RELATED PARTY DISCLOSURES – A PRECONDITION FOR IMPROVING THE TRANSPARENCY OF THE FINANCIAL STATEMENTS OF COMMERCIAL BANKS IN BULGARIA

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Abstract: The specific nature of transactions between banking institutions and parties related thereto implies that such institutions have higher exposures to various types of risk (credit, interest, liquidity, market, etc.). This necessitates detailed disclosures in the financial statements of banking institutions.

The aim of this paper is to examine the practices of banks in the Republic of Bulgaria regarding their approaches to disclosing information about their relationships and transactions with related parties in their financial statements. To this aim the authors have studied the existing literature and analysed practices related to disclosure of information about related parties in the financial statements of these banks. In order to achieve an in-depth analysis, the relationship between the detailed disclosures of bank institutions and the amount of their assets was investigated. The study resulted in an assessment of the applied disclosure approaches with concrete recommendations for their improvement in order to increase the transparency of the financial statements of banking institutions.

Keywords: financial statements, related party, transparency of information, commercial banks

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Part I. Introduction

Related party transactions are part of the normal course of business for businesses. The criteria for identifying related party transactions can vary significantly across accounting jurisdictions, but generally these criteria are built on the assumption that participation in a related party transaction is defined by "the ability to influence the contractual terms of the transactions." (Muhammed, 2020); (Pizzo, 2011), (Chen et al., 2009). The possibility that related parties may agree terms (volumes, prices, interest rates, fees, collaterals, delivery terms, etc.) that differ from those that would be agreed between independent parties could lead to a misunderstanding of the information presented in the financial statements.

According to the Accountancy Act (Accountancy Act, 2015), banks in the Republic of Bulgaria shall prepare their financial statements in compliance with the International Accounting Standards (IAS), which implies a compliance with the requirements of IAS 24 *Related Party Disclosures* for disclosing their relationships and transactions with related parties.

IAS 24 *Related Party Disclosures* sets out the requirements for reporting and disclosure of related party relationships, transactions and outstanding balances. Its objective is to enable the users of the financial statement to understand the related circumstances and their actual or potential effects on the financial statement.

Regulators, supervisors, standard setters, market participants and other corporate stakeholders generally view related party transactions as a potential risk of misrepresentation that could harm the value of the enterprise and thus the efficiency and transparency of the market (Pozzoli, 2014). Many of the most infamous corporate scandals of the recent past, such as Enron, Wordcom and Parmalat, were actually caused to related party transactions (Beerbaum, 2021). An example from Bulgaria from the recent past in this regard is the declared bankruptcy of the Corporate Commercial Bank, which was found to have large exposures and loans to entities related to the bank[3].

[3] During its supervisory audits, the BNB has established the presence of large exposures and loans to entities related to the bank, large concentrations of exposures of borrowers related to the bank's shareholders, and preferential treatment of related parties. The auditors (after the closure of CCB) report loans granted by the bank to related parties in the amount of BGN 3.5 billion.

The specialized legal framework for banks also requires banks to submit periodic disclosures to the BNB regarding their internal exposures, as well as to notify the Supervisory Authority of any new transaction with related parties.

The aim of this study is to examine the practices of banks in the Republic of Bulgaria regarding their approaches to disclosing information about relationships and transactions with related parties in their financial statements.

The research hypothesis is that the disclosure of facts and circumstances about related parties is of key importance for the transparency of financial statements and the quality of information thereof, which should allow investors and other stakeholders to make a reliable assessment of the financial status and performance of the respective banking institution. Transparency is also a prerequisite for effective preventive control by banking supervision.

Part II. Literature Review

IAS 24 *Related Party Disclosures* defines a related party transaction as "a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged" (Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, 2008). Two or more persons/entities are considered related if either of them has control or joint control or significant influence over the other regarding the latter's operative or financial decisions. The standard's definition of "related person" in fact refers to controlling shareholders, members of the key management personnel and any other entity that may have significant influence over the reporting entity (e.g. a subsidiary, an associated or joint venture or close members of the family of a related party).

Unlike IAS 24 *Related Party Disclosures*, the Law on Credit Institutions provides for a broader range of criteria for categorization of the relations between banks and their related parties. For example, it provides for a lower threshold of the subscribed capital or qualified share holding (10 or more percent of the subscribed capital or qualified share holding that ensures 10 or more percent of the voting rights in the General Shareholders

Meeting) to qualify a person as related to the bank (Law on Credit Institutions , 2006).

In the accounting literature, there are two main theories that explain the economic nature of related party transactions and their dual nature. (Muhammed, D., 2020); (Pozzoli et al., 2014); (Gordon, et al., 2004). The first theory is referred to as “efficiency theory“, “propping” or “efficient transaction hypothesis”. According to this theory, related party transactions may benefit the reporting entity being strategic decisions that may increase the entity’s shareholders value. According to Pozzoli and Venuti, related party transactions “represent internal dealings able to reduce transaction costs and increase efficiency through the creation of an internal market within the corporate group“ (Pozzoli et al., 2014). The second theory is referred to as “conflict of interest theory“, “tunnelling” or “conflict of interests transaction hypothesis” and deals with the negative effect of related party transactions. According to this theory, related party transactions “may imply the misuse of company’s resources (moral hazard) and the misrepresentation of private information (adverse selection).“ (Pozzoli et al., 2014). Therefore, this theory is of great interest not only to researchers but also to regulators and corporate stakeholders.

The existing publications present contradictory results regarding the effects of related party transactions on the financial performance of entities and this is primarily due to the dual role of the related party transactions on corporate performance. (El-Helaly, et al., 2018); (Chen et al., 2009); (Fang et al., 2018); (Muhammed et al., 2020); (Pozzoli et al., 2014); (Umobong, 2017); (Maigoshi et al., 2016); (Magdalena, 2015); (Downs et al., 2016). Some empirical studies have found a positive relationship between corporate performance and related party transactions, while others have found a negative relationship. Others have found that there is no relationship between related parties transactions and the financial performance of enterprises.

In compliance with the requirements of IAS 24 *Related Party Disclosures*, when a bank has transactions with related parties, it should disclose the nature of the relationship with the related party, the type of transactions (on-balance sheet and off-balance sheet credit exposures and receivables; relationships such as service contracts, purchase and sale of assets, construction contracts, lease agreements, transactions with derivative instruments, borrowed funds and written-off loans), as well as the parameters of transactions with the related parties. Regarding the transactions, the disclosures should include: the amount of the transaction and the amount of outstanding balances, including their terms and conditions, collaterals, details of guarantees given or received, the amount of existing provisions for unsettled settlements between related parties as well as the recognized costs during the period related to the impairment of bad or doubtful receivables owed by related parties. The disclosure of compensations of key management personnel is also mandatory both in total and for each of the following categories: short-term employee benefits; post-employment benefits; other long-term benefits; termination benefits; and share-based benefits.

Given the possibility that related party transactions and the existing outstanding balances with such parties may affect the financial position and performance of banks, the Law on Credit Institutions, 2006 and Ordinance No 37 of the BNB of 16 July 2018 on the Internal Exposures of Banks[4] have set out strict restrictions for related party transactions of banks as well as strict regulations for approval by and disclosure to BNB of any such transactions. Banks are required to submit quarterly reports on their internal exposures, both on an individual and consolidated basis, in form and content according to a template approved by the BNB. Also, banks should notify the BNB regarding the formation of new internal exposures within 10 days of taking a decision on this or when an approved limit for such exposures is reached. These requirements aim to strengthen the preventive control of the Banking Supervision, avoid mistreatment of transactions with related parties and address the risk of conflict of interest.

Disclosures of information about parties related to banks is required by other national and EU regulations as well. According to Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC, 2017), the prospectus shall include information about major shareholders and others that may control or have an influence on the company as well as related-party transactions and the terms of such transactions. This information shall be disclosed under the following headings: major shareholders; related-party transactions; interests of experts and advisers.

[4] The Ordinance provides for the reports and disclosures banks should submit to the BNB regarding their internal exposures.

According to Art. 435, Para. 1, item e) of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013), institutions shall disclose a risk statement describing the nature, scope, purpose and economic essence of intra-group transactions as well as transactions with subsidiaries, associates and joint ventures and related entities. Disclosure should be limited to transactions that have material effect on the institution's risk profile (including reputational risk) or on the distribution of risks within the group (European Bank Authority, 2017).

Note that disclosures for supervisory purposes and financial reporting purposes in the banking sector are derived from more or less the same sources of information. Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013) enable the annual disclosures for supervisory purposes to refer to the information from the annual financial statement. It is therefore of paramount importance that the disclosures in the annual financial statement are complete and in accordance with the requirements of the related accounting standards.

The requirements of the international accounting standards and the specialized banking legal framework for adequate disclosure of transactions with related parties in the financial statements of the reporting entity aims to mitigate potential conflicts of interest since transparency improves supervision. However, general observations in the literature indicate that these transactions are not always disclosed properly (Mackenzie, et al., 2014). IAS 1 *Presentation of Financial statements* requires full compliance with all IAS/IFRS related to recognition, measurement and disclosure in order for the reporting entity's financial statements to be considered compliant with the International Accounting Standards. Many of the banks operating in Bulgaria are of foreign ownership. The policy and interests of their equity holders are not always associated with a high degree of disclosure, especially taking into account the fact that the majority of banks in Bulgaria are not public companies.

According to Art. 76, Para. 1 of LCI, the annual financial statements of each bank shall be subject to an independent audit carried out jointly by two audit firms which are registered auditors under the Law on the Independent Financial Audit (Law on Credit Institutions, 2006). The auditors' assessment of related party disclosures and transactions in the context of IAS 24 *Related Party Disclosures* is based on their opinion whether the facts and circumstances of related party relationships and transactions have been summarized and presented in an understandable manner. According to the Conceptual Framework for Financial Reporting, understandability is one of the four qualitative characteristics that enhance the usefulness of financial statements. Disclosures may not be understandable if the business logic and effects of the transactions on the financial statement are unclear or misleading or the important terms or other material elements of the operations necessary to understand them are not adequately disclosed. Adequate disclosure requires that financial statements contain all relevant information that will lead to proper analysis, interpretation and informed decision making. This is how the qualitative characteristic - completeness of the financial statements - is achieved. Disclosure of incomplete information by the reporting entity reduces the transparency of financial statements and creates uncertainty among stakeholders.

Barth and Schipper define financial reporting transparency as the degree to which the financial statements reveal an entity's underlying economics in a way that it is easily understandable for the users of financial statements (Barth et al., 2008). The authors' theoretical and empirical research show that increased reporting transparency can reduce the cost of capital, provided that transparency reduces information risk. Thus, their research supports the idea that transparency is a desirable feature of financial statements.

Pankaj Madhani defines transparency as “the timely and adequate

disclosure of the operating and financial performance of the company and its corporate governance practices related to its ownership, board, management structure and processes” (Madhani, 2007). The author emphasizes that voluntary disclosure and transparent financial reporting help businesses build long-term sustainable competitive advantages. Therefore, in order to improve their competitiveness, businesses should view disclosure as an opportunity rather than a burden. The relationship between the level of disclosure and the information risk premium is inversely proportional. The cited author concludes that companies benefit from building a reputation for transparent reporting, as this ultimately leads to higher management credibility, higher price/earnings (P/E) ratios, increased liquidity, and lower cost of capital.

Popova-Yosifova (Popova-Yosifova, 2018) concludes that the transparency of financial and accounting information is its qualitative characteristic. It is the result of the achieved qualitative characteristics of the information in the general purpose financial report - relevance, credibility, comparability, verifiability, timeliness and understandability.

Non-disclosure of information about related-party relationships and transactions violates good corporate governance. Without this relevant information, the users of the financial statements will not be aware that the financial position and performance of the business may have been affected by the existence of related-party relationships and transactions.

IAS 24 *Related Party Disclosures* has a significant impact on the level of disclosure in annual financial statements. In the conditions of increased competition, the formal requirement to disclose related-party relationships and transactions can be used by a bank as a means for creating a positive image among the users of public information. The only way to achieve fair presentation of the financial statements is a full compliance with the IASs.

Part III. Data and Methods

The research on practices related to the disclosure of related-party transactions in the financial statements of banking institutions (banks and branches of foreign banks) operating in the Republic of Bulgaria was carried out under a specific constraint and following a certain algorithm.

- *Constraint*

Since the study is devoted to the analysis of disclosure practices based on IAS 24 *Related Party Disclosures*, the branches of foreign banks in our country that do not apply IASs as the main methodological basis of their reporting process are excluded from the scope of the study. Of the banking institutions operating on the territory of Bulgaria, these are three branches of foreign banks, namely: Citibank Europe AD, Bulgaria branch, T.C. ZIRAAT BANKASI - SOFIA BRANCH and Varengold Bank AG, Sofia Branch.

- *Research algorithm*

✓ The main source of information for the purposes of this study are the financial statements prepared in accordance with the requirements of the IAS and published by the banking institutions (banks and branches of foreign banks) operating on the territory of the Republic of Bulgaria. In order to establish trends and reliability of the results, the study covers a five-year period (2017-2021).

Paragraphs 13 through 21 of IAS 24 *Related Party Disclosures* provide guidance on disclosures. Some of these provisions are dispositive, which provides some freedom in the institutions regarding what information to disclose regarding their related-party transactions, thus reducing the comparability of the information from the financial statements of the individual institutions. Based on the provision of this accounting standard, for the purposes of the analysis in the present study, the practices of banks related to disclosing of information regarding their related-party transactions in their financial statements are categorized in two main groups:

- Detailed disclosures;
- Concise disclosures.

The categorization criteria are presented in the figure below:

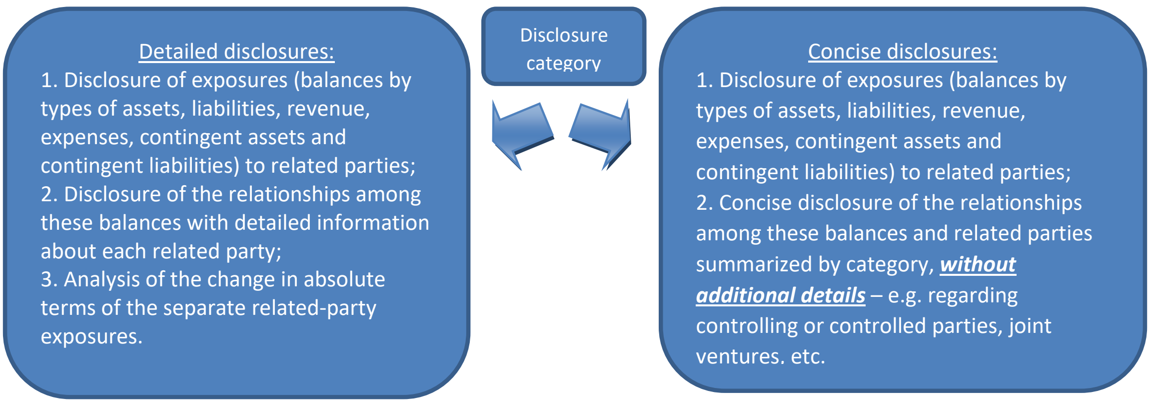

Figure 1. Classification of banks' practices related to disclosure of their related-party transactions in their financial statements

Such a categorization of disclosures for research purposes helps to define more accurately the differences in financial statement disclosure practices.

The most significant and important difference between the two categories of disclosures established through the comparative analysis is the detailed disclosure of information about the relationships between the bank's individual exposures and each of its related parties. Regardless of the fact that banks provide information on their exposures to related parties in compliance with **Ordinance No. 37 of the BNB on the internal exposures of banks**, it is important that such information be included in the banks' financial statements since such disclosures help the users of financial statement information to establish the concentration of risk in relation to each of the related parties, which ultimately affects their decisions and the quality of information in the banks' financial statements.

✓ A comparison and grouping of disclosure approaches in banks' financial statements was performed to assess the level of detail of related party transaction disclosures across the banking sector. On this basis, the share of banks that provide detailed disclosures regarding their transactions with related parties is determined. As banks use IAS as a methodological basis for preparing their financial statements, the degree of comparability of the disclosure approaches in the financial statements can be assessed.

✓ The assessment of the degree of comparability of the disclosure approaches in the financial statements for groups of banks has been differentiated using the classification of banks according to the criterial system of the Banking Supervision department of the Bulgarian National Bank (BNB), as it is the main regulatory authority. Based on this, banks in our country are classified into the following groups (*see Table 1*):

Table 1.
Classification of banks in Bulgaria according to BNB's criterial system

Group One	Group Two	Group Three
DSK Bank AD	Investbank AD	ING Bank N.V. – Sofia Branch
UniCredit Bulbank AD	Central Cooperative Bank AD	BNP Paribas S.A. - Sofia Branch
Eurobank Bulgaria AD	Allianz Bank Bulgaria AD	BNP Paribas Personal Finance S.A. - Bulgaria Branch
United Bulgarian Bank AD	Bulgarian-American Credit Bank AD	Bigbank AS – Bulgaria Branch
First Investment Bank AD	TBI Bank EAD	
	ProCredit Bank (Bulgaria) EAD	
	International Asset Bank AD	
	D Commerce Bank AD	
	Bulgarian Development Bank EAD	
	Tokuda Bank AD	
	Municipal Bank AD	
	Texim Bank AD	

Source: Bulgarian National Bank (Bulgarian National Bank, 2023*)*

The first group includes the banks with the largest amount of assets in our country, the second group includes the remaining banks, and the third group includes the branches of foreign banks that operate on the territory of the country.

The predominance, for example, in the first classification group of banks that make disclosures with a higher degree of generalization will make it difficult for users of financial statement information to assess the extent to which the bank is exposed to potential risks of concentration of exposures to related parties.

Based on the results obtained, specific recommendations are given to improve the guidelines for disclosure of related-party transactions so that users of financial statement information can make a more reliable assessment about the exposure (Al-Maghzom et al., 2016) of the respective institution to different types of risk such transactions give rise to.

Part IV. Analysis and results

Based on the conducted studies and the analyses of the data from the financial statements of the banking institutions operating on the territory of the Republic of Bulgaria, the practices for disclosing information on related-party relationships and transactions are summarised *(see Table 2).*

Based on the analysis and summarization of information on disclosure approaches in the financial statements of banking institutions, the relative share of those making detailed disclosures is determined.

The data from table above clearly shows that almost a third of the banking institutions operating on the territory of our country submit disclosures with a high degree of generalization of information regarding their related-party transactions.

The results by BNB classification groups are as follows:

✓ 80% of the banks in Group One submit detailed disclosures.

✓ Almost the same share is observed for the banks in Group Two – 75% of the banking institutions in this group submit detailed disclosures regarding their related-party transactions.

✓ Conversely, only 25% of the banks in Group Three, which includes branches of foreign banks operating on the territory of the country, submit detailed disclosures.

Table 2.
Analysis of the practices for disclosing information on related-party relationships and transactions in the financial statements of the banks in Bulgaria (2017-2021)

Banks operating in Bulgaria	Type of disclosure of exposures (assets, liabilities, revenues, expenses, contingent assets, contingent liabilities) from transactions with related parties (parent company, subsidiaries, key management personnel, etc.)	
	Detailed disclosure	Concise disclosure
DSK Bank AD	✓	
UniCredit Bulbank AD	✓	
Eurobank Bulgaria AD	✓	
United Bulgarian Bank AD	✓	
Texim Bank AD	✓	
First Investment Bank AD		✓
Investbank AD	✓	
Central Cooperative Bank AD		✓
Allianz Bank Bulgaria AD	✓	
Bulgarian-American Credit Bank AD	✓	
TBI Bank EAD		✓
ProCredit Bank (Bulgaria) EAD		✓
International Asset Bank AD	✓	
D Commerce Bank AD	✓	
Bulgarian Development Bank EAD	✓	
Tokuda Bank AD	✓	
Municipal Bank AD	✓	
ING Bank N.V. – Sofia Branch	✓	
BNP Paribas S.A. - Sofia Branch		✓
BNP Paribas Personal Finance S.A. - Bulgaria Branch		✓
Bigbank AS – Bulgaria Branch		✓

Source: Authors' qualitative assessment of banks' financial statements.

In order to achieve depth of analysis, the banks which submit detailed disclosures are grouped according to the volume of their assets. The aim is to determine whether there is a relationship between the amount of assets held by a banking institutions and the degree of comprehensiveness of its disclosures.

According to the data of the Bulgarian National Bank, at the end of 2021, the amount of assets of the banks included in this study is presented in the following table:

Table 3.
Amount of assets of the banks surveyed

Banks operating in Bulgaria	Total assets In thousands of BGN
DSK Bank AD	24 413 119
UniCredit Bulbank AD	24 948 376
Eurobank Bulgaria AD	14 490 546
United Bulgarian Bank AD	15 530 321
Texim Bank AD	536 816
First Investment Bank AD	12 713 561
Investbank AD	2 842 847
Central Cooperative Bank AD	7 380 634
Allianz Bank Bulgaria AD	3 624 068
Bulgarian-American Credit Bank AD	2 198 692
TBI Bank EAD	1 305 647
ProCredit Bank (Bulgaria) EAD	3 191 211
International Asset Bank AD	1 911 730
D Commerce Bank AD	1 402 210
Bulgarian Development Bank EAD	3 412 189
Tokuda Bank AD	429 746
Municipal Bank AD	2 154 155
ING Bank N.V. – Sofia Branch	1 178 898
BNP Paribas S.A. - Sofia Branch	638 727
BNP Paribas Personal Finance S.A. - Bulgaria Branch	776 691
Bigbank AS – Bulgaria Branch	5 767

Source: Data of the Bulgarian National Bank.

The grouping is presented in the following table:

Table 4
Grouping banks making detailed disclosures according to the amount of their assets

Amount of assets - in thousand BGN	Number of banks making detailed disclosures	Total number of banks in the group
less than 1,000,000	2	5
from 1,000,000 to 5,000,000	8	10
from 5, 000, 000 to 10,000,000	0	1
from 10,000,000 to 15,000,000	1	2
from 15,000,000 to 20,000,000	1	1
more than 20,000,000	2	2

Source: Financial statements of banks and authors' systematization of information.

Graphically, the grouping is represented as follows:

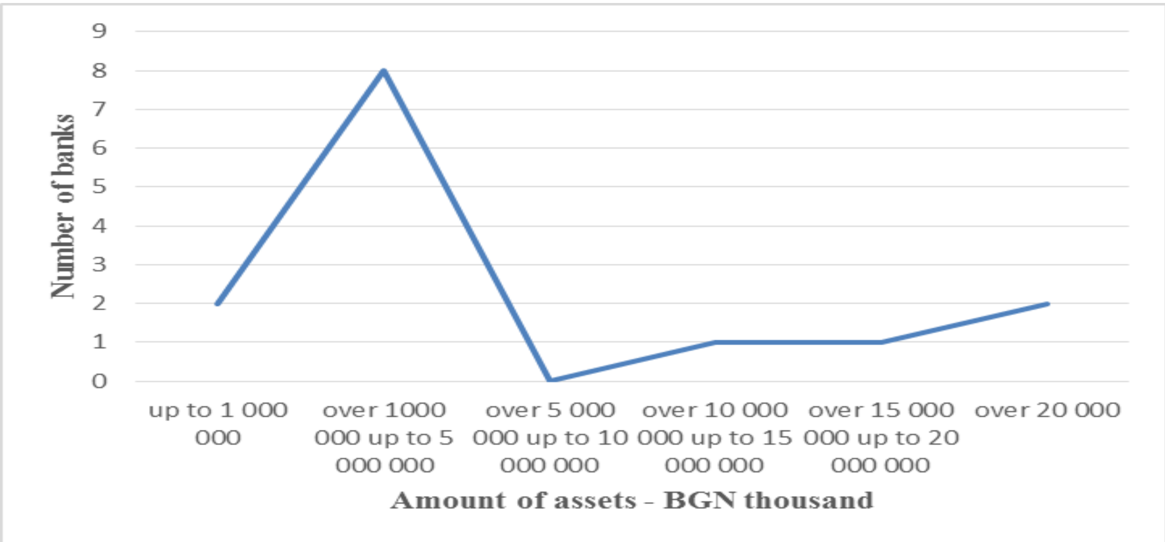

Figure 2. Distribution of banks which submit detailed disclosures according to the amount of their assets

The presented data and distribution show that there is no relationship between the amount of assets held by banking institutions and the degree of comprehensiveness of their disclosures.

The established asymmetry of disclosed information is mainly due to the lack of uniform compliance with the requirements in IAS 24 *Related Party Disclosures* for disclosure of information about related-party transactions and relationships. This makes the financial statements more difficult to compare in terms of the information they contain and also affects their transparency.

IAS 24 *Related Party Disclosures* should be amended by adding a detailed provision disallowing alternative disclosure guidelines for transactions with related parties. Such a change in IAS 24 Related Party Disclosures must be imperative, particularly for banks considering their key functions on national and international scale.

Part V. Conclusions

The study covers banks and branches of foreign banks operating on the territory of Bulgaria, which apply IFRS as a basis for preparation of their financial statements.

The results of the conducted study lead to the conclusion that the practices for disclosing information about related-party transactions and relationships in banks' financial statements should be harmonized. The following solutions are possible:

First. Enforcing clearer and more detailed requirements for the disclosure of information in IAS 24 *Related Party Disclosures*. The disclosure of information on the amount or relative share of the following exposures arising from related-party transactions is with a higher degree of usefulness: each loan or transaction, indicating the total amounts due at the beginning and end of the period as well as transfers during the period; each of the main types of financial income and expenditure; the amount of expenses during the period related to losses on loans and receivables, as well as the amount of provisions as of the balance sheet date; the off-balance sheet items representing contingent liabilities. Disclosure of the bank's related-party credit policy as well as its policy regarding other transactions with related parties would facilitate the correct interpretation of the information included in the financial statements.

Second. Ensuring greater publicity by the regulatory authorities (mainly the Bulgarian National Bank) of the information they require about the transactions and relationships of the banks and their related parties. It would be appropriate if such information is disclosed in the general purpose financial statements of banks.

The above recommendations would ensure greater transparency of the financial statements as main sources of information for decision-making by a wide range of users.

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