

Internal control systems in Bulgarian banking corporations

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I. Introduction

A number of socio-economical changes have been done in Bulgaria during the last years. They generated fast growth of the corporate property, raising by this way many problems. Generally, the practice of management in Bulgaria corporations, including internal control, forestalls the theory development and the best practices adoption. This created preconditions for internal control inefficiency and ineffectiveness and by this way – for insufficient minority shareholders' protection. Despite of the existence of a number of corporate governance researches, a study of the internal control in Bulgarian firms and, in particular, in corporations doesn't exist.

Bulgarian legislation, like the Continental Europe one, is to the highest degree liberal to the private corporations' internal control systems (ICS) organization and operation. Legislative requirements in this area exist only for the banking corporations. For this their internal control systems (ICS) have to be studied separately. The main objective of this paper is to ascertain the Bulgarian banks' ICSs state and to outline the main directions for improvement.

II. Legal framework

Eventual failure of the banking system would lead to considerable social cataclysms. For this banks are subject of strengthen state regulation. First of all this accomplishes through the central banks. According to the Law on the Bulgarian National Bank, art. 2, par.6, The Bulgarian National Bank shall regulate and supervise other banks' activities in this country for the purpose of ensuring the stability of the banking system and protecting depositors' interests. The Deputy Governor, head of the Banking Supervision Department, fulfils this function.

Beside the existence of banking supervision, that is external banks' control, there are legal requirements about the internal banks' control. Such requirements exist even in Continental Europe countries, which have liberal legislation of the private corporations' ICSs. In 1998 Basel Committee on Banking Supervision issued two publications: (1) Framework for Internal Control Systems in Banking Organizations and (2) Framework for the Evaluation of Internal Control Systems. In 2003 according to this documents passed Regulation No.10 on the Internal Control in Banks, which abrogated the old Regulation No.10 (1993). This is the main act, regulating Bulgarian banks' ICSs. To a great extent it determines their organization and operation.

Also, banks' internal control idiosyncrasy is that the control subjects have to report to an external body - banking supervision. Such requirement does not exist for non-financial corporations. Their internal control subjects are obligated to report only to the management and to the owners.

The main legislation, which regulates ICS in Bulgarian banks, as above-mentioned, is Regulation 10 of BNB for internal control in banks. For this, firstly its edicts should be analyzed. Although the regulation is new, it contains some outdated texts. According to art.4 internal control in banks consist of the following elements: (1) management oversight; (2) risk control; (3) reporting and information; and (4) internal audit. In contrast to COSO and other contemporary internal control frameworks Regulation No.10 does not focus on soft controls – ethical values, competency, trust, integrity. But big financial scandals last years - Enron, WorldCom, etc. clarified that the control environment is especially important for effective ICSs' operation.

The outdated definition for internal auditing is other important disadvantage. According to art.13, par.1 internal auditing is an independent appraisal function, established within a bank to examine and evaluate its transactions, operations and control systems which shall be carried out by the internal audit unit. It is in conformity to the old Ixia's definition and does not give an account of the last trends for expanding the internal auditing scope, in particular for rendering consultative services. Besides this, according to the Regulation the bank department, fulfilling internal auditing function, is so called specialized internal control unit.¹ This induces confusion in the banks, because so the terms 'internal control' and 'internal audit' are confused. These Regulation disadvantages have important effect on banks' internal control organization and operation.

III. Collecting data

Dated June, 1st, 2005 there are 29 commercial banks with an international banking license and 5 branches of foreign banks. The following *informational channels* were used in order to study their ICSs:

1. Specialized internal control unit working rules were studied. These rules are required from Banking Supervision Department, according to Law on Banks' art.58, par.1. It contains a provision that banks shall submit to the central bank copies of their Articles of Association, regulations, instructions, and other documents containing provisions regarding the scope and procedures for conducting transactions, the capital and the internal organization of the bank, within 7 days following their adoption, or after amending or supplementing them;.
2. To what extent banks comply with the requirement of the Regulation (art.28, par.2) to submit to the banking supervision bodies the annual reports on the activity of the internal audit is examined;.
3. An inquiry into banks' ICSs was conducted. An assistance from the IIA Bulgaria and Banking Supervision Department was asked for this purpose; and

4. An investigation for disclosure of non-financial information by Bulgarian corporations. We investigated separately the web-sites and the annual reports of banks.

IV. Bulgarian banks' specialized internal control unit working rules investigation

Dated June, 1st, 2005, only 3 banks submitted to the central bank Specialized internal control unit working rules. So, we could draw the following conclusions:

1. Half of the studied banks have Internal audit charter. Besides this they didn't submit it to the central bank according to their obligation. Firstly, this is evidence of insufficient Bulgarian banks' internal control transparency. This trend is dangerous because of the possibility to be caused by weak ICSs' organization and operation;
2. Secondly, this means absence of strong enough Banking Supervision Department's control, because any bank was not sanctioned for this negligence.
3. However, the other banks did not submit such rules, because they had not created them. This is much more dangerous practice, because with the lack of such a document is impossible to be guaranteed the internal auditors' work independence and effectiveness.

Following three banks submitted internal audit organization and operation rules:

- ❖ **Bank A²** –Bank A Internal Audit Department Working Rules;
- ❖ **Bank B** – Bank B Bulgaria Internal Control Rules;
- ❖ **Bank C** – (1) Internal Control System Common Rules; and (2)Internal Audit Organization and Operation Rules.

Bank C rules are the most complete and adequate. We will examine consecutively all of the enumerated documents.

Bank A: Supervisory Board adopts Internal Audit Department Working Rules. This is a positive fact, because so the conflict of interests' lack is guaranteed to some extent during the ICSs' design.

According to the Rules, art.2, the internal audit is a ICS's element, *ensuring*: (1)goals' and tasks' achievement; (2)economic and effective resources using; (3)adequate risk control; (4)assets protection; (5)financial and managerial information reliability and completeness; and (6)activities compliance with applicable laws and regulations, policies, plans, internal rules and procedures. Art.7 also consists of such a text, but these texts are not correct and are misleading to some extent. Even the best control can not ensure absolute, but only reasonable assurance that the organization's goals and

objectives will be achieved. So preconditions for unduly expectations towards internal audit are created.

According to art.3 internal audit is independent activity that appraises bank transactions and operations and ICSs. It is performing by Internal Audit Department. This definition is in compliance with the Ixia's one, in force till 1999, but not with the new one. By this way the internal auditing scope gets narrower and focuses on the assurance services, neglecting the consultative one. This is direct outdated Regulation No 10 texts' consequence and highlights the need of their change.

There is an Audit Committee in Bank A. Head of the Internal Audit Department has to report to the Audit Committee and to the Supervisory Board. This is a positive fact, because so Internal Audit Department's higher independence preconditions are created.

In the **Bank B** Internal Control Rules the terms 'internal control' and 'internal audit' are confused. According to Art.4, par.4 the done from administrators and other persons with governance functions reviews and control activities within the framework of their competencies, can not replace internal audit functions. At the same time this term is not used anywhere else in the Rules. Instead of this the term 'internal control' is used and instead of the term 'internal auditors' – 'internal controllers'. This confusion is a Regulation No 10 consequence also.

According to Art.2, par.2 the internal control is organized as an independent appraisal activity. This statement is true about the internal audit, not about the internal control as a whole. In the cases when the control is done as a part of the management functions is not correct to write about independence existence. Internal auditors (according to the Rules – internal controllers) are independent because they can not combine their position with other positions in the Bank and they can not have authorities and responsibilities in the auditee (Art.4, par.2).

Even if we suppose that this definition refers to the internal audit, not to the internal control as a whole, it is outdated and does not takes into account the last internal audit trends. This is a Regulation No 10 consequence too.

Other Rules disadvantage is the lack of clearly defined Internal Control Department position within the organization and Head of the Department reporting lines. This have to be changed because it could be an insufficient bank's internal audit independence sign.

In contrast to the other banks, in **Bank C** there are two different documents- (1) Internal Control System Common Rules; and (2) Internal Audit Organization and Operation Rules. This is a sign, that the difference between 'internal audit' and 'internal control' is clearly realized. Besides this these two documents are much more comprehensive and adequate then the other banks' submitted documents.

According to the Rules internal control is continuous process that provides assurance regarding the achievement of the goals and objectives at all organizational levels. As already was pointed, this generates excessive expectations toward internal control, because it could provide only

reasonable, not absolute assurance. At the expense of this according to the Internal Audit Organization and Operation Rules internal audit is independent, assuring the achievement of the goals and consultative activity, created to check the bank's transactions, operations and control system, to add value and to improve organizational operations. This definition is in accordance with the new internal audit comprehension and recognizes its consultative function.

Internal Control System Common Rules' Part II (Management control), Par.4, emphasizes the Code of Administrators' and Employees' Ethical Behavior and the Controllers' Training, Assessment and Stimulation System importance, i.e. ethic and competence importance. Similarly it highlights tone of the top importance – according to Part IV, Par.3 management board is responsible for high ethical and moral standards encouragement and for the construction of such an organizational culture, that highlights and demonstrates to all employees internal controls' importance. By this way the Rules reflects the trend toward turning the attention to soft controls.

Especially positive is the fact, that the main employees' internal control fulfillment obligations are listed. So the Rules contribute to their role into the complete control process realization and create preconditions for its better fulfillment.

The supreme internal control body – the General Shareholders' Meeting, hires and fires the Head of Internal Audit Department. Besides this, the Supervisory Board bears the responsibility for bank's ICS's main directions, strategy and policy. According to them the Management Board approves Internal Controls' Realization Instructions and Rules. So the responsibility for internal control organization is beard by the supreme governing bodies. This generates preconditions for conflict of interests' avoidance and high organizational independence.

After all this we could come to the conclusion, that even this Bulgarian banks, that have created Internal Audit Department Organization and Operation Rules, have to make considerable corrections, supplementing and bringing them up-to-date. Besides this, it is necessary Bank Supervision Department's control to be strengthened and Regulation No10 to be changed.

IV. Bulgarian banks' Internal Control Reports study

Dated June, 1st, 2005, any bank has not submitted Internal Control Report, despite the legal requirement. This fact corroborates our lack of transparency and strong enough Central bank's supervision thesis. This is mostly due to the fact, that according to Regulation No 10 such report has to be submitted firstly in 2005 (for the financial 2004) and effective control mechanisms are not created yet. This, combined with the lack of internal controls' information disclosure practice and willingness, leads to this result.

V. Inquiry

Main purpose of the inquiry is to determine Bulgarian banks' ICSs' condition. Questionnaires were sent to the all banks' internal auditors e-mails. In spite of this that they were sent on the behalf of Banking Supervision Department and IIA Bulgaria only 12 returned the questionnaires. This again proves our lack of transparency thesis.

The fact that half of the answered to the inquiry banks are from first group, i.e. from the banks with the banks with highest assets sum.³ So we could conclude that the biggest Bulgarian banks' management teams have realized the need of higher transparency and positive image creation. It is necessary conditions to be improved in the other banks.

We could assert confidently enough that the received questionnaires' results present the real conditions in Bulgarian banks' ICSs, because the banks, that answered the inquiry, manage more than the half Bulgarian banks' assets (Exhibit 1). So, according to the main massive method¹ the possible mistakes and disturbance. This method is applied because of the general population small size and the impossibility for all respondents answers receiving.

Inquiry's questions could be divided into two groups: (1) concerning internal control organization; and (2) concerning internal control technology.

Through the *first question group* (Exhibit 2) is made an attempt to be received information about these subjects that are common for the ICS and the corporate governance system – internal auditors, Audit Committee, Board of Directors (Management and Supervisory Boards) and General Shareholders' Meeting. The General Shareholders' Meeting's means for fulfilling direct internal control are minimal. Besides this the problem about Bulgarian corporations' Board of Directors is relatively well investigated during the corporate governance studying. For this with these questions we attempt to receive information for the Bulgarian banks' remaining two subjects' existence and status.

On the basis of the received answers the following findings are done:

- ◆ Only three of the investigated banks (25 %) have created audit committee. At that each of these audit committees consists only from one director, and in one of them there are non-resident such. Knowing that usually is assumed that the optimal directors' number is three to five, we could conclude that even these audit committees are created formally;
- ◆ The problem with the directors' independence is not solved. Only in one of the banks the audit committee's member is an independent director. In the other cases the directors are insiders. This additionally hampers the independent and effective committee's function fulfilling.
- ◆ In one of the banks there are simultaneously functioning Internal Control and Internal Audit Departments. By this way an attempt is made the Regulation No 10 inaccuracy to be

¹ Nonrandom sampling, consisting of the general population's biggest part.

overcome, but this could lead to bigger confusion because of the existing overlapping functions' risk.

- ◆ Half of the investigated banks have not written internal Audit Department' written charter. This potentially could impede department's activity, because this is the main document, regulating the internal audit function. The lack of such a document creates an insufficient independence danger and to some extent to formal internal auditors' duties execution
- ◆ Head of the Internal Audit Department reports functionally to the audit committee, where such is created. In two of the other banks he reports functionally to the highest organizational level – Management Board or Supervisory Board. However, in the other cases he reports to the Chief Executive Officer (CEO). This contradicts to the International Standards for the Professional Practice of Internal Auditing, according which “the chief audit executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities . So preconditions for insufficient internal auditors' independence are created.
- ◆ At the same time the administrative reporting lines are satisfactory – usually chief audit executive (CAE) reports to the chief executive officer (CEO). In two banks he reports administratively to the audit committee. This is unusual, because the committee should not fulfill operative functions. This shows an insufficient understanding of its functions again.
- ◆ Big part of the investigated banks (10 or 83 %) uses only their internal audit departments' resources. This is predetermined from the Regulation No 10 internal control department existence requirements. On one hand, this is a positive fact because internal auditors are more aware of the banks' operations than the outsourcing organization's employees. On the other hand, the internal auditing concept is not well known yet and there are little specialists. For this it would be useful external organizations' services to be used for these activities that need specific knowledge and skills, what is the practice in two of the investigated banks.
- ◆ Only one of the banks with audit committee the Chief Internal Auditor (CIA) has unrestricted access to the audit committee. In the other two banks the CAE has not such unlimited access. Besides this in one of them it is determined this meetings to be done only at determined dates. In the other case they communicate only by written reports. By this way the rapid reaction possibilities are restricted and the audit committee usefulness is limited to high extent.

With *the second group of questions* (Exhibit 3) information for internal control fulfillment technology in Bulgarian bank is collected. On the basis of the received answers the following findings are done:

- ◆ Internal auditors in banks rate highly the degree of support by the managers for realization of internal control and of internal audit: 92% of them answer that managers fully understand the necessity of internal control and fully support the attempts of the internal auditors. This fact is very important by itself. One should keep in mind however the preconditions for insufficient

independency of internal auditors which due to defects in the organization of banks ICS. We pointed these defects in the previous chapter; one of them is insufficient popularity of internal control concept in Bulgaria. That makes negative the fact that the half of the Bulgarian banks does not organize trainings of their managers for explanation of internal control basic principles.

- ◆ The majority of banks have approved ethic code: 92% of them. As mentioned in the annual evaluation for corruption of Coalition 2000 (2005) there is already critical mass of firms, which are approved ethic codes and standards for socially responsible behavior: such as Standard for business ethic, Global contract, etc. Their observation however is still problematic. In majority of cases they are assumed as elite clubs for improvement of their charter, which do not lead to strict engagements for observation of the social responsibility standards. Significant fact is that the half of the banks does not organize trainings for improvement of the ethical behavior of their officials.
- ◆ Property in Bulgarian banks is mainly foreign one (83% from the investigated banks). Hence it is interesting to investigate in how foreign owners effectuate control on bank activities. In some of them (40%) foreign shareholders are members of the Managerial Board and/or Supervisory Board. In more than half of them (60%) there is also direct control to the mother's part by periodical examinations by its section for internal control and/or periodically sent reports. That is due to the fact that usually foreign owners are majority shareholders.
- ◆ Internal auditors in banks rate not very high the degree of realization of employees for their role in internal control effectuation. Half of them answer "they realize", 17% answer "somewhat realize" and only 1/3 answer "fully realize". That talks about potential danger ICS not to be able to operate effectively (even if they are well designed and well organized) because of absence support to the officials' part. As known, internal control is an obligation of each employee. Hence, the absence of comprehension to the part of some of the employees for their own role in this process would break the normal activity of the entire system.
- ◆ Because of the absence of sufficiently well prepared specialists in the internal audit field, interesting is the question about the selection of officials in the internal audit department. Leading is the requirement for higher economical education language skills (usually English), computer skills, and experience in bank field. It is not required however, specific knowledge in the internal control (or audit) field. Concerning increasing the competence of already employed auditors, half of the banks organize for them internal trainings. 83% encourage them to attend courses and seminars, organized by other organizations. No one of the banks, however, stimulates internal auditors to pass exams for certified internal auditors; nevertheless this certificate is internationally recognized proof for good professional skills.
- ◆ In general banks effectuate all stages of risk assessment: (i) identification; (ii) risk analysis; and (iii) management of environment change. That is explained with a view to the fact that

because of the higher risk, to which they are subjected, there are normative requirements in this direction. In one of the investigated banks, however, they do only risk identification. Another one does not manage the environment changes. That strongly decreases the effectiveness of risk assessment, which is especially danger for types of organization such as banks.

- ◆ The majority of internal auditors have answered that the banks, where they work, apply mainly current control (83%) and/or subsequent one (58%). This supposes lower prevention of the realized control and hence, smaller effectiveness of the process. Besides, they realize the necessity of previous control: all the inquired answer that they preview its priority applying in future.
- ◆ 75% of the investigated banks have built system for internal whistleblowing in case of detected irregularities. This is undoubtedly positive fact, as it increases the probability for discovering of errors and abuses to the part of both managers and officials.
- ◆ Positive fact also is that in almost all investigated banks internal audit assesses not only the internal control but also the risk management and the corporative management. Only in one bank internal audit is directed to assessment of internal control solely. Hence, in general banks have assumed wider scope of internal audit.
- ◆ Only 42% of the investigated banks apply control self-assessment. All the others use another method for monitoring: examinations to the part of internal audit department, to the part of head office for branches of foreign banks, etc. Interesting is that only two from the investigated banks ally simultaneously control self-assessment and monitoring to the part of internal audit. Therefore, firstly the tool for control self-assessment are still weakly known for the majority of banks and hence it is not applied. Besides, some of the banks use it as unique method for monitoring performing, which is not recommendable because of its above-explained defects.

Third phase of the inquiry is the investigation of the situation concerning information disclosure in bank sector. To this aim we studied the annual reports of banks for 2004 and their web-sites.

In general Bulgarian banks disclose mainly normatively required financial and accounting information. The exceptions are just few. Only **UBB** takes actions for disclosure of information about the realized internal control. The annual report of the bank contains chapter entitled “Corporative management”, which declares the responsibility of the Board of Directors for the operation of ICS in the bank. Critical description of the ICS is done there, but without giving an evaluation to it.

More banks make disclosure concerning activities, taken in relation to society interests’ protection and environment protection. Six of the banks have separated chapters in their annual reports and/or in their web-pages, devoted to observation of society rights:

- **UBB** – chapters “Sponsors both in annual report and in web-page of the bank;
- **Euro bank** – chapter “Sponsor politics in the annual report;
- **Citibank** - chapter “Donors programs in the web-site of the bank;
- **Post bank** – chapter “Social engagement in its annual reports;
- **ING Bank** – chapter “ING and the society in the web-site of the bank;
- **ProCredit Bank** – chapter “Ethical standards and related to the environment ones in the annual reports.

Four banks are members of the Global contract: Bulbank, Bulgarian-American credit bank, Citibank and ING Bank. Only **Bulbank** however discloses definitively this fact.

On the base of the above we could summarize that Bulgarian banks make attempts for applying of the last achievements in the field of internal control. Besides their control processes are not transparent. Hence, needed are many improvements of the control process, some of which defects are due to imperfections of the applied normative organization.

VI. Approaches for Bulgarian banks’ ICSs improvement

Based on the information about the Bulgarian banks’ ICSs organization and technology, received through the pointed out three informational channels, we could conclude that as a whole transparency is missing. Besides this the best control practices are yet to be applied. To a high extent this is due to the small number of well qualified internal audit specialists in Bulgaria. To be facilitated this process it is necessary revision to be done to the Regulation No 10.

Based on this, the following approaches for improvement of Bulgarian banks’ ICSs organization and entire operation could be made:

- Firstly, the following **changes in BNB’s Regulation 10** for internal control in banks must be passed: **(1)** to be changed the content of ICS elements. It has to be carried out in agreement with the text of Frame for ICS of Basel’s committee (including the so-called control culture), as well as with all the other contemporary frames for internal control. Besides it has to be emphasized on the importance of soft controls; **(2)** to be changed the definition for internal control in agreement with this one, passed in 1999 by IAS. By this way consulting functions of internal control will be recognized; **(3)** the name “specialized office for internal control to be changed to “internal audit department . By this way the confusion in creation of ICS in Bulgarian banks will be avoided. Also avoided will be confusion of the notions “internal control and “internal audit ; **(4)** to be entered an obligation for creation of audit committee, attached to the Board of Directors (Supervisory Board, respectively) of banks (except the branches of foreign banks), which consist in fully independent directors;

- Another direction for improvement of organization of ICS in banks is creation of big enough audit committees, which could effectively perform their functions even if normative obligation is absent. Besides, they must be consisted fully in independent directors as by this way some independency of their activity will be guaranteed;
- Especially important in ICS organization is adequate **reporting lines** of CAE to be previewed. For this they must rearrange their ICS in such a way that functionally the internal audit manager to report before the audit committee (in case it is not created yet – before the Board of Directors). Besides, in case of necessity the CAE has to have unlimited access to the audit committee;
- Board of Directors of banks, wit the help of the audit committee, must pass **charter of the internal audit department**, if such one is present. By this way possibility for internal auditors to perform effectively and independently their obligations is guaranteed in a certain degree.
- The following **changes in Regulation 10** of BNB for internal control in banks must be introduced: **(1)** banks to be demanded to create written ethic code; **(2)** to be changed the requirement of article 19 paragraph 2 all control subjects to be covered in the frames of one control period with prolongation no more than two years. This period is too short for the large activities of bigger banks and hence, it puts obstacles to the applying of risk-based approach in audit.
- These banks, which have no written **ethic code**, must approve such one. That makes preconditions for increasing of the officials' corporative culture and for improvement of the ethical climate in corporation.
- Moreover, all banks must organize **tutions and trainings of their employees** for ethical behavior and for increasing of their corporative culture. That avoids the risk approved ethic code to rest just a sheet of paper without practical application. Also the reasons for introduction of each new type of control must be explained to the employees, as well as the profits which it brings. This will help to avoid the risk of boycotting the innovations in internal control field to the officials part because of misunderstanding of the profits and because of considering them for onerous and nonsense.
- All levels managers are main control subjects. Their support determines in considerable degree how much effective will be the internal auditors' activity. For this especially important is they to realize the necessity of effectuation of internal control and of internal audit. To this aim **management** must be submitted to periodical **tutions** concerning the internal control principles and techniques.
- Internal auditors must be stimulated to pass exam for CIA. This certificate is worldwide recognized guarantee for their qualification. Besides, according to the IIA rules the practicing certified internal auditors must take for each two-years-long period 80 classes for Continuing

Professional Education (CPE). Such classes are recognized for various forms of tuitions, publications, presentations, etc.. That guarantees for keeping up and for improvement of internal auditors qualification.

- All banks must apply all the stages of risk assessment, but not only this one of risk identification. That will guarantee in higher degree for applying of more effective risky-based control process.
- Gradually must be transited to wider using of various methods for preliminary control. That will increase the preventive and prophylactic function of internal control, and hence its effectiveness.
- Wider usage of the control self-assessment method is recommended, as it ensures participation to the monitoring not only of the internal auditors but of the very managers also. That facilitates the work of auditors which to its part, supports them to effectuate more comprehensive and more all-embracing control inside the bank. On another hand, participating to the monitoring and to the control, managers much better comprehend their own role in the entire process of internal control realization.

VI. Conclusion

Based on the information for Bulgarian banks' ICSs organization and technology, received through the pointed out three informational channels, we could conclude that as a whole transparency is missing and the best control practices are yet to be applied. To a high extent this is due to the small number of well qualified internal audit specialists in Bulgaria. To be facilitated this process it is necessary revision to be done to the Regulation No 10.

EXHIBIT 1**Amount of investigated banks' assets (thousands of BGN)**

| Investigated banks | Assets amount |
|--|----------------------|
| I group | |
| Bulbank | 3 303 073 |
| United Bulgarian Bank | 2 704 278 |
| HVB Bank Biochim | 2 190 038 |
| Raiffeisenbank | 2 238 343 |
| First Investment Bank | 2 229 582 |
| DZI Bank | 940 375 |
| II group | |
| Hebrosbank | 655 656 |
| Municipal Bank | 519 381 |
| Union Bank | 429 751 |
| D Commerce Bank | 61 961 |
| III group | |
| ING Bank - Sofia Branch | 320 453 |
| Alpha Bank - Sofia Branch | 145 602 |
| Amount of the investigated banks' assets | 15 738 493 |
| Amount of the whole banking system's assets | 27 926 520 |
| Investigated banks' assets as a part of the whole banking system's assets (%) | 56% |

EXHIBIT 2

Questions concerning the internal control organization in Bulgarian banks

Questions according to the Audit Committee:

Do there is an Audit Committee at the bank's Board of Directors?

a) Yes

b) No

How much are the Audit Committee's directors?

How much of the Audit Committee's directors are independence one?

Questions according to the Internal Audit Department:

Do there is in the bank an Internal Audit Department apart from the Specialized Internal Control Unit?

a) Yes

b) No

If you answered with yes, what type of functions performs each of them?

Has the bank's Board of Directors adopted a written Internal Audit Charter?

a) Yes

b) No

To whom does the CAE administratively report?

a) Audit Committee/Board of Directors

b) Chief Executive Officer/President

c) Chief Financial Officer

d) Next level Financial/Controller/Treasurer below CFO

e) Other, please specify:

To whom does the CAE functionally report?

a) Audit Committee/Board of Directors

b) Chief Executive Officer/President

c) Chief Financial Officer

d) Next level Financial/Controller/Treasurer below CFO

e) Other, please specify:

Do some internal audit activities are outsourced?

a) No

b) Yes, but only for special projects

c) Yes, the major part

Questions according to the communication between the Audit Committee and the Internal Audit Department:

How frequently do the CAE and the audit committee meet?

Do the CAE has unlimited access to the audit committee in a case of necessity?

a) Yes

b) No

How the CAE communicates with the audit committee?

a) Written reports

b) Oral reports

c) Both written and oral reports

d) Without reports

EXHIBIT 3

Questions concerning the internal control technology in Bulgarian banks

| | |
|-------------------------------------|--|
| <input checked="" type="checkbox"/> | To what extent do bank's managers understand the internal control necessity? |
| a) | Fully understand |
| b) | Somewhat understand |
| c) | Understand |
| d) | Somewhat misunderstand |
| e) | Fully misunderstand |
| <input checked="" type="checkbox"/> | Do there is in the bank internal control trainings for the managers? |
| a) | Yes |
| b) | No |
| <input checked="" type="checkbox"/> | To what extent do bank's managers support internal auditors' efforts? |
| a) | Fully support |
| b) | Somewhat support |
| c) | Support |
| d) | Somewhat do not support |
| e) | Fully do not support |
| <input checked="" type="checkbox"/> | Have the bank's Board of Directors adopted written Code of Ethics? |
| a) | Yes |
| b) | No |
| <input checked="" type="checkbox"/> | Do there is in the bank regular ethics trainings for the employees? |
| a) | Yes |
| b) | No |
| <input checked="" type="checkbox"/> | Does the bank have foreign shareholders? |
| a) | Yes |
| b) | No |
| <input checked="" type="checkbox"/> | If you answered with yes, how do the foreign shareholders control banks' activity? |
| <input checked="" type="checkbox"/> | To what extent do bank's employees understand their own internal control role? |
| a) | Fully understand |
| b) | Somewhat understand |
| c) | Understand |
| d) | Somewhat misunderstand |
| e) | Fully misunderstand |
| <input checked="" type="checkbox"/> | What are internal auditors' recruitment criteria? |
| a) | High education - please specify: |
| b) | Professional experience - please specify: |

c) Language skills - please specify:

d) Other - please specify:

How the bank does stimulate internal auditors' competence enhancement?

a) Through internal trainings

b) Through external trainings and seminars attendance stimulation

c) Through encouragement internal auditors to pass the CIA exams

d) Other - please specify:

e) Does not stimulate internal auditors' competence enhancement

Do all risk assessment stages are applied?

a) Risk identification Yes No

b) Risk measurement risk analysis Yes No

c) Prioritizing risk Yes No

What form of internal control is applied most frequently?

a) Preventive control

b) Detective control

c) Corrective control

Do you foresee preventive control predominantly applying in the future?

a) Yes

b) No

Do there is whistleblowing system in the bank?

a) Yes

b) No

Do the bank's Internal Audit Department periodically appraise:

a) Internal control Yes No

b) Risk management Yes No

c) Corporate governance Yes No

What monitoring tool is employed in the bank?

a) Control self-assessment

b) Independent body monitoring

c) Other - please specify:

ENDNOTES

¹ In the Regulation 10 English version this term is translated as ‘internal audit unit’, but in the original variant is used the term ‘specialized internal control unit’.

² Banks’ names are changed due to the confidentiality of the information.

³ Since April 2003, the BNB Banking Supervision Department classifies the commercial banks in three groups. This grouping does not entail any rating element. Arranging banks into groups is done based on the amount of their assets and is changed as of each particular period. The first group always consists of 10 banks, the second group comprises all the remaining banks, and the third group comprises the branches of foreign banks in Bulgaria.