CORPORATE SCANDAL: BAD APPLES OR BAD DESIGN OF CORPORATE ENVIRONMENT, THE CASE OF PROTON BANK

Themistokles Lazarides*

Abstract

Corporate scandals during the last years have been proven to be stigmata on the corporate environment. Greece has been the focus point for its public financials, but it has its share of corporate scandals. The last thirty years a rapid reform has taken place in Greece. The legal, regulatory and capital market framework has changed in order to create a more comparable, compatible and isomorphic European business environment.
Initiatives like the introduction of IFRS (2003-2004), corporate governance best practices (2002-2003), monitoring and auditing reforms, were some of the main tools of creating a new business environment in Greece. The paper argues, using specific data that these initiatives weren't efficient enough, not by designers fault but because they weren't appropriate for the fundamental characteristic of the social, political, legal and economic business environment of Greece. The paper, using the Proton bank case, shows these inefficiencies and highlights the fallacies of the policy makers in Greece and in Europe.

Keywords: Banks, Greece, IFRS, Corporate Governance

* *Technological Education Institute of Western Macedonia, Applied Informatics in Business and Economy, Grevena, 51100, Greece*
Fax: +302462061603
Tel.: +302462061621
E-mail: themis@themis.gr

1 Introduction

The occurrence of corporate scandals throughout the previous fifteen years has been without a doubt numerous and the causes identified are also numerous. A discussion has started to identify the causes. This has lead to a philosophical discussion about the role corporations in the current business environment and the mechanics of the occurrence. Studying the causes of these scandals can help academics, executives, shareholders, regulation and public policy makers to redesign – reinvent a more stable system of values, procedures, methods, controls. The crisis hasn't been isolated in USA, evidence of a systemic meltdown (scandals, corporate defaults, etc.) is found all over the world. Corporate ethics, auditing procedures and methods, regulation, organizational structure, corporate culture, market inefficiencies, etc. have highlighted by many as the areas of the systemic meltdown of 2002 and 2008.

During the last two decades a significant effort has been made to establish an isomorphic business environment around the world. Initiatives like the introduction of IFRS, corporate governance good practices, common provisions in the regulative and legal framework, etc. aimed to help to create a more efficient market environment worldwide. Although these initiatives were in right direction, there are no panaceas to the issues of transparency, equitable treatment of shareholders, stakeholders' right recognition, shareholders' rights protection, effectiveness of corporate governance (as these issues or principles are cited by OECD (2004)).

Greece was one of the European Union countries that participated in this effort. Major changes in Greece are: the introduction of corporate governance in 2002 (Law 3016/2002 and voluntary initiatives mainly focused on best practices), the introduction of International Financial reporting Standards (IFRS) in 2003-2004 and mandatory opening of money and capital markets. All these changes have been initiated by outside stimuli, mainly European Union (EU), which was promoting legal harmonization of all regulation in EU members.

The banking sector has a significant impact on the economy. Many of the corporate scandals during the last decade have at their center a bank. Banks have some unique characteristics (Capital structure, Risk structure, Ownership structure, Management and governance structure, Product cycle, Impact on society and economy, etc.). These unique characteristics and their size and role in the economy distinguish them from manufacturing and other service corporations. Their product life cycle

may be extremely long term and extremely short term. Furthermore, the banking sector faces risk very differently and very different risks and its dependence of managerial effectiveness, skill and knowledge is higher from other sectors of the economy. Finally, the product and services provided by the banking sector are in many occasions too complex for a non specialist to comprehend their managing and evaluation processes. Hence, corporate governance and financial reporting is crucial for this sector.

Issues like asymmetry of information and moral hazard due to the special nature of the banking sector. A special characteristic of the sector is its interconnection (interbanking lending and their monitoring and lending relation with the central bank). "Given the level of asymmetric information between banks and its prospective creditors and shareholders, and the importance of a stable banking system, the capital levels of commercial banks are subject to substantial regulation" (Akhigde, et al., 2012). The problem with this statement in Greece is that although the regulation exists, the inability or ineffectiveness of monitoring authorities leaves the regulation provisions inert.

The recent corporate scandals and the inability of the public policy makers to present a stable and feasible plan to exit the crisis are phenomena of the inability to control the power and influence of the banking sector. Even after ten years from the scandals, the role of banks and their operational – regulating framework is still under debate. Regulating the balance of interests of the banking sector is a difficult task. Difficulty factors are: the complexity of the products, the extremely small product cycle, the variety of stakeholders and the high political influence that the banking sector has.

The paper argues that the banking sector in Greece has some characteristics that differentiate it from the banking sector of other countries. The Proton Bank scandal highlights these characteristics and reveals the flaws of regulation and the mismatch of the fundamentals of the business environment and the framework (operational, legal, social, etc.) that has been established. Especially the paper focuses on the IFRS introduction and the introduction of corporate governance principles and practices in Greece.

2 The Banking System in Greece

The differences of the banking in Greece with the perspective sectors in other European are many. The banking system in Greece is mainly characterized by high concentration. Ownership concentration in the Greek banking sector is twice or thrice the concentration of the mean in Anglo-Saxon countries and other European developed countries and their asset portfolio and capital mix is also very different. Hence the banking sector in Greece has unique characteristics that need to be addressed in order to analyze the causality of the phenomena regarding the banking scandals. The notion that one theory can explain universally the behavior and ethics of the banking sector is deeply flawed. When the organizational, cultural, legal-political, economic (mainly structure and development of markets) fundamentals are diverse the same diversity must be for the theoretical approach of any misconduct, ethical divergence or scandals. The top five banks hold the 68.45% of the total assets in the banking sector, they have the 72.43% of the loans and the 73.59% of deposits (see Table 1). The Hellenic Banks Association (2010) reports a 69.5% Herfindahl – Hirschmann index (in assets) for 2008, 67,7% for the year 2007 and 66.9% for the year 2003. The data shows that throughout the last decade the banking system in Greece has been concentrating. The last mergers (of ATE Bank and General Bank with Piraeus Bank, the intension to sell Post Bank and the default of Aspis Bank) contribute to the concentration of the Greek banking system. Greece is not an international financial centre and the cooperative banking has not been as successful as in other countries (Germany, Austria, Spain and Italy)

Table 1. Market Share (in Assets, Loans and Deposits)

Bank	Assets	Loans % to Total	Deposits % to Total
NBG	17,60%	19,58%	24,68%
Eurobank	12,80%	16,74%	13,10%
Alpha Bank	11,20%	15,54%	14,50%
Piraeus Bank	9,30%	12,47%	11,58%
ATE	6,60%	8,10%	9,74%
Commercial Bank	5,80%	9,30%	7,14%
Marfin	3,90%	5,47%	4,33%
TT	3,70%	3,28%	5,95%
Cyprus	3,30%	4,16%	4,76%
Citibank	1,60%	0,00%	0,00%
Milennium	1,40%	2,08%	1,52%
Attica Bank	1,10%	1,53%	1,62%

RBS	1,10%	0,00%	0,00%
General Bank	1,00%	1,75%	1,08%
HSBC	0,80%	0,00%	0,00%
Cooperative banks	0,80%	0,00%	0,00%
Probank	0,80%	0,00%	0,00%
Proton	0,70%	0,00%	0,00%
Aspis	0,50%	0,00%	0,00%

Sources: Bank of Greece, UBS

Table 2. A taxonomy of systems of corporate governance

	Market-oriented		**Network-oriented**	
Country class	**Anglo-Saxon**	**Germanic**	**Latin**	**Japan**
Concept of the firm	Instrumental, shareholder-oriented	Institutional	Institutional	Institutional
Salient stakeholder(s)	Shareholders	Industrial banks, employees, in general oligarchic group	Financial holdings, the government, families, in general oligarchic group	City banks, other financial institutions, employees, in general oligarchic group
Importance of stock market in the national economy	High	Moderate/high	Moderate	High
Active external market for corporate control	Yes	No	No	No
Ownership concentration	Low	Moderate/high	High	Low /moderate
Performance-dependent executive compensation	High	Low	Moderate	Low
Time horizon of economic relationships	Short term	Long term	Long term	Long term

Source: Weimer and Pape (1999)

Contrary to what happens in the product market, ownership in Greek banks is relatively (to the other sectors of Greek economy) dispersed according to the Greek standards to ownership concentration (the average sum of ownership above the threshold of 3% of the equity is quite high). Ownership concentration varies from bank to bank and two groups of can be identified. The first group has high ownership concentration and involve foreign banks that have acquired banks in Greece (Commercial Bank and General Bank) or they are state owned banks (TT, ATE). The second group (NBG, Piraeus Bank, Alpha Bank) are banks that evolved through the capital market and show the same characteristics of an Anglo-Saxon corporate governance system corporation (see Table 2). But these characteristics do not apply to all Greek banks. The five largest in size banks do have these characteristics. Smaller banks seem to retain the characteristics of the Germanic or Continental Europe system. Greece's legal framework comes from a mix of German and French law (Lazarides, 2011) the market for corporate control has been relatively active during the last 10 years and the largest banks have shown, during the last two decades, a dynamic in acquiring firms-banks abroad and extending their activities in the neighbouring countries, eastern Europe and western Europe.

Table 3. Average Ratios (2011-2008)

	National Bank of Greece SA	Eurobank Ergasias SA	Alpha Bank AE	Piraeus Bank SA	Marfin Egnatia Bank SA	Emporiki Bank of Greece SA	Millennium Bank SA	Proton Bank S.A.	AVE-RAGE	Divergence
Loan Loss Res / Gross Loans	3,33	2,83	2,95	2,24	2,75	7,14	1,45	3,36	3,26	3%
Loan Loss Prov / Net Int Rev	27,80	42,27	79,75	77,57	35,34	105,62	23,99	32,97	53,16	-38%
Loan Loss Res / Impaired Loans	56,86	57,79	50,50	47,03	52,65	43,25	35,07	136,77	59,99	128%
Impaired Loans / Gross Loans	6,13	6,21	6,37	4,90	5,05	16,89	4,78	3,31	6,70	-51%
Impaired Loans / Equity	44,21	60,78	62,60	55,57	63,37	415,02	66,94	10,55	97,38	-89%
Tier 1 Ratio	10,90	9,83	10,35	8,82	7,55	7,02	8,82	14,06	9,67	45%
Total Capital Ratio	11,38	11,76	12,35	10,32	10,61	9,22	9,65	12,82	11,01	16%
Equity / Tot Assets	8,82	6,99	7,78	6,24	5,71	3,96	5,51	16,07	7,63	110%
Equity / Net Loans	14,32	10,54	10,33	9,28	8,64	5,16	7,30	29,12	11,83	146%
Equity / Cust & Short Term Funding	10,95	9,40	9,95	7,87	6,67	5,03	6,78	20,68	9,67	114%
Equity / Liabilities	9,71	7,59	8,60	6,77	6,15	4,25	5,87	19,59	8,57	129%
Net Interest Margin	3,12	2,54	2,36	2,56	2,24	2,38	2,61	3,53	2,67	32%
Return On Avg Assets (ROAA)	0,78	0,67	0,66	-1,65	0,16	0,58	0,22	0,57	0,25	130%
Return On Avg Equity (ROAE)	10,63	10,34	9,63	-44,62	3,11	0,49	3,17	5,92	-0,17	-3678%

Source: Bankscope

3. The IFRS Introduction, Auditing Standards and Corporate Governance in Greece

The IFRS introduction in Greece has taken place in 2003-2004. The introduction was mandatory due to the compliance with a European Directive. Hence it was not an initiative that began endogenous. The introduction of IFRS in Greece "may prove to be an immaterial change if it is not combined with parallel improvements in other factors that influence the financial reporting system" (Karampinis and Hevas, 2010). The reporting of financial or other information is not related with financial performance (Lazarides et al. 2009) and it is more related with the costs (direct or indirect costs such as the loss of control) related to the introduction of IFRS (Sykianakis, Naoum and Tzovas, 2012).

IFRSs' scope and perspective are broader. Central to the argument by the paper is the IAS 24 provisions. IAS 24 states that "The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties". IFRS require information disclosure that goes well beyond accounting and financial information. For example: "The disclosures required shall be made separately for each of the following categories:

(a) the parent;

(b) entities with joint control or significant influence over the entity;

(c) subsidiaries;

(d) associates;

(e) joint ventures in which the entity is a venturer;

(f) key management personnel of the entity or its parent; and

(g) other related parties" (IAS 24)

Information under the new financial – accounting standards and under the new auditing standards (which refer directly to the international auditing standards as alternatives to the Greek ones) has the potential to be more accurate, timely and detailed. Greece in 2002 has enacted a corporate governance framework that facsimiles the European framework (introduction of the institution of the independent directors, board committees, etc.). These frameworks can be efficient when the organizational and motivational scheme can facilitate the goal of transparency and rational decision making process.

The auditing standards in Greece are adequate because they were designed to be compatible (see Greek Auditing Standard 1120) with the International Standards on Auditing (ISA). ISA can be used as an alternative or supplementary to the Greek standards if the auditor thinks that the ISA standards are more suitable to conduct an effective and efficient audit. The auditing firms in Greece are subsidiaries or partners with the most prestigious international auditing firms. Hence, auditors in Greece have the same tools, methods and restrictions as in any European country.

The final piece of the information cycle is corporate governance framework and market for corporate control. Corporate governance in Greece is different than the one in Anglo-Saxon countries. The fundamental characteristics of ownership, management and capital market structures and finally the product market is characterized as oligopolistic. Greek firms have high ownership concentration (>52%) and they are mainly family firms or controlled by a group of stockholders (Lazarides, et al., 2009). Free float is relatively small in percentage (20-50%) and the ability to achieve control through the capital market is limited. The members of the family or the controlling group are actively involved in management and normally, there is no distinction between management and ownership. Management and the Board of Directors are closely related to the dominant shareholders. Managers and the majority of the directors that are not members of the family or the controlling group are closely connected with these groups and their decisions are subject to their control and monitoring.

The Greek business model does not favor Mergers and Acquisitions (M&As). Dominant shareholder group are not willing to lose power and control over the firm. Controlling the firm has been made a goal for the governing group. As long as ownership concentration remains high there is no motive for any M&As to take place. Potential buyers cannot acquire a substantial portion of the firm's equity capital to actively participate in governing the firm. But, even so, M&As during the last decade have been a strategy that Greek firms didn't abolish, on the contrary an inclination towards has been observed.

The business environment in Greece is not characterized by high frequency and value of transaction in M&As. M&As in a country like Greece have a different scope-goal and determinants, than in a typical Anglo-Saxon country. The main impediments for the lack of M&As are the ownership structure and the relatively undeveloped capital market (the costs of a M&A remain high and the capital necessary for the transaction is rarely obtained by the banking system). Greek firms' M&A activity depends mainly on the balance of power within the firm, rather than performance or the existence of an active market for corporate control. Fundamentally, M&As in Greece are the result of product market competition (Tsagkanos et al. 2008) and

opportunity (Lazarides, Drimpetas and Pitoska, 2010) and managerial incentives (Tampakoudis, Subeniotis and Eleftheriadis, 2011).

4. The Proton Bank Case

In this environment the exploitation of minority shareholders and other stakeholders like government, depositors and other capital providers can be exploited by the dominant group. This is the case of Proton Bank.

Proton Bank was founded in 2001 by John Markopoulos, a stock broker. After his death in 2004, ownership has changed many times. In 2005 Proton Bank was listed in Athens Stock Exchange (ASE) and acquired Omega Bank (a small bank with many financial problems at the time). In 2007 Piraeus Bank acquired (exchanging shares) the 31.3% of the equity capital and took over the management of Proton Bank. Two and a half years after that (December 2009) Piraeus Bank sold its shares to Mr. Lavrentiadis (the cost of the transaction was 70.6 mil. € or 3,6 € per share). On December of 2010 the bank had 32 branches and 577 employees. On March 2011 business loans increased by 70.7%.

The equity share price (see Graph 1) reveals the organizational and financial and ownership turmoil that the firm had gone through. From 10 € per share in the beginning of 2008 the price has fallen to 1 € per share before the end of 2008. At 7/10/2011 the price was 0,18€ per share. The total amount of capitalization was 11,28 million €. During the next working day ASE has stop any trading for Proton Bank stocks as a precaution to protect the shareholders!

Figure. Proton Bank share price

It took only eighteen months for the bank to fail. The failure was the result of a series of transactions that lead the bank to insolvency. Bank of Greece intervened when the Proton Bank's shareholders refused to provide more capital to cover the bad loans. Bank of Greece in its report suggested that are a numerous of evidence that involve money laundering and misappropriation of funds. On November of 2011 a new bank was created to transfer deposits and loans. The new bank was recapitalized (with 250 million €) by EFSF and the Hellenic Deposit & Investment Guarantee Fund (in total the amount needed to recapitalize the bank was 500 million €) in order to be sold to another bank later. At the same time the provisions of the Law 4021/2011 have been activated. Under the new law a new bank must be founded to receive any "healthy" assets and this bank must be sold to a third party in two years. The shareholders of the old bank will receive nothing after the liquidation of the rest assets and the payment of the Hellenic Deposit & Investment Guarantee Fund. It is estimated that the total cost for the bail out of Proton Bank could be up to 1,5 Billion Euros.

The string of transactions that lead to failure and collapse of the bank are a series of M&A and sales. Although a small number of the transactions have been analyzed by auditors and the Bank of Greece, it seems that the dominant shareholders

have taken advantage of the absolute decision making right. The basic mechanism is best described by Jesover and Kirkpatrick (2005). They argue that when control pyramids or cross shareholdings are active in a corporation or group of corporations this may lead to a separation of cash and voting rights. This separation leverages the private benefits of the dominant group. The risk of ownership is diffused and at the same time total control of the subsidiary corporations is ensured. The benefits of power and control emanates from the control of assets.

The Proton Bank dominant group has been involved in a series of sales using the bank to obtain the capital to acquire the profitable subsidiaries at book value or even less. The Alapis Corporation owned by Mr. Lavrentiadis bought in 2008 Gerolimatos S.A. at the cost of 200 million Euros. The next year the corporation bought the 100% of the equity of Beauty Works. On July of 2009 Gerolimatos Cosmetics is founded to absorb the cosmetics operations of Gerolimatos and Alapis. On June 2010 Alapis sales eight subsidiaries of the group at the price of 144,7 million Euros, in order to focus only in pharmaceuticals products. Amongst the companies that have been sold are Gerolimatos Cosmetics and Beauty Works. The buyer was Ballis Home Care that is owned by a former employee of Mr. Lavrentiadis. The purchase was funded by Proton Bank. This is an example of the series of transactions. The loans were approved on the day of application or even without any application or business plan. No guarantees (personal or otherwise) have been given as collateral to mitigate the credit risk of the bank.

The total amount of loans was 2,4 Billion Euros. Thirty per cent of these loans have been given to firms that seem to be related to Mr. Lavrentiadis. The operations of these firms are extremely connected Many of them have solely supplied one the other with products.

The Hellenic Financial Intelligence Unit has pressed criminal charges against Mr. Lavrentiadis. The independent unit has accused Mr. Lavrentiadis that he used the bank to accumulate deposits, using high interest rates, to give loans to corporations that were owned by him, or sold but continued to be under the influence of him.

According to Proton Bank's annual report, the bank had two independent board members and three non executive members (in accordance with the local corporate governance law) and an additional member, representing the state, could attend all board meetings. The positions of the president of the board and the CEO were held by different persons. One member of the board (with long tenure, more than 5 years) was the former president of the Athens Stock Exchange, university professor with specialty in finance and corporate governance. The board of directors had many committees i.e. audit, remuneration, executive and risk assessment was conducted by the audit committee and the department of internal control.

As Table 3 shows Proton Bank has reported a set of financial statements that didn't alarm any investor. On the contrary the ratios show a bank that is relatively in better financial position than other banks in Greece. Proton Bank's statements have been audited by a very prestigious auditing firm and by two monitoring agencies (Hellenic Capital Market Commission and the Bank of Greece). None of them have identified any risk factors or the possibility of false reporting in their studies or reports. The safeguards placed to ensure that the Greek corporate environment is safe to invest, in the case of Proton Banks, failed.

5. Fallacies and fundamental errors

Although IFRS introduction is an improvement of the reporting standards the introduction per se is not adequate to mitigate the problems of misreporting or taking advantage of the inside information and power accumulation. The main problem is not the IFRS per se. They were designed to facilitate a specific type of corporation, with specific characteristics, organizational dynamics, capital market conditions and especially goals.

Ownership concentration, organizational development paradigms, regulation – monitoring framework and inefficiency are the main factors of corporate failures in Greece. Hence a mix of endogenous and exogenous variables contributes to the creation of a business environment that doesn't have the necessary mechanisms to prevent corporate failure and the exploitation of the relatively weak protection minority shareholders position. The enactment of laws and regulations isn't adequate to prevent any failures or misappropriations. On the other hand the lack of an efficient capital market can create opportunities and threats.

Any initiatives to reform the business environment had little impact in Greece. The problems are that these initiatives were designed for a different type of economic activities and fundamental corporate characteristics. Initially these initiatives (IFRS, corporate governance best practices, monitoring and auditing standards, capital market provisions, etc) were designed for countries with Anglo-Saxon characteristics. These initiatives, although they weren't panacea for the prevention of corporate failures and misappropriations, they were a good start to begin discussing the issues that lead to ones.

6. Conclusions

Corporate collapses or failures do not happened in an instance. Usually the causes of the collapse or

failure have existed long time before the collapse. The causes may be systemic and not and they may not be easy identified. Corporate culture, ethics, incentives failure, organizational and governance failure, etc. are some of the main reasons. Introduction of regulations and policies that is not suited for the characteristics of the corporations and the historic development of the business environment could be another source of failure and corporate collapses. Policy making failures and the other causes may coexist.

The Proton Bank case can or should be a wakeup call for the policy makers in Greece. The scandal has already cost the taxpayers a lot of. The main fallacies and errors of the banking system are still present. During the last two decades all the initiatives to establish a more isomorphic corporate environment in European Union failed. There is a need to create a new set of respective initiatives to address the special issues of the corporate environment.

The Proton Bank case is a failure of business ethics, legislation, regulation, auditing and monitoring authorities. The main question is: Should banks be bailed out by tax payers? This question troubles the whole financial and political system. The fact that banks are a crucial – integral part of a globalized economy cannot justify by itself the socialization of losses.

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