it is a great deal of trouble for the whole of society.

77    **Can the non-application of benefits to corporate governance practices lead to the bankruptcy of a  
78    commercial enterprise or vice versa?**

79    Everything is possible, but I think this is more a consequence of bad management decisions, not so  
80    much of non-compliance. A good manager can easily bring his company into a better financial  
81    position without using these practices, or using them and going bankrupt. I.e. corporate governance  
82    principals and corporate management have no cross section.

83 **Ie. Does corporate governance fulfill the function of a pillar to eliminate fraud, increase social**  
84 **responsibility and transparency of the business?**

85 Yes, as far as these mechanisms are used by people who want to work honestly without fraud and  
86 are socially responsible. Everything rests on the human factor.

87 **In your opinion, what are the three practices that most effectively contribute to the prosperity of**  
88 **your group of companies?**

89 I believe that good and transparent accountability is the basic thing. The third practice: that I have  
90 adopted in a very creative way - the development of human resources. We strive to give inspiration  
91 to people and to support their personal development-better people do what they can. That is the  
92 only way we can build ... we actually support a team of people who do exactly that.

93 **In your opinion, what are the reasons for poor corporate governance?**

94 The human factor - especially greed.

95 **How do state regulators contribute to good corporate governance?**

96 With their independence and the presumption that they follow a state policy that is in favor of  
97 society. While there is a clearly scheduled program and is followed by these regulators - everything  
98 will be fine. However, I believe that we have lost ourselves in Bulgaria. There may be something  
99 on paper, but people do not keep it, or at least have no idea of keeping it.

100 **What are the specific good practices that contribute against poor practices in your companies?**

101 Mostly this is transparent accounting. We want our partners to know who they are negotiating  
102 with, what our results are and we have no problem showing up. it is the clear accounting that we  
103 can demonstrate. And personal development of people's potential, not turning them into robots.  
104 The best results are achieved by happy and content people.

105 **The financial sector**

106 **Is there a conflict of interest when the decisions of a member of the board of directors as well as at**  
107 **the operational level (the employees) in a bank are influenced by the member of the supervisory**  
108 **board?**

When this occurs in a structure, there is a very substantial conflict of interest. It totally contradicts the agent's theory. On the practice, it turns out that one person offers, controls and executes the decisions.

To what extent can an internal audit or audit committee perform its supervisory functions in good faith, bear in mind that it is elected and remunerated by the governing bodies of the bank?

This is related to human resources. Whether an auditor will fulfill his duties depends only on him. What will be written in the report to the management and the external auditor - depends on many things. This dependence implies that the official report will be different from the unofficial.

To what extent can the external audit firm perform its control functions in good faith if being elected and paid by the bank's governing bodies?

Banks are required to have an external auditor and they will always pay to an external auditor no matter whom. On the other hand, auditors who can afford to audit banks are not that much, and in this sense it is a moral issue how they will cope with this pressure-which may be significant. The last few years we have witnessed such a case. It is a question for people to decide what to write in the report. Specifically, in the banking sector, social engagement is so serious that dirt should be displayed, in order to be clean easier.

What are the mechanisms against fraudulent behaviour?

In the case of external auditors, a certain circulation of several years is a good solution. The auditors themselves carry out their personal, criminal, financial and moral responsibility for what they discover and do not share with regulators.

Liability can be in two directions: Empirical loss of license; 2. Loss of trust.

Can the state regulator establish vicious governance practices and counteract effectively?

Yes, I believe the state regulator can do it. He has the opportunity to go in everywhere, to see what's going on. There are models according to which experts can calculate the risk for certain financial institutions to be placed under more substantial monitoring and to examine the processes inside. State regulator can prevent problems because that's their function and duties.

In 2014 there was a financial crisis. Did this reflect the political and economic situation in the country and to what extent? What is the significance of the financial sector for the Bulgarian economy?

138 The importance of the financial sector to the economy of the country is huge. This crisis has  
139 affected significantly. Many people lost their money, many businesses sank; taxpayers became  
140 increasingly indebted because of the loans the state was supposed to take. In this sense, we all pay  
141 for the mistakes of other people - I do not think that's good.

142 Yes, the crisis reflects the political system indirectly because the same people were in the  
143 government yesterday and they are today.

144 **Is it possible to predict financial crises and how?**

145 Financial crises can be predicted. There are models for this, and financial analysts do it.

146 **Are the Bulgarian legislative mechanisms adequate enough?**

147 Yes, they could be if people are aware that their goal and responsibility to society is to detect  
148 crises. They are cyclical - coming to waves. The question is how people will deal with them.



**Interview 3. Galin Petrov**

*September 5, 2017 19:00-19:38H. Face-to-face at TBC Office Sofia*

1 Please present yourself!

2 My name is Galin Marinov Petrov. My company Transcontinental Business Consulting is working  
3 in the sphere of the realization of structural projects, which are related to the construction of linear  
4 objects, cable routes, pipelines, gas pipelines and, respectively, in telecommunications - the  
5 different types of communications for signal transmission.

6 I graduated in Biology and Chemistry, with a second Master Degree in Engineering Ecology, but I  
7 work in other majors in practice.

8 How long have you been doing this?

9 For 19 years.

10 Have you implemented the principles of good corporate governance in your commercial  
11 enterprises?

12 As much as the principles of good corporate governance can be applied to the audits, in order to  
13 obtain ISS Certificates, starting from 200 and coming to the next, in connection with my activities -  
14 yes.

15 This means in practice that there is a vertical and horizontal governance structure. It is *de facto* to  
16 know who employees assign tasks to whom and to whom they are responsible for. Yes- I have.

17 Could you share the reasons and since when did you apply these practices?

18 These practices have been implemented for 9 years. Certificates are not just a necessary “evil”.  
19 When your partners see that you have a full certificate in your area...it takes trust. But these  
20 certificates also teach you. In practice, when trainers come, they teach you first. The accredited  
21 agencies to issue such certificates, they do the training of the staff; they come into the structure and  
22 the way employees work. Then trainers make a line that can be complied to match the particular  
23 certificate. I actually put them in and go on when they go to my area to be able to train the staff and  
24 be the most appropriate for the topic.

25 However, my partners, knowing that I have these certificates, can rely that whatever we do in the  
26 field, it will always be the same. That is not going to be done today in one way, and then in

another. There is no other structure of thinking and realization of the projects. Certificates, in practice, give you a sequence of actions that you should always follow.

Reasons for implementation are for internal compliance and for external trust. However, behind these certificates are companies and structures that do not give them easy.

**Is a one-tier or two-tier corporate structure implemented in your business enterprise?**

The structure is one-tier, as long as the enterprise is Ltd. From the point of view of the supervisory board and the board of directors, it is practically one-tier. Of course, these are people who carry out post-control activities.

**In your opinion, what are the advantages / disadvantages of the one-tier / two-tier governance structure?**

It is difficult to talk about advantages or disadvantages because it is a matter of legal regulations. The one-tier structure knows exactly who decides and who is responsible. The disadvantage is that the management cannot stand on a parallel opinion, on a parallel responsibility. Besides, there is no sideways view of the activity, which could be a kind of corrective itself.

**How is internal control organized in your business enterprise?**

Internal control is still part of the Certification System. In practice, there are people in charge of various activities, including even when comes to labour medicine. An employee is responsible for certain activity. Another is responsible for instructing people. For example, lawyers supervise their implementation horizontally, or define them to the people they need to approach.

There is an internal control system and it is written in a vertical and horizontal structure. An internal audit, in the specific sense of the term, is not an exact audit. These are people who have been entrusted with my order such functions to exercise control over the activities of others. Above them there are also employees who exercise control over their activities.

**What is the significance of internal control to prevent fraud?**

I would not call it fraud because fraud can happen in companies that are large enough to have no interest and no direct involvement of management as an owner or as a person to implement the policies of the company in which he is appointed. Frauds could happen in companies where there are some people appointed to manage, and some other people who own it, but they stay away. In practice, then, both internal control and internal audit are very important to be chosen by the

owners. Internal and external control structures control those who are elected to manage the company's activities.

The idea of internal control is important, it is very important to be realized. A fraud - no way, because the structure is distributed vertically and there are no executive directors who can do anything like fraud.

Can the non-application of good corporate governance practices lead to the bankruptcy of a commercial enterprise or vice versa?

There is a way to keep an eye on what's happening, no matter applying or not applying the good practices. If you actually control the task from beginning to the end; to judge the strength of the company whether it can or cannot cope with a task and do not accept engagements or volumes of activities that would cast your resource in practice. This can lead to bankruptcy. So the practices of corporate governance are unified, they apply to everyone - taking into account the real situation.

Would the failure to comply these practices lead to poor results?

In any case, the level of internal control is such that any failure should be noticed at an early stage; that something is wrong; and some of the engagements of certain people are not being respected. Then the person has to be changed - in general. Or it can be seen in practice whether it depends on someone else who does not do its responsibilities properly. This is a sense of concreteness.

Yes, everything can lead to bankruptcy. If a procedure is violated at work, there are always ways to be seen by the manager - he cannot wait for anything to go in the wrong direction endlessly.

In your opinion, what are the three practices that most effectively contribute to the prosperity of your businesses?

Good practices are to engage in activates and types of activities that you know you can accomplish. It is not first and second. They are parallel. They can be ranked in the most important way: do not mislead your partners with whom you work, your outsourcers; do not start something- if you not going to end it; integrity and honesty.

It is very important in the period and years when you worked on a project. The project has finished. Whatever it is after its realization, your sponsor-partner will find you again in a few years. You will again work, you will complete the job. Not to finish a job and to say the warranty expires - I

84 do not care anymore. No such thing. When you have partners, you are always part of the project,  
85 no matter how many years have passed. Consistency.

86 **In your opinion, what are the practices to motivate employees?**

87 To show them that you know what they are doing and there is a control. This encourages them  
88 because they will be appreciated, and they will not go wrong with poor practices. When there are  
89 good results, there are financial incentives. In the small corporation the relationships are close as to  
90 a family- aid in different spheres. Employees know they can rely on the corporation.

91 It is very important to know whether you are wrong or not wrong. When things go well to  
92 encourage him, tell him.

93 **How do state regulators contribute to good corporate governance?**

94 There must be order. Different companies meet a different status under the trade law and legally,  
95 but there must be regulations for each type of company. Once you have chosen to have certain  
96 type- there are common rules to obey to the state regulation. Yes, I think state regulation is useful.  
97 It is not accidental to invent laws that are subject to different companies. There are regulations  
98 applicable to financial terms, in management and as registration. When one knows that a partner is  
99 registered in a certain way - one can expect certain reactions on his part: way of managing, way of  
100 control, opportunities. It has a positive role.

**Interview 4. Nikolay Mithankin**

*September 11, 2017 13:30-15:00h. Face-to-face at the HQ Sofia*

1 Please introduce yourself briefly!

2 My name is Nikolay Mithankin. I work as Investor Relations Director of Stara Planina Hold. Stara  
3 Planina Hold is a public company. It is a Holding structure that owns several businesses. We have  
4 nearly 23,000 shareholders. The holding has no majority owner.  
5 Though, the holding itself is the majority owner of most of its businesses.

6 I have graduated Mathematics with computers. Then, I graduated in Economics with a major in  
7 Management. I have been working in the holding for 12 years.

8 Thank you. Did the business enterprise in which you work at implement the principles of good  
9 corporate governance?

10 Yes. As early as 2003, we have adopted here a program for internationally recognized standards  
11 for good corporate governance for the first time. Then, in 2007, more precisely on October 30th,  
12 Stara Planina Hold became a co-founder in the adoption of the National Corporate Governance  
13 Code. So, we can say that for more than 10 years we apply good practices of corporate governance.

14 What do you think, what are the direct / indirect benefits / damages from their implementation?

15 We believe, we not only believe but we see it in practice, that introducing good corporate  
16 governance practices could lead to greater trust in two directions. The first direction comes from  
17 the customers and the suppliers. As a result, stability of the market presence of our enterprise is  
18 ensured. Second, investors look for the securities of the holding. Thus, through good corporate  
19 governance, we provide more transparency about the market capitalization of the company. As a  
20 result, this leads to a guaranteeing shareholders' investments and their profitability.

21 I.e. these were your goals that motivated you to implement good practices of corporate  
22 governance?

23 Exactly! Back in the days, the adoption of the good corporate governance program originally  
24 began as a good practice. It was then introduced as a law. Then, the adoption of the National  
25 Corporate Governance Code was not an obligation for companies quoted on the stock exchange.  
26 The adoption itself was an expression of good practice as the requirements of the Code exceeded

the requirements of the law, as well as, the requirements of the broadly applied programs which stockbrokers had to oblige due to the law.

We find that since last year, every public company has already been obliged to adopt the Code of Good Corporate Governance. Whether a code that the company itself has decided to adopt or the code of the Financial Supervision Commission.

What is the structure of your company - one-tier or two-tier governance structure?

We have a one-tier governance structure. The Board of Directors consists of four persons. This also applies to subsidiaries. Typically, the Board of Directors consists of 3 to 4 persons.

In your opinion, what are the advantages / disadvantages of the one-tier governance structures in comparison with the two-tier? Can you make a comparison between the two?

Most Bulgarian companies have a one-tier governance structure. And this is dictated primarily by management costs. This is the main reason – the management costs. You can also make statistics and find that almost anywhere the Board of Directors consists of 3 to 4 members. The two-tier governance structure is applied to those companies that are required by law such as banks, insurance companies, and so on. There are separate cases of companies that are not legally obliged, but they have a two-tier structure. You should rather ask these companies why they are implementing such a structure.

For our local conditions, for our geographical latitude, the one-tier structure is more practical.

Does a one-tier structure act faster when dealing with crises within the enterprise?

Of course, that's right. This is correct! The one-tier structure is more operational.

How is internal control structured in your business?

Firstly, we have an internal control system in place. It is clearly explained on the holding's website. In fact, on the website of the holding within the framework of good corporate governance practices all internal regulatory documents are published, even the Code of Ethics for Employees.

So we have internal control rules. It is a little bit specific at our company because the appointed employees are 4, namely: Investor Relations Director, Development Director, Chief Financial Officer and Office Manager. That is all! And somehow to internally appoint individuals to be in charge of internal control is not logical. Nevertheless, we have concrete rules for internal control

that these employees apply. Moreover, we also have an Audit committee. We have an External auditor appointed by the shareholders.

Outside of the questionnaire, I would like to ask you, this transparency that you have, accessible by everyone through your website, do you think it helps to improve the attitude of your partners or users to have more confidence in your business?

I suppose. I hope so. We have not conducted any research. But we know that when our enterprises are looking for partners, when they assess the possibility of partnering with someone, this is also a criterion that is being addressed. I can tell you that the largest customer of one of our plants is Palfinger Austria, which is one of the leading manufacturers of truck equipment. It is a highly transparent business with its entire holding structure.

Otherwise, criteria for achieving the objectives of good corporate governance are not available. In the end, we can assume that this is the company's external assessment, therefore the capitalization - the prices of shares.

In February 2009, after the global crisis, the price per share of our company was 1.04 BGN. Before the crisis it was 9 BGN. Now you tell me if the price fell due to the good corporate practices.

But I can give you concrete examples of good corporate practices exactly in this period of steep slope down that cannot be found even in the most detailed corporate governance codes.

Such a good practice is namely, the acquisition of our own shares. You will not see this practice anywhere written in any regulation, nor in any corporate strategy or approved code. What happens when the company decides to acquire its shares in conditions of a steep stock market collapse? Our holding purchased its own shares. Of course, this is a rather complicated procedure, because the decision of the General Meeting of shareholders is first sought. We did it. It empowers the Board of Directors to make the appropriate procedures. In a public company there are many complicated bureaucratic procedures, but we did it. At any given moment, the market appreciates this fact.

You can see the steep collapse of the shares three times and we have three redemption procedures and at each procedure the result is a rise in the share price, enhancing investor confidence. After the last procedure, the shares went up on their own.

What happened in 2008-2009, after the global financial crisis? It first hit the stock prices of public companies. And what happened 7-8 years later, after the bottom? Our bottom was in February 2009. Currently the cost per share is between 8-8.50BGN.

85 What has happened in that period since then? In 2007, on the Bulgarian Stock Exchange, but not  
86 only, this process was not local, it was global. There was over-confidence in the stock exchange.  
87 Shares were bought continuously and their price grew steadily. After the stock market crash, the  
88 confidence in them instantly vanished. Very difficultly and very slowly a recovery took place.  
89 Please note, this happened only to those companies that were quality companies. We have an  
90 example of a company whose share in 2007 had reached 12-14BGN. After the collapse, the stock  
91 price goes to 0.5 BGN and is currently at 1.40 BGN. I.e. we cannot talk about a recovery. This is  
92 not a singled out case. The reverse side of the coin are those companies that were rated more  
93 equitably by the stock exchange. Our company is one of these. From hitting the bottom in 2007, in  
94 recent times the maximum share price is 8.60 BGN. I.e. we go back to those positions when the  
95 stock market was “peacocked” - this is the working name when ‘many people buy without being  
96 interested in the foundation’. Current investors are interested in the foundation. One of the criteria  
97 for a good company rating is good corporate governance.

98 So the first example was acquisition of own shares. Now I will give you a second example. Each  
99 public company is required by law to publish regulated information. For example, it publishes  
100 financial statements every quarter of year. The company is obliged to do so. In 2009, at the peak of  
101 the crisis, in March 2009, we decided to publish monthly reports. We have not stopped ever since.  
102 Of course these monthly reports are in a more concise form, but they provide basic information at  
103 the end of each month about sales and earnings of the end of the previous month, and what are the  
104 forecasts for the current month. We publish these forecasts on the 22<sup>nd</sup> every month depending on  
105 the weekend it can be up to 24<sup>th</sup>. But on 21-22<sup>nd</sup>, we publish information till the 30<sup>th</sup> of the previous  
106 month, which are real results and forecasts, and also how we will finish the current month. I.e. 10  
107 days before we finish the current month, we announce how we will finish. We do not hesitate  
108 telling the audience that we are in poor trade-off.

109 (Shows charts of stock levels)

110 Do you see the price levels in 2009? Then we decided to take this step. Since then, we have not  
111 moved back - we do it every month. We were given as example and many companies followed our  
112 example. Thus, one of the criteria for achieving the objectives of good corporate governance is  
113 market capitalization correlated to the total market capitalization of the stock exchange or some of  
114 its indices.

115 I think, I have some statistics in the unconsolidated half-year report (...). One of the documents that  
116 every public company has to publish is an interim activity report. It contains legally required



parameters. It makes it a little clumsy to read, but investors know where to look. All this is required by the law. It is under the section Structure of the Investment Portfolio and at the enterprises one by one.

(Indicates a text from the report)

Here, you see the movement of our company's shares; you see the SOPHIX where it moves.

Yes, yes

For the period from 1.01.2017 to 30.06.2017, we have a 27-28% share growth. At the same time, the representative benchmark of the Sofia stock exchange - Sophix, its growth was 19.6%. I.e. we surpass it.

(Phone rings)

Can we go a step backwards to clarify something, what is your opinion about the internal control and what is its value in the prevention of fraud?

As an end-goal - it has value, it has a meaning. But ultimately, it depends on whether this goal is achieved and that depends on the management of the particular enterprise.

The history of the legislation in our area, the regulated enterprises - public companies, banks, insurance companies, investment intermediaries, insurance brokers, etc. The history of the development of law on a global scale shows how a good practice is been created even since 1920 and then, it shows how this good practice sooner or later becomes a normative norm.

The most ancient case is the case with the auditor when the owner has several businesses. He's already a billionaire. He appoints a trusted person to check the accounting books - to do an independent accounting audit. Currently, the legislation with the independent audit is very strict, in some cases even unnecessary.

We cannot look for the answer to the question whether the independent audit leads to good results and efficiency. It leads to an extent depending on the interaction between the independent auditor and the management or the owners, who have appointed him, especially if the owners are managers. It depends on their interaction.

For example, in a situation when you (the auditor) see a number, but hide it, forget it, and then you sign. These examples are well-known. The same applies to the audit committees. Until a few years

ago, audit committees were a very good practice. And we had an audit committee. Suddenly a law came, which said, everyone is obliged to have audit committees. Why everyone? Why is it not left as good practice?

With regard to good practice, I have always said - leave the good practices' territory as a good practices' territory. The very moment a good practice turns into a law, it jabs the eyes of most of the business. In some cases, the idea is good, the implementation is formal. In other cases, it really obstructs the business.

How does it hinder the business though, financially or due to bureaucracy?

Bureaucracy is being created. There are many examples in my head. There is no point in giving them, but that's the general impression. Otherwise, with us, both in the holding and in the enterprises, not all have internal control bodies, but all have such a procedure. According to us this procedure fulfils its obligations. Not all enterprises have Audit Committees, but only those that are legally bound to such regulation. They have their own rules accepted by the shareholders.

I would like to emphasize that the Audit Committee has no control functions, it only monitors the processes. The extent to which they monitor these processes depends on the interaction of the managing body that assigns the monitoring and then pays the salary.

This is in fact one of my questions, how can the Audit Committee perform its duties in good faith, being financially dependent on the management of the company?

We can ask the same question about the Auditor. The auditor also receives remuneration, but he has the rights guaranteed by the law, having the right not to sign or to request special action from the management of the company, or to request a declaration or a description of the policy over a certain problem when there is a contradiction between the managers and the auditors. In this way, he signs with an opinion. The law is well-suited. And when the investor reads this document, he can draw his own conclusions, whether to invest in this venture or to withdraw the investment.

In the case of audit committees, however, their rights are not so well defined in the law. I am talking about European legislation in this case. There the question is of good will. Where there is good corporate governance, the function of audit committees makes sense and vice versa.

Can an enterprise that does not apply the principles of good corporate governance be successful?! There are examples. An enterprise can only follow the law without committing to additional good practices and it can also be successful. I can give examples of such businesses. Perhaps I should

not mention the names though. But there are companies with an extremely negative image, yet successful and giving dividends. After all, shareholders who buy and sell shares on the stock exchange with speculative (in the good sense of the word) are looking at making a return on their investment. In this case, I have observed their reactions. There is no transparency, but see what dividend they gave.

In this case, what are the reasons for poor corporate governance, whether the human factor plays the important role or rather the manager's goals?

I do not acknowledge the term "poor corporate governance". We can talk about 'lack of good corporate governance', but that does not mean poor corporate governance.

What does "poor corporate governance" mean? Let's go back to an example: if an enterprise complies with laws, it does not violate the law - is this poor corporate governance? This enterprise lacks good corporate governance. Is that correct? That's correct!

The concept of "poor corporate governance," if it comes down to a lack of good corporate governance, then we can continue the topic.

Then, is the lack of good corporate governance motivated by one's mercenary interest or self-advantage and what is the reason for not applying such?

In Bulgaria, we have examples of public companies that have been brought to bankruptcy by the lack of good corporate governance within the framework of the law. Here comes the role of law enforcement and supervisory authorities. When a supervisory body makes the initiative to turn a good practice into a rule of law, we, who are on the side of good corporate governance, support the state's efforts in this direction.

Is this how the state regulators can contribute to good corporate governance?

Yes! Several businesses were drained and then the law was found incapable, without any texts that could be used preventively, to avoid such practices. Nowadays, we already have these texts within the law but we still have bad examples.

What are the specific good practices that contribute to limiting bad practices internally in your corporation? In other words, how do you stimulate your employees to perform their functions in good faith? Do you motivate them through additional bonuses or in other ways?

By accepting to comply with the National Corporate Governance Code our company has integrated its internal rules so that actions that result in compliance with the requirements of the National Corporate Governance Code (which are not legal requirements). We in our internal rules have introduced such requirements for employees that are made mandatory for them, i.e. when a company agrees to use good corporate governance practices that are more than the requirements of the law. Then this company must ensure the procedures for this compliance. This happens by making the internal rules for their employees so that it is an everyday life for them. We could not say that we are 'encouraging them through bonuses'. These are simply internal regulations that are binding for them.

I will quickly go back to the issue of good practices in state regulators.

This is a very painful question, because in the case of our business - a business that is regulated, any kind of bureaucracy is put on us. In one of the structures of the EC, which is the 'ultra-bureaucracy in the world', there is a department with appointed people called "Gender equality". This department exercised its powers on the back of regulated business. We've always asked the question. If you want gender equality, you have state-owned enterprise with predominantly state-owned role, make it gender equal. Our business is such that we cannot put Gender equality first, the second the quality of the management team, because managers are hard to find. We cannot find managers. He wants a regulation to oblige us half or a third to be of a particular sex.

The lack of good practices in state regulators is subject to much discussion. A good practice of a state regulator is when it puts forward its projects in advance - its draft amendments. We are witnessing a lot of cases when a state structure that has the right to decision-making puts somewhere unknown on its website a notification about a change in regulation and then nothing! Notifications are not made publicly accessible on media about a project. Then they say that the 14-days deadline has already passed. This is a massive example of 'poor' practice in the state regulator. See the Law on Legislation Acts. This is a law that was changed first in 2007 and the in 2016 to adhere to the European requirements.

For us a good practice in the state regulator is the relationship between them and the non-governmental sector. I am pleased to say that, with regard to our supervisory body, we have a great deal of interaction over the last year.

I have a few questions from the financial sector

I've been working in a bank for 10 years before I came here.

In your view and experience, is there a conflict of interests when, in a bank, a member of the Supervisory Board influences the decisions of the Board members and is an employee on an operational level?

You are asking about the case when a member of the Supervisory Board is a majority owner.

Yes.

This is natural. There can be no conflict of interest. That's perfectly normal. Banks have a two-tier structure. There is a Supervisory board, a Board of directors. He is either a member of the Supervisory board or member of the Board of Directors. This is a global practice. The majority owner is a member of some of these boards and is entitled to have only one vote. If the Supervisory board consists of 3 members, he does not have a majority, he cannot impose on his own solutions or decisions, but the Supervisory board only impose decisions on the Board. He cannot impose decisions on his employees. If you see an example where a member of the Supervisory Board asking a staff member and tells him what to do today at 12 o'clock, a task connected to his usual job this is not normal. This is a conflict of interests. If he is called upon, however, as a client, to order him some kind of action - then, it is okay. A member of the Supervisory Board cannot interfere with the company's operating activities.

To what extent can an Internal audit or Audit committee perform its supervisory functions in good faith, given that it is appointed and remunerated by the governing bodies of the bank?

It is important to note that the Audit committee is not appointed by the bank's management but by the shareholders. The important point is that the Audit committee provides an external service to this enterprise. That's why it is remuneration. The amount of the money should not be tied to the results of the Audit committee. If the Audit committee identifies poor practices and reports them, this should not affect its remuneration.

My opinion is the same as for any audit committee. As long as the regulation of the law permits, it monitors processes - it could signal and as a result also prevent. The Audit committee must not be considered a panacea, though. It cannot be blamed if it does not see anything wrong.

And how about the case of an external auditing firm?

Precisely! This is essential! The new regulations require having two independent auditors. One of the independent auditors must be selected from a pre-approved list by the supervisor (as it is in whole Europe). To what extent these external independent auditors have the commitment under

their regulation? We should not consider that there is any deviation from the relationship because they receive remuneration from the company they audit. This is normal. This is an external service. Their legal duties are such that if they do not perform by the law they will suffer.

I can give you a form of audit in a machine-building enterprise - it's called Quality Control. These are employees that work at the end of the production line, and each product goes through that certifying employee. This employee is responsible if it turns out that some consignment is scrapped by a customer and is returned to the enterprise. Then the question is: Can the director of the company call this employee and tell him to close his eyes on this consignment? It will be returned, and then the Audit/Quality control will suffer. This is the regulation of the enterprise. Despite that this employee's remuneration is determined by that director, if that person accepts a poor quality – he will suffer. The same is with the auditors. They have such regulations that if they do not perform properly, regardless of the desire of the management team or the majority owner, they will suffer.

What are the mechanisms to prevent unsound or unlawful conduct on the part of audit firms?

Audit firms have a supervisor or a regulator. The task of this regulator is to monitor whether the audit firms fulfil their obligations under the regulation, including if such a case is reported.

Can the state regulator effectively follow their job requirements within the current regulatory framework?

This is a very difficult question. The answer should be a 'yes', but the regulatory framework is getting more and more complicated always. This complication is caused by the practice. Complicating is good for people generally. It can increase the cost of the business, but it makes it more expensive proportionally for everyone. Every business is subject to some regulation.

Your question depends on the quality of the civil servant. The quality of the civil servant depends on the remuneration. There is no way that we can expect when civil servants have such low salaries to perform effective supervision of supervised persons. This is the answer to the question – depends on the competence.

We have examples and observe examples of incompetent, not bad will, as a result of which the interests of certain businesses are impaired. The damage was not to the point of lawsuits. There have also been, however, lawsuits that the business has repeatedly won.

When we go to the court, the question rests with the judge's competencies. This is usually done in the Supreme Administrative Court. There the judges are appointed on the basis of legal competences. When the dispute is complicated, it depends on the judge's own conviction to decide in favour of the public authority or in favour of the private person. In my experience, I would say that the results have always been in favour of the private business. When we talk about a court decision, we raise our hands. We cannot do anything.

The question of the competence of the state body depends on the employees who enter there to work. It is important to note, that it is possible that the private business might have already taken all good specialists and the inferior ones are left to control them.

In 2014, there was a financial crisis. To what extent did it impact the political and economic situation in the country?

I do not believe that there was a financial crisis in Bulgaria in 2014. This is not true. In 2014 there was a crisis in a single bank. This was also no crisis in the banking sector.

How do you define it then, as taxpayers in Bulgaria paid for it?

Yes exactly! It was not a crisis, however. For me, this case was a violation of multiple laws that were omitted from both the auditor and the supervisory body. I cannot comment this case anymore. After this case, the normative base was amended and I hope that these amendments will contribute to the prevention of such cases in the future.

Whether this has affected the political situation in the country - I have no opinion about it.

How about from a business point of view?

No. It did not affect. It affected to the extent that the bank had relationships with certain companies. But it did not affect our holding. We own 13% of one bank and interact with it. We cannot control it with 13%, but we have a strong voice in the management.

Thank you very much!

**Interview 5. Svetlana Georgieva**

*August 31, 2017 16:00-16:50h. Face-to-face at Supreme Bar Association Sofia*

1 Please present yourself!

2 My name is Svetlana Georgieva. I have been a lawyer for 26 years in the field of corporate law. I  
3 work with companies, mainly from Bulgaria, in the field of trade, construction, financial  
4 management.

5 Is the commercial enterprise, where you work, have implemented the principles of good corporate  
6 governance?

7 I can talk about my clients. Some of them have included the principles of good corporate  
8 governance for many years. For others, this is not a legal necessity.

9 Why your clients implemented these principals? Since when?

10 At the earliest, these standards are implemented by my client, who has realized the need for this, as  
11 their idea was to achieve transparency in the business.

12 What are the direct / indirect benefits / damages from implementation of these principals?

13 In my point of view, the goal is to ensure transparency in the company's business and greater trust  
14 from customers and investors.

15 As for damages- it is the increase in the expenses on corporation's activity and the danger of  
16 influence by the internal control bodies.

17 What are the most important goals / objectives for your (or, in principle) commercial enterprise  
18 after the introduction of good corporate governance practices?

19 I believe that the underlying reason is the implementation of legal provisions where there is some  
20 kind of trust from investors. With regard to internal security, I do not think they are relevant. In  
21 Bulgaria, the companies are basically small, so the control of the business can easily be done by  
22 the management. There is no need for separate structures to deal with control.

23 Is a one-tier or two-tier governance structure embedded in your business enterprise (or in  
24 principle)?

25 Basically one-tier, as the two-tier is a burden on management.



26 In your opinion, what are the advantages / disadvantages of the one-tier / two-tier governance  
27 structure?

28 The two-tier structure implies a larger form of share capital, as well as a different structure of share  
29 capital. In Bulgaria, the business is small and medium size, which excludes the need for  
30 supervisory board.

31 Which is more effective in terms of preventing bad practices and bearing higher social  
32 responsibility?

33 My point is that there are enough reserves that can be found in the one-tier structure to help other  
34 departments of the company to cope with bad practices. There is no need for supervisory boards.

35 How is internal control organized in your business enterprise (internal audit, audit committee) (or  
36 in principle)?

37 Essentially, through the Internal Audit Bodies.

38 What is the meaning of the internal control to prevent from fraud?

39 Internal control ensures the observance of the internal company acts and the observance of the  
40 basic requirements from the normative acts.

41 Can the internal control suspend or play a role for fraud prevention?

42 Not in accordance with the fraud, because fraud implies the intent of fraudulent action, but rather  
43 how the normative provisions embodied in internal-company acts are observed.

44 Do the companies with whom you work have external control?

45 Yes, in some forms of commercial enterprises, joint-stock companies have a mandatory external  
46 audit. It takes place at least once a year.

47 Do you consider that external control (a specialized external audit firm) is a necessary “evil”  
48 because it is imposed by law or has real added value to prevent crises (fraud) in the commercial  
49 enterprise?

50 I do not think there is any added value, but a normative regulation.

51 Can the non-application of good corporate governance practices lead to the bankruptcy of a  
52 commercial enterprise or vice versa?

53 The question is very complex and very dependent on the management of a particular company.

54 I.e. does corporate governance fulfil the function of a pillar to tackle fraud, increase social  
55 responsibility and transparency of the business?

56 This function is performed by the internal control authorities. Where they are, they could perform  
57 this function.

58 In your opinion, what are the three practices that most effectively contribute to the prosperity of  
59 these businesses?

60 My impression is that the best practices that most effectively contribute to the prosperity of the  
61 companies with which I work are the feeling of teamwork and the sense of responsibility each  
62 person's assigned work. It seeks responsibility for the company's good results. In this sense, the  
63 human capital of a company seems to be the best practice that can contribute to prosperity.

64 In your opinion, what are the reasons for bad corporate governance?

65 Concentrating power in the hands of one person.

66 How do state regulators contribute to good corporate governance?

67 Rather, the transportation of international standards. On the other hand, these standards overload  
68 the financial resources of the company.

69 Can you give examples?

70 I cannot give examples because it is a trade secret and I have no right to comment.

71 The financial sector

72 Is there a conflict of interest when the decisions of a member of a supervisory board influence the  
73 operation of the board of directors as well as at the operational level (the employees) in a bank?

74 This is definitely a conflict of interest.

75 To what extent can an internal audit or audit committee perform its supervisory functions in good  
76 faith, given that it is elected and remunerated by the governing bodies of the bank?

77 Everything again leads to the conscientiousness of control bodies, but there is a way in which the  
78 management can influence their activities.

79 Can the internal audit perform the inherited control functions in good faith?

80 It can. The question is whether the results would not have been manipulated by the governing  
81 bodies, and this is already a problem.

82 To what extent can the external audit firm perform its control functions in good faith if it is elected  
83 and paid by the bank's governing bodies?

84 Paying the external audit firm is usually on the basis of an external agreement, as the audit firm  
85 undertakes duties to perform the audit on the basis of the current legislation, i.e. to write down all  
86 of its remarks regarding the keeping of financial records in accordance with the laws. In this sense,  
87 I believe that external audit firms can be less influenced by the management than the internal audit.

88 What are the mechanisms for deterring fraudulent behaviour?

89 Essentially, the application of criminal law, other - not, as well as inter - company acts where  
90 penalties and sanction for unregulated actions are provided.

91 Can the state regulator establish poor governance practices and counteract effectively?

92 Yes, if we even accept the tax authorities. They are a state authority that establishes irregularities.  
93 The point is that there are no common objective criteria for detecting frauds. In this sense,  
94 subjective judgment is very high as a percentage. In this sense, the conclusions could be  
95 manipulated and reports will be inaccurate.

96 In 2014 there was a financial crisis. Did this reflect the political and economic situation in the  
97 country and to what extent? What is the significance of the financial sector for the Bulgarian  
98 economy?

99 Relations between financial sector representatives and the political class have been established. In  
100 this sense, the financial crisis has affected the political and economic situation a lot.

101 What do you think are the most difficult to overcome the consequences of the crisis in 2014?

102 Mistrust in the state.

103 Is it possible to predict financial crises and how?

104 There is a cyclical specific of the financial crises. There are indices that can be analyzed and the  
105 crisis is predicted. Yes, it could be, but not through legal regulations. Rather, economic crises can  
106 be anticipated more economically.

107 Are the Bulgarian legislative mechanisms adequate enough?

108 No.

**8.2. Appendix 2. Informed Consent Form**

Project Title: Corporate Governance Mechanisms in the Banking Sector

Project Description:

In order to graduate from the European Studies B.A. at The Hague University of Applied Sciences I am undertaking a research in the field of corporate governance practices and mechanisms that can be applied for the detection and prevention of fraud. For this purpose I need to compile thorough academic and empirical data. The research will be conducted in the course of a full academic semester. This will allow me to conduct the required desk-research and to interview professionals.

**If you agree to take part in this study please read the following statement and sign this form:**

- I am 16 years of age or older.
- I can confirm that I have read and understood the description and aims of this research. The researcher has answered all the questions that I had to my satisfaction.
- I agree to the audio recording of my interview with the researcher.
- I understand that the researcher offers me the following guarantees:
- All information will be treated in the strictest confidence. My name will not be used in the study unless I give permission for it.
- Recordings will be accessible only by the researcher. Unless otherwise agreed, anonymity will be ensured at all times. Pseudonyms will be used in the transcriptions.
- I can ask for the recording to be stopped at any time and anything to be deleted from it.
- I consent to take part in the research on the basis of the guarantees outlined above.

**Signature:** \_\_\_\_\_ **Date, City:** \_\_\_\_\_

### 8.3. Appendix 3. European Studies Student Ethics Form

**Your name:** Gabriela Slavova

**Supervisor:** Agota Szabo

#### Instructions/checklist

Before completing this form you should read the APA Ethics Code (<http://www.apa.org/ethics/code/index.aspx>). If you are planning research with human subjects you should also look at the sample consent form available in the Final Project and Dissertation Guide.

- a) Read section 3 that your supervisor will have to sign. Make sure that you cover all these issues in section 1.
- b) Complete sections 1 and, if you are using human subjects, section 2, of this form, and sign it.
- c) Ask your project supervisor to read these sections (and the draft consent form if you have one) and sign the form.
- d) Append this signed form as an appendix to your dissertation.

#### Section 1. Project Outline (to be completed by student)

Title of Project:

Aims of project:

Will you involve other people in your project – e.g. via formal or informal interviews, group discussions, questionnaires, internet surveys etc. (Note: if you are using data that has already been collected by another researcher – e.g. recordings or transcripts of conversations given to you by your supervisor, you should answer ‘NO’ to this question.)

**YES / NO**

If no: you should now sign the statement below and return the form to your supervisor. You have completed this form.

This project is not designed to include research with human subjects. I understand that I do not have ethical clearance to interview people (formally or informally) about the topic of my research, to carry out internet research (e.g. on chat rooms or discussion boards) or in any other way to use people as subjects in my research.

Student's signature \_\_\_\_\_ Date, City \_\_\_\_\_

If yes: you should complete the rest of this form.

**Section 2.** Complete this section only if you answered YES to question (iii) above.

- (i) What will the participants have to do? (v. brief outline of procedure):  
Participants will be interviewed over the phone or personally. They will be first contacted via Email or phone, presented with the general idea of the thesis and asked to comment at a time convenient for them.
- (ii) What sort of people will the participants be and how will they be recruited?  
They will be highly positioned executive. The selection will happen based on the company size and their experience. Contact details at most times will be available on the company's sites, or when contacting the Secretary of their department.
- (iii) What sort stimuli or materials will your participants be exposed to, tick the appropriate boxes and then state what they are in the space below?  
Questionnaires[ ]; Pictures[ ]; Sounds [ ]; Words[ ]; **Other** [they will be presented a printed copy of the interview questions].
- (iv) **Consent:** Informed consent must be obtained for all participants before they take part in your project. Either verbally or by means of an informed consent form you should state what participants will be doing, drawing attention to anything they could conceivably object and the measures you are taking to ensure the confidentiality of data. A standard informed consent form is available in the Dissertation Manual. (vi) What procedures will you follow in order to guarantee the confidentiality of participants' data? Personal data (name, addresses etc.) should not be stored in such a way that they can be associated with the participant's data.

**Student's signature:** .....

**Date:** .....

**Supervisor's signature:**.....

**Date:** .....

(if satisfied with the proposed procedures)

#### 8.4. Appendix 4. CCB Organizational Structure

