

## **MOULDING CORPORATE BOARDS: A KEY CHALLENGE OF BULGARIAN CORPORATE GOVERNANCE?**

*The modern corporate governance structure in any country includes as its key factor the structure and functionality of the corporate boards. Currently, the boards experience a more or less radical change of their traditional activities and structure, acquiring new features and diversifying the old ones in order to answer of the raised demand before them by the business and social communities. The paper is revealing the status of the problem in Bulgarian companies within the immediate pre-accession period; it is based on a companies' survey selected from the main economic sectors. And, the main findings show an inclination of the current boards toward more traditional functionality and conservative structuring, i.e. the boards concentrate more in terms of time and quality to the traditional functions as overall governance and/or operational management and adopt appropriate structures. This also means that the surveyed boards are more reluctant of dealing with the functions like resolving of conflicts of interests and more flexible structuring as creating specialized committees, especially when things come to the nomination and compensation of the board members. Hopefully, the recent amendments of the legal framework in the field will provoke a restructuring and diversification of board functionality toward the highest present-day standards.*

JEL: G32, G34, G38, K22

### **Introduction**

The analysis of the modern corporate governance structure applied to one or another country includes the analysis of the structure and functionality of the corporate boards as a key factor for it. The boards experience a more or less radical change of their traditional activities and structure, acquiring new features and diversifying the old ones in order to answer of the raised demand before them by the business and social communities. That demand is constantly increasing, especially in the light of the current evidence of business and managerial malpractice, abuse of the accounting and financial standards. For the countries of the South Eastern Europe, the importance of the issue for better corporate board practice is even higher because of the still large spread practices of violated minority shareholders rights, weak stock markets etc.

The current survey is targeted on revealing the status of the problem in Bulgarian companies within the immediate pre-accession period; data is from 2002. It is based on the survey for 81 companies selected from the main economic sectors<sup>2</sup>.

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In most synthesized appearance, the main findings show an inclination of the current boards toward more traditional functionality and conservative structuring, i.e. the boards concentrate more in terms of time and quality to the traditional functions as overall governance and/or operational management and adopt appropriate structures. This also means that the surveyed boards are more reluctant of dealing with more recently assigned to them functions as resolving of conflict of interests and more flexible structuring as creating specialized committees, especially when things come to the nomination and compensation of the board members. However, the recent amendments of the legal framework in the field initiated a rather deep restructuring and diversification of board functionality toward the highest present-day standards.

The paper consists of nine sections, devoted on data of the survey and on the important aspects of the corporate boards role as their structure, presence of independent members in them, evaluation and compensation of their members, their committees and their functions.

## **1. Legal framework**

The Bulgarian legislation regulating the activity of the companies goes under a deep reconstruction in the last 12 years, which changes radically a large number of laws. Unfortunately, for most of the time of this renovation, the very idea for the corporate governance was not recognized as a separate problem, thus contributing much to dispersion of the relevant legal matter among number of laws. Nevertheless, it is still possible to study the regulation of corporate boards as an integrated problem spread into several different layers. First, there is a general regulation applied to all the joint-stock companies.

Then, the issue could be tracked down through various laws, treating businesses from more specific branches, such as banks, investment companies, insurance and pension assurance companies. These provisions vary throughout the acts, but it is still possible to cast those institutions in a more general group of financial sector.

The third major (and different) regulation is provided by the Law on the public offering of securities (LPOS). It covers only public companies, which for Bulgaria does mean the exclusion of a very large part of the banking system; in fact just two average-size banks are public companies.

### *General Case*

The Bulgarian Commercial Code provides just very basic regulation of the **duties and powers** of the corporate boards. Perhaps, the most important piece concerns the structure of the governance bodies; Bulgarian law allows existence of both single-tier and two-tier structures. Thus, there are companies with just a board of directors (BD) or with supervisory board (SB) and management board (MB). Boards of directors and supervisory boards are selected by the General Shareholders Meeting (GSM) and management boards – by the SB.

As to the **composition of the boards**, the legal framework determines the maximum length of one mandate of any of the boards at five years, unless it is shorten by the company's statutes, but there are no limits on the number of mandates a person could serve. There is no required qualifications for the board's members except of that to be legally capable to act. While, the Code leaves space

for the companies' by-laws to impose further requirements for their board members, the only restriction imposed by itself prevents from membership persons who served on a corporate board of a failed company which unsatisfied creditors for the two years preceding the failure.

At that level of aggregation, Bulgarian law does not recognize the intracompany's allocation of functions among the board members and assigns equal rights and responsibilities to them even in terms of representative and managing powers. This resembles the Anglo-Saxon tradition, but it is not the case. That rule is targeted only on ensuring equally **loyal** behavior among all the board members. That is explicitly stipulated by bounding their service to the interests of the company. The crucial and perhaps, the controversial point here seems to be that, what is ensured are the interests of the company and not of its shareholders. That seems a minor difference, but it is very substantial if one consider that company's interests are always realized through its managers.

There are no provisions for the due diligence in the Commercial Code and the **conflict of interests** is barely marked. It is regarded just at GSM level, banning the votes of those shareholders, who have complaints or actions brought against. While, the law requires a minimum amount of money to be provided by the boards' members as a guarantee for their service, again, there is neither criteria for this service nor rules, how should that guarantee be used.

As a general tendency, Bulgarian law follows the German tradition as to the governance structure. It clearly divides the board members into executive and non-executive, prohibiting the members of the supervisory board to be members of the management board and vice versa. Moreover, functions of the supervisory board are confined to electing and overseeing performance of the executive managers. The same differentiation is applicable for the members of the Board of Directors requiring that the executive members should be less than the others. True, this differentiation covers just the functions performed, but does not encompass their actual status in the company's business, e.g. the size of their holdings, established business relations etc. Thus, the separation line does not cross through the insiders and outsiders; moreover, even the definition of the independent directors is not introduced at this level of aggregation.

### *Financial Sector Regulation*

Not surprisingly given the scarce general regulation, the business units from the financial sector have to comply with more rules for their corporate boards. First of all, the members of managing boards/boards of directors of all types of the companies – banks, insurance and pension assurance companies and investment intermediaries, need to possess professional qualification and skills in the relevant field. Most strict are those requirements for the insurance companies and for the banks. Both call for university degree in economics or law (mathematics for the actuaries) plus certificate from the Central Bank for banks and, alternatively, long experience (more than 5 years) in the field for the insurers. Pension companies could be managed with any university degree, and that is not specified for the investment intermediaries suggesting that qualification of their managers could be obtained by shorter training programs or even just by practice.

Further, more restrictions are added on participation in the BD and MB of the close relatives – spouses, brothers etc., more stringent are the restrictions on

membership in boards of failed companies – for the banks the monitored period is prolonged to 5 years before the bankrupt and for other institutions it is not specified at all including this way under observance, all the time of service of a particular board member. The relatively lax restriction for banks could be understood, if one recalls the not so distant in time wave of bank failures, which left very few bank managers not affected one or another way.

Also, more restrictions are added before the person wishing to get a position on corporate board: the sentence for general criminal offences, the ban on taking financially accountable position and some more specific, as any involvement in security business, especially introduced for the insurance companies. To understand last idiosyncrasy one should know, that for a period of time, part of the criminal groups in the so called “security” business became fully legal “insurers”, which undermined stability of the sector.

The requirements for the members of supervisory boards are similar, but they do not have to possess specific background and professional experience.

What concerns, the loyal conduct of the business there are many rules covering the relations between the financial institutions and their clients, bounding the action of the former to the interests of the latter, but again there are no specific regulation on the relation between the major and minor shareholders, no explicit differentiation between the interests of the company and its shareholders, no mention to the obligation of the board members to act as prudent agents of their principals. Accordingly, there is no definition of the standards for diligence and loyalty. Similarly, there is no explicit regulation of the possible conflict of interests. Except for the banks.

The Law on banks clearly and specifically defines the cases of business interests which possibly may involve an administrator in a conflict of interest with his position in the bank. It is interesting that the law spans the regulation not just to the board members, but also to any administrator, which is a good point if one considers that the chief accountants are often not members of the governing boards.

The definition includes the interests not only of the members and their companies, but also of their families, of businesses related to them and also the companies they participate in with as small share as 10 percent. There is a procedure for notification and resolving of these conflicts, which brings that regulation to the highest standards. Moreover, the law on banking subordinates the interests of the board members to the interests of the bank and, most interesting point, stipulates that any deal made in violation of those rules are not legitimate and the latter might be proclaimed by courts. And the cases could be set up by, among the others, “a third interested party”, which plainly includes minor shareholders and stakeholders as well.

This sophisticated banking regulation is not surprising and largely justified. As mentioned earlier, Bulgarian banks are almost entirely out of the public companies list, and there are not many signs that they will be included there in near future. And that makes understandable why their corporate governance regulation is more detailed and precise than the one provided by the Commercial code.

### *Public Companies*

This is the group, which has the most detailed corporate governance regulation. True, most of the provisions, which are discussed below have been adopted few

months ago and practically all of the rules, which need to be approved by the GSMs are not in action since the Law on Public Offering of Securities (LPOS) provides time for adoption to the next General meeting. Nevertheless, most of the changes are profound and will change the corporate environment radically in this country.

First of all, there have been adopted a number of rules for composition of the corporate boards. A definition for the independent board members was introduced. It is relatively strict and excludes:

1. all the company's officers;
2. shareholders with 25+ percents of the votes in the GSM possessed directly or via related persons;
3. persons with longstanding commercial relations to the company;
4. all board members plus procurators and/or officers of the companies from p.2 and p.3;
5. persons related to another board member.

Moreover, for the first time in Bulgarian commercial practice, it is established a quota for representation of the independent members in the BD or SB and it is, at least, one third of them. The quota is dynamic and requires information on any status change and provides for suspension of the duties and remuneration of those members who lost their independent status. True, the legislation still has not come to the perception for the length of the membership as a factor limiting the independence of the members, but it is a large step in the right direction.

Second, the last changes in LPOS establish the most open and clear statement of the duties of the board members. They should run the business with the due diligence of the prudent owner in the interests of all the shareholders and using only the information taken faithfully as reliable and complete. Further, the board members due loyalty to the company and that means "preferring company's before one's own interest" avoiding conflict of interests and not disclosing insider information, even after being released from the board.

The board members plus the procurators are obliged to answer honestly, comprehensively and accurately to the questions of all the shareholders, no matter are they on the agenda or not, except for the insider information.

Third, the provisions for the conflict of interest are not just proclaimed, but well secured. There are a number of norms requiring disclosure of the possible conflicts to the relevant board and abstention from discussions and decisions upon that issue. Apart of that, there are restrictions for a set of deals which may involve the so called "interested parties"; these are namely the insiders, when they are party of a deal with the company or are related persons to such a party. Those deals should be reported by managing body to the GSM and it decides on them, with qualified majority of  $\frac{3}{4}$  in some cases. The law goes even further, stating that many deals involving "interested parties" should be concluded only under the regime of a joint-venture contracts, requiring approval from the two companies and with additional regulation.

That complicated procedure is not surprising having in mind the already 12 years history of so called "company's tapping" when parties related to the management stick to its entrance and exit with "transfer price" contracts. After the privatization, this practice, once developed for the state-owned enterprises, was successfully applied to the public companies inflicting huge loses on minority and individual

shareholders. Hopefully, those new regulations will help to quit with certain abusive practices.

Forth, the recent amendments in the law enlarged regulation of the procedure for determination and conditions for receiving of the board members remuneration. The level and the terms of it are explicitly assigned to the GSM, which is not new. Maybe it is important to underline that in Bulgaria the compensation of all the boards, including the managing board and/or those of the executive directors of the MB are within the competence of the GSM, and as such are accountable. Even in the case of procurators, an executive position which received immense spread last years, as a good tool to avoid some regulations applied to the boards, the law holds SB/BD accountable before the GSM. They have to explain what salaries have been paid to the procurators and what was the performance of the latter. Further, the above mentioned collateral due by the board members as guarantee for their governance and management is now precisely outlined; who has to deposit it, where and how, how it might be released and under which conditions it will be withheld; all those questions are clearly answered.

A more thorough revision of the legal framework may find some regulatory blocks still missing, e.g. the existence and the role of board committees are not even mention nowhere, but the recent amendments introduced in it seem to be an excellent basis for a serious improvement of the corporate governance of Bulgarian companies.

## **2. The survey – sample and method**

Any regulation has always two sides – legislation and enforcement, and unfortunately, at least for the transitional countries, the second one is always more controversial. Thus, if one needs to know a bit more for the structure and functions of the corporate boards, he/she needs to observe them in practice. The sources of information for current Bulgarian corporate boards are limited. The Commercial registers provide general biographical data; more information is maintained in the Securities Commission registers, especially for the ownership structure.

However, the information for the existing practice, e.g. for resolving conflicts of interests could only be found in the minutes of the board meetings or directly from the board members. Thus, the methodological choice went on surveying opinions and information from highly positioned officials in hundred joint-stock companies on the composition and practice of the corporate boards in Bulgaria. It is important to say, that this survey is a pilot one, to the best of my knowledge for Bulgaria and, accordingly, it bears all of the omissions and faults of such a pioneer effort.

The survey (data is from 2002) does not cover the formal standards for a representative sociological survey because of many reasons, but perhaps, the most important is its limited budget. Although, any effort was made by the survey agency and the research team to gather an active and diversified sample of joint-stock companies. The general method was a standardized interview, though in some cases the responses were acquired impersonally.

Eventually, 83 valid cases were gathered; the companies are grouped into three aggregated branches – industry, building, tourism - 54.22%, financial, banking, insurance, assurance, investment intermediation - 24.10% and trade, services (non-financial) - 16.87%. 4.82% of the companies determined themselves as others.

More than half (54.22%) of the companies are with less than 100 employees, 21.69% are between 101 and 250, 10.84% - between 251 and 500, another 8.43% are between 501 and 1000 and just 3 cases are with more than 1000 employed persons; one answer is missing.

Bulgarian corporate ownership is highly concentrated (see Tchipev, 2001) and the actual results for that index were not surprising: 61.45% of the companies are majority controlled, 42.17% - with Bulgarian and 19.28% - with a foreign dominant shareholder. Another 6.02% of the sample companies have a leading shareholder controlling between 33 and 50% of the stock and again the dominant shareholder's control in them is almost unlimited. Just 14.46% are with smaller leading blocks and they might be expected to be at least a bit more demanding in terms of better corporate governance model, though even their shareholding packages are far bigger than what is considered a dispersed ownership by the international standards. To that group might be added, with less certainty, those 17% of companies which have two and more leading blocks of 33-50% size, but that heavily depends on the extent the biggest and the second large shareholders collude among themselves; an issue practically impossible for independent verification.

About one quarter of the companies indicate in their ownership structure a presence of former privatization funds as portfolio investors, which are considered to be potentially active in the corporate governance.

More than 80% of the companies from the sample have single board governance structure; they are distributed as follows - 51% in the industrial sector; 23% in the financial business and 20% are providing non-financial services. Fifteen companies (18% from the total sample) are with 2-tier governance structure (supervisory and managing boards); they are split between the industrial and financial sectors in proportion two to one.

No specific distribution of the governance structures could be detected by size.

### **3. Structure of corporate boards**

The majority of the BDs - 54.10%, consist of 3 members and another 33% of them have 5 members. If one recall that the minimum legal number is 3, an average of 3.97 members per board of directors seems number-wise. The figure for the supervisory boards is similar; the average board has 3.4 persons and over 70% of them are constructed of three persons (3 to 7 allowed by law). Managing boards in the survey are bigger - the average of them has 4.4 members and an equal distribution of three- and five-member boards (up to 9 allowed by the law).

The survey has not identified in the corporate statutes setup of other or stronger qualifications for taking a position on the board than those required by law. True, some of the companies in our example pointed out such qualifications as educational or professional skills as needed, but all of those cases belong to the financial sector and hence, those requirements are also established by law. The actual educational and professional structure of the members in the observed boards is represented in the following table.

Table 1

	Educational level			Professional qualification				
<b>BD</b>	High school	BSc.	MSc., MA, PhD	Law	Economics	Finance*	Civil engineer	Other
242 cases	0.00%	15.29%	77.69%	10.74%	42.15%	10.74%	29.75%	8.68%
<b>SB</b>								
51 cases	0.00%	5.88%	88.24%	18%	37.25%	17.65%	19.61%	1.96%
<b>MB</b>								
66 cases	0.00%	6.06%	81.82%	6.06%	28.79%	16.67%	30.30%	10.61%

Note: In few cases the same members are shown as both economists and financiers.

The rather high educational level has at least two explanations; first, the standard university program until recently was targeted at magisterial level as a basic one and so people who graduated 5-7 years ago and earlier obtained normally that level. Second, perhaps the more important, university education is still easy accessible at relatively low cost, which makes it a must, though it also devaluates it.

More unusual seems the high share of civil engineers in the managing boards and the boards of directors. That may signal a more technical attitude in the roles performed by the boards, than usually expected, but this fact certainly should not be exaggerated at this level of the analysis. On the whole, the size and the qualification structure of the observed corporate boards do not represent anything specific; maybe they are rather smaller, which definitely speak about more plain functionality and certainly is not a very strong prerequisite for a diversified subsystem of committees.

Much more interesting is the board structure in terms of “additional” relations of the members with the company itself or its business. **Table 2** shows the distribution of board members along three such important relations. Some points need a comment here:

First, not all of the boards report members with “additional” company relations. The actual number vary between 30 and 50 percent of all cases for the different relations.

Table 2

	<b>BD</b>		<b>SB</b>		<b>MB</b>	
<b>Board members who are:</b>	Share from all members	Average number*	Share from all members	Average number*	Share from all members	Average number*
employed as managers or else in their companies	47.11%	2.15	9.80%**	2.50	56.06%**	3.08
(or represent) shareholders with 25% or more votes in GA	35.54%	1.79	11.76%	0.75	1.52%	1.00
in governing bodies of other companies	34.71%	2.55	23.53%	1.71	25.76%	2.43
in governing bodies of affiliated company	30.99%	2.59	27.45%	2.33	22.73%	2.50

\* cast just out of the non-zero cases; they vary along the features

\*\* a possible misunderstanding, the law prohibits SB members to participate in the operational management; from the other hand, all of the MB members are supposed to be involved in it.



Second, in those boards which reported, have quite large number of members have such complex relations. Almost half of the members of the BDs in our example receive another remuneration from the company; that is more than half on an average board.

Third, a considerable share of the board members, especially on the boards of directors are themselves, or represent large shareholders. The relevant figures for the companies with two-tier governance structure are much lower. That, especially for the structure of SBs, corresponds with the lower share of majority controlled firms among them and with the higher share of the foreign leading shareholders. The lower figure for the managing boards seems due to the predominant practice to appoint professionals for the operational management.

Sitting on another board is a good instrument for securing preferential contacts with a controlled or else related company; that explains the high figure for the BD/SB. The explanation for the MB is more uncertain; it seems that this has something to do with the also high share of managers sitting on the boards of affiliated companies.

Forth, the number of the BD members who possess more than one of those feature is large, the total share is 148.3% and the excess over 100 percents suggests that many members have more than one such a relation, i.e. large shareholders are often also managers in their or related companies. apparently, this is a serious prerequisite for entering in conflicts of interests especially if the alternative number of the independent directors is low.

#### **4. Independent Members**

Fortunately, it is not that low; according to the survey, almost 34% of all members of the boards of directors are independent, a fair enough figure. That is 1.33 independent persons on average board of directors. Here, the averages are calculated from all of the cases, which provided data for their boards, i.e. contrary to the above cases we include here also the zero-independent cases too. True, a 47% of the BD do not indicate independent members, but that does not necessarily mean that they had not them at all; the qualifications for independence are rather strict and quite new, hence one may expect that some of the interviewed officials simply do not know all the board positions taken by their colleagues.

Supervisory boards show surprisingly close figures - 35.29% of all reported cases and 1.2 persons on average board. Finally, 29.41% members of the managing boards are shown as independent, which makes just one persons per board, although they have an overall bigger size. The data still reveals the situation before implementation of the obligatory quota for the independent members of BDs and MBs and one may expect that number to rise soon.

That hope seems justified to some extend from the answers concerning the *issue of adopting provisions in the companies' by-laws guaranteeing the opportunities of the independent directors to stand their opinion*. True, just less than 4% of the valid cases (57 for this particular question) answer positively, that they have already adopted such provisions; it is also true that another 40% provide the firm answer - *no, this question is not on the agenda*, but there is also almost 20% of respondents, who admitted that the issue is discussed, though still not accepted, and another 20%, who discarded the issue, because the number and the influence of the independent directors in their company are negligible. Since, they will face it

pretty soon, at the next GSM, one may expect that more companies will understand that it is important not only to have the independent directors in the board, but also to allow them to stand up that position.

An interesting information to that picture is that in 70% of the cases the chairman of the BD/MB and the CEO are not the same persons. This is a good evidence that in the case of two-tier governance structure the executive (managing) functions are quite well separated from the functions with more governing character. What concerns the figure for the managing boards, which is even higher than that for the BD (75 against 68%) it is little puzzling. True, the management boards are bigger as whole, which give them a chance for some diversification of the functions, but at the same time this is a clear indication that not all of the managing boards are completely involved in the direct management. Regardless, how it will be interpreted as abstaining of that involvement or the opposite as interference of the related persons (given the large number of large owners in the boards for example) in it, the eventual outcome is that managing boards in Bulgaria are resembling the BD in some extent.

To round up, Bulgarian corporate boards are not very big in size, with a relatively high qualified members, most of whom are connected to the company or its business by one or more "stronger" relations, though a substantial part of them are independent, especially what concerns to the single-tier governance boards.

## **5. Evaluation and compensation**

The overwhelming majority of the companies (75.9%) respond that they do evaluate performance of their boards as a whole in a purposely section at the annual General Shareholders' Assemblies; in few cases - less than 3%, the boards are evaluated at the end of their mandate and 21.7% of the cases do not have any special practice of evaluation stating that the best evaluation for the boards is the overall performance of the company.

Almost the same are the figures concerning the evaluating of just the executives - 70% of the companies report that their CEO are accountable periodically before the BD/SB; in another 5% of the cases controlling board oversees several indices of firm's performance (e.g. the sales) and evaluates the activity of the CEOs on that base and 21.7% say that they do not have practice an explicit evaluation. Hence, the controlling board decides about the CEO's activities on the base of its overall perception.

Just less than 40% of the companies prove that there is a connection between company's performance and both the basic remuneration and the bonuses awarded to their board members; 28.92% report a partial connection including, i.e. the basic remuneration is definite and the bonuses are flexible, dependent on the performance. And, unfortunately, the share of the companies, which believe in policy of compensation disconnected from the performance of the CEOs is rather high - 27.71%.

The forms for the bonuses over the basic salary are also notable - 48.19% of the board members receive pecuniary bonuses, 25.30% receive various non-pecuniary benefits as covered housing or training expenditures etc. Corporate stock is really unpopular as a compensation bonus (0%!), but this seems a justified outcome from the illiquid and underdeveloped stock market in the country. Another 2.41% use a mix of bonuses, which differ from case to case and 7.23% believe that

they do not need to pay bonuses if the basic remuneration is high enough; 17% have not responded to that question.

**Table 3** presents the performance indices used as benchmarks for determining the variable part of the board members compensations. Three points deserve more attention here.

The total does not exceed much the 100%, pointing that not many companies use more complex system for measuring the boards' performance. The third place is occupied by others, but unfortunately most of the respondents did not specified what do they mean; among the provided answers are: the level of attained investments, the level of company debt, the level of average wage. And of course, the last place of the care for the returns per share! Again, we encounter the low level of care for the plain investors.

Here it comes one of the most challenging questions in the survey - *How the average remuneration of the CEOs relates to the average remuneration of the non-executives?* A huge share of companies' policies (47.83%) do not differentiate the remuneration of the CEOs and non-executive board members. For another 27.54% - executives' compensation does not exceed with more than 30% the average remuneration of the non-executives and just in 1/4 of the cases, the remuneration of executives is higher. Of course, one may interpret the data in a way that the non-executive receive a really high compensation, but my feeling is that the alternative explanation fits the case better – the compensation of the executives does not reflect to a sufficient degree their efforts to run the company.

Table 3

net profit	55.22%
sales volume	43.28%
other (please specify)	16.42%
market expansion	7.46%
maximizing the returns (capital gains and dividend) on a share	7.46%
Total	129.85%

Note: the total exceeds 100% because some of the interviewed persons pointed more than one index, the overall valid cases are 67; 16 companies have not responded to the question

The attempt to investigate the absolute levels of board members' compensation failed almost completely. We got about 60% of declined answers plus another 3.6% not answered at all, though according to the legal regulation, the remunerations of the board members are determined and announced at the GSMs, i.e. they are public by their nature. But, it seems, that the issue is still very sensitive for the top officials and most of them consider it too personal. Among those which provided positive answers, 60% indicated remunerations up to three average company salaries and just 13% reported levels above 5 times the average company's salary. This speaks for a rather moderate absolute remunerations, which coincides by the way with the information coming from the tax service, but as I said our data is not enough large to judge decisively on it.

The survey included also a question about regularity of board seminars to discuss important corporate issues, which is not exactly a matter of board valuation, but it definitely may help the self-valuation process. Almost 75% of our respondents report some kind of such discussions, but only 31.33% have them regularly and

formal; others meet informally or as an exception. And 24% find themselves too busy to bother with such events.

Finally, we asked the boards also for a direct self-evaluation and of course, more cases were in the upper part of the 1 to 5 scale – 85% indicate 3 and higher, but in fact the valuation is rather objective – 57% stick to the average.

Rounding up this section it has to be said, that in more cases functioning of Bulgarian boards is monitored, though this monitoring is rather formal – as more or less standard annual reports prepared supposedly, by the boards themselves. Monitoring of just the executives seems to be more intensive, though its organization and frequency do not seem to be radically different. Even the self-evaluating meetings are not regular. As a general practice executives and non-executives are treated equally, which seems to me being on the account of the executives. Naturally, compensation seems to depend somehow on the performance of the company, though this is again very general, sticking to indicators, which benefit the company (and the managers) themselves than the shareholders particularly.

Thus the overall impression is, that the nomination and remuneration of the board members is more or less a self-understanding, (and not very public) issue and there are not many attempts to use it as a powerful instrument, which is consistent with the results received on another question – out of all 83 investigated companies just 2 (2.41%) reported that they have committees on managerial compensation and none on nomination and selection.

## **6. Board committees practice**

Apparently, it is not just the above two board committees, which are unpopular among the Bulgarian corporate boards. Unfortunately, all of kinds of them share similar fate; we found almost 75% of all cases without committees - the only 21 positive answers offered a total of 28 committees. The excess over 100% indicates the presence of few cases with more than one committee – 2 cases with three and 3 - with two committees. The “others” cases include two committees - on investments and on damages, whatever the latter may mean.

**Table 5** summarizes the main findings about the existence and the size of the specialized committees created to the corporate boards. The relatively high number of auditing committees is a result of the increasing significance of this process for disclosure of information and for independent monitoring of the corporate performance. At the background of the overall short-termed business horizons in Bulgaria, perhaps it is slightly surprising, the share of the strategic planning committees, but the financial stability in last years, encourages the companies to look farther.

The average size of those committees varies among the different types and it is rather large – between 3-4 members, i.e. it is even larger than the average board. That is, of course, due to the much smaller pool of the valid cases here, which contains apparently companies with bigger boards. This is an interesting proof that the average size of the Bulgarian boards in general, is not large enough to match the higher standards raised before the contemporary corporate boards.

Table 5

Committees	Number	Share of all cases	Share of positive cases	Average number of members	Efficiency valued on 1 to 5 scale
For strategic planning	11	13.25%	52.38%	4.56	3.80
Auditing	13	15.66%	61.90%	3.33	4.18
On compensation	2	2.41%	9.52%	3.00	4.00
On selection & nomination	0	0	0	0	0
Others	2	2.41%	9.52%	n.a.	3.50
Sum	28	33.73%	133.33%		
No official committees	62	74.70%			
Total	83	108.43%			
Just positive cases	21	25.30%			

The investigation of the independent members in those committees show averages of one person for the planning and auditing committees and zero for the others, but the positive cases are few and the criteria for independence, as mentioned earlier, are introduced just recently, hence those answers do not seem enough revealing. Similarly to the overall evaluation of the boards provided in the previous section, here also the higher marks prevail, though the element of self-evaluation is supposedly weaker – the probability that the respondent is him/herself member of such a committee is lower.

One of most helpful questions for understanding the real role and significance of Bulgarian corporate boards' committees is that on the regulation of their creation. There is just one statement that the committees are regulated under a Code of Best (governance) Practice, adopted voluntarily as an instrument for improving of company's governance; the other positive answers divided equally (47.06% each) between "committees are set and guided under the company by-law" and "we create just ad hoc committees when needed"; about 20% of those who reported their committees have not provided information on their regulation.

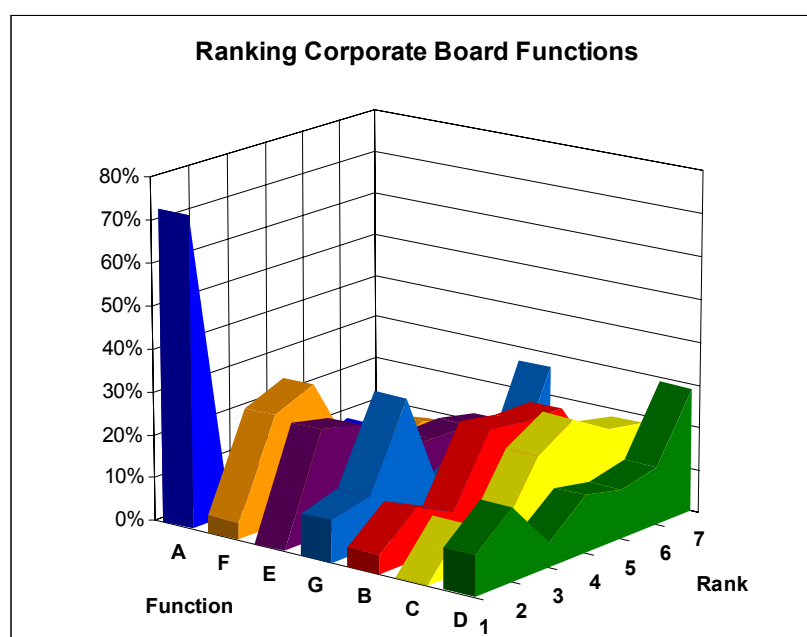
This might well help summing up that section. Bulgarian practice still does not include very often creation of the board committees – they are often created on case by case basis and used in connection with the most usual functions and mainly for auditing purposes. Particularly limited is the use of those institutions in the most sensitive areas of selecting, valuating and compensating the board members themselves.

## 7. Board functions

Special attention in the survey has been devoted to the functions performed by the corporate boards. There were investigated the scope of performed functions; the time, which the boards spend on each of them; how efficiently they are performed and eventually what is the status of their regulation. As a basis to step on, the functions defined in Section V of the OECD Principles on Corporate Governance are chosen. Those seven functions are recommended, not required and cover a large scope of important activities more or less inherent to the corporate boards. Their character is rather fundamental and it does not seem a problem for an average company to adhere to them.

The functions are ranked by importance according to the preferences of survey respondents. The distribution of their preferences shaped four quite distinctive groups. Two of them are represented by functions **A** and **D**, which occupy quite definitely the first and the last places respectively. The functions **F** and **E**, exposing also close distributions, form the third group and share the second and third position in respondents' preferences. The same applies to the functions **B** and **C**, the fourth group, which may fit equally well positions four, five or six. The most intriguing is the distribution of the function **G**, which has two picks and may fit all positions after number 3; considering its overall distribution, as presented at the **Chart 1**, I placed it at the fourth place.

Chart 1



**A** Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

**B** Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

**C** Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.

**D** Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

**E** Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.

**F** Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.

**G** Overseeing the process of disclosure and communications

**Table 6** presents the main findings about the board functions ordered according their rank (**column 1**). The second column shows what share of time is spent by the boards on each of those functions if time spent on all of them is considered 100

percents. The third column shows the values, which the respondents give to the performance of each of those functions and the last one shows which functions have an explicit reflection in the corporate by-law.

Table 6

	Rank	Time spent*	Values	Explicit regulation**
<i>A) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.</i>	1	42.38	4.06	91.67%
<i>F) Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.</i>	2	16.36	3.88	70.83%
<i>E) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.</i>	3	17.04	4.27	62.50%
<i>G) Overseeing the process of disclosure and communications.</i>	4	9.76	3.85	62.50%
<i>B) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.</i>	5	8.46	3.54	66.67%
<i>C) Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.</i>	6	7.21	3.51	66.67%
<i>D) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.</i>	7	8.20	3.63	41.67%

\* few respondents have not divided the time precisely

\*\* percent just of the valid cases

The largest share of the board time is spent on performance of function **A** encompassing quite comprehensively the activities, which are usually assigned to the operational management and which is equally innate for the boards of directors and managing boards. The time spent takes almost half of all time of the relevant board and corresponds with the highest ranking of that function. The **A** function is regarded also as second best in terms of quality of its performance.

The two functions of the second ranked group - monitoring of the governance process itself (**F**) and monitoring of the financial reporting and auditing (**E**) - represent the other basic activity of the boards of directors and supervisory boards, namely, overseeing the management. The times spent on them are similar and are second largest in boards' agenda, though they are more than 2 times shorter than the time spent on the first function. In spite of the difference in the valuation of the two functions, their performance is valued relatively high, which corresponds with the importance and time they are given.

The time spent on the other four functions is close each to other, but much shorter; more than five times less compared to the operational management and more than two times – than the time for supervision. This puts them together more or less,

though they are very different in nature. The function with a bit longer performance time (**G**), and also with little higher performance value, represent an issue of currently fast growing concern - monitoring of the disclosure process and communications with the shareholders and the general public. As mentioned, it has also the most idiosyncratic preference distribution, which speaks out that this function is now developing, changing its place and importance in the priorities of the current Bulgarian corporate boards.

While the last place of the function called to ensure avoiding or resolving the conflict of interest is not unexpected under the current situation of Bulgarian corporations, with concentrated property, with recently introduced and not yet finished distinction between independent and not-independent board members etc., the relatively backward places of the two functions dealing with the selection and compensation of the board members seem rather strange.

In fact it fits well the low results on same issue received within the analysis of the board committees. The answer, at least partially, might be found in the Bulgarian Commercial Code; it assigns to the General Assembly not only the selection, but also the compensation of the BD and SB members. This certainly reduces the interest to those functions, given the predominance of the companies with single-tier governance structures, but selection of the executives is *par excellence* up to the boards themselves. Thus, the other part of the explanation seems to be the already uncovered reluctance of the boards to regulate those functions explicitly and therefore more open for public discussion.

The evidence on how the functions are regulated confirm that conclusion in most general way. The highly ranked functions and that means the very basic and unquestioned ones, receive not just more time, but they are also better performed and more frequently recorded explicitly in the companies' by-laws. And the low-ranked functions, more recent and/or more reluctantly open for public attention, like avoidance of the conflicts, are less often explicitly regulated – in our case more than twice than the functions and less well (or not at all) performed, though the differences in valuation are rather small as a whole.

## **8. Conflict of interests**

As mentioned the legal matter concerning the conflict of interests has very short history in Bulgarian corporate governance practice. That imposes certain specifics of the investigated issue. In fact, on the question *Do you have in your company a procedure for dealing with such conflicts*, more than 50% answered *no*, *that issue is not in the agenda* and one need to add also another 19.28%, which simply declined the issue. Thus, at first glance, the issue might be interpreted negatively dubbing Bulgarian corporate boards like having low level of regulation and protection of the company's business from the conflicts of interests. But I believe, that one may see the issue in dynamics adding to those 7.46%, which already have a written procedure how to deal with the conflicts, that cases which insists that even without written procedure they have extended practice in the field and also those influenced by the recent law, who are currently discussing setting up of such procedure. Thus, the cumulative share of those cases reaches 28.93% out of all cases or 35.82% out of the valid ones; it still not that high, but seems promising in perspective.



The issue is not just important, but also controversial and the different representatives of the governing bodies meet it with different attitudes depending on the ownership structure in the company, on their own position of related or not person etc. That is the reason which stimulated us to seek opinion of our respondents on the actual (or possible) implementation of the procedure for resolving the conflicts. Unfortunately, this question reveals one of faults inevitable for a pilot survey we allowed an option avoiding the direct answer and eventually received more than 40% declined answers which sharply decreased the pool of valid answers, diminishing that way the validity of our conclusions.

Nevertheless, the results are challenging - the large majority – more than 58% of the valid cases believe that the procedure is well backed by the law and could not be avoided or blocked; almost 35% of the respondents believe that its implementation will be progressively improving and just less than 7% see serious obstacles before it. That could be interpreted as a general positive attitude toward the recent amendments in the legal framework.

## **Conclusions**

The survey provided interesting data about the current status of corporate boards in Bulgaria:

1. They are rather small in size, close to the lower figures required by the law; managing boards being bit larger than others. Surveyed boards encompass relatively high educated and properly professionally qualified members. The rather small size suggests limited structure of corporate committees.
2. A considerable share of board members - on boards of directors approximating 50%, are certainly non-independent. They have frequently more than one "additional" relation to the company; those relations are more often connected to the large stake in the corporate ownership for the BD and SB, and to the placement in other boards, very often of affiliated companies for the MB.
3. Independent are considered about 1/3 of the board members, slightly lower for the MBs; that makes about 1 - 1.3 persons per board; the figure reflects the situation after introducing the board membership quota, but before the actual reconstruction of the boards.
4. The latter circumstance is important, since most of the companies do not have provisions in their by-laws offering opportunities for standing up independent opinions. True, there is a ground to expect that the number of such by-laws will rise soon.
5. In large majority of the observed boards, there is no overlap between their chairmen and the CEOs. That may be a good proof of separation of controlling from managing functions, in BD for example, but for the managing boards, that may mean, a possible shift in the nature, a resemblance to the boards of directors.
6. The survey showed that the respondents do not have a common perception for the influence of the shareholders over the boards – they spread almost equally among the 5 offered values. A majority of the respondents evaluate the influence of the managers and independent members over the board decisions as shared, and the others give slight prevalence to the executives.

7. While, a significant deal of companies assert, their boards as a whole and their CEOs particularly, are monitored regularly, that seems to be largely formal, as for reports before the GSMs, which are prepared by the boards themselves. Even the seminar meetings to discuss important corporate issues are irregular or exceptional.
8. A modest part of the boards have a practice to connect comprehensively the board members compensation to the firm's performance, though, again, the forms used for that seem quite simple – most frequently just some cash or much rarely - on the job benefits, with virtually zero dispersion of stock participation.
9. In the limited number of boards practicing monitoring of economic indices as performance benchmarks, the operational ones prevail and those connected to the shareholders value are neglected.
10. The survey showed little difference in the remuneration of the executive and non-executive members, which I tend to interpret like an undervaluation of the effort of the executives, rather than an overvaluation of that of non-executives. The boards are reluctant to disclose the absolute level of compensation and they seem to be sensible to accept broader discussion on the matter.
11. The latter is proven from the analysis of the corporate board committees; out of 83 total corporations with overall of 28 created committees just 2 reported committees on compensation of the board members and none on nomination and selection of executives.
12. The vast majority of the corporate boards committees are auditing and strategic planning, i.e. heavily connected to the operational management, and few cases have more than one committee. An interesting point, the average number of the members of such committees appeared to be larger than the average board, which is up to me, an indication that the current average size of the boards is an obstacle for more diversified set of functions and for creation of committees particularly. the number of independent board members in those committees is not significant yet.
13. Almost half of those committees are set on the grounds of their statutes, and another half are ad hoc created, without any regulation; the only case where they are created under a CG Best Practice Code is a plain exception.
14. The investigation of ranking and performing of the basic 7 corporate board functions, mentioned in the OECD CG Principles, showed clear preference, in terms of importance and time spent, to the most "basic", those connected with the operational management and with the general governance; the monitoring of the conflict of interests is definitely ranked last; close to it are functions on selection compensation of the executives.
15. An indirect proof of the latter result is incorporated in the regulation status of the surveyed functions; again the most frequently the companies by-laws explicitly list the operational functions and the least – dealing with the conflict of the interests.
16. The evaluation and self-evaluation of the boards from the survey tend to be modes with the marks between 3 and fourth of the 5 grade scale; highest marks are given to the auditing committees and to the operational functions.
17. The legal regulation of the conflict of interests concerning the board members is rather new and most of the companies does not experience and procedures

for dealing with those problems. Although, the majority of them see the legal regulation as good and believe that it will be well implemented gradually; moreover, the number of the cases where the issue is discussed is rising. Shortly, the observed Bulgarian corporate boards show clear predominance of traditional structuring and functionality of their activities, targeted mostly on the operational management and the overall governance practice. Thus, they still miss that more or less diversified functionality typical for the highest present-day standards, though that reconstruction is already underway, with the latest radical amendments of the regulating framework.