

THE ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE OF BANKS IN A DEVELOPING COUNTRY: EVIDENCE FROM SRI LANKA

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ABSTRACT

The purpose of this study is to examine how accounting could contribute to the corporate governance of banks in a developing country. Accounting and corporate governance failures of banks have figured prominently in discussions of the possible causes leading to the Asian financial crisis in the late 1990s and the recent global financial crisis. These discussions suggest that accounting has failed to play its potential role in corporate governance of the failed organizations.

To achieve the above purpose, this study has the following five objectives: (a) to conduct a comprehensive literature review in order to explore the ways in which accounting could facilitate corporate governance of banks; (b) to analyse the actual role that accounting plays in the corporate governance of banks; (c) to explain the contextual relativity of the role of accounting in corporate governance of banks; (d) to examine the differences in the role of accounting in the corporate governance of public and private sector banks; and (e) to make recommendations for enhancing the role of accounting in corporate governance in the banking industry.

Following the qualitative research approach, this study adopts the case study research method to achieve the aim of the study. Two major banks in Sri Lanka were selected as the case organizations representing the public and the private sectors. Data collection and analysis were guided by the analytical framework developed in this study. Data were gathered primarily by semi-structured interviews and also by documentary evidence. Data analysis was undertaken using three interactive processes, namely data reduction, data display, and conclusion drawing and verification.

The findings of the study suggest that although accounting has a potential role in the corporate governance of banks, in reality that role is influenced to a large extent by various contextual factors, such as the level of effectiveness of the enforcement mechanisms for laws and regulations, and, in the case of public sector bank in particular, the multiple roles played by the government and political interference. Further, this study finds a number of differences between the roles played by accounting in corporate governance in the public and the private sector banks.

STATEMENT OF THE CANDIDATE

The work presented in this thesis has not been submitted for a higher degree to any other university or institution. The sources of information used and the extent to which the work of others has been utilized are acknowledged in the thesis. Ethics Committee approval has been obtained (Protocol Number: HE26SEP2008-D06094) (See Appendix 7).

Athula Ekanayake

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
AGM	Annual General Meeting
ARC	Annual Report Competition
ASC	Accounting Standards Committee
ASX	Australia Stock Exchange
ATM	Automated Teller Machines
AuSC	Auditing Standards Committee
BOD	Board of Directors
CAPA	Confederation of Asian & Pacific Accountants
CBSL	Central Bank of Sri Lanka
CEO	Chief Executive Officer
COPE	Committee on Public Enterprises
CSE	Colombo Stock Exchange
DHM	Debtholder Monitoring
DPE	Department of Public Enterprises
EA	External Auditing
EE	External Environment
EFTPOS	Electronic Fund Transfer facilities at the Point Of Sale
ER	External Reporting
GDP	Gross Domestic Production
IA	Internal Auditing
IAPS	International Auditing Practice Statements
ICASL	Institute of Chartered Accountants of Sri Lanka
ICBS	International Comprehensive Banking System
ICT	Information Communications Technology
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IO	Internal Organization
ISA	International Standards on Auditing
KPI	Key Performance Indicators
LM	Labour Market
L&R	Laws and Regulations

MA	Management Accounting
MCP	Managerial Compensation Plans
NPA	Non Performing Assets
NYSE	New York Stock Exchange
OECD	Organization for Economic Co-operation and Development
OI	Organizational Interface
PM	Product Market
PRIB	Private Sector Bank
PUB	Public Sector Bank
RC	Registrar of Companies
SAFA	South Asian Federation of Accountants
SBE	Specified Business Enterprises
SEC	Securities and Exchange Commission
SHM	Shareholder Monitoring
SLAASMB	Sri Lanka Accounting and Auditing Standards Monitoring Board
SLAPS	Sri Lanka Auditing Practice Statements
SLAS	Sri Lanka Accounting Standards
SLAuS	Sri Lanka Auditing Standards
SLR	Sri Lankan Rupees
U.K.	United Kingdom
U.S.	United States of America

CHAPTER 1

OVERVIEW OF THE THESIS

1.1. Introduction

Accounting and corporate governance failures and regulatory weaknesses of banks have figured prominently in discussions and debates on the possible causes leading to the Asian financial crisis in the late 1990s and the recent global financial crisis. It has been highlighted that boards and managers failed to manage risks, while shareholders, depositors and regulators did not receive accurate information to allow them to scrutinize the behaviour of banks' management (Clarke and Klettner, 2009; Nam, 2004; Kirkpatrick, 2009; Rost and Osterloh, 2010). The need for additional precautionary measures in many countries has also been noted (Basel Committee, 2010; Kirkpatrick, 2009; Walker Review, 2009). The general concerns seem to be that accounting has failed to play a role in securing good corporate governance of those organizations. This thesis investigates the role that accounting plays in corporate governance of banks in a developing country. More specifically, based on two case studies representing commercial banks in private and public sectors in Sri Lanka, the study aims to examine the degree to which accounting contributes to corporate governance in the banking industry in the country (see Appendix 1 for a brief introduction to Sri Lanka).

The remainder of this chapter is structured as follows. The next section discusses the motivations for the study. Section three presents the aim and objectives of the study. Section four outlines the theoretical underpinnings and the analytical framework used, and Section five presents the research method employed in the thesis. The penultimate section outlines the contributions of the thesis, and the final section provides the structure of the remainder of the thesis.

1.2. Motivation

This study is motivated by (a) the importance attributed to the role of accounting and corporate governance in recent corporate collapses and financial crises; (b) the desire to

provide an understanding of the contextual relativity of the role of accounting; (c) the lack of research aimed at enhancing our understanding of the role that accounting plays in corporate governance in the banking industry; (d) the importance of the role of accounting in the corporate governance of banks in developing countries; and (e) the desire to explore whether there are differences in the role of accounting in corporate governance depending on the ownership and governance structures of banks. Each of these factors is discussed in turn.

(a) The importance attributed to the role of accounting and corporate governance in recent corporate collapses and financial crises

Major corporate collapses in recent times have clearly revealed the inter-dependent nature of accounting and corporate governance. For instance, accounting and corporate governance issues have been raised in analysing the causes for a number of major financial crises including the Asian financial crisis in the late 1990s (e.g., Levine, 2004; Nam, 2004), high profile corporate failures in the U.S. (such as Enron and WorldCom) and in many other industrialized countries (such as HIH Insurance in Australia, Equitable Life Assurance Society in the U.K., Parmalat in Italy and Royal Ahold in the Netherlands) at the beginning of the 21st century (e.g., Carnegie and Napier, 2010), and the more recent global financial meltdown caused by the sub-prime mortgage crisis in the U.S. (e.g., Arnold, 2009; Rost and Osterloh, 2010). The discussions in relation to such events have frequently revolved around the role of accounting and accountants in corporate governance practices (see Laux and Leuz, 2009; Vinten, 2002; Wyatt, 2004). For example, in the case of Enron, accounting errors have been shown to inflate earnings by almost U.S. \$600 million in 2001 (Vinten, 2002).

Despite this close relationship between accounting and corporate governance, the attention given in the existing literature to systematically investigating the role of accounting in corporate governance is very limited. The literature on corporate governance identifies various internal and external mechanisms that are established to enhance governance of organizations (e.g., Gillan, 2006; Moerland, 1995; Shleifer and Vishny, 1997). Accounting has the potential to facilitate these mechanisms (e.g., Bushman and Smith, 2001). In the absence of accurate and reliable financial information, most corporate governance mechanisms, including the Board of Directors (BOD), managerial compensation plans (MCP), laws and regulations, shareholder and

debtholder monitoring, labour and product markets, may not operate to their potential levels. This situation has been identified as a main cause leading to the recent global financial crisis (e.g., Clarke and Klettner, 2009; Kirkpatrick, 2009).

Most corporate governance research in accounting has focused on the role of financial accounting information in MCP (e.g., Cornett, Marcus and Tehranian, 2008; Mueller, 2006). Studies that pay attention to other aspects of the relationship between accounting and corporate governance are relatively limited. For example, only a small number of studies have examined the relationship between corporate governance and management accounting, although both are concerned with organizational control (see Seal, 2006). Further, a broad perspective of accounting can also include internal and external auditing, both of which have the capacity to play an important corporate governance role (e.g., Imhoff, 2003; Koh, Laplante and Tong, 2007; Whittington, 1993), and could prevent possible corporate collapses and financial crises (see Sikka, 2009). One motivation for this study is therefore to undertake a comprehensive analysis of the role of accounting in corporate governance with special reference to the banking industry.

(b) The desire to provide an understanding of the contextual relativity of the role of accounting

Accounting is increasingly seen as a social rather than a purely technical phenomenon, as it is implicated in both organizational and social contexts. Hopwood (1978) emphasized the importance of examining accounting within its organizational context. Subsequently this point was further emphasized and elaborated by various researchers, for example, Burchell, Clubb, Hopwood, Hughes and Nahapiet (1980), Burchell, Clubb and Hopwood (1985), Hoque and Hopper (1997), Adams (2002) and Alawattage and Wickramasinghe (2008). Following this notion, this study is motivated by the desire to provide an understanding of whether the actual role of accounting in corporate governance is different from its potential role due to the complexities in the banking environment, particularly in a developing country context.

For this purpose, two streams of literature in accounting have been reviewed for the study. The first body of literature argues that the effectiveness of the role of accounting in organizations depends on the context within which accounting operates. Accounting is no longer identified as a static or a homogeneous phenomenon (e.g., the provision of

“relevant information for decision making”, with the achievement of a “rational allocation of resources” and with the maintenance of institutional “accountability” and “stewardship”), but rather seen as a mirror of the societies or organizations in which it is implicated (Burchell *et al.*, 1980). The review of this literature was aimed at identifying important elements in the organizational and social context that influence the effectiveness of the role of accounting (see Section 2.5.3).

The second body of literature examines the role of accounting in developing countries and highlights various country specific factors that affect that role (Hoque and Hopper, 1994; Wickramasinghe, Hopper and Rathnasiri, 2004). Findings of those studies suggest that accounting’s role in those countries differs from that in industrialized countries, as accounting is argued to play a more constitutive role in decision making and control in the latter (Alawattage and Wickramasinghe, 2008). The review of this literature also assisted in identifying specific accounting and corporate governance issues related to banks in developing countries (see Section 2.7).

(c) The lack of research aimed at enhancing our understanding of the role that accounting plays in corporate governance in the banking industry

The large body of existing research on corporate governance is focused mainly on firms in unregulated industries (Macey and O’Hara, 2003). Banks are different from those firms in many respects. For example, they are regulated firms, in that governments usually oversee the affairs of banks by way of imposing strong regulations and providing financial safety nets to maintain a stable banking industry in a country. Such differences are likely to have implications for corporate governance in general, and for the role of accounting in corporate governance more specifically. A detailed discussion of specific features of banks is in Section 2.4.1.

Further, corporate governance can also be seen as industry-specific, as the nature of governance issues differs in various sectors (Adams and Mehran, 2003; Macey and O’Hara, 2003). For instance, compared to the manufacturing industry, banks operate under a high degree of leverage, and it can therefore be argued that one of the main aims of the corporate governance of banks should be to protect the interests of the debtholders in addition to those of the shareholders. In this respect, the Basel Committee (2010) highlighted that further to their responsibilities to shareholders,

banks also have a responsibility to their depositors, which would be determined by the legal system in a country. Moreover, it is important that banks have corporate governance practices to achieve and maintain public trust and confidence, which are considered vital elements of a stable banking industry (Basel Committee, 2010; Walker Review, 2009). It is also argued that a corporate governance approach to banks needs to accommodate a wider spectrum of stakeholders (e.g., Macey and O'Hara, 2003).

Many countries have experienced banking crises in the last few decades. The failure of a major industry of the economy, such as the banking industry, or even of a single major bank, could result in a loss of investor confidence, leading to an unhealthy economic environment (Levine, 2004; Trayler, 2007). For instance, the failure of numerous financial institutions in a number of industrialized countries including the U.S. and members of the European Union led to the more recent global financial crisis. The causes of the global financial crisis more closely related to banks include insufficient board oversight of senior management, unduly complex or opaque bank organizational structures and activities, poor risk management practices, and excessive incentive schemes that were not closely related to the risk appetite of the bank and its longer term interests (Basel Committee, 2010; Clarke and Klettner, 2009; Turner Review, 2009; Walker Review, 2009). To a large extent, these factors are likely to be associated with weaknesses in corporate governance arrangements that failed to serve their purpose to safeguard against excessive risk taking in those institutions (Kirkpatrick, 2009).

These failures of corporate governance practices have also often been attributed to lack of information about banks' activities, and also to inadequacies in disseminating the available information. For example, Kirkpatrick (2009) states that in a number of cases information about exposures did not reach the board and even the senior management. In some other cases, although boards had approved strategies to manage risk, suitable arrangements were not established to monitor their implementation. Moreover, shareholders and other stakeholders including depositors and regulators did not have access to accurate information to enable them to monitor the activities of banks. Such inadequacies are more than likely to have contributed to the bank failures in the past (Clarke and Klettner, 2009; Kirkpatrick, 2009; Walker Review, 2009). However, no research has been undertaken to examine systematically the role of accounting in corporate governance in the banking industry.

(d) The importance of the role of accounting in the corporate governance of banks in developing countries

A developing country context offers a unique setting to examine the study phenomenon. Banks occupy a dominant position in the financial system in developing countries and are important engines of economic growth (Arun and Turner, 2004; Levine, 1997; Reaz and Arun, 2006). For instance, debt financing is an important source of finance for investment in most developing countries (Levine, 2004). Further, banks are typically the main depository for their economy's savings (Arun and Turner, 2004). Moreover, in recent years, many developing countries have implemented financial deregulation and liberalization programs, enabling managers of banks to enjoy greater freedom in decision making. The banking industry in Sri Lanka, which is the research site in this study, dominates in the financial system, claiming approximately 58 per cent of the total financial institution assets in the country (Central Bank of Sri Lanka, 2007a).

Banks in developing countries operate to a large extent within a regulatory framework similar to that of industrialized countries. This is mainly because most of the laws and regulations in developing countries have originated in industrialized countries (Tsamenyi and Uddin, 2008). For example, Ghana adopted Western models of corporate governance in banks to address poor performance and failure of rural banks in the country (Adu-Amoah, Tsamenyi and Onumah, 2008). Liew (2008) reported that Malaysia promoted international corporate governance reforms in the aftermath of the 1997 Asian financial crises. Similarly, in Sri Lanka, the laws and regulations applicable in accounting and corporate governance in the banking industry are largely based on international laws and codes of best practice, such as Basel Committee reports, OECD recommendations, and International Financial Reporting Standards (IFRS). Adoption of regulatory frameworks similar to those of industrialized countries is mainly an outcome of the influence of donor agencies such as the World Bank in granting financial aid and facilities to developing countries (Hopper and Hoque, 2004; Tsamenyi and Uddin, 2008).

Despite the influence of international laws and best practice, corporate governance practices in the banking industry in developing countries are often subject to criticism due to mismanagement and neglect (Arun and Turner, 2004; Nam, 2004). In many developing countries the banking industry is also faced with a high risk of

misappropriation, as a result of heavy government ownership and involvement, deficiencies in prudential regulation, and poor implementation, weak legal protection and the presence of special interest groups (Reaz and Arun, 2006).

Certain recent incidents in the banking industry in Sri Lanka raised doubts over the quality of accounting and corporate governance. For example, there have been failures of a number of financial institutions, including a savings bank, several finance companies, and a number of small-scale money lenders who are unauthorized to accept public deposits. Such failures highlight the inadequacies of laws and regulations in monitoring those institutions. The Central Bank of Sri Lanka also had to intervene to overcome the financial distress of a large private sector bank in December 2008, due to the bankruptcy of a finance company within the group to which that bank belonged (Sunday Observer, 25.01.2009). Following this incident, questions were raised about the existence and proper implementation of laws and regulations dealing with the related party transactions in banks.

This thesis argues that the role of accounting in corporate governance of banks in developing countries is likely to be different from that of industrialized countries because of the nature of the context within which banks operate. The effect of the influence of various contextual factors on the role of accounting in corporate governance has not been discussed adequately in the literature, particularly in relation to banks in developing countries. The literature on the corporate governance of banks in developing countries focuses mainly on corporate governance issues in general, and only limited attention is given to identifying the factors influencing the effectiveness of accounting in corporate governance, and to providing any systematic analysis of factors influencing the role of accounting in corporate governance of banks in developing countries. For instance, Arun and Turner (2004) focused on banking reforms required to improve corporate governance of banks in developing economies; Nam (2004) examined corporate governance issues in banks in developing countries; and Levine (2004) established good corporate governance in banks in such countries. Hence, focusing on the banking industry in Sri Lanka, this thesis aims to contribute to that literature.

(e) The desire to explore whether there are differences in the role of accounting in corporate governance depending on the ownership and governance structures of banks

Many comparative studies of public and private sector organizations have been undertaken in the disciplinary areas of political economics and public administration (see Caves and Christen, 1980; Rainey and Bozeman, 2000; Sarkar, Sarkar and Bhaumik, 1998). Most such studies are based on the property rights theory, which predicts efficiency differentials on the basis of the type of ownership.¹ Following the arguments in property rights theory, it can be expected that due to the dissimilarities in ownership and governance structures, the effectiveness of the role of accounting in corporate governance would differ in public and private sector banks.

A comparative analysis of the role of accounting in corporate governance of public and private sector banks is important because banks with these two types of ownership are common in developing countries. For example, nearly 40 per cent of the assets of the commercial banking sector in Sri Lanka are controlled by two banks that are fully owned by the government. The high government ownership of banks in developing countries has caused various problems leading to major bank failures, especially at the time of the Asian financial crisis in the late 1990s. For example, the symbiotic relationship between the government or political circle and banks has contributed to the lack of prudential regulation and supervision, weak bankruptcy codes, and poor corporate governance rules and regulations (Nam, 2004). Within Sri Lankan public sector banks, poor lending practices and inefficiencies have created many corporate governance problems over the years (Fitch Ratings², 2007). Accounting research in public sector organizations in developing countries has provided insights into the differences in the potential role of accounting and its role in practice, explaining those differences by highlighting the influence of particular contextual factors prevailing in those countries (e.g., Hopper and Hoque, 2004). However, no research has examined this issue more specifically related to public sector banks in developing countries.

¹ The essential argument is that the public ownership has little economic incentive for any owner to monitor the behaviour of managers, in contrast to the private ownership of firms, which is concentrated among fewer individuals, each having the right to sell their shares, and thus presenting incentives to scrutinize management to ensure efficiency in production and service (Caves and Christen, 1980).

² Fitch Ratings is a global rating agency that provides credit opinions, research and data, which has been operative in Sri Lanka since 1999 in the name of Fitch Ratings Lanka Limited.

On the other hand, most developing countries, following their reliance on market-based development strategies, encourage private ownership of banks (see Section 2.7). However, private sector banks in those countries also seem to have specific corporate governance dilemmas. For example, during the Asian financial crisis, most of the failures of private sector banks occurred where the bank was part of a large family controlled business group and was used as a tool to maximize the family interests at the expense of the other stakeholders (Nam, 2004). It is possible for the private sector banks in Sri Lanka also to experience similar corporate governance problems, for instance, with regard to related party lending (Fitch Ratings, 2007). This thesis therefore proposes to provide an understanding of the role of accounting in corporate governance practices in public and private sector banks in Sri Lanka, and explores the factors that lead to differences, if there are any.

1.3. Aim and objectives

The aim of this thesis is to address the research question: How does accounting contribute to the corporate governance of banks in Sri Lanka?

To achieve this aim, the thesis has the following five objectives:

a) To conduct a comprehensive literature review in order to explore the ways in which accounting could facilitate corporate governance of banks

This thesis acknowledges the dearth of any systematic analysis to investigate the role that accounting plays in corporate governance. Following the notions of several theories, and also informed by the literature on accounting and corporate governance, the first objective of this study is to develop an analytical framework to explain the ways in which accounting could facilitate corporate governance of banks in a developing country.

b) To analyse the actual role that accounting plays in the corporate governance of banks

The analytical framework developed in objective (a) provides a basis for examining the role of accounting in the corporate governance of banks in an actual setting. The second objective of this study is to investigate empirically the actual role that accounting plays

in the corporate governance of two banks in Sri Lanka, using the analytical framework developed for that purpose.

c) To explain the contextual relativity of the role of accounting in corporate governance of banks

Due to the nature and the extent of influences from the organizational and social context, the actual role that accounting plays in corporate governance of banks is likely to vary from its potential role. The third objective of this study is therefore to identify and examine the influence of contextual factors on the role that accounting plays in corporate governance in the banking industry in Sri Lanka.

d) To examine the differences in the role of accounting in the corporate governance of public and private sector banks

The effectiveness of the role of accounting in corporate governance could vary between public and private sector banks, due to the dissimilarities in ownership and governance structures. The fourth objective of this study is therefore to compare and contrast the role of accounting in the corporate governance of a public and a private sector bank in Sri Lanka.

e) To make recommendations for enhancing the role of accounting in corporate governance in the banking industry

Based on the findings of the investigations carried out to achieve the above (i.e., (a) – (d)), the final objective of this study is to make recommendations for the utilization of accounting in the corporate governance of banks.

1.4. Theoretical underpinnings and analytical framework

The research question outlined in Section 1.3 is addressed using the analytical framework developed in the study. The framework draws on concepts developed in the literatures on agency, stakeholder, and contingency theories.

According to agency theory, corporations experience conflicts of interest arising between owners (principals) and managers (agents) due to the separation of ownership and management. Agency theory highlights the possibility of an agent not performing in

the best interests of the principal (Berle and Meanes, 1932; Coase, 1937; Jensen and Meckling, 1976), and suggests paying necessary incentives to managers and monitoring their activities, as strategies to limit this opportunistic behaviour (Hill and Jones, 1992; Subramaniam, 2006). These notions have direct relevance to the focus of this thesis, hence are drawn on when developing the analytical framework.

The underlying assumption of this thesis is that banks pay attention to looking after the welfare not only of the shareholders, but also of the depositors and other stakeholders (e.g., Basel Committee, 2010). This is consistent with stakeholder theory, which emphasizes the need for organizations to safeguard the interests of a wider group of stakeholders, contrary to traditional theories of the firm which assert that the primary function of the corporation is to maximize the return on investment to shareholders (Gibson, 2000). Bank failures during the recent global financial crisis had negative effects on various stakeholders including shareholders, depositors, customers and governments, and showed the importance of protecting the interests of the depositors and other stakeholders in addition to those of the shareholders. Those incidents also highlighted the significance of the use of corporate governance by banks.

Studies based on contingency theory show clearly that the effectiveness of accounting controls in organizations depends on the context within which those organizations operate (Burchell *et al.*, 1980, 1985; Hopwood, 1978). There is also literature on the role of accounting which suggests that the actual role of accounting in organizations would differ from its potential role due to the influences of the context within which accounting operates (e.g., Alawattage and Wickramasinghe, 2008; Hoque and Hopper, 1994; Uddin and Hopper, 2001; Wickramasinghe and Hopper, 2005). Consistent with these literatures, this thesis argues that the effectiveness of accounting in assisting various corporate governance mechanisms depends on internal and external contextual factors related to the organization.

Within the analytical framework developed by drawing on the theories named above, (a) corporate governance mechanisms are the various devices established in banks to align the interests of the managers with the interests of the shareholders and debtholders (i.e., depositors); (b) accounting is a means to facilitate the operation of those corporate governance mechanisms; and (c) this process is influenced by various elements in the

context within which accounting aims to assist corporate governance. The framework is detailed in Section 2.8 and depicted in Figure 2.1.

Corporate governance mechanisms are classified into internal and external categories. The first category includes BOD and MCP, and the second category includes laws and regulations, shareholder and debtholder monitoring and labour and product markets (e.g., Bushman and Smith, 2001; Gillan, 2006). These internal and external corporate governance mechanisms of banks are discussed in detail in Section 2.4.3. The framework identifies four broad areas of accounting that provide information to corporate governance mechanisms, namely external reporting, external auditing, management accounting and internal auditing, which are discussed in Section 2.5.1. However, the degree to which the information provided by these four areas of accounting mitigates the agency problem depends to a large extent on the robustness of the contextual factors, namely internal organizational factors, and factors in the organizational interface and the external environment (see Section 2.5.3). The framework also highlights that the utilization of accounting information in corporate governance mechanisms leads to a number of desirable outcomes, including shareholder and debtholder protection, efficient flow of scarce resources to feasible investments, and securing banks' stability (see Section 2.6).

1.5. Method

This study follows qualitative research methodology that facilitates a holistic examination of the phenomenon under investigation. More specifically, it adopts case study research method. Two leading public and private sector commercial banks in Sri Lanka that have over the years been highly regarded for their corporate governance practices, domestically as well as internationally, were selected as the case organizations to examine the research question outlined in Section 1.3. These organizations provided the opportunity for more extensive evaluation of the role of accounting in the corporate governance of banks.

To examine the research question, data related to the banking industry in Sri Lanka as well as the two case organizations were gathered through semi-structured interviews and document survey (for the period 1997–2009). Twenty-seven interviews were

conducted to gather data: (a) to examine the extent to which accounting information was used by the two case organizations to assist corporate governance mechanisms; and (b) to identify the influence of various contextual factors on the role of accounting in the corporate governance of banks. The documentary evidence used in this study includes laws and regulations applicable to the banking industry in Sri Lanka, annual reports of the two banks, and various publicly available documents such as media reports and parliamentary Hansards. Data were analysed in three interactive processes, as suggested by Miles and Huberman (1994), namely data reduction, data display, and conclusion drawing and verification.

1.6. Contributions

This thesis makes theoretical, empirical and practical contributions.

Theoretical contributions: This study develops an analytical framework to systematically examine the role of accounting in corporate governance of banks in developing countries (Chapter 2). The proposed framework highlights the importance of accounting information in assisting various corporate governance mechanisms of banks, leading to a number of desirable outcomes. This framework could be used by future researchers to investigate similar research questions.

Empirical contributions: The thesis documents the results of an under-studied issue in the literature, namely the role of accounting in corporate governance of banks. It provides empirical evidence to show the extent to which accounting assists corporate governance of banks in actual settings (Chapters 4 and 5). The study reveals that although accounting systems in the two case organizations appear to have the potential to facilitate corporate governance mechanisms, the actual role of accounting in this regard is different, due to the influence of various contextual factors that are related to the internal organization, the organizational interface, and the external environment of the banks. Further, the study provides empirical evidence to show certain similarities as well as differences in the use of accounting in corporate governance of public and private sector banks. These findings therefore suggest that the degree to which accounting contributes to the corporate governance of banks depends on the context within which they operate.

Practical contributions: This thesis offers policymakers useful insights into the manner in which accounting could be used to assist corporate governance as well as the factors that could influence the use of accounting in corporate governance of banks in a developing country (Chapters 4 and 5). Such insights could be used in introducing further measures to improve the effectiveness of accounting in corporate governance in different contexts, for instance, in developing rules and regulations and in enforcing them effectively. The insights offered also would be useful to banking practitioners in their attempts at improving corporate governance. Finally, the thesis offers a checklist (Appendix 2) to assess the extent of usage of accounting information in the corporate governance of banks, which would be useful to banks/banking practitioners in identifying areas for improvement.

Please see Appendix 3 for details of dissemination of research findings during the PhD candidature.

1.7. Outline of the thesis

The thesis comprises six chapters. Chapter 2 details the literature review and introduces the analytical framework. The research methodology and methods used to collect and analyse data are described in Chapter 3. The two chapters that follow analyse the accounting and corporate governance environment within the banking industry in Sri Lanka, and the role of accounting in the corporate governance of the two case organizations. Chapter 6 provides a summary of the thesis and conclusions. The synopsis of each chapter is given below.

Chapter 2: Literature review

This chapter focuses on the literature on corporate governance issues in general, as well as those specific to banks. The relationship between accounting and corporate governance is also described in this chapter. More specifically, the chapter identifies the role that accounting can play in corporate governance of banks in developing countries, and draws attention to three levels of contextual factors that can affect the nature and the degree of this role. The chapter also presents an analytical framework developed in the study to explain the role of accounting in the corporate governance of banks.

Chapter 3: Research design

This chapter introduces the qualitative research methodology employed in designing the research, and explains the rationale for using the case study research method in this study. The chapter also describes the multiple methods used to gather data, and the procedures adopted in organizing and analysing data for interpretation and verification purposes.

Chapter 4: Accounting and corporate governance environment within the banking industry in Sri Lanka

This chapter discusses the nature and the degree of influence of the elements in the organizational interface and the external environment on the role of accounting in corporate governance in the banking industry in Sri Lanka. The organizational interface describes the institutional and regulatory framework within which accounting and corporate governance operate in the banking industry, and its influences on the role of accounting in the corporate governance of banks. The section on external environment identifies the key issues in relation to each factor in the external environment, and discusses their implications for accounting and corporate governance in the banking industry.

Chapter 5: Role of accounting in corporate governance in the banking industry in Sri Lanka

This chapter provides empirical evidence of the manner in which accounting information is used in the corporate governance of banks. The chapter briefly describes the two case organizations, and then examines the extent to which these two banks utilize accounting information derived from four broad areas, namely external reporting, external auditing, management accounting and internal auditing, in their corporate governance mechanisms. The differences identified in relation to the potential role and the actual role of accounting in corporate governance, as well as the actual role that accounting plays in the corporate governance of the public sector bank and the private sector bank, are explained using the contextual factors identified in the analytical framework.

Chapter 6: Summary and conclusions

This chapter provides a summary of the study and the conclusions, which include the findings and their implications for researchers, policymakers, banking practitioners, and international organizations and donor agencies. The limitations of the study and suggestions for future research are also stated.

CHAPTER 2

LITERATURE REVIEW

2.1. Introduction

The types of corporate governance issues faced by organizations, the ways in which such issues are addressed and the mechanisms used for that purpose appear to differ in different contexts, for example in different industries. Limited attention has been paid, however, to examining corporate governance issues in different industries. For instance, only a few studies have been conducted to examine corporate governance issues in banks. Banks are characterized by high levels of leverage, opacity, and regulation, which hinder the efficiency of most corporate governance mechanisms that are used effectively in other industries. Further, corporate governance mechanisms as well as the role of accounting in facilitating them are influenced by various contextual factors, such as laws and regulations, and their enforcement mechanisms. This chapter reviews the existing literature to identify corporate governance in general, corporate governance mechanisms, corporate governance in the banking industry, corporate governance issues in banks in developing countries, the role of accounting in corporate governance, and contextual influences on that role. Based on a comprehensive review of the relevant literature, an analytical framework is developed to analyse the role of accounting in the corporate governance of banks.

The chapter is structured as follows. Section two introduces and defines corporate governance. Section three describes corporate governance mechanisms in general. Section four examines specific corporate governance issues and mechanisms of banks. The section that follows discusses the role of accounting in corporate governance and contextual influences on that role. Section six explains the expected outcomes of role of accounting in corporate governance of banks. Section seven identifies accounting and corporate governance concerns related to banks in developing countries. Section eight provides a framework to analyse the role of accounting in corporate governance of banks, followed by a summary of the chapter and some concluding remarks in the final section.

2.2. Corporate governance

2.2.1. Definitions

The term *corporate governance*, although used widely in the literature, lacks a generally accepted definition. Gillan (2006) states that the definition of corporate governance depends on a person's view of the world. A review of the existing literature suggests that the appropriateness of the definition for corporate governance depends on three factors, namely subject area, environmental context and industry. The topic of corporate governance has been discussed in many fields, such as economics, law, finance, accounting, management, sociology and political science. In each of these areas, corporate governance is viewed from a particular perspective (Turnbull, 2000). It also appears that scholars from different disciplinary backgrounds tend to set boundaries on corporate governance depending on their intellectual background and interest. For example, Farrar (2005) appears to take an accounting view in explaining corporate governance as “the control of corporations and of systems of accountability by those in control” (p. 3). La Porta, Lopez-De-Silanes and Shleifer (1999) use a legal approach to understand corporate governance, in which the focus is on how well investors, both shareholders and creditors, are protected by law from expropriation by managers and controlling shareholders of firms. With an economic point of view, Tirole (2001) defines corporate governance as the design of institutes that includes or forces management to internalize the welfare of stakeholders.

The way corporate governance is defined can be further influenced by the environmental context in which corporations operate. For instance, Moerland (1995) identifies alternative corporate governance systems in different countries, namely market oriented systems (i.e., Anglo-American countries³) and network-oriented systems (i.e., Franco-German countries⁴), and corporate governance mechanisms and disciplinary devices appear to be different in these systems. The market for corporate control via takeovers and acquisitions is the main corporate governance mechanism to restrain managerial discretion in Anglo-American countries, whereas it tends to be inoperative in Franco-German countries. Key environmental factors that distinguish

³ These countries include the U.S., the U.K., Canada, Australia and New Zealand.

⁴ These countries include Germanic countries (such as Germany, Switzerland, Austria and the Netherlands), Latinic countries (such as France, Italy, Spain and Belgium), and Japan.

corporate governance systems across countries are laws and regulations under which corporations are established and function and the level of capital market development and availability of banking finance.

Finally, a definition of corporate governance can depend on the industry to which corporations belong. For example, financial institutions such as banks are more regulated than manufacturing firms, and face specific corporate governance issues (Adams and Mehran, 2003).

Based on accounting and finance related corporate governance literature, the definitions of corporate governance can be classified into two categories, narrow and broad, depending on the extent to which corporate governance issues are addressed therein. In a narrow sense, corporate governance may mean the formal system of accountability of senior management to the shareholders (Keasey, Thompson and Wright, 1997). The board of directors (BOD), as the custodian of the shareholders, has a fiduciary duty to safeguard the interests of shareholders, and is held responsible for the governance of the firms. For this purpose, the BOD sets the corporation's strategic aims, provides the leadership to put them into effect, supervises the management of the business, and reports to shareholders on their stewardship (Cadbury Report, 1992). Accordingly, the Cadbury Report (1992) defines corporate governance as the system by which companies are directed and controlled. In a similar manner, the ASX Corporate Governance Council (2003) defines corporate governance as the system by which companies are directed and managed that influences setting and achieving the objectives, monitoring and assessing the risk and optimizing the performance of a firm.

A broader view of corporate governance tends to incorporate more stakeholders and contextual factors into the governance framework. For example, Shleifer and Vishny (1997) define corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (p. 737). This definition incorporates the interests of both shareholders and debtholders. The OECD principles of corporate governance also seem to take a broad view, stating that "corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders" (OECD, 2004, p. 11). This view of corporate governance also supports Jensen and Meckling's (1976)

definition of a firm as a “nexus of contracts”. They assert that most organizations are simply legal fictions, which serve as a nexus for a set of contracting relationships among individuals, and thus all these parties are expected to benefit from corporate governance practices. Further, the broader definitions of corporate governance are stretched to include the entire network of formal and informal relations involving the corporate sector and their consequences for society in general (Keasey *et al.*, 1997). Based on this view, Gillan and Starks (1998) define corporate governance as the system of laws, rules, and factors that control operations of the company. Ratnatunga and Ariff (2005) also take a holistic view of governance in terms of economic, legal and societal definitions and expectations. Consequently, external environmental factors such as laws and regulations, economic, political and market factors seem to be integrally related to corporate governance mechanisms.

2.2.2. Importance

The importance of corporate governance lies primarily in the separation of management and ownership of corporations. This issue has been discussed in the context of agency theory, which argues that the separation of corporate managers from outside investors leads to an inherent conflict of interests, and that the interests of investors need to be protected against expropriation by corporate managers (Bushman and Smith, 2001; Dey, 2008). Berle and Means (1932) appear to be the first to identify this problem in modern large corporations, particularly in the U.S. They claimed that selfish managers embarked on ‘corporate plundering’ at the cost of outside widely spread owners, giving rise to contemporary corporate governance issues. Later, Coase (1937) deemed the relationship between management and owners in a firm to be similar to the master-servant relationship and emphasized the need for formal contracts. This idea was further developed by Jensen and Meckling (1976), who viewed the relationship between management and owners in a firm as an agency relationship. Because of differences in goals and risk profiles of the two parties in the agency relationship there is often the possibility of an agent not performing in the best interest of the principal. This situation could also be exacerbated by information asymmetry and incomplete information provided by the agent to the principal(s) (Subramaniam, 2006; Subramaniam and Ratnatunga, 2003). Organizations therefore need to introduce suitable mechanisms to

address and manage such agency issues so that the interests of managers and owners can be aligned.

2.3. Corporate governance mechanisms

The literature on corporate governance suggests that various mechanisms are used to align the interests of corporate managers with those of shareholders (e.g., Brown, Beekes and Verhoeven, 2011; Bushman and Smith, 2001; Dey, 2008). These mechanisms can be classified into two broad categories: those that are internal to corporations (e.g., BOD, managerial compensation plans (MCP)), and those that are external to corporations (e.g., laws and regulations, shareholder monitoring, debtholder monitoring, market for corporate control, labour markets, product markets). The next two sub-sections discuss these two categories.

2.3.1. Internal corporate governance mechanisms

(a) Board of directors (BOD)

The BOD can be an important corporate governance mechanism in a publicly held corporation. The BOD is held responsible for good corporate governance, and it has a fiduciary duty to outside shareholders to monitor the activities of managers and to provide strategic direction to the corporation (Cadbury Report, 1992; Kim, Burns and Prescott, 2009; Pugliese *et al.*, 2009; U.K. Corporate Governance Code, 2010; Zhang, 2010). The board tends to supervise managers to ensure goal congruence behaviour, and reports to the shareholders on its stewardship. For these purposes, the board is expected to meet regularly to discuss matters important for the corporation, perform checks and balances, and ensure that control systems are in place to avoid malpractice by managers and other employees. In addition, the board is expected achieved these ends by paying attention to its duty to present a true and fair view of the affairs of the corporation to the shareholders via financial reporting (Whittington, 1993). The board sets the corporation's strategic aims and provides the leadership to put them into effect. In order to fulfil these tasks, it is necessary to have a right combination of directors in the board. It is considered desirable to include executive directors who possess necessary qualifications and knowledge of the business and non-executive directors who can bring a broader view of the activities of the corporation (Cadbury Report, 1992).

The effectiveness of the BOD as a corporate governance mechanism depends also on two factors, namely how roles of the board are defined and the way in which it is structured (Cadbury Report, 1992; Carver, 2010; Gillan, 2006; Sarkar, Sarkar and Sen, 2008; U.K. Corporate Governance Code, 2010). These alternative tasks of the BOD have been examined widely in corporate governance research in a variety of disciplinary areas. Firstly, as explained above, the board performs monitoring and advisory roles to oversee the activities of managers and to provide strategic direction to the corporation. Raheja (2005) theoretically examines the roles of BODs as monitors of, and advisors to, corporate management, and highlights that the board is responsible for monitoring projects and making CEO succession decisions. Further, he argues that inside directors are better informed regarding the quality of firm investment projects, but outsiders can use CEO succession to motivate insiders to reveal their superior information and to help the board implement higher value projects. Moreover, empirical research suggests the importance of frequency of board meetings for governance purposes. More frequent meetings would improve the ability of the board to monitor and advise managers. For example, Vafeas (1999) reveals that an increase in board meeting frequency is followed by improvements in operating performance.

Secondly, an appropriately structured board, for instance, one that includes members from different backgrounds, can more efficiently contribute to the performance of corporations. The literature suggests a number of factors that should be considered in structuring the board in order to perform well as a governance mechanism. These include board size (e.g., Hermalin and Weisbach, 2003; Jackling and Johl, 2009; Kiel and Nicholson, 2003; Raheja, 2005; Taylor and O'Sullivan, 2009), board independence (e.g., Brick and Chidambaran, 2010; Cheng and Courtenay, 2004; Chiang and He, 2010; Dahya, Dimitrov and McConnell, 2008; Jackling and Johl, 2009; Rediker and Seth, 1995; Setia-Atmaja, 2009; Taylor and O'Sullivan, 2009; Yermack, 1996), board committees (e.g., Brick and Chidambaran, 2010; Dionne and Triki, 2005; Huang, Lobo and Zhou, 2009; Klein, 1998, 2002; Main and Johnston, 1993; Setia-Atmaja, 2009), board expertise (e.g., Agrawal and Chadha, 2005; Chiang and He, 2010; Dionne and Triki, 2005; Krishnan and Visvanathan, 2009), and Chairman-CEO duality (e.g., Goyal and Park, 2002; Taylor and O'Sullivan, 2009).

Board size can positively influence the level of corporate governance. For instance, Kiel and Nicholson (2003) found that board size was positively correlated with firm value of a large number of Australia's biggest public listed companies after controlling for firm size. However, optimum board size appears to be a debatable issue. For example, Hermalin and Weisbach (2003) investigated the impact of the board size on profitability and revealed a negative relationship with corporate performance. Linck, Netter and Yang (2008) found that board sizes of small and large firms differ dramatically.

As suggested by most of the international corporate governance guidelines, such as the NYSE corporate governance rules (2003) and the Walker Review (2009), board independence can contribute positively to the performance. This implies that corporations appear to benefit by appointing independent directors to their board in addition to the executive directors.⁵ Raheja (2005) argues that on the one hand, the inclusion of insiders on the board can lead to more effective decision making, since they have important firm-specific information about projects, and on the other hand, outsiders are expected to have the power and sufficient information to accept better projects and reject inferior projects. Besides the BOD functioning as a separate corporate governance mechanism, an independent board can also play a supporting role in other corporate governance mechanisms. For example, a majority of independent directors could lead to more disclosures of accounting information, and thus shareholder and debtholder monitoring could be enhanced. In this respect, Cheng and Courtenay (2004) identify that firms with a high proportion of independent directors on the board are associated with higher levels of voluntary disclosure. Farinha and Viana (2009) find that firms with more independent boards are less likely to receive a modified audit opinion.

Another aspect of board structure is the appointment of committees such as audit, remuneration and nomination committees in the board. Following the Enron and WorldCom scandals in 2002 in the U.S., a number of international laws and corporate governance guidelines (e.g., Sarbanes Oxley Act (2002) and NYSE (2003)) recommend that such committees should consist of independent directors (Bebchuk and Weisbach,

⁵ However, in appointing independent directors, it is important that they have broader knowledge of the activities of the corporation (Cadbury Report, 1992).

2010). Empirical evidence suggests that these committees have been useful in enhancing the level of corporate governance of firms. For instance, Dionne and Triki (2005) reveal that the requirements of the NYSE corporate governance rules (2003) and the Sarbanes Oxley Act (2002) on the audit committee size and its independence are beneficial to shareholders.

Board expertise, exemplified by composition of the board by qualified members from different disciplines, tends to improve the level of corporate governance by the board. In particular, international guidelines on corporate governance suggest that board members should be competent in accounting and finance. For example, the NYSE corporate governance rules (2003) require each member of the audit committee to be financially literate. The Cadbury Report (1992) recommends that a board member be selected to oversee the finance function. Moreover, the Walker Review (2009) recommends that non-executive directors have sufficient knowledge and understanding of the business that they contribute to the board. Empirical findings are also consistent with the suggestion that independent directors with financial expertise are valuable in providing oversight of a firm's financial reporting practices (Agrawal and Chadha, 2005).

Chairman-CEO duality can be established to ensure a balance of power and authority, and also to ensure that no individual has excessive powers in decision making (Cadbury Report, 1992). Moreover, this results in a clearly accepted division of responsibilities at the top level of management in corporations. Bhagat and Bolton (2008) find that Chairman-CEO duality is significantly positively correlated with better contemporaneous and subsequent operating performance.

(b) Managerial compensation plans (MCP)

MCP⁶ are useful in minimizing goal incongruence behaviour of managers (Bushman and Smith, 2001). They are designed to align the interests of corporate management with those of shareholders, and thus have the ability to perform as a corporate governance mechanism. For this purpose, they should be set to offer incentives for the achievement of various organizational performance targets (see Sun and Cahan, 2009).

⁶ Most compensation packages contain four basic components: a base salary, an annual bonus tied to performance, share options, and long-term incentive plans (Murphy, 1999).

Most studies of the relation between CEO remuneration and firm performance argue in favour of managerial incentive plans as a mechanism to mitigate the agency problem (Jensen 1993; John, Mehran and Qian, 2010; Leonard, 1990; Murphy, 1985; Sun and Cahan, 2009). These studies focus on (a) the relation between CEO pay and company performance (Jensen and Murphy, 1990; Leonard, 1990; Murphy, 1985, 1986); and (b) whether CEOs are rewarded for performance measured relative to the market or the industry (Antle and Smith, 1986; Gibbons and Murphy, 1990).

However, managerial incentives have become a debatable issue, especially due to their excessive levels for managers whose firms are in decline, raising doubts over the use of this method as a corporate governance mechanism. For example, following the recent sub-prime mortgage crisis, U.S. President Obama announced certain restrictions on executive pay, particularly when corporations undergo financial difficulties and such rewards are subsidized by taxpayers. The U.K. Corporate Governance Code (2010) recommends that although the levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the corporation successfully, firms should avoid paying more than is necessary for that purpose. Earlier, Healy (1985) provided empirical evidence to show that managers manipulated accounting procedures and accruals to maximize their compensation. His findings suggested that changes in accounting procedures and accrual policies by managers were associated with adoption or modification of their bonus plans.

2.3.2. External corporate governance mechanisms

(a) Laws and regulations

Laws and regulations designed to protect the rights of stakeholders, particularly those of shareholders, are considered to be an important corporate governance mechanism (Hill, 2010). It appears that in many countries, the government enforces various laws and regulations such as companies acts, capital market regulations, bylaws and charter provisions to safeguard the interests of shareholders and other stakeholders. Shareholder rights include, among other things, voting rights on major issues, dividend rights, right to transfer ownership, and right to receive information of the corporation. Further, the rights of other stakeholders such as debtholders, customers, and the government can also be protected by such regulations. In particular, the rights of debtholders, for

example, constrain the actions of directors through loan covenants rights, and can be considered an important corporate governance mechanism (e.g., Whittington, 1993).

The OECD (2004) principles of corporate governance recognize the rights and the equitable treatment of shareholders (including minority and foreign shareholders), and the rights of stakeholders established by law or through mutual agreements. A basic legal right of shareholders is to vote on important corporate decisions such as mergers, liquidations, and election of the BOD (Shleifer and Vishny, 1997). Stakeholder interests also need to be protected by law, and stakeholders should have the opportunity to obtain necessary redress for violation of their rights (OECD, 2004).

A number of empirical studies have been undertaken to investigate the impact of laws on corporate governance. Some of them focus on governance and wealth changes following changes of laws (e.g., Bruno and Claessens, 2010; Chhaochharia and Grinstein, 2005; Mengoli, Pazzaglia and Sapienza, 2009; Petra, 2006; Robins, 2006). Law amendments related to shareholder and debtholder protection explicitly affect the corporate governance of firms. For example, Chhaochharia and Grinstein (2005) examined the impact of the 2002 governance rules (Sarbanes-Oxley Act) on firm value in the U.S. They found that the rules on corporate governance had a positive effect on firm value, and those firms that had previously been less compliant with the rules benefited more by realizing a greater value improvement than firms that had been more compliant with the rules.

There are also investigations of the impact on corporate governance of law amendments on adoption of anti-takeover measures (e.g., Coles and Hoi, 2003; Gompers, Ishii and Metrick, 2003). Changes of law that allow corporations to adopt anti-takeover measures have both favourable and unfavourable impacts on corporate governance. The advantage of anti-takeover measures is that they allow corporations to issue additional shares to shareholders other than hostile bidders. This results in protecting the rights of the current shareholders, since the potential bidders have to pay a fair amount to existing shareholders in case of a negotiation for a takeover (Jarell, Brickley and Netter, 1988). On the other hand, the increased use of anti-takeover measures can be a potential barrier to market for corporate control, which is considered to be an important external corporate governance mechanism (Gompers *et al.*, 2003).

Finally, some studies have examined the effectiveness of legal protection in financial markets around the world as a corporate governance mechanism. These studies generally argue that the differences in investor protection against expropriation by managers (i.e. level of corporate governance) have been reflected by the differences in the nature and the effectiveness of financial systems (i.e. laws and their levels of enforcement). For example, La Porta, Lopez-De-Silanes, Shleifer and Vishny (1997) found that countries with poorer investor protection, measured by both the character of the legal rules and the quality of law enforcement, have smaller and narrower capital markets, as their levels of corporate governance tend to be weak.

(b) Shareholder monitoring

Shareholders can operate as an important corporate governance mechanism by monitoring the activities of the BOD and managers and by participating in the important decisions in the corporation (Hill, 2010; Ward, Brown and Rodriguez, 2009). For the purpose of monitoring, shareholders have been given the right to obtain relevant and material information on the corporation on a timely and regular basis (U.K. Corporate Governance Code, 2010). For instance, shareholders have the legal right to be informed via annual reports and quarterly reports. Such information can be used by shareholders for monitoring and decision making purposes. Shareholders have also been given the right to participate and vote in shareholder meetings on important issues such as the election and removal of members of the board and proposals for fundamental changes affecting the corporation, for example, change of objectives, mergers and acquisitions, and liquidation (OECD, 2004).

Large shareholders can play a significant role in corporate governance in publicly held corporations (Crespi and Renneboog, 2010; Shleifer and Vishny, 1997; Ward *et al.*, 2009). For example, institutional investors and blockholders have substantial ownership stakes, which provide them with an incentive to collect information and monitor management, thereby enhancing shareholder value. There is a large body of research that provides empirical evidence on the importance of institutional investors and blockholders for corporate governance. This body of research, for instance, shows that large shareholders are associated with a high turnover of directors (Franks and Mayer, 1994) and CEO (Del Guercio, Seery and Woidtke (2008), and moderate executive compensation (Hartzell and Starks, 2003). Further, Kang and Shivdasani (1995) and

Kaplan and Minton (1994) reveal that firms with large shareholders are more likely to replace managers in response to poor performance than firms without them. Moreover, Bethel and Gillan (2002) find that active blockholders lead to enhanced shareholder value.

It should, however, be noted that the effectiveness of large shareholders as a corporate governance mechanism can be tempered by possible conflict with the interests of other shareholders. For example, Holderness (2003) argues that while blockholders have the incentive and the opportunity to increase the corporation's expected cash flows that accrue to all shareholders including the blockholders, they also have the incentive and the opportunity to consume corporate benefits to the exclusion of smaller shareholders. Shleifer and Vishny (1997) also identify three potential costs associated with large shareholders: straightforward expropriation of other investors, managers and employees; inefficient expropriation through pursuit of personal (non-profit-maximizing) objectives; and incentive effects of expropriation on the other stakeholders. In particular, the literature confirms the limited protection of minority rights in Asia, allowing controlling shareholders to expropriate minority shareholders (e.g., Claessens and Fan, 2002).

(c) Debtholder monitoring

Debtholders also can play a role in corporate governance by monitoring the activities of the corporation (Sarkar and Sarkar, 2008). Debtholders have a basic right to specified interest and capital redemption payments. This right can be considered as a governance mechanism, as managers are forced to generate cash flows adequate to meet the interest and capital obligations of the debt capital (Gillan, 2006). Further, debtholders can restrict the actions of managers and the BOD through loan covenants, which allow debtholders to enforce various restraints on the corporation, if management violates the terms and conditions of the loans granted (Whittington, 1993). For example, provisions can be made in loan agreements to repossess collaterals, to convert the loan into equity, and to appoint a member/s to the board to represent the interests of the debtholder in a poorly performing corporation. However, the effectiveness of loan covenants tends to depend largely on the legal system prevailing in the country in which the corporation operates (Shleifer and Vishny, 1997). Furthermore, since debtholders typically lend short term, and the borrowers have to come back at regular short term intervals for more

funds, the debtholders can use this situation to influence the corporation's performance (Shleifer and Vishny, 1997).

Unlike shareholders, debtholders do not usually possess legal rights to participate and vote in important decisions, and hence have limited opportunity to influence operations of the corporation. Moreover, debtholders do not have the same right or opportunity as shareholders to obtain sufficient information. This can reduce their ability to monitor managers.

(d) Market for corporate control

The market for corporate control appears to be the ultimate corporate governance mechanism, as the corporation is ultimately controlled by the market forces if it is not properly controlled by other mechanisms (Gillan, 2006). The market for corporate control represents the threat of acquisition and takeover when a firm's share is undervalued relative to its potential because of poor management (Brigham and Houston, 2001). There are several mechanisms for taking over the control of corporations, such as proxy fights, direct purchase of shares and mergers (Manne, 1965). The risk of takeover induces managers to perform well and discourage opportunism. The goal directed behaviour in such situations is important to retain their employment, as a new team of management is often appointed to manage the corporation following acquisition. As discussed above, this mechanism is particularly significant in Anglo-American countries where large shareholders' involvement is limited in monitoring corporations (Bittlingmayer, 2000). In contrast, this particular mechanism has not been prominent in Franco-German countries, as the operation of markets is not strong in those countries (Franks and Mayer, 1990).

(e) Labour markets

Labour market forces can be used as an important corporate governance mechanism to align the interests of the CEOs and senior executives with those of the shareholders (Jensen and Meckling, 1976; Murphy, 1986). Due to the threat of dismissal from the current employment and the risk of not finding suitable employment in future because of reputation concerns, managers are motivated to achieve a higher level of corporate performance, from which shareholders can achieve their wealth maximization goal (Fama and Jensen, 1983).

This corporate governance mechanism tends to be more operative in the Anglo-American countries, as the level of executive dismissal is high in those countries, compared to, for example, Franco-German countries and Japan (Franks and Mayer, 1990). In Japan, there is a high degree of internal mobility within *keiretsu*, and managerial failure is mostly corrected by means of internal measures (Moerland, 1995). In contrast, in the U.S., market forces influence executive resignations subsequent to significant abnormal share performance, and such executives are usually replaced by an outsider as the CEO (Borokhovich and Parrino, 1996; Rosenstein and Wyatt, 1997).

(f) Product markets

Competition in product markets can play a role in the corporate governance of corporations. In a highly competitive market, a corporation must perform more efficiently in order to survive and to retain its market share than in a less competitive or monopolistic market. Since incentive schemes of managers are also usually linked with the firm's performance, managers are motivated to improve the efficiency of corporations. Moreover, product market competition has favourable effects on cost efficiency and quality improvement. For example, Baggs and Bettignies (2007) argue that competition can have a direct positive effect on quality improvements and cost reductions, not only in widely held corporations but also in sole ownership firms.

Further, the labour market operates more efficiently in a highly competitive product market than in a less competitive product market. For example, DeFond and Park (1999) reveal that the frequency of CEO turnover is greater in highly competitive industries than in less competitive industries. Parrino (1997) argues that poor CEOs are easier to identify and less costly to replace in industries that consist of similar firms than in those with heterogeneous firms, and the likelihood of forced CEO turnover and intra-industry appointment increases with industry homogeneity.

This section has detailed the typical corporate governance mechanisms internal and external to organizations that help to minimize goal incongruence behaviour of managers. The next section describes corporate governance in the banking industry. More specifically, it introduces specific features of banks and explains their impact on the effectiveness of corporate governance mechanisms.

2.4. Corporate governance in banking industry

2.4.1. Specific features of banks

Banks have received limited academic scrutiny in the large body of existing literature on corporate governance (Adams and Mehran, 2003; Macey and O'Hara, 2003; Nam, 2004). Much of the corporate governance literature focuses on large industrial corporations (Adams and Mehran, 2003). A possible reason for this omission could be the presumption that banks also conform to the concept of the firm used in agency theory (Ciancanelli and Gonzalez, 2000). However, there are certain differences between banks and non-banking organizations such as manufacturing firms (Adams and Mehran, 2003).

The specific features of banks, namely leverage, opacity and regulation, which distinguish their corporate governance from that of non-banking organizations are discussed in the following sub-sections.

(a) Leverage

Unlike non-banking firms, banks typically operate with a high debt-to-equity ratio (Nam, 2004). Their capital structure tends to have very little equity and the liabilities are largely in the form of deposits, which are available to their creditors (depositors) on demand. On the other hand, the assets of banks often take the form of loans that have longer maturity, in contrast to the short term nature of their liabilities (Fan, 2004; Macey and O'Hara, 2003). This mismatch between the maturities of deposits and loans creates a problem for banks, where they become exposed to the risk of collective action by depositors. Banks can face liquidity problems if a large number of deposits or a large amount of money is withdrawn at a given point of time. In such situations, banks are forced to withdraw their long term investments, which is not always possible. Therefore, the safeguard of depositor confidence is an important aspect of banks as a going concern. For this reason, it can be necessary even for governments to intervene in certain situations to maintain depositor confidence. For example, the Australian government offered guarantees to all bank deposits in the wake of the recent financial crisis. It is possible even for profitable banks to run into bankruptcy without such assurance in such circumstances (Nam, 2004). Overall, the high leverage, the maturity mismatch between assets and liabilities in the balance sheet and the high reliance on

depositors' confidence mean that banks are exposed to a higher level of risk than other types of organization.

(b) Opacity

Information asymmetry is a common problem in all organizations where ownership and management are separated, but empirical evidence suggests that it is more critical in banks compared than in other firms (Levine, 2004).

The greater opacity of banks creates a barrier for shareholders and depositors to monitor managers, as they may not have adequate information for that purpose. For instance, Nam (2004) argues that information asymmetry is higher in the banking industry than in non-banking industries due to inter-temporal nature of typical financial contracts, which involve a promise to pay in the future. As a result, the risk composition of the assets in banks can change within a short period of time. For example, a major customer of a bank could face financial difficulty, leading to outstanding loans becoming doubtful within a short period of time. Further, the increasing complexity of financial products and the use of advanced technology also have contributed adversely to this situation.

The opacity of banks can also provide an incentive for managers to manipulate banks' financial affairs (Fan, 2004; Levine, 2004). Financial statements of banks can be manipulated to give an inaccurate view. For example, loan quality can be hidden for a long period by extending the repayment term to clients who are unable to service their debts according to the original debt obligations. In this way, the interest accrued on these loans can be recognized as an income, and the loans can be shown under the performing assets category by not recognizing possible bad and doubtful debts. To sum up, the high level of information asymmetry in banks can impede shareholder and depositor monitoring, and can also enable managers to engage in sub-optimal behaviours. Such possibilities clearly highlight the implications for corporate governance of banks.

(c) Regulation

The presence of a high level of regulation in the banking industry is another factor that differentiates banks from firms in other industries. Governments influence banks' activities by way of prudential regulation and supervision. Such influence is necessary

because the stability of the financial sector in a country depends largely on the banks, and failure of a single bank can lead to the loss of public confidence in the total banking system (Nam, 2004). Moreover, even the failure of a large bank could have adverse consequences internationally (Trayler, 2007). For example, the sub-prime mortgage crisis of banks in the U.S. recently caused major adverse consequences for banks and financial markets around the globe. Therefore, governments are involved in the banking industry by way of various regulations and safety nets. These include government deposit guarantees, restrictions on bank ownerships and new entrants, regular audits, oversight of the issuance of bank charters, authorization of mergers and other consolidations among banks, capital adequacy requirements, asset composition rules, fit and proper standards for senior managers and board members, and the lender of the last resort function (Alexander, 2006; Fan, 2004).

These regulations are important for banks as they are aimed at mitigating the social costs by way of prudential measures (Alexander, 2006). For example, deposit guarantees reduce the social costs of bank default while helping to gain economic benefits from bank risk taking. In the absence of deposit guarantees, depositors would demand higher interest rates to compensate for higher risk, which could lead to an increase in the cost of capital (Meacy and O'Hara, 2003). The lender of the last resort function provides a safety net for banks that allows them to discount the cost of their risk taking while not allowing them to fail. The literature suggests that these regulations have a favourable effect on the stability of banks. For example, in the U.S. the creation of Federal Deposit Insurance has been helpful in preventing bank failures and subsequent damaging impacts on the economy (Macey and O'Hara, 2003).

However, prudential regulation and supervision weaken most of the corporate governance mechanisms of banks (Levine, 2004; Macey and O'Hara, 2003; Nam, 2004). Due to restrictions on bank ownership and new entrants, the competition for corporate control in the banking industry is low compared to other industries, and this in turn seems to weaken the market for corporate control by mechanisms such as hostile takeovers (Levine, 2004). Further, because of the possibility of support from the lender of the last resort (i.e., the central bank) in the case of insolvency, managers may not be concerned about being penalized for their poor performance. Furthermore, government deposit guarantees tend to induce banks to rely less on uninsured creditors with

incentives to monitor banks (Levine, 2004; Nam, 2004). Macey and O'Hara (2003) argue that deposit guarantees give shareholders and managers of insured banks an incentive to engage in excessive risk taking. Managers can create shareholder wealth by reducing the value of the bank's debt capital via engaging in high risk investments, since shareholders are the residual claimant with limited liability for the firm's debt (Moerland, 1995). Without deposit insurance, depositors would demand that banks refrain from engaging in risky investment strategies or else demand a higher interest rate for the extra risk (Meacy and O'Hara, 2003). Therefore, a conflict exists between depositors and shareholders because of the high debt-to-equity ratio and the existence of deposit guarantees in banks. The presence of government deposit guarantees also reduces incentives for fixed claimants to monitor activities in banks (Meacy and O'Hara, 2003). This in turn provides an opportunity for employees to engage in fraud or misuse of funds, as the assets of banks exist largely in the form of cash or cash equivalents. For example, Demirguc-Kunt and Detragiache (2002) reveal that countries where deposit insurance covers exist tend to have more banking crises.

2.4.2. The notion of corporate governance of banks

Traditional theories of the firm, such as agency theory which focuses on shareholder value maximization, may not be solely adequate to discuss corporate governance of banks, as they focus only on shareholders and give limited attention to other stakeholders such as depositors. The discussion of the specific features of banks in the previous section suggests that a corporate governance system for banks should protect the interests of depositors in addition to the interests of shareholders. Bank failures, particularly during the 1997/98 Asian financial crisis and the more recent global financial crisis, further support such arguments, as those failures adversely affected not only shareholders but also a larger spectrum of stakeholders, for example, depositors, customers, governments and by and large the general public of the countries. These arguments are in line with stakeholder theory.

Stakeholder theory asserts that it is important to consider the interests of groups affected by the firm (Christopher, 2010; Gibson, 2000). The central admonition of this theory is to pay attention to the interests and well-being of those who can assist or hinder the achievement of the organization's objectives (Phillips, Freeman and Wicks, 2003).

Taking a property rights view, Asher, Mahoney and Mahoney (2005) also emphasize that a stakeholder perspective does not regard shareholders as the only residual claimants. Hence it is argued that managing for stakeholders involves paying attention to more than simply maximizing shareholder wealth (e.g., Christopher, 2010; Phillips *et al.*, 2003).

As banks normally operate under a high level of debt-to-equity ratio, depositors play an important role for the existence of banks. Further, banks also have to consider the interests of other stakeholders, such as customers and governments, as failure to do so is likely to lead to a banking crisis. Such crises can give rise to significant public costs and consequences due to their broader macroeconomic implications, such as contagion risk and impact on payment systems (Basel Committee, 2010). Such crises in the past have crippled economies, destabilized governments, and intensified poverty (Levine, 2004). Hence it is argued that, besides their responsibilities to shareholders, banks also have a responsibility to their depositors and to other recognized stakeholders. Accordingly, the Basel Committee (2010) describes corporate governance of banks as the manner in which the business and affairs of a bank are governed by its board and senior management, to ensure, among other things, that they protect the interest of depositors, meet shareholder obligations, and take into account the interests of other stakeholders.

The specific features of banks discussed in Section 2.4.1, namely leverage, opacity and regulation, differentiate banks from firms in other industries. As explained in this section, it can also be argued that banks require a stakeholder approach to corporate governance (as opposed to a shareholder approach, which may be suitable for non-banking firms), particularly to protect the interests of depositors. The next section explains the impact of the specific features of banks on the corporate governance mechanisms discussed in Section 2.3.

2.4.3. Corporate governance mechanisms in banks

The discussion in Section 2.3 was focused on corporate governance mechanisms generally applicable to unregulated industries such as manufacturing firms. However, banks are different from those organizations due to the specific features discussed in Section 2.4.1 and they raise unique corporate governance issues (Adams and Mehran,

2003; Arun and Turner, 2004; Ciancanelli and Gonzalez, 2000; Fan, 2004; Levine, 2004; Macey and O'Hara, 2003; Nam, 2004, 2006). In this section, internal and external corporate governance mechanisms particularly applicable to banks are examined.

The first and the main internal corporate governance mechanism mentioned in Section 2.3.1 is the BOD. The board is expected to play a significant role in a bank due to the inability of external corporate governance mechanisms to operate at the same level as in non-banking organizations (Andres and Vallelado, 2008; Basel Committee, 2010; Nam, 2004; Walker Review, 2009). The fiduciary duty of the board is a valuable device in the banking context, because of the high level of information asymmetry (Macey and O'Hara, 2003). The literature suggests that the fiduciary duty of boards of banks should go beyond the protection of the interests of the shareholders to incorporate the interests of the depositors and regulators, as they also have a direct interest in the performance of banks. For example, the Basel Committee (2010) recommends that the boards of banks should meet their obligation of accountability to shareholders while taking into account the interests of other stakeholders, namely depositors, supervisors, and governments, due to the unique role of banks in national and local economies and financial systems. In this respect, Macey and O'Hara (2003) argue that "there are many situations in which non-shareholder constituencies such as uninsured depositors in banks might value a particular contractual right or protection more than shareholders value it" (p. 95). Further, regulators are interested in the performance of banks to maintain a stable financial system in a country and to minimize the social cost (Alexander, 2006). Empirical evidence also supports the particular importance of boards in banks. For example, Adams and Mehran (2003) reveal that boards of banks are larger than those of manufacturing organizations, have more outside directors, have more committees, and meet more frequently.

The second internal corporate governance mechanism discussed in Section 2.3.1 is the MCP. The literature suggests that the use of MCP to mitigate the agency problem tends to be different in banks than in other organizations due to the specific features of banks. For example, John and Qian (2003) argue that, since depositors are the primary claimholders in banks, the objective of corporate governance is not only to align the interests of managers closely with the interests of shareholders, but also to ensure that managers act on behalf of depositors.

Further, Mehran and Winton (2001) argue that as banks are highly leveraged compared to manufacturing firms, they should provide more cash compensation than equity based compensations in the MCP (see also John *et al.*, 2010). If MCP are aligned with equity ownership in banks, managers have strong incentives to undertake high-risk investments to increase the share price. In such a situation, uninsured depositors may lack devices to protect themselves against excessive risk taking by managers (John *et al.*, 2010). On the other hand, insured depositors may lack any incentive to control excessive risk taking behaviour of managers (Macey and O'Hara, 2003). This in turn creates wealth of equity capital by reducing the value of the debt capital via shifting the excessive risk from shareholders to debtholders (Moerland, 1995).

Furthermore, the pay for performance sensitivity in the compensation structure of banks can be lower than in manufacturing firms, because banks are highly regulated institutions, and thus regulation substitutes the role of incentivization of managers (John and Qian, 2003). For example, regulators establish procedures to control managers in undertaking high risk investments and thereby perform a supervisory role.

Finally, when the outcomes are difficult to measure and easy to manipulate, the MCP cannot be properly administered and/or the managers find it easier to manipulate MCP (Levine, 2004). For example, in banking contexts, managers can approve a high interest loan to a borrower to boost the interest income in the short term, so that they receive an increased level of compensation.

Laws and regulations constitute the first external corporate governance mechanism discussed in Section 2.3.2. The high level of laws and regulations in the banking industry plays an important role in corporate governance. The literature provides arguments in favour of laws and regulations as an external corporate governance mechanism in banks. For instance, the opacity of banks hinders typical corporate governance mechanisms, such as shareholder and depositor monitoring, and thus governments replace those mechanisms by way of regulatory oversight (Levine, 2004). Further, the use of regulation is justified as it provides safety and soundness in the financial sector (Alexander, 2006). However, there are also arguments against the effectiveness of laws and regulations of banks as a corporate governance mechanism. It is argued that governments are not particularly concerned about minimizing information

and transaction costs, which is one of the aims of enforcing laws and regulations, but they are interested in regulating banks as a source of fiscal revenue. On the other hand, powerful banks can have the ability to influence governments. In such situations, regulators tend to fulfil the interests of powerful bankers rather than the intended objective of regulatory oversight, to protect the interests of society in general (Levine, 2004).

While operating as a corporate governance mechanism in the banking industry, the high level of laws and regulations makes most of the other external corporate governance mechanisms nominal. For example, Levine (2004) explains the implications of bank regulations for (a) governance by shareholders, (b) governance by depositors, and (c) competition. The regulations usually restrict concentrated share ownership and therefore banks do not have large shareholders to monitor and influence managers. Further, the deposit insurance schemes reduce the incentives of depositors to monitor banks. Additionally, the ownership restrictions imposed on banks by governments limit the market for corporate control through takeovers and acquisitions.

The second external corporate governance mechanism discussed in Section 2.3.2 is shareholder monitoring. Shareholders of banks appear to be less operative than those of non-banking firms in the monitoring process for several reasons. Firstly, the opacity of banks restricts the monitoring role of shareholders (Levine, 2004). Secondly, the high level of regulation can reduce the incentives of shareholders to monitor banks (Adams and Mehran, 2003). Large shareholders are also unlikely to exist in the banking industry due to the special laws on ownership restriction, and thus the ability of shareholders to monitor banks is reduced (Adams and Mehran, 2003). Finally, since banks operate under a high level of leverage, shareholders can benefit from the excessive risk taking behaviour of bank managers. Therefore, shareholders may not be concerned about excessive risk taking behaviour by bank managers.

The extent of shareholder monitoring can also differ in government and family owned banks. In government owned banks, an agency problem can exist between the government/taxpayers who own the banks and the managers/bureaucrats who control the banks. To avoid such situations, governments usually impose strict controls and regulations. However, due to the two government roles of owner and regulator, a

conflict can arise when implementing such controls and regulations (Levine, 2004). In the case of family owned banks, the concentrated family share ownership creates an agency problem for minority shareholders and depositors (Fan, 2004).

The third external corporate governance mechanism discussed in Section 2.3.2 is debtholder monitoring. The high level of debt-to-equity ratio of banks is expected to provide a strong incentive for debtholders to monitor banks. The capital structure of banks largely consists of fixed interest bearing deposits with little amount of equity capital. Due to the high level of leverage, depositors and other debtholders are more concerned about their interest income and outstanding capital balance. Therefore, debtholders in banks have an incentive to monitor operations of banks more closely. The ability and the interest of debtholders to monitor banks are restricted in several ways. First, the opacity of banks limits debtholders' ability to monitor banks. However, large debtholders are likely to have the ability to influence and monitor bank managers. The literature suggests that the effectiveness of the monitoring role of large debtholders depends on several factors. For instance, debtholder monitoring can be substituted by regulation and supervision, which can play a monitoring role in banks (Adams and Mehran, 2003; Levine, 2004). Further, large debtholders can use their insider status to serve their interests at the expense of minority debtholders (Calomiris and Powell, 2001). Also, depositors lack incentive to monitor the banks in the presence of deposit insurance cover, as their invested money is protected regardless of the banks' performance (Macey and O'Hara, 2003).

The fourth external corporate governance mechanism discussed in Section 2.3.2 is the market for corporate control. Market for corporate control is virtually nonexistent in the banking industry due to the high level of government intervention over banks and the opacity of banks (Fan, 2004; Levine, 2004; Nam, 2004). Governments usually impose ownership restrictions and regulate who can own banks (Levine, 2004). This results in reducing the competition in the banking industry and limits the room for hostile takeovers. For example, Adams and Mehran (2003) reveal several consequences of excessive government regulation over banks, including substantial delays in hostile bids. Stakeholder groups such as competitors and consumer advocates use that delay to organize opposition to a regulated acquisition and influence the decision of the regulatory body. Further, the opacity of banks limits the supply of relevant information

for hostile takeovers (Fan, 2004). To offer a bid for a potential takeover, the bidder needs accurate and reliable information, but the information asymmetry of banks restricts the provision of such information.

The fifth external corporate governance mechanism discussed in Section 2.3.2 is labour markets. As in non-banking firms, the market for CEOs and senior executives can operate as an important corporate governance mechanism in the banking industry. Reputation concerns tend to be an important element of labour market forces in the banking industry, because poor performance of CEOs and senior executives can affect adversely their marketability and current employment. These factors force CEOs and senior executives to act for the best interest of the bank without involvement in high risk investments. For example, Meacy and O'Hara (2003) argue that managerial incentives to undertake risky investments in banks are limited, as managers have invested their nondiversifiable human capital in their employment, which could be depreciated significantly in the case of failure of the bank. Nevertheless, the opacity of banks can restrict the efficient functioning of this corporate governance mechanism. For instance, CEOs and senior executives can manipulate information to show better performance of the bank in the short run (Nam, 2004).

The last external corporate governance mechanism discussed in Section 2.3.2 is product markets. Product market competition can perform an important role in corporate governance in the banking industry. Banks can offer their services more efficiently than their competitors, for example, by adding more features to the products they offer, and by providing such services more efficiently to attract customers and to maximize profitability. For instance, at present, most large banks offer total banking solutions such as general banking, credit cards, investment solutions and insurance services to their customers. Further, modern technology is used to provide a rapid service at a low cost, such as the provision of ATMs and internet banking. The efficiencies gained through product market competition can be used as a corporate governance mechanism in mitigating the agency costs of banks.

However, the specific issues related to banks hinder product market competition in the banking industry, and thus restrict its role as an efficient corporate governance mechanism. The host of regulations in the banking industry weakens the product market

competition. For example, Nam (2004) classifies regulations which can influence the product market competition into two categories, namely (a) those of a social or political nature, such as policy lending to agriculture or small and medium size enterprises, and (b) those that contribute to the stability of the financial market, such as entry barriers, restrictions on services provided, interest rates, and branching. The former category can have a significant influence on government owned banks, and the latter can influence all banks. Ultimately, both types of regulation restrict banks from performing at their optimum level in the market and weaken the product market competition. Moreover, the long term relationships developed by banks with their clients to mitigate information asymmetry problems also have negative implications for product market competition (Levine, 2004).

In conclusion, the discussion in this section suggests that the effectiveness of corporate governance mechanisms in banks is largely influenced by the specific features of banks, namely their high levels of leverage, opacity and regulation. The applicability of corporate governance mechanisms in non-banking firms vis-à-vis banks is summarized in Table 2.1. It shows the industry specific nature of corporate governance, and thus the need for separate examination of corporate governance of banks. The next section explains the role which accounting could play in facilitating the operation of corporate governance mechanisms.

Table 2.1: Applicability of corporate governance mechanisms in non-banking firms vis-à-vis banks

Corporate governance mechanisms	Non-banking firms	Banks
Internal:		
1. Board of directors	High: Fiduciary duty towards shareholders	High: Fiduciary duty towards depositors and regulators beyond the shareholders
2. Managerial compensation plans	High: More equity compensation	Moderate: (a) More cash compensation to avoid high risk taking behaviour of managers; (b) low pay-for-performance sensitivity due to the presence of regulator who also performs a monitoring role
External:		
1. Laws and regulations	High: Both positive and negative impact on corporate governance	High: But also create a low competitive business environment which hinders most other corporate governance mechanisms
2. Shareholder monitoring	High: For example, large shareholder monitoring	Low: (a) Opacity of banks reduces the ability to monitor banks; (b) Presence of regulation reduces shareholders' incentives to monitor banks; (c) High level of leverage encourages high risk taking
3. Debtholder monitoring	High: For example, large creditors and their control rights	Low: (a) Opacity of banks reduces the ability to monitor banks; (b) Presence of regulator substitutes debtholder monitoring; (c) Existence of deposit insurance cover reduces incentives for depositors to monitor banks
4. Market for corporate control	High: The ultimate corporate governance mechanism	Low: (a) Opacity of banks decreases information for takeover bidders; (b) Presence of regulation (e.g. prohibition and delay of takeovers) weakens the market for corporate control
5. Labour markets	High: Rewards and career prospects depend on performance	Moderate: Opacity of banks reduces the ability to evaluate the performance of managers
6. Product markets	High: Further impact on quality improvement and cost efficiencies	Low: (a) Regulation weakens product market competition; (b) Banks create long term relationships with clients and weaken product market competition

2.5. Accounting and corporate governance

Accounting and corporate governance play interdependent roles in corporations. The following subsection focuses on issues related to the role of accounting in corporate governance.

2.5.1. Role of accounting in corporate governance

Accounting can provide direct as well as indirect input to corporate governance mechanisms (Bushman and Smith, 2001). The direct input of accounting is the provision of information to facilitate the application of various corporate governance mechanisms. For example, the agency problem of corporations can be mitigated and the level of corporate governance can be enhanced by the provision of information through accounting systems so that BOD, shareholders and debtholders are able to monitor the activities of managers to ensure goal congruent behaviour.

Accounting can also provide indirect input to corporate governance mechanisms. The accounting culture of an organization, for instance its ethos of honesty in management from the top down, can do more to prevent financial fraud than regulation. For example, the Treadway Report (1987) recommends that the tone set by top management in an organization plays an important role in preventing and detecting fraudulent financial reporting and in enhancing disclosure and transparency levels. The true and fair view of accounting information assists the operation of corporate governance mechanisms such as shareholder and debtholder monitoring. Further, Bushman and Smith (2001) argue that financial accounting information can play an indirect role in corporate governance by contributing to the information contained in the share price. The provision of relevant and reliable accounting information helps determine a fair price in the share market, and this price can play a governance role as explained in the subsection on market for corporate control (see Section 2.3.2).

The accounting information that facilitates the operation of various corporate governance mechanisms (i.e., the direct role) can be classified into four areas, external reporting, external auditing, management accounting and internal auditing (Whittington,

1993)⁷. The following sub-sections describe the ways in which each of these areas can facilitate corporate governance mechanisms.

(a) External reporting

External reporting, which includes the annual and quarterly reports, relieves the information asymmetry between internal BOD and managers and external shareholders and other stakeholders (Whittington, 1993; U.K. Corporate Governance Code, 2010). External reports consist of both financial and non-financial information (Cho, Roberts and Patten, 2010). The former category of external reporting comprises mainly financial statements, i.e. income statement, balance sheet, statement of changes in equity, and cash flow statement, financial highlights such as financial goals and achievements, and key financial ratios, and other financial information for shareholders and debenture holders. The latter category of external reporting includes various types of information and reports, for example, the reports of the chairperson and the CEO, economic impact report, knowledge management report, corporate governance report, community impact report, risk management report, and other non-financial information available through banks' websites.

External reporting can be effectively utilized in external corporate governance mechanisms, such as shareholder and debtholder monitoring (Bushman and Smith, 2001; Kent and Stewart, 2008). This information can be used by these parties to scrutinize the activities of managers. For example, Dann and DeAngelo (1988) argue that poor earnings performance serves as a visible evidence of managerial inefficiency that can cost managers shareholder support and potentially their jobs. Shareholders and debtholders can also make various other decisions based on the information provided through external reporting, such as whether to retain or sell of existing shares and debentures. Further, the market for corporate control is mainly driven by the accuracy and reliability of the information provided through external reporting (Palepu, 1986). In the absence of such information, potential buyers may be unable to quote a realistic bid for acquisitions and takeovers. Finally, external reporting can also assist in labour and product markets. Financial performance information, for instance, represents the

⁷ Although this classification is used in this study to analyse the role of accounting in corporate governance, external auditing, internal auditing and external reporting are inter-related. For instance, external auditing can be included in external reporting. Also, following the Sarbanes Oxley Act in the U.S., internal auditing is now required as part of external reporting.

performance of the CEO and the senior management. They may be offered a better position in future, following solid performances; at the same time, poor performance may be associated with termination and subsequent difficulty in obtaining new positions (Gillan, 2006). The effectiveness of product market competition in highly competitive industries can also be enhanced by the availability of information through external reporting. For example, DeFond and Park (1999) find that firm-specific accounting measures are more closely associated with CEO turnover in highly competitive industries than in low competitive industries.

(b) External auditing

External auditing is one of the cornerstones of corporate governance that provides an external and objective check on the way in which the financial statements have been prepared and presented (Cadbury Report, 1992). It is plausible, therefore, that the audited financial statements are not likely to be distorted by managerial reporting biases and errors (Bushman and Smith, 2001). Hence external auditing can play a role in both internal and external corporate governance mechanisms.

External auditing can support the external corporate governance mechanisms in various ways. It provides an independent opinion on the quality of financial statements, and thus limits the effects of the moral hazard problems of shareholders and debtholders (Whittington, 1993). The work performed by the external auditor assists these parties to make a fair judgment on the financial statements, and thus enhances shareholder and debtholder monitoring. Like external reporting, external auditing can play a role in market for corporate control and in labour and product market competitions. The provision of audited financial information assists these corporate governance mechanisms to operate in an effective way. For instance, such information can provide reliable information for takeover bidders. It also can provide opportunities for labour and product markets to operate in an effective manner with the availability of reliable information.

External auditing can also assist in internal corporate governance mechanisms (Whittington, 1993). For instance, issues identified by external auditors during the course of the audit can be used by the BOD to take corrective action. External auditors

usually report their concerns over issues such as inappropriate accounting treatment and lapses in internal control and risk management systems.

(c) Management accounting

Management accounting systems generate information for internal purposes (Hall, 2010). For example, information generated through management accounting systems, such as budgeting, standard setting and variance analysis, transfer pricing, management control systems, performance evaluation and reward systems are used by managers for planning, control and decision making purposes (Langfield-Smith and Thorne, 2009).

Management accounting assists mainly in improving internal corporate governance mechanisms (Hoque and Alam, 2004; Whittington, 1993). Such information is also useful in external corporate governance mechanisms such as labour and product market competitions. The information generated through management accounting systems assists BOD to perform their fiduciary duties effectively (Zhang, 2010). The BOD is usually provided with detailed information prepared through management accounting systems. This information is used as the basis for providing strategic direction to the corporation (e.g., budgeting) and monitoring the work of managers (e.g., performance evaluation) by the BOD. Further, financial performance measures are used in fixing MCP (Bushman and Smith, 2001; Sun and Cahan, 2009). For instance, there is empirical evidence to suggest a strong link between accounting measures and MCP (e.g., Jensen, 1993; Jensen and Murphy, 1990; Murphy, 1985).

The information generated through the performance evaluation system is used to assess the performance of managers. This information can be useful in labour market. Moreover, management accounting information on costs and activities can be used effectively in product market competition.

(d) Internal auditing

Internal auditing validates information generated for internal purposes (Whittington, 1993). For instance, most of the checks and procedures performed by internal auditing focus on management accounting reports, and they thus assist in improving the accuracy and reliability of such information. Further, regular internal audit investigation of key controls and procedures ensure that internal control systems are in place in the

organization (Cadbury Report, 1992; Coram, Ferguson and Moroney, 2008). It facilitates the generation of accurate and reliable information for planning, control and decision making purposes of managers in the organization, and minimizes the risk of fraud and error.

Internal auditing assists in improving internal corporate governance mechanisms, particularly the BOD (Cadbury Report, 1992; Whittington, 1993). Apart from the explicit role of internal auditing in improving the accuracy and reliability of management accounting, which in turn helps the BOD to monitor the activities of managers, there are several other ways in which the BOD can use the work of internal auditing (Cadbury Report, 1992). Internal auditors can be directed to undertake special investigations on behalf of the audit committee to the board, for example, to follow up any suspicion of fraud. Further, the internal audit program can be reviewed and approved by the audit committee to ascertain the extent and the coverage of internal audit program. Furthermore, appropriate standing of the head of the internal audit function in the organizational chart, his or her level of independence and ability to access the audit committee, enhance the role of internal auditing in this corporate governance mechanism (e.g., Kaplan and Schultz, 2007). Moreover, internal auditing can enhance the validity of MCP by authenticating the information used in such plans. In this way, the goals of managers can be aligned appropriately with those of shareholders to enhance the level of corporate governance.

This section identified direct and indirect roles of accounting in corporate governance, and discussed the direct role of accounting in detail. More specifically, it discussed the ways in which four broad areas of accounting, namely external reporting, external auditing, management accounting and internal auditing, can facilitate the operation of various internal and external corporate governance mechanisms.

2.5.2. Contingent view of accounting

Although accounting is perceived to have functional attributes (e.g., providing relevant information for decision making, assisting rational allocation of resources, and maintaining institutional accountability and stewardship) in facilitating the operation of corporate governance mechanisms as discussed in the previous section, in reality, the

practice of accounting can vary depending on the context within which accounting operates. Studying the relationship of accounting practice to the organizational and social context has entered into the agenda of many accounting researchers, for example, Burchell, Clubb, Hopwood, Hughes and Nahapiet (1980), Burchell, Clubb and Hopwood (1985), Hoque and Hopper (1994), Uddin and Hopper (2001), Wickramasinghe and Hopper (2005), and Alawattage and Wickramasinghe (2008). This contextual relativity of the role of accounting can be explained using the notion of contingency theory.

Contingency theory posits that organizational structures and systems (including accounting systems) are a function of environmental and firm-specific factors (Chenhall, 2003). Hence, the theory claims that organizational performance depends on the “fit” between the organizational structures and systems on the one hand and the context within which the organizations operate on the other (Cyert and March, 1963). According to the accounting literature based on contingency theory, there is no universally “best” design for an accounting system, but that “it all depends” upon situational factors (Otley, 1980). Contingency theory first became prominent as a means of explaining variations in organizational structures and later became widely used in management accounting literature (e.g., Cadez and Guilding, 2008; Chapman, 1997; Evans, Lewis and Patton, 1986; Otley, 1980; Waterhouse and Tiessen, 1978). Also, to a limited extent, financial accounting research has used the contingency framework (see Thomas, 1986).

Despite the support that it gained with a large body of literature, definitions and measures of variables in contingency based research have often lacked conceptual clarity (Cadez and Guilding, 2008; Chapman, 1997; Waterhouse and Tiessen, 1978). For example, the development of contingency theory literature relies heavily on contingency variables such as environment and technology. These terms, however, have not been precisely defined and, as a result, they have been interpreted in many different ways (Evans *et al.*, 1986). This study uses its own classification of the context to examine the influences on the role of accounting in the corporate governance of banks. The next section discusses the basis for such classification, and introduces various elements of the context affecting the role of accounting.

2.5.3. Contextual factors affecting the role of accounting

As illustrated in the previous section, using the notion of contingency theory, the perceived role of accounting and the actual practice of accounting appear to have an equivocal relationship, mainly because of contextual influences (Kuasirikun and Constable, 2010). For instance, Burchell *et al.* (1980) attempt to show theoretically how the actual practice of accounting can be implicated with the furtherance of many and very different sets of organizational and social ends. These complexities can arise as a result of the influence of both internal organizational factors and external environmental factors. Burchell *et al.* (1985) describe the internal influences on accounting. They claim that financial accounting information is an outgrowth of institutional processes of enormous complexity, and that the use of such information for various internal and external purposes is subject to the organizational and behavioural contexts prevailing in the organization. Uddin and Hopper (2001) examine external influences on the practice of accounting, finding that accounting systems were merely maintained (in their case organization) but became marginal and ritualistic due to political intervention. These findings suggest that the actual role of accounting often tends to depend on the environmental context in which accounting operates.

Burchell *et al.* (1980) classify the external environment into two levels, namely organizational interface and the much broader external environment. The former is the inner layer between the organization and the much broader external environment. It consists of regulatory bodies, professional accounting bodies, formal representatives of social interests and agencies of the state. The latter is the outer layer, which includes broader environmental influences such as economic, political, social and international factors. The organizational interface largely influences the accounting practices of the organization, and is exposed to a very different array of economic, political, social, and international pressures from the much broader external environment.

The following section introduces important elements of the internal organization, the organizational interface and the external environment that could influence the accounting practices of organizations.

(a) Internal organization

The internal organizational factors that could influence the practice of accounting in an organization can be classified into three categories, namely firm characteristics, organizational and behavioural contexts, and institutional processes (Adams, 2002). Each of these factors is discussed as follows.

Firm characteristics

Firm characteristics, such as size, industry, performance, and debt/equity ratio, have been found to influence accounting practices (Adams, 2002; Archambault and Archambault, 2003; Inchausti, 1997). The size of the organization can have a positive relationship with the level of disclosure. Accordingly, large firms appear to disclose more information due to public demand for information, international resource dependence, political pressure and availability of resources (Archambault and Archambault, 2003; Inchausti, 1997; Zarzeski, 1996). Further, reporting practices can differ depending on the industry in which a firm operates. For instance, firms in the same industry tend to disclose similar information to external parties (Inchausti, 1997), and industrial membership is related to the level of disclosure (Adams, Hill and Roberts, 1998). Furthermore, performance of firms can also influence accounting practices. For example, the greater the profitability of a firm, the greater would be the level of disclosure (Roberts, 1992). Finally, highly leverage firms tend to disclose more information to reduce the agency costs of debt (e.g., Ahmed and Courtis, 1999).

Organizational and behavioural contexts

Organizational and behavioural contexts can have a significant influence on the accounting practices of organizations. Factors such as the attitudes of top management towards external reporting, the corporate culture, and the power and conflicts prevailing in the organization determine the accuracy and reliability of accounting information and the level of disclosure (Treadway Commission Report, 1987). There is also empirical evidence to suggest that the organizational and behavioural context is an important element which decides reporting practices (e.g., Adams, 2002; Campbell, 2000).

Institutional processes

Institutional processes, consisting of organizational structure and procedures, can have an influence on accounting and reporting practices (e.g., Adams, 2002; Dionne and

Triki, 2005). The existence of an organized accounting function in organizations with clearly defined powers and responsibilities ensures proper generation of accounting information. For instance, such factors have an impact on the quality, quantity and completeness of reporting (Adams, 2002). Further, the presence of various accounting related committees such as the audit committee can improve accounting and reporting practices (Dionne and Triki, 2005).

(b) Organizational interface

The practice of accounting in an organization can also be influenced by various factors in the organizational interface. The tendency towards increasing demands for financial information made by agencies of the state, organizations within the accounting profession, capital markets and other pressure groups such as environmental organizations has resulted in more extensive and rigorous approaches to financial reporting and disclosure (Burchell *et al.*, 1985). Each of these categories is discussed in the following section.

Regulatory bodies

Regulatory bodies administer the laws and regulations of a country. Such laws and regulations can influence the financial reporting system of the country (Archambault and Archambault, 2003). Hence, proper implementation of laws and regulations related to financial reporting would improve the standard of accounting and reporting practices of organizations within that country. On the other hand, weak enforcement of laws and regulations, for various reasons such as lack of qualified human resources and absence of implementation guidelines, can hinder the effectiveness of laws and regulations on accounting and reporting practices (Iyoha and Oyerinde, 2010; Mengoli *et al.*, 2009, World Bank, 2004).

Professional accounting bodies

The developments that have taken place in accounting are largely associated with the professionalization of the accounting craft (Burchell *et al.*, 1980). For example, the development of accounting and auditing standards is initiated by the professional accounting bodies, which have a marked influence on the reporting practices and the level of disclosure of organizations. Burchell *et al.* (1980) identified a number of implications of such institutions for the accounting practices of organizations. The

recognition of accounting as a profession and the influential occupational specialization in organizations gave some measure of autonomy to accounting practice. Further, the emergence of professional institutions provided new forums in which accounting deliberations and debates could take place, and from which changes in accounting practice could emanate. Finally, these developments created new possibilities for the autonomous development of accounting knowledge.

Capital markets

Capital markets and stock exchanges enforce disclosure regulations (Archambault and Archambault, 2003). Hence, a corporation's disclosure policy is influenced by the listing rules of the stock exchange in which its shares trade. Further, Douppnik and Salter (1995) find that disclosure increases with capital market size, and thus corporations from countries with large capital markets tend to disclose more information than corporations from countries with small capital markets. Moreover, corporations quoted in several stock exchanges disclose more information (Inchausti, 1997).

Other key stakeholders

Apart from the three institutional categories discussed above, several other pressure groups such as media and formal representatives of social interests can exert pressure on reporting practices in corporations. For instance, Cooke and Wallace (1990) and Miller (2006) identify the financial press as a factor that influences disclosure practices. The general public who desire more information can support the relevant media, and corporations may have to respond by providing that information. Further, the level of social disclosure has been found to be related to stakeholder power in a country (Roberts, 1992).

(c) *External environment*

Both the internal organization and the organizational interface discussed in the previous two sub-sections are open to an array of economic, political, social, and international pressures from the much broader external environment. These influences can have a direct impact on the accounting practices of corporations as well as an indirect impact by influencing the key players in the organizational interface. Each of these elements is discussed in the following section.

Economic influences

Factors in the economic environment, such as economic policies and development, inflation, and capital market developments, can influence the level of disclosure practices in organizations (Archambault and Archambault, 2003). The growth of corporations is closely associated with the development of the economy. Hence, when an economy is more developed, corporations tend to raise more capital by disclosing more information. For example, Salter (1998) reveals that average disclosures at firm level are higher in developed countries than in emerging markets. Further, Meek and Saudagaran (1990) identify inflation as factor that influences reporting practices. Since the historical cost assumption becomes meaningless under conditions of inflation, corporations tend to increase disclosure to further assist investors (Archambault and Archambault, 2003). Finally, as discussed under capital markets, the nature of capital markets and the capital market regulations influence the disclosure levels of listed corporations (Doupnik and Salter, 1995).

Political influences

Political influences can have an impact on organizations' accounting practices. For instance, Burchell *et al.* (1985) show that value added reporting in U.K. was largely influenced by political agenda. Stoddart (2000) explains the political influences in changes to setting Australian accounting standards that show a substantial shift in power from the professional accounting bodies to the government. Further, the level of disclosures tends to be connected with political freedom (Belkaoui, 1983). The main features of political freedom, such as political rights,⁸ civil liberties,⁹ and political structure (e.g., democracy or monarchy), influence the propensity to disclose more information by corporations (Archambault and Archambault, 2003). The absence of such features in the political environment of a country can lead to limited disclosure of accounting information.

Social influences

Research shows that there is a relationship between social context and the nature of disclosure of corporations. For instance, Archambault and Archambault (2003) argue

⁸ Ability to participate in the political process through such means as voting

⁹ Individual freedom from state control

that level of education and religious beliefs can influence corporate disclosure. As the level of education increases, the number of users of accounting information would increase (Doupnik and Salter, 1995). Hence, disclosure levels would increase following an increase in the level of education. Further, religious beliefs can have an impact on the accounting and reporting practices. For example, Hamid, Craig and Clarke (1993) reveal that the Islamic tradition places ethical/social activity ahead of individual profit maximization. In such societies, trust underlies relationships, reducing the need for accounting as a means of financial reporting. Cultural context and ethical relativism can also have an influence on reporting practices (Adams, 2002; Uddin and Choudhury, 2008). Culture tends to have an impact on the moral values of people in a society, which in turn influence what corporations would select as worthy of reporting. For example, cultural factors could be used to explain differences in environmental concerns, the strength of green politics, and demands for corporations to act in socially responsible ways (Adams *et al.*, 1998).

International influences

International pressures for accounting practices have been significant in recent times due to rapid developments taking place in the global business environment (see Elsayed and Hoque, 2010). In particular, the trend towards convergence of financial reporting standards at the global level largely influences the reporting and disclosure practices of organizations (Elsayed and Hoque, 2010; Judge, Li and Pinsker, 2010). Earlier, Susela (1999) examined the conflicts and tensions within the Malaysian accounting profession in the accounting standard setting process. She identified four interacting factors within the local and the global context (the state, the profession, the market, and the community) which influenced and were influenced by the accounting standard setting process. Further, large corporations such as multinational companies and companies with foreign operations are likely to disclose more information to acquire foreign resources such as labour and capital (Archambault and Archambault, 2003). For example, Zarzeski (1996) reveals that corporations disclose more information when they have large relative foreign sales, in order to acquire necessary resources.

This section has detailed the contextual influences on accounting. For this purpose, contextual influences were classified into internal organizational factors and factors related to the organizational interface and the external environment. The use of

accounting in corporate governance could be expected to have a favourable influence on the performance of any type of organization. The next section describes the ways in which banks could benefit by using accounting in corporate governance.

2.6. Expected outcomes of effective use of accounting in corporate governance of banks

As in any other type of organization, corporate governance plays an important role in a bank to safeguard the interest of its stakeholders. As outlined in Section 2.5.1, the information generated through external reporting, external auditing, management accounting and internal auditing is useful to various corporate governance mechanisms. The use of accounting information in facilitating the operation of corporate governance mechanisms can lead to a number of desirable outcomes at organizational and country levels.

At the organizational level, both shareholders and depositors would be secured, as properly established accounting systems and good corporate governance practices direct bank managers to make sensible investment decisions and avoid wealth expropriation. The BOD could use such information to direct the bank and monitor the activities of managers for better performance. Financial performance parameters could also be effectively utilized in setting MCP to align the interests of the managers with those of the shareholders and depositors. Moreover, accounting information would provide evidence to ensure that banks are governed in accordance with the applicable laws and regulations. Furthermore, availability of relevant and reliable information to shareholders and depositors would assist them in monitoring the bank more rigorously. Finally, accounting information helps to discipline managers in labour and product markets.

At the country level, properly governed banks could lead to efficient allocation of limited resources (Bushman and Smith, 2003; Francis, Huang, Khurana and Pereira, 2009). For instance, bank managers could use accounting information for better project selection and efficient management of assets, such as timely abandonment of loss making projects. Such information could also reduce the expropriation of investors' wealth by managers. This is particularly important in countries where banks play a

significant role in financing corporations. In such countries, proper selection of lending projects by banks also ensures the efficient allocation of limited resources in the economies. Finally, this would assist in the establishment of a stable banking industry, which is an important parameter of financial sector development in any country, contributing to its economic development.

The expected outcomes discussed in this section are more applicable to banks in developing countries. Banks in developing countries are usually the main depository for economy's savings in the absence of developed capital markets, and they thus play a significant role in financing corporations. However, they are characterized by a number of specific accounting and corporate governance concerns that can have an impact on the role of accounting in corporate governance. Such concerns are discussed in the following section.

2.7. Accounting and corporate governance concerns related to banks in developing countries

The literature suggests that banks in developing countries have their own accounting and corporate governance concerns.

Developing countries seem to have followed two approaches in the development process, namely central state planning and market based development strategies (Hopper and Hoque, 2004). Initially, they tended to rely on government ownership of enterprises including banks. Hence, accounting was intended to provide economic information for decision making and control at both enterprise and state levels. Subsequently, developing countries have focused on the market based development strategy, under which private ownership and capital markets were diffused to facilitate economic development via efficient allocation of resources.

However, both strategies seem to have their own problems in the context of developing countries. Under the former strategy, accounting appears to be marginalized and unreliable due to heavy government involvement as the owner as well as the regulator (Levine, 2004; Nam, 2004). Further, high government ownership of banks is associated with extensive political intervention (La Porta, Lopez-De-Silanes and Shleifer, 2002;

Reaz and Arun, 2006). Governments in developing countries can misuse banks' funds to support their political cartels through politically influenced managers (Arun and Turner, 2004). For example, high risk credits can be approved to political groups, undermining the credibility of depositors and increasing the risk of banking crisis. Politically influenced managers can also expropriate the wealth of the owners (i.e. taxpayers) and may seek to advance their political careers by catering to special interest groups (Shleifer and Vishny, 1997). Finally, managers of the government owned banks are typically bureaucrats, who can be risk averse by nature, with implications for wealth maximization of the owners (i.e. taxpayers) (Arun and Turner, 2004; Fan, 2004).

The adoption of market based strategies has tended to divest government ownership of banks in developing countries. The privatization schemes have taken place to various degrees, raising different corporate governance issues (Arun and Turner, 2002; Fan, 2004; Shen and Lin, 2009). When banks are completely privatized, introducing necessary procedures to protect depositors and prevent financial crashes becomes important. When banks are partially privatized, opportunities arise for the government as the major shareholder to expropriate minority shareholders. Hence, the corporate governance concerns of government owned banks cannot be completely eliminated by partial divestment (Arun and Tuner, 2002; Shen and Lin, 2009). For example, Arun and Tuner (2002) argue that the partial divestment of public sector banks in India was not successful in terms of improving the quality of corporate governance mechanisms.

Parallel to the adoption of market based development strategies, accounting and corporate governance reforms (e.g., international accounting and auditing standards, and international guidelines and best practice in corporate governance) have also been introduced to developing countries (Vaughn and Ryan, 2006; Uddin and Choudhury, 2008). However, empirical research raises doubts about the effectiveness of such reforms. For example, Tsamenyi and Uddin (2008) argue that corporate governance practices introduced to developing countries are largely based on the corporate governance guidelines developed in the West, which may not be applicable in developing countries. Further, Hooper and Morris (2004) claim that there were deficiencies in the application of financial reporting standards brought about by the World Bank policies in the wake of financial liberalization reforms, leading to a gap

between the intended objectives of financial liberalization and the actual corporate governance and financial reporting practices.

Family ownership and the size of corporations in developing countries are also likely to have a negative influence on the effectiveness of the convergence programs to international corporate governance and financial reporting practices. For instance, Hooper and Morris (2004) argue that financial liberalization reforms could fail if they do not address the issue of family ownership, which gives undue power and access to information to a small number of individuals in many transitional economies. Family ownership of banks is more common in developing countries than in industrialized countries. These banks seem to have performed poorly in recent times; for example, some of the banks that were hit by the Asian financial crisis were parts of large family owned business groups (Nam, 2004). Further, small and medium enterprises including banks can affect the drive to convergence of international corporate governance and financial reporting practices. For example, Singh and Newberry (2008) argue that the current standard setting process does not provide accurate voice for developing countries where small and medium enterprises are common. This raises doubts over the applicability of international corporate governance and financial reporting practices to small and medium size banks in developing countries.

Regulation of banks is another strategy adopted by developing countries in recent times (Arun and Turner, 2004; Levine, 2004; Nam, 2004; Reaz and Arun, 2006). For example, in the absence of deposit insurance schemes to protect depositors in those countries, governments impose prudential regulations, including the requirement to hold capital proportionate to their risk takings, early warning systems, bank resolution schemes, and requiring banks to be examined on on-site and off-site bases by bank supervisors (Arun and Turner, 2004). Nevertheless, empirical research findings suggest that these reforms have not been useful. For example, Reaz and Arun (2006) argue that developing countries face problems of lack of prudential regulation as well as poor implementation of such regulations. Moreover, Arun and Turner (2004) raise doubt over the effectiveness of existing prudential supervision, for various reasons such as the lack of suitably trained supervisors and the unreliability of accounting information on which the prudential supervision is carried out.

The discussion in this section of the specific accounting and corporate governance concerns related to banks in developing countries suggests that accounting and corporate governance problems in developing countries are caused by contextual factors prevailing in those countries. The wider economic, political, social and institutional contexts implicitly distinguish the role of accounting in corporate governance in developing countries and industrialized countries. The next section presents a framework for analysing the role of accounting in the corporate governance of banks, using the concepts discussed in Sections 2.2 to 2.7.

2.8. Proposed framework for the study

The proposed framework incorporates various corporate governance mechanisms, facilitated by four sub-disciplinary areas of accounting, and the contextual factors influencing the role of accounting. It also highlights the outcomes of having corporate governance of banks.

Following the notions of agency and stakeholder theories and based on the literature related to corporate governance (see Sections 2.3 and 2.4), various internal and external corporate governance mechanisms of banks are incorporated into the framework. The important internal corporate governance mechanisms include the BOD, as suggested by the Basel Committee on Banking Supervision (2006), and MCP. Recall from Section 2.4.3 that the BOD oversees the activities of managers and provides strategic guidance to the banks. MCP are used to align the interests of managers with those of shareholders and depositors of banks.

The important external corporate governance mechanisms, including laws and regulations, shareholder monitoring, debtholder monitoring, labour markets and product markets, are incorporated in the framework (see Section 2.4.3). Market for corporate control has been excluded from the framework due to the high level of regulation and opacity prevailing in the banking industry. Laws and regulations constitute an important corporate governance mechanism in the banking industry. Given the significance of the industry to the financial system and the economy as a whole, governments usually enforce various laws and regulations for proper functioning of banks. Since the ownership of banks is normally restricted to a maximum shareholding percentage, large

shareholders in banks are almost non-existent. This gives the motivation and ability¹⁰ to all shareholders to monitor the banks and to react negatively to excessive risk takings. Debtholders of banks, including depositors and debenture holders, constitute another important external corporate governance mechanism. For instance, depositors, particularly large depositors, have a strong incentive to monitor the activities of banks in the absence of a deposit insurance cover. The labour market for CEOs and senior management can also act as an important corporate governance mechanism, due to their reputation concerns in terms of retaining their present employment and seeking opportunities for career development. Finally, product market competition prevailing in the banking industry forces bank managers to manage their banks efficiently, and thus can be a useful corporate governance mechanism ensuring goal directed behaviour of managers.

Accounting has the capacity to facilitate the operation of various internal and external corporate governance mechanisms of banks. The framework identifies four broad areas of accounting as identified in Section 2.5.1, namely external reporting, external auditing, management accounting and internal auditing, which could contribute to corporate governance mechanisms.

The framework acknowledges that the potential role of accounting in corporate governance can be moderated by various contextual factors. Following the notion of contingency theory, such contextual influences are recognized in the framework by classifying them into three levels, namely internal organizational factors and factors related to the organizational interface and the external environment, as discussed in Section 2.5.3. The role of accounting in the corporate governance of banks is influenced by internal organizational factors such as firm characteristics, institutional processes, and organizational and behavioural contexts. Further, in the organizational interface, several key players such as regulatory bodies, professional accounting bodies, capital markets, and other key stakeholders such as media, depositors/associations, customers/borrowers, and formal representatives of social interests may exert pressure on financial reporting and corporate governance practices of banks. Finally, factors in both the internal organization and the organizational interface are open to an array of

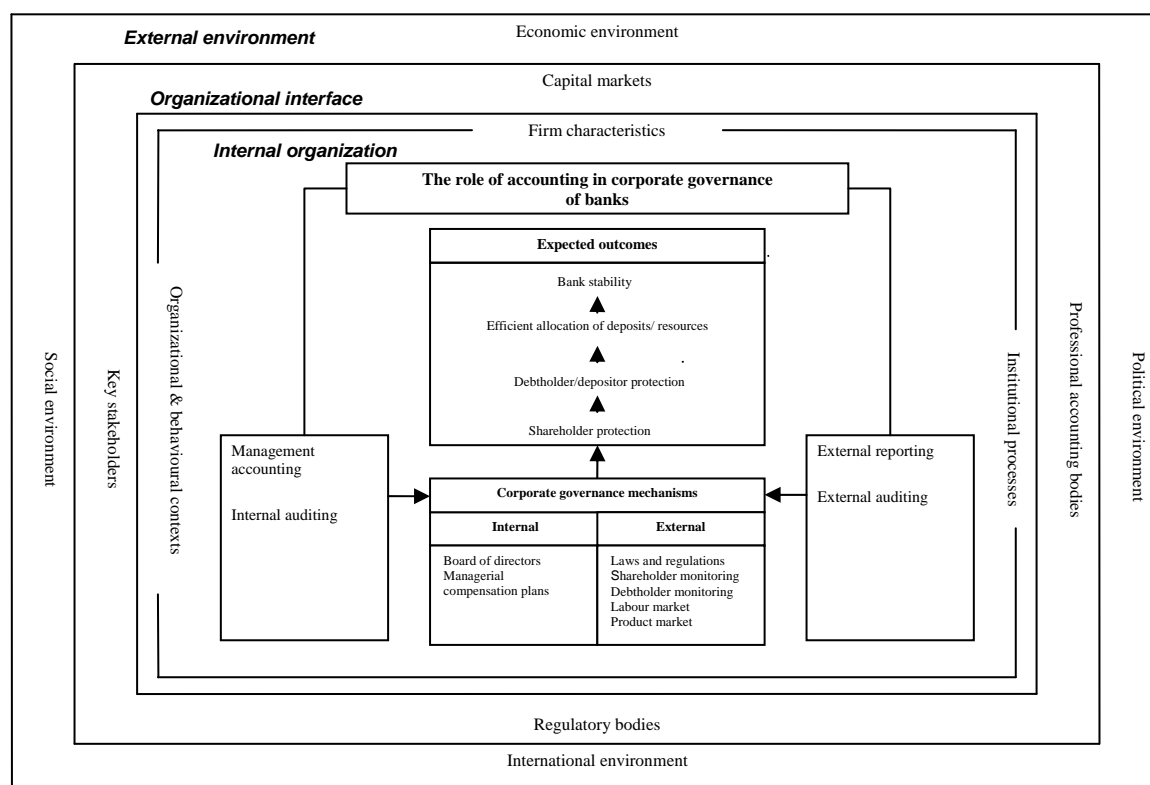
¹⁰ E.g., Shareholders from voting coalitions could gain sufficient clout to be activist investors to discipline incumbent management in the wake of bank underperformance (see Crespi and Renneboog, 2010).

political, social, economic and international pressures from the external environment. These factors can have a direct influence on the role of accounting in corporate governance, and an indirect influence on this role through the influence on the factors in the organizational interface.

The efficient use of accounting in corporate governance mechanisms could lead to a number of desirable outcomes, as described in Section 2.6. At the organizational level, the availability of relevant and reliable accounting information for the operation of various internal and external corporate governance mechanisms could ensure shareholder and depositor protection. Further, at the country level, this could lead to an efficient allocation of limited resources, and to the establishment of a stable banking industry.

Incorporating the features outlined above, Figure 2.1 provides a framework to analyse the role of accounting in the corporate governance of banks.

Figure 2.1: An analytical framework to examine the role of accounting in corporate governance of banks



Using the analytical framework presented in Figure 2.1, the checklist in Appendix 2 was developed. The checklist can be used to assess the role of accounting in the corporate governance of banks.

2.9. Summary and conclusions

This chapter reviewed the literature related to accounting and corporate governance, with the aim of developing a framework to examine the role of accounting in the corporate governance of banks. For this purpose, literature was drawn from several streams. First, the general literature related to corporate governance was reviewed to provide an understanding of the meaning and the importance of corporate governance. This review helped to identify various corporate governance mechanisms which are established to align the interests of corporate managers with those of shareholders. Those corporate governance mechanisms are internal (e.g., BOD, MCP) and external (e.g., laws and regulations, shareholder monitoring, debtholder monitoring, market for corporate control, labour market, product market) to corporations.

Second, the relevant literature was reviewed to examine the corporate governance in the banking industry. This literature suggests that a broader view of corporate governance, taking account of the interests of depositors (in addition to the interests of the shareholders) is more suitable for examining the corporate governance of banks compared to non-bank firms. It also reveals that specific features of banks, namely leverage, opacity and regulation, have implications for most of the typical corporate governance mechanisms.

Third, the literature on the role of accounting in corporate governance was also examined. Although accounting and corporate governance play interdependent roles in corporations, specific attention was given to providing an understanding of the role of accounting in corporate governance mechanisms. The review of this literature suggests that four broad areas of accounting, namely external reporting, external auditing, management accounting and internal auditing, have the capacity to facilitate corporate governance. However, the review of this literature reveals that the potential role of accounting can be moderated by various contextual factors at three levels, namely internal organizational factors (firm characteristics, organizational and behavioural

contexts, institutional processes), and factors related to the organizational interface (regulatory bodies, professional accounting bodies, capital markets, other key stakeholders) and the external environment (economic, political, social, international).

Fourth, the review of literature suggests a number of expected outcomes of the functioning of the role of accounting in corporate governance of banks. At the organizational level, realization of the role of accounting in corporate governance could contribute positively to shareholders and depositors. At the country level, it could lead to the efficient allocation of resources and the maintenance of bank stability.

Fifth, as the study focuses on developing countries, special attention was given in the literature review to identifying specific accounting and corporate governance concerns related to banks in those countries. The literature review suggests that the accounting and corporate governance practices of banks are influenced by economic, political, social and industrial factors prevailing in such countries.

Finally, this chapter presents a framework for analysing the role of accounting in the corporate governance of banks. This framework was developed by incorporating the notions of several theories (i.e., agency, stakeholder and contingency theories) and the literature related to accounting and corporate governance.

CHAPTER 3

RESEARCH DESIGN

3.1. Introduction

A review of accounting literature on methodological themes highlights different classifications of methodologies or approaches to accounting research. Such classifications include, but are not limited to (a) normative and positive research (Christenson, 1983); (b) rational accounting theory, critical accounting theory and ethnographic or interpretive research (Jonsson and Macintosh, 1997); (c) traditional (i.e., scientific) and alternative (e.g., interpretive-naturalistic) approaches (Lye, Perera and Rahman, 2006); and (d) qualitative and quantitative research methodologies (Moll, Major and Hoque, 2006).

This study follows qualitative research methodology to permit the examination of complex relationships pertaining to the research question as set out in Section 1.3. Maxwell (2005) provides a clear distinction between qualitative and quantitative approaches to research, in which qualitative studies examine “*how x plays a role in causing y*”¹¹ as opposed to quantitative studies, which test “*whether variance in x causes variance in y*”. Further, the researchers in accounting who follow a qualitative research methodology claim that this approach is more suitable to studying how accounting and control systems interact with their environment (e.g., Hopwood, 1983).

Regardless of whether a study adopts qualitative or quantitative research methodology, the quality of any research study depends largely on how it is designed. The research design consists of research method, data collection and analysis, and reporting (Humphrey and Lee, 2004). A researcher can choose from a number of research methods, including experiment, survey, archival study, field study and ethnography. Similarly, when analysing data, researchers have the choice of statistical testing or analysis using an interpretational framework. Since the research design affects the

¹¹ In this study, “how accounting plays a role in corporate governance”

validity and reliability¹² of the study and the overall quality of the research, it is important that a researcher carefully designs the study prior to its commencement. This is particularly important for qualitative studies, because of the potential for the study to be influenced by various types of bias, such as the researcher's bias in collecting and interpreting data.

The main determinant of a research design is the purpose of the study (Yin, 2003). For instance, if a researcher aims to examine a certain issue by using a large population, a survey method is more appropriate. It generally uses a structured questionnaire for data collection, and data are analysed using statistical techniques. If the aim is to undertake in-depth investigation of the phenomenon, research methods such as case studies and ethnographies are more suitable.

This study aims to examine how accounting contributes to the corporate governance of banks in Sri Lanka. The study requires in-depth analysis as there are no linear relationships between the phenomena. For instance, accounting can play a functional as well as a dysfunctional role in banks, and may or may not facilitate corporate governance, due to various contextual influences. Therefore, this study adopts the case study method. Ethnographies usually require long periods of time in the 'field' and emphasize detailed observational evidence (Yin, 2003), which was not considered for this study due to the researcher's time constraints.

The chapter is structured as follows. The next section explains the rationale for using the case study method. Section three describes methods adopted in data collection. The final section discusses the procedure adopted in the study to organize the data for analysis.

¹² Validity and reliability have been widely used as the criteria for determining the quality of qualitative research (Berry and Otley, 2004; McKinnon, 1988; Yin, 2003). Validity is concerned with the question of whether the researcher is studying the phenomenon she or he purports to be studying, and reliability is concerned with the question of whether the researcher is obtaining data on which she or he can rely (McKinnon, 1988).

3.2. Research method

The study adopts case study research method to examine the research question stipulated in Section 1.3. This method facilitates a holistic and meaningful examination of the phenomenon investigated (Adams, Hoque and McNicholas, 2006; Cooper and Morgan, 2008; Yin, 2003), namely, how accounting contributes to the corporate governance of banks. Yin (2003) defines the case study research method as an inquiry that copes with a technically distinctive situation, in which there will be many more variables of interest than data points; that relies on multiple sources of evidence, with data needing to converge in a triangulating fashion; and that benefits from the prior development of theoretical propositions to guide data collection and analysis. The study phenomenon appears to be complex, as there are many other factors that influence the level of corporate governance of banks. With its ability to triangulate data from multiple sources, the case study research method is capable of capturing such a complex relationship in a real-life situation. Further, the analytical framework presented in Section 2.8, which incorporates various contextual factors, provides the theoretical basis for the data collection and analysis in the study.

The social science research tradition, including accounting research, employs a number of research methods, including case study, survey, and experiment. Each method follows a different approach for collecting and analysing data (e.g., the survey method collects data from cross-sectional surveys and statistical techniques are used to analyse the data), and has its own advantages (e.g., the survey method allows the gathering of data from a large population) and disadvantages (e.g., the survey method does not allow in-depth investigation of the phenomenon). For deciding a suitable method in social science research, Yin (2003) suggests three criteria, namely the type of research question posed, the extent of control an investigator has over actual behavioural events, and the degree of focus on contemporary as opposed to historical events.

Based on the above criteria, case study research method is considered appropriate in answering ‘how’ and ‘why’ research questions to investigate the phenomenon under investigation, and it does not require control over behavioural events (Cooper and Morgan, 2008; Yin, 2003). As stated above, the research question of the study is descriptive in nature, and it focuses on how accounting contributes to the corporate

governance of banks in Sri Lanka. The case study research method is more suitable for the study compared to, for example, the survey and the experiment methods. The survey method also satisfies the last two conditions, but it is more suitably employed to predict certain outcomes, and the research questions usually begin with 'who', 'what', 'where', 'how many' and 'how much'; the experiment method examines similar types of research questions, such as 'how' and 'why', but it requires control over behavioural events.

The case study research method involves an in-depth investigation of the phenomenon within real-life situations (Adams *et al.*, 2006; Cooper and Morgan, 2008). For instance, it could be used in an interpretive fashion to provide wider and richer understanding of accounting practices in real organizational setups. It uses data collection techniques, such as interviews, which can generate rich data to describe, translate, analyse and infer the meanings of events or phenomena occurring in the organizational setup (Adams *et al.*, 2006; Cooper and Morgan, 2008; Horton, Macve and Struyven, 2004). The face-to-face interviews also provide the researcher with opportunities to study the body language of the participants and make a judgment on the reliability of information. Such an in-depth investigation could not be undertaken by other methods such as survey and experiment. For example, the survey method may not be suitable to undertake an in-depth investigation from a large population, due to cost and time constraints of the researcher. Further, the experiment method requires an artificial environment and cannot be undertaken in an actual organizational setup.

The purpose of the case study research method is not to generalize the results to a large population. Case studies, like experiments, are generalizable to theoretical propositions (i.e., analytic generalization) rather than populations or universes (i.e., statistical generalization) (Yin, 2003). The purpose of the case study investigation is, therefore, to expand the theory, and not to undertake statistical generalization (Burns, 2000). In this study, two case studies were undertaken to investigate the study phenomenon, and the analytical framework in Section 2.8 provided the theoretical basis for data collection and analysis. Hence, the results of the study can be used to expand the theory proposed by the analytical framework, instead of generalizing them to a population.

The study follows descriptive case study research method,¹³ as it describes a phenomenon in its real-life context. Descriptive case studies in accounting research describe accounting systems, techniques and procedures used in practice (Scapens, 2004). For instance, such studies can help in dealing with a detailed description of accounting control processes and explaining how the processes affect participants in practice. They can also help in making sense of a situation in its socio-political context; discovering how the experiences, words, feelings, attitudes and value judgments of the participants in an organization are implicated in the research question; and capturing individual differences or variations in perceptions about real-world practice (Adams *et al.*, 2006).

The study uses multiple-case studies. Two banks were selected as the case organizations, one each from the public and private sectors, to examine the role of accounting in corporate governance mechanisms. These are two ‘successful’ commercial banks in the public and the private sectors, and this study attempts to identify the ‘best’ accounting practices in the corporate governance of banks in Sri Lanka. Descriptive case studies have been popular in determining the ‘best’ practice in terms of the most common practice adopted by organizations, or the practice adopted by ‘successful’ organizations (Scapens, 2004). While accepting that there can be debate concerning what constitutes ‘best’ practice and ‘successful’ companies (Scapens, 2004), the selected organizations are leading banks from the public and the private sectors in terms of their accounting and corporate governance practices. This point is discussed in detail in Section 3.3.1.

The case study research method also has several limitations. For example, it can involve personal bias of the researcher in interpreting the context, difficulty in managing massive amount of documents, lengthy time required for some of the steps, and difficulty of obtaining confidential information (Adams *et al.*, 2006; Yin, 2003). However, there are ways in which the impact of such limitations can be minimized, and improve the validity and reliability of the study. For instance, a study can be linked with a theory to reduce the personal bias of the investigator. Further, proper case study notes can be maintained to manage the documents and the time spent on data analysis.

¹³ Yin (2003) classifies case studies into five types or applications, namely explanatory, descriptive, illustrative, exploratory, and meta-evaluation.

Finally, confidentiality of information is not necessarily a limitation in every case study research, as a study can be designed using only non-confidential information, without affecting its quality. The design of this study is discussed in detail in the next section.

3.3. Data collection

This section describes selection of case organizations, gaining access to the case organizations, and data collection procedures.

3.3.1. Selection of case organizations

The nature of the data depends on the research question addressed in the study (Yin, 2003). Special attention was paid at the time of formulating the research question to clearly recognize the units of analysis or cases for the study. The research question explicitly identifies that the cases for the study include banks in Sri Lanka. Two major commercial banks were selected as case organizations, a public sector commercial bank (hereinafter PUB) and a private sector commercial bank (hereinafter PRIB). This form of non-probability sampling is termed purposive or purposeful sampling, because the selected cases serve the purpose of the researcher of discovering, gaining insight and understanding the chosen phenomenon (Burns, 2000).

The method of selection of two banks for this study can also be described as extreme sampling. Extreme sampling involves selecting cases that are ‘information rich’ because they are unusual or special in some way, such as for their outstanding successes or notable failures (Patton, 2002). The two case organizations record impressive results in accounting and corporate governance practices over the years, and appear to represent the best possible private sector and public sector banks in Sri Lanka. PUB is a leading commercial bank in Sri Lanka, fully owned by the Government of Sri Lanka. It has won several awards in recent times for its accounting and corporate governance practices, such as the Annual Report Competition (ARC) gold award for its annual report in 2007, a gold award for the best presented public sector accounts by the South Asian Federation of Accountants (SAFA), and a bronze award for financial reporting in the banking sector by the Institute of Chartered Accountants of Sri Lanka (ICASL). PRIB is a leading private sector commercial bank in Sri Lanka, which has won a number of

awards from the ICASL for its annual reports (e.g., gold award for the banking sector consecutively from 2001 to 2007). It also won awards from the SAFA for the best presented accounts in the years 2001 and 2007. Since the study aims to examine the role of accounting in corporate governance, it was important to select banks with good corporate governance.

The sample also represents heterogeneity in ownership structure, which appears to be an important element of corporate governance practices. Patton (2002) states that heterogeneity aims at capturing and describing the central themes that cut across a great deal of variation. The purpose of selecting a public sector and a private sector bank for the study is to identify and discuss sector-specific accounting and corporate governance issues, and to undertake a comparative study between these two types of banks in Sri Lanka. For example, the dissimilar institutional arrangements and ownership structures of the two banks are likely to produce different case study findings. Further, the selection of a public sector bank is particularly important in the context of a developing country such as Sri Lanka, due to the high government ownership of banks in that countries, and the implications of such ownership for corporate governance.

3.3.2. Approaching case organizations

Gaining consent from organizations to access information for research purposes is a central problem in field-based research, for reasons such as lack of interest of the organization in the research question, confidentiality and sensitivity of information, and the background or style of the investigator (Perera, 2005). In this study, confidentiality and sensitivity of information seemed to be the factor in making the banks that were approached hesitant to give access. Because of the immense competition in the banking industry in Sri Lanka, banks in general do not release commercially sensitive information to outsiders. Further, corporate governance issues are mainly related to the board of directors (BOD) and the top management, and are considered commercially sensitive.

Gaining access to the two case organizations, therefore, was planned carefully. As an initial step, a considerable amount of time was invested in learning about the organization (for instance, the history, nature of its activities, and external influences on

the organization) from various sources, such as annual reports and banks' websites. Such an understanding enables a researcher to speak the language of the organization, and to demonstrate to the organization that an effort had been made to understand its background (Perera, 2005).

The two banks were initially approached using informal links. A former chairperson of a commercial bank in Sri Lanka (herein after "the facilitator"), known to the supervisors, played a significant role in securing access to the case organizations. On his advice the supervisors prepared two letters addressed to the CEOs of the two banks identified for this study, requesting permission to undertake the proposed study using their banks as case organizations. These letters were intended to be handed over to the CEOs by the investigator personally during his visit to Sri Lanka. During this visit, he was first introduced to the Deputy Governor of the Central Bank of Sri Lanka (CBSL) by the facilitator. This meeting was immensely useful, as the Deputy Governor of the CBSL directly contacted the CEOs of the two banks and introduced the investigator and the research. As a result of this meeting, the investigator was able to make appointments with the CEOs of the two banks. At the meetings with the CEOs, after explaining the aim and objectives of the study, the investigator requested permission to select their banks for the study. A summary of the research proposal and the letter from the supervisors requesting assistance were also presented to the CEOs at this meeting. The responses from CEOs were favourable, but both expressed concerns about providing any confidential and sensitive information. The investigator assured that the data sought from the banks would be limited to non-confidential information.

3.3.3. Methods of data collection

Data for the study were gathered from multiple sources, such as semi-structured interviews and documentary evidence. Each of these is described in the following subsections. This type of data triangulation in a single study assists the investigator to take advantage of the relevant points of each type of data, cross-check them, and collect information that is available only through particular techniques (Hopper and Hoque, 2006).

3.3.3.1. Semi-structured interviews

According to Patton (2002), interviewing is typically used to gather information in situations where the phenomenon cannot be directly observable. Semi-structured interviews were the main method of data collection for this study. The type of information sought in the study was related to personal experiences of interviewees of accounting and corporate governance practices in the case organizations. Hence, interviewing was the suitable method to capture such information.

Further, as interviewing focuses directly on the research question, it is regarded as an important source of data collection in case study research (Yin, 2003). It also provides greater flexibility, in both designing and refining the interview guide (Horton *et al.*, 2004). For example, open ended questions in interview guides give interviewees the flexibility to explain their thoughts and to highlight areas of importance. Interviewing also enables the researcher to gather additional information by using probing questions. Probing questions are situation-specific and are a powerful means of reducing threats to validity and reliability (McKinnon, 1988). Finally, interviewing provides an opportunity to the researcher to reveal issues that were not identified at the beginning of the research, and these issues can be further investigated (Horton *et al.*, 2004).

Semi-structured interviews were regarded as a correct approach for the study. Unstructured interviews would not be suitable, as all the interviewees were members of the board, senior managers and accountants, who work under time pressure. Further, as the study intended to apply theory based on the analytical framework, rather than build theory from the case studies, unstructured interviews were seen to be unnecessary. On the other hand, structured interviews would not allow exploration of important themes or areas not covered in the structured questionnaire.

The procedures followed to collect data through interviews are discussed in the following sub-sections in relation to the design and development of the interview guides, selection of participants, scheduling of interviews, and the interview process.

Design and development of interview guides

The interview guides were based on the analytical framework developed in Chapter 2 to examine the research question. As a first step, all possible relationships in the

framework were identified and classified under three main categories, namely accounting practices of banks, use of accounting information in corporate governance mechanisms in banks, and contextual factors influencing accounting and corporate governance of banks. Questions were constructed to capture the elements under each category. The first category of questions was developed to assess external reporting systems, management accounting information systems, external auditing and internal auditing practices of the banks. The second category of questions was developed with the aim of assessing the use of accounting information in corporate governance mechanisms, namely BOD, managerial compensation plans (MCP), laws and regulations, shareholder monitoring, debtholder monitoring, labour market and product market. The third category of questions was aimed at assessing the impact of the banking context, namely factors related to the internal organization, organizational interface and external environment, on accounting and corporate governance practices of banks.

The interview guide went through several iterations before it was finalized. After completion of the first draft a number of problems were identified. It came to light that interviewees would need special knowledge to respond to some of the questions in the interview guide. It also became clear that there was room to improve the flow of questions. For instance, questions about the management accounting information system and the use of such information by the BOD were under two headings, and would have been raised at two different times during the interviews. Moreover, it was found that there were some repetitions of questions, mainly due to the close connection of several elements. For example, performance evaluation of managers (labour market) and MCP are usually linked in most organizations, and therefore some of the questions encompassed more than one issue.

The interview guide was subsequently amended. Three separate interview guides were designed to use for interviews with accountants, members of the BOD and managers, instead of having one interview guide to be used for all three groups.¹⁴ Further, the order of the questions was rearranged to provide a better flow during the interviews. For

¹⁴ However, some questions were common to the three interview guides, as they could be answered by interviewees of all three categories.

instance, questions were organized under three headings: first to discuss the accounting and corporate governance issues, then auditing and corporate governance issues, and last the influence of the environmental context on accounting and corporate governance. Finally, repetitive questions were excluded, and some of the questions were redefined and split into more than one question for easy understanding.

The interview guide for accountants was aimed at gathering information about the accounting and corporate governance practices of the banks (see Appendix 4). More specifically, since accountants' responsibility is to prepare and present accounting information, questions in the interview guide sought to assess the accounting systems in the banks and the types of information generated through such systems. Additionally, several questions were aimed at identifying the context in which the banks operated, as they would influence the accounting and corporate governance practices of the banks.

The interview guide for members of the BOD was mainly aimed at assessing the use of accounting information in corporate governance by this category (see Appendix 5). For instance, this interview guide included questions about the availability of accounting information to the BOD, and how such information is used by the BOD to direct the bank and monitor the performance of managers.

The interview guide for managers was aimed at assessing the availability of accounting information to them, and the extent to which they used such information more specifically for planning, control and decision making purposes, and in general in assisting corporate governance mechanisms (see Appendix 6). For example, the information gathered from them was useful in evaluating the role of accounting in MCP and labour market. Further, this information was triangulated with the information received from the other two categories to improve the validity and reliability of the study (see e.g., McKinnon, 1988).

The interview guides were sent to the two case organizations well in advance of the interviews. This action was expected to help the CEOs to overcome their concern about the level of confidentiality of information sought by the investigator. Making the interview guides available to case organizations prior to commencement of the interviews had several advantages. The case organizations were given the opportunity to

raise concerns about any questions in the interview guides, so that such questions could be amended or deleted from the final version of the interview guides. It also eliminated possible misunderstanding by the banks' management towards the research project. When it became clear to the banks that the research project was unlikely to have any negative impact on their competitiveness, and also that the findings could be useful to them, they showed positive responses thereafter (see e.g., Perera, 2005). No objections were raised by the case organizations with regard to the questions incorporated in the interview guides.

Selection of participants

The interviewees sought for this study represented three categories, namely accountants (eight from each case organization), managers (four from each case organization) and BOD members (three from each case organization). Thirty semi-structured interviews were scheduled. Given the focus of the study on the role of accounting in corporate governance, it was decided to interview more accountants than the other two categories. However, PRIB restricted access to the members of the board.¹⁵ Therefore, eventually only twenty-seven interviews were conducted. All the interviewees held senior management positions. In particular, the accountants selected were the most senior and experienced staff in the two case organizations, and the investigator was therefore able to obtain comprehensive and reliable information during the field study.

Selection of suitable interviewees representing the three categories was a major part of the data collection procedure. The initial plan was to identify the interviewees before visiting Sri Lanka for data collection, in order to effectively utilize the time available for the field study. For this purpose, assistance was sought from the CEOs of the two case organizations. However, only the CEO of PRIB responded to this request, sending a list of potential participants. Therefore, selection of the participants in PUB had to be postponed until the investigator visited Sri Lanka for the field study. The advantage of getting assistance from the CEOs in selecting interviewees was that they would select more suitable interviewees, as they were well aware of their top management and senior staff. However, there was a possibility that they would select a biased sample, which

¹⁵ To address this issue, additional questions were incorporated in the interview guide for accountants, to assess the availability of accounting information for the BOD, and their use of such information in directing the bank and monitoring the performance of its managers.

would have an impact on the validity and reliability of the study. To minimize the threats to validity and reliability on this issue, probing questions were included in the interviews.

The investigator could not meet the CEO of PUB after arriving in Sri Lanka, to identify prospective participants for the study, due to his time constraints. To select potential participants from PUB, the investigator obtained the details of the structure of the accounts department and the names of a number of its senior accountants informally through a senior manager of PUB who had some previous connection with the investigator.

Participants were also identified through the 'snowballing' method (see e.g., Horton *et al.*, 2004). McKinnon (1988) distinguishes participants as informants and interviewees. The former category provides general background data on the organization and the people in it, whereas the latter category provides more specific information about the phenomenon of interest to the researcher. Informants were used to identify the prospective interviewees during the field visits. They were also helpful in obtaining background information about the case organizations. The interviewees who were selected by this method included four from PUB (three managers and one member of the board) and three from PRIB (two managers and one accountant), and they were found to have the experience and knowledge to answer the questions in the interview guides.

Scheduling of interviews

The initial plan was to schedule all the interviews before leaving for Sri Lanka for the field study. Difficulties arose, however, in selecting participants and scheduling interviews. For instance, the investigator was unable to obtain a list of potential participants from PUB, and the majority of potential participants identified by the CEO for this study in PRIB did not confirm their participation before the investigator arrived in Sri Lanka to conduct the field study.

To schedule the interviews in PRIB before leaving for Sri Lanka, an initial email was sent to all prospective interviewees in the CEO's list, inviting them to participate in the study. This email contained all relevant information regarding the research project. It

included, among other things, details about the investigator and the supervisors, a brief description of the research project, the fact that formal approval for the study had already been granted by the bank, the type of information sought, and assurances of confidentiality about the names of the participants and the information provided. They were requested to indicate their consent to participate in the study by responding to the email. A reminder was sent after two weeks to those who did not respond to the initial email. However, this initial attempt was not successful, as only four prospective participants responded: three agreed to participate, and the fourth stated that she did not wish to take part in the study due to heavy workload during the end of financial year. This led to an approximately thirty-three percent response rate at this initial point of contact. Interview guides were sent to those who agreed to participate via email, and they were asked to nominate a convenient time slot to conduct the interview.

Within the first two weeks during the field visits, the investigator was able to complete two of the three interviews scheduled in PRIB. The attempt to meet the CEO of PRIB was not successful due to his busy schedule. However, the investigator had the potential participants list of PRIB. This list was shown to a senior academic in Sri Lanka known to the investigator to see if he recognized any names. He personally contacted one person that he recognized from the list and requested his assistance for the research project. As a result, this person agreed not only to be interviewed, but also helped to introduce other suitable individuals for interviews, including those who were in the CEO's list in PRIB. The information they provided was very useful. Hence, the investigator benefited by way of snowballing effect (see Horton *et al.*, 2004).

The information obtained from the senior manager of PUB was used to schedule the interviews in that organization. With this information, the investigator met the Board Secretary of PUB, who attended the initial meeting with the CEO to seek permission to access the bank. This meeting was very successful, as she personally organized every meeting with the accountants, managers, and BOD members including the chairperson and the CEO of PUB. Ultimately, the investigator was able to conduct all fifteen interviews as planned, and productively utilize the time in PUB.

The failure to schedule the interviews in advance caused several disadvantages during the field study. The investigator had only a limited time to undertake interviews and

gather other relevant information for the study. It was crucial that the investigator commenced the interviews early, to be able to spend more of the two months budgeted for data collection on the research sites and effectively utilize the field study duration. Further, advance scheduling would have ensured that a sufficient number of interviewees were selected for the interviews, thus promoting a higher level of validity and reliability of the study. Finally, the plan was to send the interview guides to the interviewees before the interview times. That might have facilitated more productive interviews, as the interviewees would have had more time to prepare for the interviews (see Perera, 2005). It also could assure that more detailed and comprehensive answers were received most of the time (see Perera, 2005).

The process of interviewing

Every attempt was made to productively utilize the interview time without inducing psychological stress to the participants. Managing time appeared to be a crucial factor during the interviews, because all the interviewees participated in the study held senior positions and worked under time pressure (see e.g., Ferreira and Merchant, 1992). The interviews lasted approximately sixty to ninety minutes. Given their importance in the study, it generally took longer to interview accountants compared to other two groups of participants. In the first five to ten minutes, details were provided with regard to the investigator and the research project. Since the interviewees had also been provided with a copy of the interview guide at the time of arranging the interviews, they were reasonably prepared for a productive interview session.

Before commencing interviews, interviewees were provided with the Information and Consent Form, which was a requirement of the University Ethics Committee. It included information regarding the ethical aspects of the research project, such as measures that would be taken to maintain confidentiality, how to obtain a summary report of the findings of the study, and a statement indicating that participation was voluntary, and guaranteeing interviewees the right to withdraw from further participation at any time without any consequence. Upon agreement to participate in the study, two copies of the Information and Consent Form were signed by both the investigator and the interviewee, and one copy was given to the interviewee for their information. The investigator found this document useful in building the trust of the

interviewees, as it added official status to the research project. This was also expected to improve the reliability of information provided.

It was decided to audio record interviews whenever possible for a number of reasons. Hayes and Mattimoe (2004) identify several determinants for the decision to audio record or take manual notes, namely the nature of the research project, willingness of the interviewee to be taped, the interviewer's preference and competence, and benefits and drawbacks of each method. The study sought descriptive information regarding accounting and corporate governance practices of the case organizations, therefore audio recording was more appropriate than manual note taking. It also avoided inaccuracies due to poor recall and poor or inaccurate articulation (Yin, 2003). Further, since all the interviewees gave their consent to audio recording, it facilitated more systematic analysis of recorded data (see e.g., Perera, 2005).

Besides audio recording, additional notes were taken during or soon after each interview. Schatzman and Strauss (1973) suggest three types of notes that can be recorded during interviews: observational notes, which detail what the researcher hears and sees; theoretical notes, which develop ideas about the data in the observational notes; and methodological notes, which summarize the types of research strategy that have been followed. In this study, the investigator mainly took theoretical notes, as the need for observational notes was fulfilled by the audio recording. These notes represented a summary of important issues identified during the interviews, and were useful in analysing the interview transcripts and writing up the case reports. Such note taking not only provided a record of data, but also acted as a means through which the research was managed, and allowed control over threats to validity and reliability of the study (McKinnon, 1988).

The interview guides were generally followed in conducting the interviews, with variations in certain situations. For example, there were instances where the responses given by some interviewees to a particular question included their responses to several other questions in the interview guide. In such situations, the questions already answered by the interviewee were skipped. Further, probing questions were used during the interviews. Probing questions allowed the investigator to quiz the interviewee further about any unsolicited statements that were made, or about a response to a

specific question, and assisted the investigator to separate the factual (i.e., what the respondent had experienced or observed first hand) from the presumed (i.e., what the respondent assumed happened, based on hearsay and previous experience of similar instances) (McKinnon, 1988, pp. 51, 52).

The audio recorded interviews were transcribed verbatim. The interview transcripts were sent to those interviewees (thirteen of the total twenty-seven) who had requested the opportunity to review them in the Information and Consent Form, before they were used in the data analysis. Two interviewees returned their interview transcripts after making some minor changes, while the others accepted the original transcripts. These final versions of the interview transcripts were used for coding purposes, utilising the NVivo software.

3.3.3.2. Documentary evidence

The documentary evidence used in this study includes laws and regulations applicable to the banking industry in Sri Lanka, annual reports, and various publicly available documents, including media coverage and parliamentary Hansards. The following subsections describe each of these sources separately.

Laws and regulations

As identified in the analytical framework, regulatory bodies, professional accounting bodies and capital markets in the organizational interface, which administer the laws and regulations in the banking industry, tend to influence the accounting and corporate governance practices of banks. Hence, laws and regulations administered by these parties related to external reporting, external auditing and corporate governance in the banking industry were reviewed for this study. Moreover, this information was used to corroborate the evidence found from other sources, such as interviews. It was also useful in conducting interviews. For example, questions were asked during the interviews to ascertain the banks' level of implementation of such laws and regulations.

Annual reports

The review of annual reports was undertaken mainly to assess the financial and non-financial reporting practices of the case organizations. This information was

triangulated with the information collected from other sources. Further, such information was useful in identifying the differences in external reporting practices of public sector and private sector banks. Information given in the annual reports was also useful in developing questions in the interview guides. Finally, as described in Section 3.3.2, annual reports were useful in gaining background knowledge prior to approaching the case organizations.

Annual reports were reviewed for the twelve year period from 1997 to 2008. The first code of corporate governance was introduced to Sri Lanka in 1997. Hence, a review of annual reports from that year to date was expected to provide some insights into the development of corporate governance practices in the banking industry in Sri Lanka.

Publicly available documents

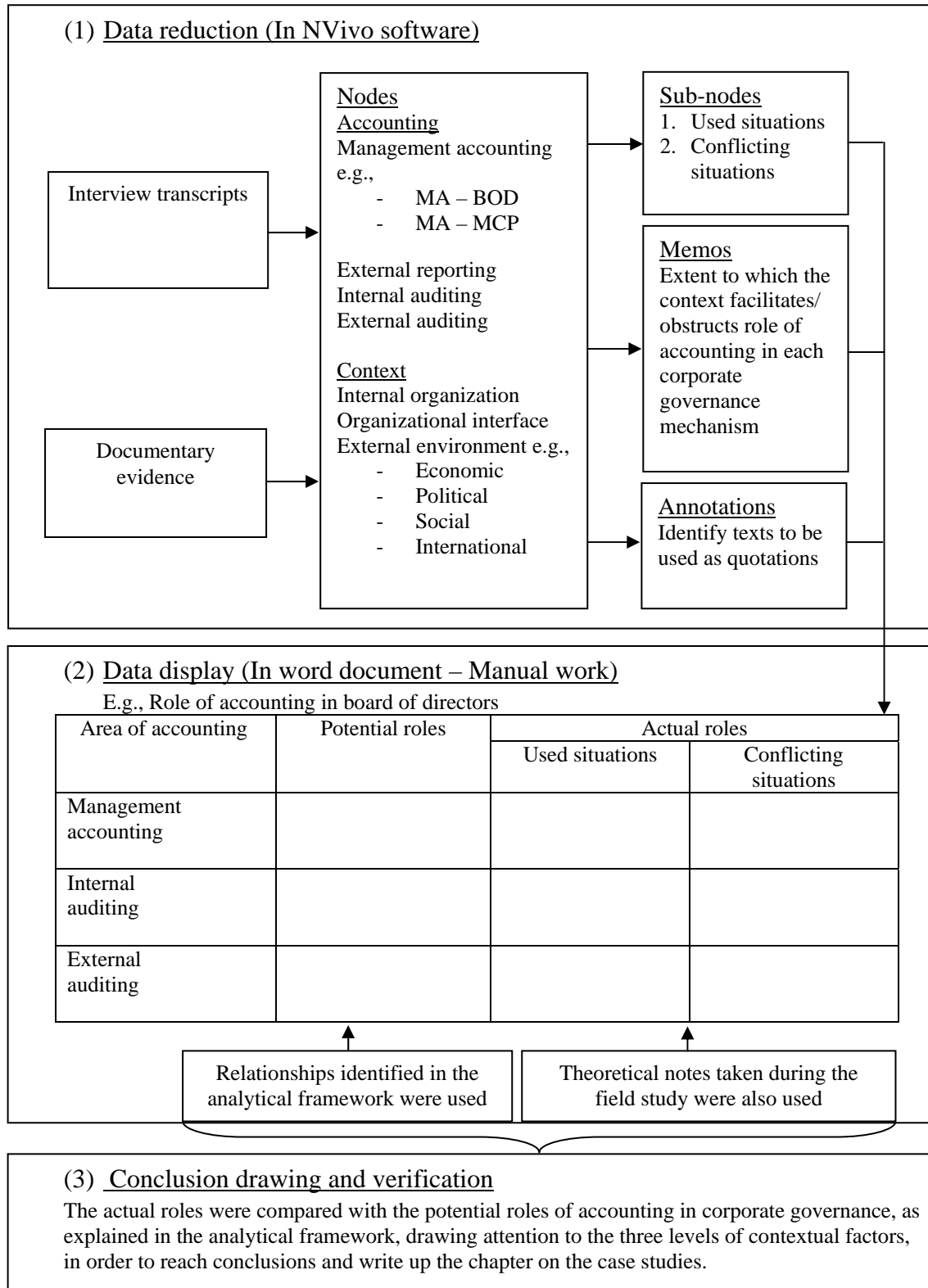
Publicly available documents about the banking industry and the case organizations were identified as another source that could provide useful information for the study (see e.g., Perera, 2005). In particular, reports published by the CBSL, the Fitch Ratings, and international organizations such as the World Bank and the ADB, in connection with the banking industry in Sri Lanka, provided useful information to evaluate accounting and corporate governance practices of banks. Further, the related parliamentary Hansards were gathered and reviewed. Finally, media reports are useful for corroborating other sources of information, helping to reinforce and validate such information (McKinnon, 1988; Yin, 2003). Newspaper items related to accounting and corporate governance practices in the banking industry and the case organizations were collected and reviewed for this purpose.

3.4. Data analysis

Like all other forms of data analysis, the analysis of qualitative data in case study research involves processes of reduction or summarization, classification and interpretation (Lillis, 1999). To minimize the impact of the weaknesses of case study research method, this study followed a systematic analytical protocol as suggested by Miles and Huberman (1994, p. 10) that includes three sequential activities: data reduction, data display, and conclusion drawing and verification. Figure 3.1 summarizes

and exemplifies the way Miles and Huberman’s (1994) analytical approach was used in this study.

Figure 3.1: Data analysis – Flows of activity



Data reduction

The first activity is data reduction, which is the process of selecting, focusing, simplifying, abstracting, and transforming the data from interview transcripts and documentary evidence (see e.g., Miles and Huberman, 1994). This in fact occurred even before data collection. More specifically, only applicable data were gathered from the interviews, as per the relationships identified in the analytical framework developed in the study. That is, the interviews captured data only with regard to the actual roles of accounting in the corporate governance of banks, while drawing attention to the three levels of contextual influences. Further data reduction occurred in the actual data analysis that was undertaken using the NVivo software under the following steps.

Nodes¹⁶

Interview transcripts and related documents were coded using the qualitative analysis package, NVivo. For this purpose, interview transcripts and documents were first uploaded into NVivo, and then coded by associating the sentences in the transcripts/documents with one or more themes defined in a hierarchical coding structure. In this way, each text unit was identified as relating to one or more predetermined thematic nodes. The hierarchical coding structure shown in Figure 3.2 reflects the initial codes used to classify text. No data reduction occurred at this stage. The aim was to classify all but the most superfluous data, relating the data to at least one thematic node (e.g., Lillis, 1999). The actual data reduction occurred in the next step, sub-nodes.

Sub-Nodes

The nodes under ‘role of accounting in corporate governance’ (see Figure 3.2) were sub-coded into situations where accounting facilitated corporate governance (i.e., used situations) and where accounting did not play its potential role in corporate governance (i.e., conflicting situations). These situations provided evidence on the extent to which accounting contributed to the corporate governance of the case organizations. At this stage of coding, data reduction occurred, because only the relevant texts were coded. These sub-nodes could be audited back to the transcript/document using the facility (link) given in NVivo. An audit trail from transcripts/documents to the results of

¹⁶ The name given in the NVivo software has been used in this study for coding.

analysis, through successive stages of data reduction and summarization, enhances the reliability of the study (Lillis, 1999). However, at this stage the sub-nodes did not identify the reasons as to ‘why’/‘why not’ accounting facilitated corporate governance in each of the situations. This requirement was fulfilled by writing memos, which was the next step in the data reduction process.

Figure 3.2: Data coding tree

Role of accounting in corporate governance	External reporting (ER)	ER – L&R	Contextual influences	Internal organization (IO)	IO – FC
		ER – SHM			IO – IP
		ER – DHM			IO – O&BC
		ER – LM		Organizational interface (OI)	OI – RB
		ER – PM			OI – PAB
	External auditing (EA)	EA – BOD			OI – CM
		EA – MCP		External environment (EE)	OI – KSH
		EA – L&R			EE – E
		EA – SHM			EE – P
		EA – DHM			EE – S
		EA – LM			EE – I
		EA – PM			
	Management accounting (MA)	MA – BOD			
		MA – MCP			
		MA – LM			
		MA – PM			
	Internal auditing (IA)	IA – BOD			
		IA – MCP			

Key: BOD – board of directors; MCP – managerial compensation plans; L&R – laws and regulations; SHM – shareholder monitoring; DHM – debtholder monitoring; LM – labour market; PM – product market; FC – firm characteristics; IP – institutional process; O&BC – organizational and behavioural contexts; RB – regulatory bodies; PAB – professional accounting bodies; CM – capital markets; KSH – key stakeholders; E – economic; P – political; S – social; I – international

Memos

Data interpretation occurred in this step. For each and every ‘used’ and ‘conflicting’ situation identified in the previous step, explanations were given by analysing and linking the nodes under ‘contextual influences’ into each of the situations (see Figure 3.2). For this purpose, the memo facility in NVivo was used; each memo explained the

extent to which the context facilitated/obstructed the role of accounting in corporate governance mechanisms in the case organizations. In addition to memos, annotations were also recorded.

Annotations

Annotations were recorded mainly to identify statements of interviewees and the documents to be used as quotations in the chapter on case studies. NVivo has this facility to trace such annotations in a later stage (e.g., in the report writing stage).

Data display

The second activity in data analysis is data display. Miles and Huberman (1994) describe display as an organized, compressed assembly of information that permits conclusion drawing and verification. A matrix was prepared to explain the role of accounting in each corporate governance mechanism. For instance, the structure of the matrix prepared for displaying data related to the role of accounting in BOD is shown in Figure 3.1. Three areas of accounting, namely management accounting, internal auditing and external auditing have the potential to facilitate the BOD's discharging of corporate governance responsibilities. These potential roles were identified in the analytical framework developed in Section 2.8. Based on the sub-nodes and the memos written, the actual roles were also identified in relation to these three areas of accounting by classifying them into 'used' and 'conflicting' situations. Summaries were written in each of the matrix cell indicating 'how' each area of accounting assisted the BOD to operate as a corporate governance mechanism; and 'why' each area of accounting did or did not facilitate corporate governance by specifically referring to the three levels of contextual influences, namely factors related to the internal organization, organizational interface and external environment. In the summaries of the actual roles of accounting, the theoretical notes taken during the field visits were also used. Since these matrices were written in the investigator's own words, they reflect some data interpretation and reduction. Matrices were designed to assemble organized information into an immediately accessible, compact form so that the investigator could see what was happening and draw justified conclusions (see Miles and Huberman, 1994).

Conclusion drawing and verification

The last activity in data analysis is conclusion drawing and verification. As discussed under the previous activity, the matrices provided the basis for drawing conclusions on the extent to which accounting contributed to corporate governance mechanisms in each case organization, and to writing the chapter on the case studies (see Figure 3.1). For this purpose, the actual roles of accounting were compared with the potential roles, and deviations were explained by referring to contextual influences.

The matrices prepared for individual corporate governance mechanisms for each case organization were merged to undertake a comparative analysis. For example, the two matrices prepared for analysing the role of accounting in the BOD in PUB and PRIB were combined, and variations were explained with reference to the specific contextual factors related to each of the case organizations.

The analytical procedures adopted in this study are expected to improve the validity and reliability of the study. First, because the study was linked with the theory developed through the analytical framework in Section 2.8, it was constrained from collecting excessive and irrelevant data, and provided a basis to commence the analysis using a deductive approach¹⁷ in the case studies, where categories (i.e., nodes) were developed from the framework. Second, the use of the hierarchical coding structure forced the investigator to analyse the content of the initial information set meticulously, limiting the potential for arbitrary categorization or interpretation of data (Perera, 2005). Finally, because NVivo was used in this study to analyse the data, an audit trail was always maintained in order to track data from the complete, original transcripts, through the selective summarization inherent in the data displays, and then from the data displays to interpretation (see e.g., Lillis, 1999).

¹⁷ A deductive approach involves drawing on existing or pre-ordained theories to provide a frame of reference for analysing the case material, as opposed to an inductive approach, which attempts to build up a theory using case material (Moll *et al.*, 2006).

CHAPTER 4

ACCOUNTING AND CORPORATE GOVERNANCE ENVIRONMENT WITHIN THE BANKING INDUSTRY IN SRI LANKA

4.1. Introduction

In Chapter 2, elements of the context that could influence the role of accounting in the corporate governance of banks were identified in developing the analytical framework of this study. Focusing on the banking industry in Sri Lanka, this chapter aims to describe the nature and the extent of influence of the elements in the external environment on the role that accounting plays in corporate governance, and changes to that environment over the period from 1997 to 2009. Recall from the analytical framework that the external environment is viewed in terms of the organizational interface and the much broader external environment.¹⁸ The same classification has been used as the basis for this examination.

This chapter examines the institutional and regulatory frameworks that govern accounting and corporate governance of public and private sector banks in the organizational interface, and investigates the influences of factors in the external environment on the role of accounting in the corporate governance of these two bank types in Sri Lanka.

The context within which accounting and corporate governance operate can influence corporate governance directly, apart from its influence on corporate governance through accounting. The chapter also recognizes the impact of the factors related to the organizational interface and the external environment on both accounting and corporate governance practices, and assesses the extent to which those factors influence the role of accounting in corporate governance in the banking industry in Sri Lanka.

¹⁸The discussion in this chapter is limited to these two contextual factors. The other contextual factor included in the analytical framework, namely internal organizational factors, is not discussed here as it is specific to individual banks.

The remainder of the chapter is structured as follows. The next two sections analyse the influences of the organizational interface and the external environment respectively on the role of accounting in corporate governance in the banking industry in Sri Lanka. A summary of the chapter and some concluding remarks are provided in the final section.

4.2. Organizational interface

The organizational interface of the banking industry in Sri Lanka provides the institutional and legislative framework within which accounting and corporate governance operate in banks. The nature and the extent of influence of the organizational interface differ depending on whether a bank is in the public or private sector and whether or not it is listed on the Colombo Stock Exchange (CSE). Nevertheless, the laws and regulations enforced by the key governing institutions in the organizational interface such as the Central Bank of Sri Lanka (CBSL) and the Institute of Chartered Accountants of Sri Lanka (ICASL) are commonly applicable to both public and private sector banks. Following the proposed analytical framework, Table 4.1 illustrates the important institutions in the organizational interface, their primary functions, key governing laws and regulations, and their potential influences on the role of accounting in the corporate governance of banks in Sri Lanka. These institutions include regulatory bodies, professional accounting bodies, capital market and key stakeholders.

Table 4.1 focuses on external reporting and external auditing, because the influences of the other two areas of accounting (management accounting and internal auditing) appear to be negligible.¹⁹ The following subsections examine how each factor in the organizational interface influences corporate governance through accounting as well as directly.

¹⁹ For example, the formation of an internal audit function in banks is mandatory according to CBSL regulations. It is expected that a proper internal audit function will assist banks to improve the effectiveness of risk management, control, and governance processes, and provide information for bank managers and supervisors on the quality of the internal control system of the bank (CBSL, 2008).

Table 4. 1: Context of banking industry in Sri Lanka – Organizational interface

Governing Institutions in the Organizational Interface and Their Primary Functions	Key Governing Laws and Codes of Best Practice	Major Implications for Accounting, Auditing and Corporate Governance in Banks
1. Regulatory Bodies		
<u>The Central Bank of Sri Lanka (CBSL)</u> <i>(Applicable to private and public sector banks)</i> <ul style="list-style-type: none"> Administers the Banking Act Approves bank auditors Approves accounting and auditing standards for banks Determines formats and disclosure requirements for financial statements 	<ul style="list-style-type: none"> Banking Act (No. 30) 1988 amended by Act (No. 33) 1995 and Act (No. 46) of 2006 Directions, circulars and guidelines issued by the Central Bank of Sri Lanka Code of Corporate Governance for Licensed Banks in Sri Lanka, 2008 	<u>External Reporting:</u> Formats of financial statements; continuous reporting system; publication of quarterly financial statements <u>External Auditing:</u> List of qualified auditors; list of restricted non-audit services; guidelines for external auditors <u>Corporate Governance:</u> Mandatory code of corporate governance 2008; prudential regulations and supervisory practices
<u>Registrar of Companies (RC)</u> <i>(Applicable to private sector banks)</i> <ul style="list-style-type: none"> Administers the Companies Act 	<ul style="list-style-type: none"> Companies Act (No. 7) 2007 	<u>External Reporting:</u> Maintenance of proper books of accounts; preparation of financial statements; certification of financial statements by the officer responsible for that purpose; details of AGM and annual report <u>External Auditing:</u> Appointment of external auditor; details of external audit report <u>Corporate Governance:</u> Qualifications and responsibilities of directors; rights of shareholders
<u>Other Government Agencies:</u> <u>The Department of Public Enterprises (DPE), Strategic Enterprise Management Agency, and Public Enterprise Reform Commission</u> <i>(Applicable to public sector banks)</i> <ul style="list-style-type: none"> Provide institutional framework for public enterprises 	<ul style="list-style-type: none"> Articles 148 to 154 of the 1978 Constitution of Sri Lanka relating to public financial management and regulations Regulations, rules, circulars and directives of the General Treasury 	<u>External Reporting & External Auditing:</u> Time frames for preparation of audited financial statements; appointment of external auditor

Table 4.1 (Continued)

Governing Institutions in the Organizational Interface and their Primary Functions	Key Governing Laws and Codes of Best Practice	Major Implications for Accounting, Auditing and Corporate Governance in Banks
2. Professional Accounting Bodies		
<u>The Institute of Chartered Accountants of Sri Lanka (ICASL)</u> <i>(Applicable to private and public sector banks)</i> <ul style="list-style-type: none"> Approves accounting and auditing standards Supports the activities of the Accounting Standards Committee (ASC) and Auditing Standards Committee (AuSC) 	<ul style="list-style-type: none"> Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995 Code of Best Practice on Corporate Governance, 2008 	<u>External Reporting:</u> Requirements of Sri Lanka Accounting Standards (SLAS) based on International Financial Reporting Standards (IFRS) <u>External Auditing:</u> Requirements of Sri Lanka Auditing Standards (SLAuS) based on International Standards on Auditing (ISA); and Sri Lanka Auditing Practice Statements (SLAPS) based on International Auditing Practice Statements (IAPS) <u>Corporate Governance:</u> Code of Best Practice on Corporate Governance 2008 (partnered with SEC)
<u>Accounting Standards Committee (ASC)</u> <ul style="list-style-type: none"> Develops accounting standards 	<ul style="list-style-type: none"> Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995 	<u>External Reporting:</u> Develops SLAS based on the respective IFRS
<u>Auditing Standards Committee (AuSC)</u> <ul style="list-style-type: none"> Develops auditing standards 	<ul style="list-style-type: none"> Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995 	<u>External Auditing:</u> Develops SLAuS based on the respective ISA; develops SLAPS based on IAPS
<u>Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB)</u> <ul style="list-style-type: none"> Monitors the application of accounting and auditing standards 	<ul style="list-style-type: none"> Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995 	<u>External Reporting & External Auditing:</u> Monitors the Specified Business Enterprises (SBE) to ascertain their conformity with SLAS and SLAuS
3. Capital Markets		
<u>Securities and Exchange Commission (SEC)</u> <i>(Applicable to banks registered in the CSE official list)</i> <ul style="list-style-type: none"> Administers the Securities and Exchange Commission of Sri Lanka Act Oversees the Colombo Stock Exchange 	<ul style="list-style-type: none"> Securities and Exchange Commission of Sri Lanka Act (No. 36) 1987 amended by Act (No. 26) 1991 and Act (No. 18) 2003 Rules on Corporate Governance for Listed Companies, 1990 Guidelines for Appointment of Auditors of Listed Companies, 2008 Code of Best Practice on Corporate Governance, 2008 	<u>External Reporting:</u> Routine and non-routine disclosures; declaration of CEO and CFO ensuring true and fair view of financial statements <u>External Auditing:</u> Criteria in relation to qualifications, appointment, rotation of partners, and independence of auditors <u>Corporate Governance:</u> Code of Best Practice on Corporate Governance 2008 (Partnered with ICASL)
<u>Colombo Stock Exchange (CSE)</u> <i>(Applicable to banks registered in the CSE official list)</i> <ul style="list-style-type: none"> Monitors the listing rules 	<ul style="list-style-type: none"> Colombo Stock Exchange Listing Rules 	<u>External Reporting:</u> Rules on continues reporting requirements <u>Corporate Governance:</u> Rules on corporate governance

Table 4.1 (Continued)

Governing Institutions in the Organizational Interface and their Primary Functions	Key Governing Laws and Codes of Best Practice	Major Implications for Accounting, Auditing and Corporate Governance in Banks
4. Key Stakeholders (<i>Applicable to private and public sector banks</i>)		
<u>Media</u>	• None	<u>External Reporting, External Auditing, and Corporate Governance:</u> Publication of quarterly financial reports; financial press
<u>Formal representatives of social interest</u>	• None	Not significant
<u>Depositor associations</u>	• None	Not significant
<u>Customers/Borrowers</u> <u>The Ceylon Chamber of Commerce; The Federation of Chambers of Commerce and Industry of Sri Lanka</u>	• None	<u>External Reporting:</u> Represents ASC <u>External Auditing:</u> Represents AuSC <u>Corporate Governance:</u> Represents committees of the development of codes of corporate governance

Regulatory bodies

The laws and regulations enforced by regulatory bodies often influence the functioning of accounting in a country (e.g., Archambault and Archambault, 2003). The nature and the degree to which accounting facilitates the corporate governance of banks in Sri Lanka are influenced by several regulatory bodies, namely the CBSL, the Registrar of Companies (RC), and the Department of Public Enterprises (DPE).

The Central Bank of Sri Lanka (CBSL)

The CBSL is the key regulatory body that governs the banking industry in Sri Lanka. Part V of the Banking Act (No. 30) 1988, amended by Act (No. 33) 1995, specifies the provisions for accounting and auditing of banks in both private and public sectors.²⁰ By the power vested through the Banking Act, the CBSL stipulates the formats to be used when preparing and publishing banks' financial statements (Section 38(3)). The uniformity of presentation of financial statements is intended to improve the comparability of the performance and stability among banks. Improved comparability facilitates shareholder and debtholder monitoring of a bank, which in turn enhances the bank's corporate governance.

In accordance with the requirements of the Banking Act, every licensed commercial bank must publish its annual audited financial statements, and must lodge those reports with the CBSL within 5 months after the end of the financial year (Section 38(3)). The availability of these statements on a timely basis is expected to increase the effectiveness of the regulatory oversight by the CBSL. Additionally, the CBSL requires the publication of quarterly financial statements in the newspapers in Sinhala, Tamil and English, the three main languages used in the country, within 2 months of the end of each quarter²¹ (CBSL, 2008). These statements contain summarized financial statements and a selected number of performance indicators, but do not include accompanying notes or disclosure of accounting policies. This requirement assists external corporate

²⁰ The requirements related to accounting and auditing stipulated in this section are in addition to the requirements of the Companies Act (No. 7) 2007 and the Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995.

²¹ If the bank publishes its annual audited financial statements within 3 months from the end of the financial year, the requirement to publish the financial statements for the fourth quarter is not mandatory (CBSL, 2008).

governance mechanisms in banks in a number of ways. The availability of information on a regular basis makes shareholder and debtholder monitoring possible on a timely basis, and publishing such information in the three main languages enables shareholders and debtholders from different ethnic backgrounds to perform their monitoring role effectively.

Furthermore, as stipulated by the Banking Act and directions, circulars and guidelines issued by the CBSL from time to time, commercial banks are required to submit various reports daily (e.g., foreign exchange position and liquidity data), weekly (e.g., interest rates), monthly (e.g., assets and liabilities, liquid assets, and income and expenditure), quarterly (e.g., non-performing assets exceeding SLR 500,000²² and risk-based capital calculations), and annually (e.g., assets and liabilities, income and expenditure, and calculations of capital adequacy ratios). The provision of such information on a continuing basis facilitates the regulatory oversight in preserving banking sector stability in the country.

The laws and regulations administered by the CBSL also influence the external auditing function of banks. The CBSL issues a selected list of qualified auditors²³ from time to time to audit the banks (Section 38A). The list issued in 1998 consisted of 10 audit firms including three of the “big four” audit firms.²⁴ Banks are required to appoint their auditors from the list issued by the CBSL, and this requirement is intended to ensure that banks are subject to high quality audits.

External auditors of banks in Sri Lanka are provided with certain guidelines by the CBSL relating to their statutory duties under the Banking Act (Section 39). These guidelines cover areas such as audit planning, scope of audit, internal control systems, assessment of bank automation, branch audits and review of financial statements. The

²² On 21 December 2010, the exchange rate between the US dollar and the Sri Lankan rupee was US\$1 =SLR 111.

²³ A qualified auditor is an individual who, being a member of the ICASL or of any other institute established by law, possesses a certificate to practise as an accountant, issued by the council of such institute, or a firm of accountants each of the resident partners of which, being a member of the ICASL or of any other institute established by law, possesses a certificate to practise as an accountant, issued by the council of such institute (Section 38 A (1) of the Banking Act).

²⁴ Deloitte, one of the big four audit firms, does not operate in Sri Lanka.

CBSL is also empowered by the Banking Act to extend the scope of audits or to appoint auditors to perform additional audits in special circumstances. These guidelines issued by the CBSL appear to enhance the quality and consistency of bank audits, ensuring that banks provide reliable financial information for governance purposes.

Another CBSL guideline that ensures effective audits of banks relates to protecting auditor independence (Section 39). External auditors are prohibited from undertaking consultancy or other non-audit services with a bank contemporaneously with the external audit. The restricted non-audit services include *inter alia* book-keeping, financial information system design and implementation, actuarial services, internal audit outsourcing services, management functions and legal services to the bank.²⁵ Such guidelines were introduced by the CBSL to ensure auditor independence, making a positive contribution to the corporate governance of banks in Sri Lanka.

The CBSL also influences the degree of corporate governance directly through the enforcement of a mandatory code of corporate governance for banks, effective from 2008. This code consists of principles of corporate governance relating to eight areas, namely responsibilities of the board of directors (BOD), composition of the BOD, criteria to assess the fitness and propriety of directors, management functions delegated by the BOD, responsibilities and duality of the chairperson and the chief executive officer, BOD appointed committees, related party transactions, and disclosures. These principles are particularly intended to strengthen the operation of the BOD as an important corporate governance mechanism in banks.

Finally, the CBSL, through its prudential regulations and supervisory practices, aims to improve the corporate governance of banks, for example, the directions for setting prudential norms for capital adequacy, asset classification and disclosure standards. Significant changes have recently been introduced into the laws and regulations applicable to banks. For example, in 2007, the ceiling on shareholding by a single shareholder or a group of related shareholders was restricted to a maximum of 15 per cent of the issued voting equity of the domestic private banks. Although large shareholders have the ability and incentive to monitor corporations, the reduction in

²⁵These restrictions exclude tax consultancies.

concentration of share ownership of banks could help to address the issue of conflict of interest with minority shareholders that could arise due to large shareholdings (e.g., Holderness, 2003), and also the potential costs associated with expropriation of other stakeholders (e.g., Shleifer and Vishny, 1997). In 2005, the minimum capital requirement for licensed commercial banks was increased to SLR 2.5bn from SLR 500m. It appears that these regulatory changes were mainly aimed at safeguarding the interests of the depositors in banks. Moreover, effective from January 2008, the CBSL implemented Basel II Accord to direct banks to create formal risk management structures (Fitch Ratings, 2007). It was also intended that the implementation of Basel II Accord would result in disciplining the banks in the market due to its high level of disclosure requirements (CBSL, 2007b).

The Registrar of Companies (RC)

The Registrar of Companies administers the Companies Act (No. 7) of 2007.²⁶ The Companies Act, among other things, specifies requirements for accounting and auditing to be adopted by the companies incorporated in Sri Lanka. These requirements specified in the Companies Act influence corporate governance in private sector commercial banks in Sri Lanka as they are incorporated as limited liability companies.

The Companies Act outlines certain accounting obligations for limited liability companies. Such requirements include maintenance of proper accounting records (Section 148); preparation of financial statements in a way that give a true and fair view of the state of affairs of the company as at the balance sheet date and the profit or loss of the company for the accounting period ending on the balance sheet date (Section 151); certification of these statements by the person responsible for their preparation stating that the statements are in compliance with the requirements of the Companies Act; signatures, with dates, of two directors on behalf of the BOD; and making them available within 6 months after the balance sheet date (Section 150). Additionally, in the case of a public limited company, the financial statements should be open to inspection by the general public at its registered office at all times (Sections 116 and 148). These provisions also have a favourable impact on the corporate governance of private sector banks. For example, the increased reliability of financial statements due to their

²⁶ This Act superseded the Companies Act (No. 17) 1982.

certification by the chief financial officer and two members of the BOD enhances shareholder and debtholder monitoring of the bank.

The Companies Act requires that, except in the year of incorporation²⁷, the BOD of limited liability companies should hold an annual general meeting (AGM) of shareholders in each calendar year, not later than 6 months after the balance sheet date of the company, and not later than 15 months after the previous AGM (Section 133). For this purpose, an annual report must be prepared on the affairs of the company, and sent to every shareholder not less than 15 working days before the date of the AGM (Sections 166, 167). The annual report should contain both financial as well as non-financial information as detailed in Section 168. These requirements for the AGM and the annual report not only facilitate but also encourage shareholder monitoring of the bank's activities.

There are also certain requirements in the Companies Act that affect external auditors and auditing in limited liability companies. Such provisions include the requirement to appoint an independent qualified auditor to conduct the audit of financial statements of the company at each AGM (Section 154), and the need for auditors to issue a report to shareholders on the financial statements audited by them after the completion of the audit (Section 163). These provisions under the Companies Act are consistent with and also reinforce the guidelines provided by the CBSL, and are designed to ensure good corporate governance of private sector banks by facilitating shareholder and debtholder monitoring.

The provisions of the Companies Act with regard to the qualifications and responsibilities of directors provide a basis for corporate governance, particularly in public limited companies. Such provisions include, among other things, the qualifications of a person to be appointed as a director of a company (Section 202), and disclosures of directors' interest in transactions in the Interests Register (Section 192). Moreover, the BOD is required to be conscious of the solvency of the company, especially at the time of authorizing a distribution of dividends. For this purpose, the

²⁷A company is not required to hold its first annual general meeting in the calendar year of its incorporation, but is required to hold the meeting within 18 months of its incorporation (Section 133).

company is required to obtain a certificate of solvency from the external auditors to ensure that it has adequate net assets to pay dividends at such time and in such amount (Section 57). These requirements have a favourable effect on the corporate governance of private sector banks. The need to disclose directors' interest in transactions in the Interests Register could, for example, minimize the possible agency cost between the BOD and shareholders.

The Companies Act also incorporates several specific provisions to safeguard shareholder rights. These provisions protect fundamental rights of shareholders, such as the rights to attend and vote in shareholder meetings, alter the company's articles, approve major transactions, reduce the company's stated capital, and resolve that the company be wound up voluntarily (Sections 92, 135 and 136). These rights allow shareholders to become aware of major changes and to participate in major decisions, and assist in shareholder monitoring in private sector banks.

The Department of Public Enterprises (DPE)²⁸

As public enterprises, public sector banks in Sri Lanka are required to abide by the guidelines issued by the DPE, which is the governing authority for administering laws and regulations for public enterprises in Sri Lanka. The legislative framework for public enterprises includes statutory provisions of the 1978 Constitution of Sri Lanka relating to public financial management, and other regulations such as special or general acts of parliament under which public corporations are created (Code of Best Practice in Corporate Governance for Public Enterprises in Sri Lanka, 2003). However, public sector banks seem to have been given more autonomy in financial management compared to other public sector enterprises in Sri Lanka, as they have been exempted from provisions in Part II of the Finance Act (No. 38) 1971.²⁹ Such changes might have been necessary for public sector banks in order to operate competitively with their private sector counterparts in the banking industry.

²⁸ The institutional framework for public enterprises also includes the Strategic Enterprise Management Agency (SEMA) and the Public Enterprise Reform Commission (PERC).

²⁹ These provisions are related to financial control of public corporations, including requirements for preparation and approval of budgets, calculation of net surplus or net deficit, transfer of net surplus revenue to the Consolidated Fund at the end of the year, restrictions on investments, etc.

Additionally, the General Treasury issues regulations, rules, circulars and directives from time to time to ensure that institutions, including banks, that come under its purview operate in the best interest of the enterprises and their stakeholders. These laws and regulations have implications for the role of accounting in the corporate governance of the public sector banks.

As per the 1978 Constitution of Sri Lanka and the Finance Act (No. 38) of 1971, the Auditor General should be the auditor for every public enterprise. The audited financial statements, together with the Auditor General's report, should be tabled in the three languages (Sinhala, Tamil and English), in the Parliament within 150 days after the close of the financial year (Code of Best Practice in Corporate Governance for Public Enterprises in Sri Lanka, 2003). These requirements for external reporting and external auditing improve the efficacy of reporting practices in public sector banks, contributing to good corporate governance in those banks.

Although the findings of this study reveal that various regulatory requirements (e.g., the Banking Act, Companies Act, 1978 Constitution of Sri Lanka) result in banks providing relevant information on a timely basis, there have also been several incidents in recent times in the banking industry in Sri Lanka which raise doubts about the adequacy of the institutional capacities and enforcement mechanisms available to implement such laws and regulations effectively. For example, some banks were found to publish flawed statements, and also failed to publish information with regard to non-compliance with statutory regulations in quarterly reporting (CBSL, 2008). These problems seem to have arisen due to lapses in the law enforcement mechanisms, for instance, delays in identifying instances of non-compliance and enforcing penalties.

Further, as highlighted in Chapter 1, failures of a number of financial institutions and a savings bank have occurred in recent times (Fitch Ratings, 2003), and a leading commercial bank owned by a group of companies experienced a financial distress situation in 2008 (Sunday Observer, 25.01.2009). In the case of the former, the CBSL pointed out that such unregistered finance companies and informal deposit takers did not come under its purview, and thus it did not exercise prudential regulation and supervision over those institutions (Sunday Observer, 25.01.2009). However, concerns

have also been expressed regarding the CBSL's core responsibility to maintain financial system stability in the country (e.g., Sunday Times, 28.12.2008; 11.01.2009).

In the latter two situations, the CBSL had to enforce its legal powers to rescue the banks, thereby their depositors. Intervention by the CBSL in this manner raises doubts about the ability of the bank supervisors (i.e., the CBSL) and the external auditors to prevent or detect such situations at an earlier stage. For example, it could be reasonable to question the auditor's role, as it was possible that the audited financial statements did not reflect a true position of the banks. Also, there could be concerns about the CBSL's failure to detect any discrepancies and irregularities in its regular supervision of these banks (Sunday Times, 11.01.2009). One could also question the independence of the external auditors, although various rules and procedures exist to maintain auditors' independence, such as auditor rotation and restricted non-audit services.

Professional accounting bodies

Professional accounting bodies influence the functioning of accounting in a country, thereby influencing the accounting practices of organizations within that country (see e.g., Burchell, Clubb, Hopwood, Hughes and Nahapiet, 1980). The role of accounting in corporate governance of banks in Sri Lanka is significantly influenced by the activities of the ICASL.³⁰ The ICASL is the only national professional accounting body in Sri Lanka, and the sole authority in the country for setting accounting and auditing standards under the Accounting and Auditing Standards Act (No. 15) 1995. The application of these standards is mandatory for Specified Business Enterprises (SBE), which include banks (in both public and private sectors) as defined in the Accounting and Auditing Standards Act (Section 5).

The Accounting and Auditing Standards Act also provides the basis for the establishment of the Accounting Standards Committee (ASC), the Auditing Standards Committee (AuSC), and the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB). The ASC and AuSC make recommendations and assist the ICASL

³⁰ Other than the ICASL, the Chartered Institute of Management Accountants (CIMA), and the Association of Chartered Certified Accountants (ACCA) operate branches in Sri Lanka. Further, the Association of Accounting Technicians (AAT) was established in 1987 to address the shortage of accounting technicians in the country.

in the adoption of accounting and auditing standards (Sections 8 and 9). The SLAASMB is an independent corporate body which monitors SBE to ensure their conformity with the Sri Lanka Accounting Standards (SLAS) and Sri Lanka Auditing Standards (SLAuS) in the preparation and audit of financial statements (Section 11).

The SLAS have been aligned with the International Financial Reporting Standards (IFRS). The current practice in setting SLAS is that the ASC and the Council of the ICASL narrow down the differences in the IFRS, in terms of social, economic, and legal circumstances, to match the IFRS with local conditions (ICASL, 2007). The ICASL has also approved a policy that the SLAS will be fully compliant with the respective IFRS effective from 2011 (IAS Plus, 2007). Hence, in future, a company that complies with SLAS will also be automatically compliant with IFRS. Since, banks are required to follow all applicable SLAS when preparing and presenting financial statements, the new development that accompanied the IFRS compliance requirement has further strengthened the level of external reporting of banks, with implications for shareholder and debtholder monitoring.

The external audit function of banks is influenced by the SLAuS, which are based on the International Standards on Auditing (ISA) issued by the IFAC with slight modifications to meet local conditions and needs. These standards are reviewed by the AuSC and are recommended for adoption by the Council of the ICASL. The Accounting and Auditing Standards Act requires SBE to take all necessary measures to ensure that their accounts are audited in accordance with the SLAuS (Section 7). The ICASL has also issued Sri Lanka Auditing Practice Statements (SLAPS), based on the corresponding International Auditing Practice Statements (IAPS), for practising accountants who render services in specialized areas. Several SLAPS directly address issues in the auditing of commercial banks. For example, SLAPS 7 deals with the relationship between bank supervisors and external auditors and SLAPS 9 deals with the audit of commercial banks. The adoption of SLAuS and SLAPS based on the related international standards enhances audit quality, thereby enhancing the reliability of financial statements of banks, with implications for the corporate governance of banks.

The ICASL is also the main source of generating qualified accountants for the needs of the country. It conducts qualifying examinations, supervises and regulates student

education and training, and secures the maintenance of professional standards among members and the advancement of the profession. It has developed a global relationship in accounting by obtaining membership of the IFAC, the Confederation of Asian and Pacific Accountants (CAPA), and the South Asian Federation of Accountants (SAFA). Most senior accountants, including several members of the BODs in banks in Sri Lanka, are members of the ICASL. Further, the Accounting and Auditing Standards Act requires that the accounts of every SBE should be audited by a member of the ICASL holding a certificate to practise. Hence the activities of the ICASL largely influence the accounting and auditing practices of banks in the country.

Moreover, the ICASL influences the corporate governance of banks directly, being the pioneer in introducing corporate governance guidelines to Sri Lanka. In 1997 the ICASL issued its first code of corporate governance, namely the Code of Best Practice on Matters Relating to Financial Aspects of Corporate Governance, followed by the Code of Best Practice on Audit Committees in 2002, the Code of Best Practice on Corporate Governance in 2003, and the Code of Best Practice on Corporate Governance in 2008.³¹

Despite the regulatory requirements enforced by the ICASL to ensure the role of accounting in the corporate governance of banks, poor institutional capacities appear to hinder the effectiveness of such regulations. For instance, although the Accounting and Auditing Standards Act requires all SBE to submit their annual accounts to the SLAASMB to determine whether the accounts have been prepared in accordance with the SLAS, and has the power to take action against an SBE that contravenes the act, due to shortage of technical staff the SLAASMB reviews only a selection of financial statements (World Bank, 2004).

Capital markets

Capital market regulations influence the reporting practices of companies listed on the share market (Archambault and Archambault, 2003). The capital market in Sri Lanka is governed by the Securities and Exchange Commission (SEC) and the CSE. These two organizations have issued various requirements for accounting practices in listed

³¹This latest Code of Best Practice on Corporate Governance is intended for voluntary adoption by listed companies. Hence it influences the corporate governance practices of private sector banks, which are listed on the CSE.

companies under the power vested through the Securities and Exchange Commission of Sri Lanka Act (No. 36) 1987. Banks listed on the CSE need to follow these requirements. The following sub-sections detail the influences of these regulatory authorities on the accounting practices of listed banks.

The Securities and Exchange Commission of Sri Lanka (SEC)

The SEC was established under the Securities and Exchange Commission of Sri Lanka Act (No. 36) 1987 in order to govern the capital market in Sri Lanka. It has issued a number of regulations and guidelines for listed companies. Although these regulations and guidelines influence the role of accounting in corporate governance of listed banks, only some of them are mandatory.

All listed banks are required by SEC rules issued in 1990 to submit their annual reports certified by auditors to the stock exchange and to make them available to the public (Section 18.1). They are also required to report to shareholders regularly as required by the stock exchange (Section 18.2), and to announce their provisional results for the financial year within 4 months of the end of the financial year (Section 18.3). These reports should also contain information in relation to occurrences or events which may materially affect the affairs of the bank, such as those related to the nature of business, objectives, and stability (Section 18.5). Listed banks must also prepare interim financial statements and submit them to shareholders and the stock exchange within 90 days of the end of the first 6 months of the financial year, in a format prescribed by the stock exchange (Section 18.7). All these requirements that are designed to make external reports comprehensive, reliable and timely in turn aid the use of a number of corporate governance mechanisms, including shareholder and debtholder monitoring.

The guidelines that the SEC issued in 2008 include a section on financial reporting, which requires the chief executive officer and the chief financial officer of the listed bank to forward a declaration specifying that all reasonable steps have been taken to ensure true and fair view of the financial statements, and requires that such declaration be included in the annual report (Section 4.1). These requirements designed to improve the reliability of financial statements can have a favourable impact on the corporate governance of listed banks.

The SEC also influences external auditing. For instance, the 2008 SEC guidelines contain provisions on the appointment of external auditors, which include criteria for the qualifications, appointment, rotation of partners, and independence of auditors. Those provisions specify that (a) a listed company should appoint an independent firm of chartered accountants with a minimum of three partners, in order to ensure that it is served by an engagement partner³² and a concurrent review partner (Section 2.2); (b) the engagement partner should be rotated at least once every 5 years, and should not be reappointed in that capacity for 2 years (Sections 2.4 and 2.5); (c) an auditor must not have any conflict of interest with the listed company or the group (for example, the audit fee of the listed company or the group should not exceed 10 per cent of the total audit fees received by the auditors in the previous financial year) (Section 3.2); and (d) the auditor is not allowed to provide non-audit services³³ (Section 3.3). These guidelines are designed mainly to ensure auditors' independence. Further, in 2004 the SEC issued guidelines in respect of audit and audit committees for voluntary adoption by listed companies. The SEC also partnered with the ICASL and issued two codes of best practice on corporate governance, in 2003 and 2008.

However, the corporate governance guidelines issued by the ICASL and the SEC are not mandatory. A survey conducted by the SEC in relation to the audit committees of listed companies in Sri Lanka in 2005 revealed that a significant number (38 per cent) of the listed companies that responded did not have an audit committee (SEC, 2005). It also revealed substantial variations in the composition and function of the audit committees. For example, although companies had independent/non-executive directors in their audit committees, a substantial number of companies (56 per cent) had not appointed an independent/non-executive director as the chairperson of the audit committee (SEC, 2005). To address this limitation, effective from 2006, additional rules of corporate governance for listed companies were developed and incorporated in the listing rules of the CSE for mandatory compliance by companies registered on the CSE.

³²A fellow member of the ICASL with a minimum of 3 years' post-qualification audit experience after obtaining the associate membership or an associate member of the ICASL who has a minimum of 10 years' audit experience qualify for this post.

³³This list has the same restricted non-audit services as those enforced by the CBSL.

The Colombo Stock Exchange (CSE)

The CSE was established in 1985 and has issued a number of listing rules, including those related to accounting and reporting, to establish an orderly and fair market. Companies listed on the CSE, including listed banks, must abide by these rules.

The listing rules of the CSE specify the preparation and submission of interim financial reports and the circulation and content of annual reports (CSE Listing Rules, 2010). For example, interim financial reports should be prepared in conformity with SLAS 35, Interim Financial Reporting, on a quarterly basis within 45 days after the end of the first, second and third quarters, and within 2 months after the end of the fourth quarter by banks listed on the main board, and half yearly financial statements within 2 months after the end of the half year by banks listed on the secondary board and the debt securities board, and submitted to the shareholders/holders of debt securities (Section 7.4). Further, listed banks are required to circulate their audited annual reports to the CSE and shareholders/holders of debt securities within 5 months from the close of the financial year (Section 7.5). These listing rules of the CSE are designed to enhance the timeliness and relevance of external reporting, and hence have implications for the corporate governance of listed banks.

Additionally, the listing rules require immediate disclosure of information about the affairs of the bank and/or about events or conditions in the market which could have a significant effect on the price of the securities (Section 8.1). Such disclosure is required where this information is considered important for investors when making decisions. This information may include details of a joint venture, merger, acquisition or takeover; a decision either to declare or not to declare dividends; and any changes to the controls, directors, company secretary, and auditors (Appendix 8A of the Listing Rules). These requirements enhance transparency and the level of disclosure in external reporting, in turn facilitating good corporate governance.

The listing rules of the CSE on corporate governance for listed companies specify the minimum number of non-executive directors (two, or one-third of the total number of directors, whichever is higher), the minimum number of independent directors (two, or one-third of the non-executive directors, whichever is higher), the criteria to determine

“independence”, and the minimum requirements to be met by listed companies in the formation of remuneration and audit committees (Section 7.10).

Key stakeholders

Key stakeholders, including media, formal representatives of social interests, depositors’ associations, and customers’/borrowers’ associations, can also have an impact on the role of accounting in corporate governance (e.g., Adams, 2002; Cooke and Wallace, 1990).

The financial press appears to have some influence on the role of accounting in the corporate governance of banks. For instance, as noted earlier, Sri Lankan banks are required to publish their quarterly financial statements in newspapers in the Sinhala, English and Tamil languages to fulfil the regulatory requirements of the CBSL. Some national newspapers also include a section on finance and business which provides information on banks, such as share prices, dividend declarations, and financial performance. These publications enhance the accessibility of information for shareholders and debtholders of banks.

Further, customers/borrowers at corporate level are formally organized by the Ceylon Chamber of Commerce and the Federation of Chambers of Commerce and Industry of Sri Lanka. These two organizations have been able to express their views on accounting and corporate governance practices in the country. For example, one member from each of the two chambers is appointed to the ASC, AuSC, and SLAASMB. These chambers have also provided comments on best practices of corporate governance, and have participated in the committees appointed for the development of codes of corporate governance in the country. Other key stakeholders, however, such as formal representatives of social interests, do not seem to operate to a level similar to that in industrialized countries, and their existence has very limited implication for the role of accounting in corporate governance of banks.

This section has detailed the influences of the elements in the organizational interface, namely regulatory bodies, professional accounting bodies, capital market and key stakeholders, on the role of accounting in corporate governance in the banking industry in Sri Lanka. It shows that the presence of various institutional arrangements in the

organizational interface enables accounting to play an important role in the corporate governance of banks. Various rulings and requirements generated in the organizational interface seem not only to facilitate but also to reinforce the role of accounting in the corporate governance of banks.

Nevertheless, the existence of such laws and regulations does not necessarily ensure the desired outcomes. As highlighted in the discussion, the effectiveness of laws and regulations is hindered by weak institutional capacities and poor enforcement mechanisms. Due to these lapses in the organizational interface, shortcomings in banks' reporting systems and non-compliance with the regulatory requirements by banks might not be identified on a timely basis. This could have a negative influence on the role of accounting in the corporate governance of banks. Moreover, the voluntary nature of implementation of most of the corporate governance guidelines could be a reason for the limited compliance.

The discussion also shows that most of the regulatory requirements in the organizational interface are applicable to both public and private sector banks, for example, the laws and regulations administered by the CBSL and the ICASL. The requirements in such common laws and regulations are also consistent with, and reinforce most of the other rulings in the organizational interface. For example, the quarterly reporting requirements of the CBSL are consistent with the requirements of the CSE listing rules, and the restricted non-audit services lists issued by the CBSL and the SEC have similar items of prohibited non-audit services. Moreover, one of the two major public sector banks in Sri Lanka is bound by the SEC and the CSE regulations following the issue of debentures in 2008 in the CSE. These situations have led to narrowing of the differences in the regulatory frameworks that govern accounting and corporate governance in the public and the private sector banks in Sri Lanka.

4.3. External environment

As shown in the analytical framework of this study, external environmental factors, including economic, political, social and international factors, can have an effect on the role of accounting in corporate governance of banks. Similar to the situation in relation to the factors in the organizational interface, the nature and the extent of influence of the

factors in the external environment can also vary, depending on the ownership structure of the bank and its listing status. Table 4.2 illustrates key issues identified in relation to each factor in the external environment, and their implications for the role of accounting in the corporate governance of banks in Sri Lanka.

While the issues highlighted in Table 4.2 can have a significant influence on external reporting and external auditing in banks, they could also have some influence on management accounting and internal auditing.

Table 4. 2: Features of the external environment of the banking industry in Sri Lanka

Elements in the External Environment	Important Issues	Major Implications for the Role of Accounting in the Corporate Governance of Banks
<u>Economic Environment</u>	<ul style="list-style-type: none"> • Economic policies adopted by the governments • High level of economic development • High level of inflation • Capital market development 	<ul style="list-style-type: none"> • The evolution of the banking industry as well as the development of accounting and corporate governance practices in the banking industry have been closely related to the economic policies of governments over the years • The growth of companies is closely associated with economic development, and there is a need to disclose more information to raise more capital • Inflation undermines the historical cost assumption leading companies to increase disclosures to further assist investors • The nature of capital markets influences the information requirements of investors
<u>Political Environment</u>	<ul style="list-style-type: none"> • Political influences on setting accounting and corporate governance regulation • Political influences on operational decisions 	<ul style="list-style-type: none"> • The formation of accounting and corporate governance regulation in the country is closely associated with the political policies adopted by the ruling governments • Rational decision making and enterprise accountability may be superseded by political expedience in government owned banks
<u>Social Environment</u>	<ul style="list-style-type: none"> • High level of education and customer awareness • Cultural context 	<ul style="list-style-type: none"> • Both literacy rate and customer awareness can influence the level of information disclosure • The existing culture may not encourage people to use information about stewardship, which in turn minimizes the influences from the culture on issues that banks would consider worthy of reporting
<u>International Environment</u>	<ul style="list-style-type: none"> • Global developments in accounting and corporate governance • Requirements of donor agencies 	<ul style="list-style-type: none"> • Global developments in accounting and corporate governance have a significant influence on the accounting and corporate governance practices in the country • The requirements of donor agencies influence regulatory requirements and best practice in accounting and corporate governance in the banking industry

Economic environment

A number of key economic variables, such as economic policies and development (e.g., Salter, 1998), inflation (e.g., Meek and Saudagaran, 1990), and capital market development (e.g., Doupnik and Salter, 1995) can influence the nature and the extent of the role of accounting in the corporate governance of banks.

The evolution of the banking industry, as well as the development of accounting and corporate governance practices in the banking industry, have been closely related to the economic policies adopted by the governments of Sri Lanka over the years. For the purpose of this study, these economic policies can be broadly classified into three phases, namely the colonial era, independent Sri Lanka, and liberalized Sri Lanka.

Colonial era

Sri Lanka was a colony from the early 16th century until 1948, when it gained independence from the British. The Portuguese, who conquered the western coastal plains, were the first Europeans to invade the country, followed by the Dutch, and lastly the British, who eventually took control over the whole island in 1815 (Yapa and Perera, 2005). The British introduced the plantation sector for commercial purposes. Initially they grew coffee, followed by tea, rubber, and coconut on a grand scale for export. The formal banking industry commenced operations as a result of this change in the economic structure, as commercial transactions had become important. Hence, accounting practices in banks in those days were closely associated with those colonial ties and economic spheres. This is consistent with the findings of Cooke and Wallace (1990) who identify colonial history as one of the factors determining the level of corporate financial disclosure regulation in many developing countries.

Independent Sri Lanka

After the country became a self-governing nation in 1948, economic and development policies tended to follow through state planning and government control of large enterprises. As a result, the government nationalized the Bank of Ceylon in 1961.³⁴ In the same year, another government owned bank, namely People's Bank, was established by the People's Bank Act (No. 29) 1961, and commenced operations. These two

³⁴ The Bank of Ceylon, a domestic bank, was established under the Bank of Ceylon Ordinance (No. 53) 1938, and commenced operations in 1939 (Rajapakshe, 2001).

government owned commercial banks held a dominant position in the banking industry (Rajapakshe, 2001). The government used these banks to facilitate industrialization and modernization, which were goals in the state planning system. The accounting system of government owned banks relied on budgets and financial reports, and made these banks accountable to the Ministry of Finance, like other government owned enterprises. The reporting system was also consistent with government owned enterprises in other developing countries which appear to have commenced operations after their independence (e.g., Hopper and Hoque, 2004).

Liberalized Sri Lanka

The liberalized economic reforms in 1977 brought many changes in the commercial banking system in Sri Lanka (Rajapakshe, 2001). For instance, foreign banks were encouraged to open branches in the country, and all banks were permitted to set up Foreign Currency Banking Units. As a result, a number of foreign commercial banks commenced operations in Sri Lanka. Additionally, several other domestic private banks also commenced operations during this period.

With liberalization of banking industry in Sri Lanka, competition in the banking industry has increased to a greater extent, and the government dominance in the banking industry seems to have decreased. For instance, the number of commercial banks was 22 as at the end of 2009, consisting of 11 domestic and 11 foreign banks. Those banks operated at the end of 2009 through a network of 2214 branches and 2788 other service outlets (CBSL, 2009). Following the increase in the network of commercial bank branches, banking services grew remarkably. For example, by the end of 2009 there were 1757 ATMs and 24,977 electronic fund transfer facilities at the point of sale (EFTPOS) machines in the country (CBSL, 2009).³⁵ The expansion of bank branches and facilities in this manner led the banks to rely heavily on sophisticated systems, including banking and accounting software, to facilitate the provision of customer services as well as to prepare accounting reports for internal and external purposes.

The significant changes in economic structure in Sri Lanka during this era mean that many improvements were required to accounting and corporate governance practices to

³⁵ At the end of 2006 these figures were 1127 and 8753, respectively (CBSL, 2006).

support the structural adjustment policies based on free trade, competition, privatization and limited government intervention. To accommodate these changes, a number of new laws and regulations were passed in relation to accounting and corporate governance in the country. The accounting and corporate governance practices in banks were also influenced by such laws and regulations, as discussed in Section 4.2 on organizational interface.

Besides the influence of the economic policies adopted by each government on the role of accounting in the corporate governance of banks, the high level of economic development in the country in recent years also seems to have had a favourable effect on this role. Sri Lanka recorded a 6.65 per cent average annual growth in GDP since 2005, which was the highest in the country over last 30 years³⁶ (Fitch Ratings, 2007). The Sri Lankan banking industry has grown in line with the growth of the GDP. For example, the contribution of financial services to GDP has increased steadily from 6.7 per cent in 1997 to 9.17 per cent in 2007 (ADB, 2008). Sustained profitability was also achieved via banks maintaining stable net interest margins, as well as re-pricing their assets and liabilities within a short period of time (Fitch Ratings, 2007). Such growth in the banking industry meant raising more capital by way of share and debenture issues and deposits. For example, two major Sri Lankan banks have recently issued debentures to raise debt capital (Seylan Bank: SLR 1 billion in 2007; Bank of Ceylon: SLR 5 billion in 2008). This has led to the need for the banks to disclose more information, such as issuing debenture prospectuses, to enable debtholder monitoring.

Despite the accelerated growth, the economy has had adverse shocks in recent times from high inflation, negative real interest rates, current account deficits and large trade gaps, and fiscal deficits. Inflation measured in terms of the consumer price index recorded a rapid 10 per cent increase from 2003 (5.8 per cent) to 2007 (15.8 per cent) (ADB, 2008). While inflation tends to affect banks' performance negatively, banks have been disclosing more information to further assist investors to understand the effects of inflation on financial reporting (e.g., Meek and Saudagaran, 1990). Moreover, following

³⁶ The GDP of Sri Lanka in 2007 was SLR 3,577,438 million (CBSL, 2007a).

the implementation of SLAS that are based on the fair value measurement³⁷, the financial statements of banks tend to better reflect market values, ensuring that shareholders, debtholders and regulators receive information relevant for monitoring purposes.

Political environment

Political factors, such as the policies of the ruling party (e.g., Burchell *et al.*, 1985; Stoddart, 2000), and political freedom in a country (e.g., Belkaoui, 1983) can have an impact, not only on organizations within a country but also on the efficient use of corporate governance mechanisms and other related control tools in that country. In particular, state owned enterprises in developing countries can be subject to political influences which have negative implications for rational decision making and enterprise accountability in those organizations (e.g., Hoque and Hopper, 1997).

The political policies adopted by the governments of Sri Lanka since its independence have changed over time, with certain effects on accounting and corporate governance regulation in the country. For instance, by the constitution passed in 1972, Sri Lanka became a Sovereign Republic, which required changes to accounting systems particularly in government owned enterprises. Moreover, Sri Lanka was made a Democratic Socialist Republic with a constitutional amendment in 1978 that aimed to free the economy from excessive government control and to promote the private sector as the engine of growth. These amendments resulted in a rapid increase in the number of companies operating in Sri Lanka, including foreign owned firms. This has created a new demand for accounting and corporate governance practices in the country, resulting in many new developments in the institutional (e.g., establishment of the Securities and Exchange Commission) and regulatory (e.g., Companies Act (No. 17) 1982) frameworks that govern accounting and corporate governance in the country.

Apart from the impact of the constitutional changes on accounting and corporate governance regulation in the country in general, over the years public sector enterprises including public sector banks have often been subject to political intervention. Such

³⁷ For example, SLAS 44/IAS 32, Financial Instruments: Presentation; SLAS 45/IAS 39, Financial Instruments: Recognition and Measurement; and SLAS 46/IFRS 7 Financial Instruments: Disclosures. These standards have been effective from 01.01.2011.

intervention has had implications for the level of corporate governance in those organizations as well as for the potential role of accounting in corporate governance. There have been many instances where politically connected personnel with poor technical and management skills were appointed as chairperson or members of the BOD of public sector enterprises (Karunatilake, 1986). These people were often inclined to pursue their own interests or the interests of pressure groups rather than the interests of the public at large, restricting the ability of the BOD to perform its role as a corporate governance mechanism. For example, there have been instances where credit in the public sector banks was granted to parties/groups/applicants who were not creditworthy, but were politically influential. Such occurrences have caused heavy losses to those banks (e.g., Rajapakshe, 2001). There was no evidence of undertaking any project evaluation or credit assessment before granting such loans, and thus accounting appeared to play no role in justifying (not justifying) those loans.

Further, public enterprises are often used by politicians and trade union leaders to achieve short term political objectives, such as providing jobs for party supporters and favouring party financiers by awarding credit/tenders (Dheerasekera, 2007). This also seems to be common in public sector banks, evidenced by the concerns raised by the PUB interviewees³⁸. For example, an interviewee commented, “There are some sighted cases where there were political influences, for example, to hire or promote a person, or there may be influences to grant a loan” (Accountant1–PUB). Excessive staff recruited due to political pressure have incurred high labour costs for the public sector enterprises, and have a negative effect on the profitability and stability of those organizations. There is also an indirect cost associated with political appointees in terms of productivity and efficiency, as they are usually unqualified and inexperienced.

Furthermore, public sector enterprises in Sri Lanka are often subject to a high degree of government interference (Wickramasinghe, Hopper and Rathnasiri, 2004). Public sector enterprises are often unable to perform independently, as the government uses these organizations to achieve certain needs of the government. For instance, it appears that public sector banks are required to fulfil government needs for credit. An interviewee of

³⁸ Participants in the interviews were selected from two major banks in Sri Lanka. Interviewees are referenced by their function or organization position (Accountant, Manager, BOD, etc.) and organization (PUB – public sector bank, PRIB – private sector bank), and are numbered in chronological sequence of interview (Accountant1–PUB was the first accountant interviewed from the public sector bank).

PUB more specifically stated, “Government banks are required to fulfil government needs for funds” (BOD1–PUB). Moreover, recently the President of Sri Lanka ordered all public sector banks to bring down their interest rates on loans granted to customers to accelerate economic revival in the country (Daily News, 28.10.2009). Such occurrences suggest that the nature of the political environment could nullify organizational control systems, including accounting controls, in decision making, resulting in undesirable consequences for the governance of public sector organizations. Hopper and Hoque (2004) and Hoque and Hopper (1994) also find the role of accounting in public sector organizations becoming marginalized, especially when the ruling party uses its powers for political gains rather than for economic ends.

Social environment

The way in which accounting facilitates corporate governance in organizations, including banks, can also be influenced by various social factors. These may include the level of education (e.g., Doupnik and Salter, 1995) and cultural factors, such as the commercial values of people in a society (e.g., Adams, 2002; Hamid, Craig and Clarke, 1993).

Although Sri Lanka records a relatively low performance across a number of macroeconomic indicators, its accomplishments in the area of social policy surpass those of most developing countries (World Bank, 2006). The World Bank (2005) states that Sri Lanka has made stellar progress on the millennium development goals. For instance, the country has maintained an impressive record in education, which can have a favourable impact on the role of accounting in the corporate governance of banks. The overall literacy rate of Sri Lanka is 92.5 per cent, and the country has already attained universal primary education and completion and has achieved gender parity at primary and secondary education levels (CBSL, 2007a). Due to the high level of education, on the one hand, there are proper institutional arrangements with able personnel to generate relevant information, and on the other hand, there is demand for information from stakeholders who are able to use that information effectively.

Public understanding in Sri Lanka about banking has increased significantly in recent years due to the rapid expansion of bank branches and facilities and to various

advertising campaigns by different banks about their banking facilities, interest rates and safety of deposits. The comment made by an interviewee highlights this situation:

Right now I think the customers are well aware of what is happening around them. Especially the 'corporate' types of customers we deal with... they are very sensitive to interest rates and similar issues. If you take other personal type of customers also, with so many products being advertised, customer awareness is very much higher than in the past. (Manager3–PRIB)

The failure of a number of financial institutions/informal deposit takers (e.g., Golden Key, Sakvithi, Danduam Mudalali) in recent times has also made customers more vigilant, particularly about the safety of deposits. This situation has led depositors and other interested parties to monitor carefully the activities of the bank, using relevant information.

The existing culture, on the other hand, is unlikely to make people demand information about stewardship. This could have a negative influence on the level of disclosures of banks in the country. Sri Lankan society, based mainly on Buddhism and quietism, seems to value trust in relationships above information about stewardship. This has implications for the need for accounting information as a means of accountability. It may also explain why in recent times a large number of people in the country incurred heavy losses by investing their hard-earned money in informal deposit takers such as Sakvithi and Daduwam Mudalali. Moreover, the majority of the population in Sri Lanka is in the low income level category, and their involvement in the share market activity is limited. As a result, the demand for accounting information is lower than in industrialized countries.

International environment

Global developments in accounting influence the accounting practices of a country. Factors such as the convergence of financial reporting (e.g., Judge, Li and Pinsker, 2010), the operation of multinational companies (e.g., Archambault and Archambault, 2003), and pressure by financial agencies (e.g., Hopper and Hoque, 2004) can have an impact on the role of accounting in corporate governance in developing countries such as Sri Lanka. Further, international laws and regulations and codes of best practice in corporate governance also directly influence corporate governance practices in those countries (Aguilera and Cuervo-Cazurra, 2009; Yoshikawa and Rasheed, 2009).

The laws and regulations applicable to the banking industry in Sri Lanka are largely based on international laws and codes of best practice in accounting and corporate governance, such as Basel Committee reports, OECD recommendations, and IFRS. In particular, as discussed in the previous section, SLAS and SLAuS have been aligned with the respective international standards for financial reporting and auditing. Moreover, the CBSL implemented the Basel II Accord with effect from January 2008 to establish formal risk management structures in banks (Fitch Ratings, 2007). These changes have also been influenced by the requirements of aid agencies and international financial institutions such as the World Bank.

Further, international developments in corporate governance, such as the Cadbury Report (1992), Sarbanes Oxley Act (2002), OECD Principles of Corporate Governance (1999; 2004), and NYSE Rules on Corporate Governance (2003), have been incorporated into the regulatory framework that governs corporate governance practices in the country. Table 4.3 provides details of the development of Sri Lankan codes of best practice in corporate governance vis-à-vis the related international laws and regulations, and/or the codes of best practice in corporate governance. It clearly shows the influence of international laws and regulations and of codes of best practice on corporate governance in the development of corporate governance regulation in the country. For instance, the mandatory code of corporate governance for licensed banks in Sri Lanka in 2008 is based mainly on the Basel Committee's 2006 report on enhancing corporate governance for banking organizations and on other recent international codes of corporate governance.

Table 4. 3: Sri Lankan codes of corporate governance vis-à-vis related international laws and regulations and codes of best practice on corporate governance

Sri Lankan Code	Relevant International Code
Code of Best Practice on Matters Relating to Financial Aspects of Corporate Governance, December 1997	- The Cadbury Committee Report on the Financial Aspects of Corporate Governance in the U.K., 1992
Code of Best Practice on Audit Committees, May 2002	- Combined Code of the U.K., 1998
Code of Corporate Governance for Banks and Other Financial Institutions, June 2002	- Basel Committee Report on Enhancing Corporate Governance for Banking Organizations, 1999; and Framework for the Evaluation of Internal Control Systems, 1998 - Corporate Governance in the Financial Sector, Commonwealth Working Group, 2000 - Corporate Governance of Banks, ADB - OECD Principles of Corporate Governance, 1999
Code of Best Practice on Corporate Governance, March 2003	- Turnbull Committee Best Practice Guidelines, 1999 - OECD Principles of Corporate Governance, 1999 - Blue Ribbon Recommendations, 1999
Guidelines for Listed Companies – Audit and Audit Committees, 2004	- Certain provisions of the Sarbanes Oxley Act (2002) in the U.S.
Rules on Corporate Governance for Listed Companies, 2007	- Combined Code of the U.K., 1998 - The NYSE Corporate Governance Rules in the U.S., 2003 - Code of Corporate Governance of Singapore - Principles for Good Governance and Best Practice Recommendations of the Australian Stock Exchange - Corporate Governance Report of the Securities and Exchange Board of India
Code of Corporate Governance for Licensed Banks in Sri Lanka, 2008	- Basel Committee Report on Enhancing Corporate Governance for Banking Organizations, 2006
Code of Best Practice on Corporate Governance, June 2008	- Combined Code of the U.K., 1998 - The NYSE Corporate Governance Rules in the U.S., 2003 - Code of Corporate Governance of Singapore - Principles for Good Governance and Best Practice Recommendations of the Australian Stock Exchange - Corporate Governance Report of the Securities and Exchange Board of India

The changes in laws and regulations, including SLAS and SLAuS, and Basel II, have led to significant changes in the accounting and reporting systems of banks, as noted in the following comments:

I think a main issue is that CBSL introduces the Basel II reporting. Now we are in the process of implementing it. In addition, the international accounting standards have to be complied with. For these, we did a lot of changes in the accounting system. (Accountant2–PUB)

IFRS 7 about disclosure of financial instruments; IAS 32 about disclosure and presentation; and IAS 39 about recognition and measurement, are going to have a tremendous impact in the banking industry. I think there will be a lot of changes to accounting practices in Sri Lanka, including in banks: they may have to revamp their accounting systems to meet these requirements. (Accountant5–PRIB)

One of the interviewees, however, noted the need for the regulatory authorities to be cautious in adopting international practices in Sri Lanka:

What I feel is we are blindly following international regulations and best practices without realizing the gravity... whether or not they are suited to the Sri Lankan context. Now, for example, the implementation of Basel II... most of the reports we have seen, even the US finds difficulties to invest in the Basel II technology. You need to have so much sophisticated operation and comprehensive systems. (Accountant6–PRIB)

Tsamenyi and Uddin (2008), Wanyama, Burton and Helliard (2009), and West (2009) also note this issue and state that the applicability of laws and regulations which are largely based on those developed in industrialized countries is questionable because developing countries operate under different sets of economic, political, social and cultural contexts.

These changes have also created a demand for more professionally qualified accounting personnel in the banking industry. It is common in the banking industry for bankers rather than professionally qualified accountants to undertake accounting functions, particularly in public sector banks. The need for a change in this regard was mentioned by a number of interviewees in this study. The following represents such a view: “It’s really a brand new accounting we are doing here. We have a lot of new regulations and accounting standards. What we are doing now is not what we did 5 years back” (Accountant6–PRIB).

This section discussed the influences of elements in the external environment, namely economic, political, social and international elements, on the role of accounting in corporate governance in the banking industry in Sri Lanka. It showed that factors in the

external environment have had both favourable and unfavourable influences in this respect. With the amendments to the economic policies adopted by the country over time, changes have been made to the institutional and regulatory framework that governs accounting and corporate governance, which have had a favourable effect on the role of accounting in the corporate governance of banks. Most such changes have been in line with the recent international developments in this area.

On the other hand, several other factors, such as the commercial values of the people in the society, seem to make the role of accounting in the corporate governance of banks less effective. Even though the majority of people are educated enough to read and understand the accounting information produced by banks, they are more likely to value trust, and thus not use accounting as a means of acquiring information for monitoring purposes. This can also have a negative influence on the banks' level of external reporting, as there is no pressure from the public to disclose more information.

The discussion also showed that most of the factors in the external environment, except influences from the political environment, influence public and private sector banks in a similar way. As discussed above, such influences can have favourable as well as unfavourable effects on the role of accounting in corporate governance in these two bank types. The discussion also highlighted that the political environment of the country does not seem to be conducive to ensuring the role of accounting in the corporate governance in public sector banks. Instances where the government's undue influence has been visible include the granting of loans to government projects, granting of facilities to party supporters, and hiring or promoting employees who are political supporters. Such occurrences are likely to hamper the potential role of accounting as well as the quality of corporate governance.

4.4. Summary and conclusions

This chapter examines the extent to which the role of accounting in corporate governance is influenced by the factors in the organizational interface (i.e., regulatory bodies, professional accounting bodies, capital markets and key stakeholders) and the external environment (i.e., economic, political, social and international) in the banking

industry in Sri Lanka. The analytical framework depicted in Section 2.8 provided the basis for the analysis.

The analysis undertaken in this chapter in relation to the influence of the organizational interface and the external environment on the role of accounting in corporate governance has led to three main findings. First, there are various institutional and regulatory arrangements designed to improve the role of accounting in corporate governance in the banking industry in Sri Lanka. In particular, recent changes in accounting regulations related to banks in the country seem to have had a favourable impact on its role in corporate governance. However, improvements in certain areas in the institutional and regulatory framework are needed, especially with regard to the strength of institutional capacities and the enforcement mechanisms of laws and regulations. Weaknesses in these issues are commonly seen as obstacles to using accounting effectively to achieving a high standard of corporate governance in banks in developing countries (e.g., Iyoha and Oyerinde, 2010).

Second, elements in the external environment influence the role of accounting in the corporate governance of banks directly as well as indirectly through their influence on the factors in the organizational interface. These factors seem to have both favourable and unfavourable influences on the role of accounting in corporate governance of banks. For example, unwarranted political interference in the operation of banks is a direct influence undermining the potential role of accounting in the corporate governance of public sector banks. The developments made to the institutional and regulatory framework by the 1978 Constitution is an example of indirect influences, as those changes have resulted in improving accounting and corporate governance practices in the banking industry.

Finally, the role of accounting in corporate governance in public and private sector banks operates mostly within a similar institutional and regulatory framework in the organizational interface. The differences in the influence of the external environment on the role of accounting in corporate governance between public and private sector banks are mainly due to excessive political intervention in public sector banks. Additionally, the multiple roles assumed by the government in such banks, as owner, directorate and main borrower, seem to adversely affect the quality of corporate governance and the

role of accounting. This finding, consistent with contingency theory, clearly demonstrates that the effectiveness of the role of accounting in corporate governance depends on various contextual factors. For example, this study reveals that political environment and the nature of ownership are important contextual factors that influence the role of accounting in corporate governance in banks in developing countries such as Sri Lanka.

These findings suggest that although accounting could play an important role in the corporate governance of banks, the effectiveness of that role would depend on the nature and the extent of influence of factors in the organizational interface and in the external environment. This conclusion supports the notion of the contingency theory (e.g., Chenhall and Chapman, 2006). The contextual factors examined in this study were found to affect the role of accounting in the corporate governance of banks in varying ways, effectively promoting that role as well as obstructing it.

CHAPTER 5

ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE IN THE BANKING INDUSTRY IN SRI LANKA

5.1. Introduction

Using the analytical framework developed in the study, this chapter investigates the role of accounting in corporate governance in the banking industry in Sri Lanka. More specifically, the chapter critically examines the extent to which the two selected banks utilize information derived from accounting, broadly classified into external reporting, external auditing, management accounting and internal auditing, in assisting corporate governance. Recall from Chapter 2 that these four areas of accounting have the capacity to facilitate the operation of various corporate governance mechanisms both internal (i.e., board of directors (BOD), managerial compensation plans (MCP)) and external (i.e., laws and regulations, shareholder and debtholder monitoring, labour and product markets) to banks. Chapter 4 revealed that factors in the organizational interface and the external environment are likely to influence corporate governance mechanisms in the banking industry in Sri Lanka. This chapter also takes into account the effects of internal organizational factors on this role.

The remainder of the chapter is structured as follows. The next section introduces the two case organizations. Section three explains the ways in which the two banks use accounting in corporate governance, and discusses how contextual factors influence the role of accounting in corporate governance. A summary of the chapter and some concluding remarks are provided in the final section.

5.2. Case organizations

This section provides a brief description of the two case organizations, the public sector bank and the private sector bank, hereafter referred to as “PUB” and “PRIB” respectively to disguise their identity.

5.2.1. The public sector bank

Background

PUB is a leading commercial bank in Sri Lanka, and it is the oldest government owned commercial bank in the country, established by a special statute in 1938 – *Annual Report, 2008*. It has expanded its business from limited services mainly for the import-export trade in the early days to a wider range of services at present. PUB was initially established to assist businesses which were involved in import-export trading during a period in which economic activities were focused on the plantation sector, by providing funding based on reasonable terms (Sanderatne, 1989). Prior to the establishment of PUB, Indian Chettiars were the main source of finance for businesses, which had to pay extremely high interest rates on their borrowings (Sanderatne, 1989).

At the inception, a number of restrictions were placed on the activities of the bank. For example, the bank's advances were not permitted to exceed 50 per cent of its total deposits; the period of advances was limited to 6 months; and foreign exchange transactions were prohibited except for those in Indian Rupees. Despite these restrictions, PUB continued to grow, and successfully competed with other foreign banks operating in the country at the time. For instance, after just a decade of operation, PUB claimed one fourth of all commercial bank deposits and one third of total bank advances. Consequently, most of the restrictions imposed at the inception of the bank were removed, and it was allowed to operate independently (Sanderatne, 1989).

In 1961, PUB was nationalized and all ordinary shares of the bank were vested in the government. Nationalization implied that the bank's main focus should be on national interests rather than on the interests of private shareholders (Sanderatne, 1989). Subsequently the government used the bank as a means to influence the economic development of the country (Sanderatne, 1989). Facilities were expanded geographically and to many sectors of the economy, including small borrowers in the private sector (Rajapakshe, 2001). For example, the number of branches grew rapidly from 23 to 56 within the first 10 years of nationalization. The scope of PUB's lending activities was also extended from trade and commerce to agriculture and industry, and the length of time for which loans were granted was increased from short term to medium and long term (Sanderatne, 1989). The branch expansion resulted in the promotion of banking habits among people in rural areas (Rajapakshe, 2001). PUB

played an important role in mobilizing savings, as evidenced by its deposit base which was equal to half of the total commercial bank deposits in the country, no more than 10 years after its nationalization (Sanderatne, 1989).

As described in the previous chapter, liberalized economic policies introduced in 1977 had major implications for the banking industry. For instance, competition within the banking industry increased, the government dominance of banks decreased, and opportunities were created by new economic activities (Sanderatne, 1989). A number of domestic and foreign banks commenced operations in Sri Lanka after the introduction of liberalized economic policies, leading to a decline in PUB's market share (Sanderatne, 1989). In the new competitive banking environment PUB needed to operate more efficiently and innovatively for survival. PUB responded to these challenges by introducing a number of new services, such as automated teller machines, credit cards, electronic fund transfer facilities, and several financial derivatives, parallel to its private sector counterparts.

Currently, PUB holds a dominant position in the banking industry in Sri Lanka. According to the annual report of PUB for 2008, PUB is the largest bank in Sri Lanka, based on assets valued at SLR 484 billion³⁹, claiming approximately a quarter of the total assets held by commercial banks in the country, and with an annual turnover of SLR 60 billion, representing a 20 per cent market share of the banking industry in the country. According to its annual report for 2008, at the end of 2008, PUB maintained 7.5 million customer accounts across all nine provinces via 309 branches and 146 extension offices in the country, and three overseas locations in London, Chennai and Male. These service points are linked by modern technology, and are connected on-line to provide more efficient and convenient service to customers.

PUB offers a broad range of banking and financial services to personal and corporate customers and to the government of Sri Lanka. Its diversified business segments and product lines include retail banking (e.g., consumer lending and finance, micro finance, leasing, pawning), corporate banking (e.g., debt-based products, transaction services), and international and treasury services (e.g., foreign exchange, money market,

³⁹ On 21 December 2011, the exchange rate between the U.S. dollars and Sri Lankan rupee was US\$1 =SLR 111.

correspondent banking). Its annual report for 2008 states that the advances of PUB at the end of 2008 totalled SLR 281 billion, representing 20 per cent of the total advances of all commercial banks in the country, and that during the same year PUB generated a profit after tax of SLR 3.6 billion, which is 1.13 per cent of return on assets and 16.13 per cent of return on equity.

Deposit mobilization is a key growth strategy of PUB, as reflected in its large deposit base amounting to SLR 316 billion at the end of 2008 – *Annual Report, 2008*. However, the relative importance of the deposit base decreased slightly in 2008 with an increased dependence on borrowed funds, which included a total of SLR 4.2 billion debentures issued during the year – *Annual Report, 2008*. The capital and reserves balance at the end of 2008 was SLR 23 billion, leaving the debt-to-equity ratio at a high value of 95 per cent, which is common among banks – *Annual Report, 2008*. The current total capital adequacy ratio of PUB is relatively high at 15.9 per cent, compared to the minimum statutory requirement of 10 per cent required by the Central Bank of Sri Lanka (CBSL).

Governing structure

PUB is governed by a BOD headed by a chairperson and a team of management led by a CEO. The Minister of Finance appoints members to the BOD for a period of 3 years subject to their reappointment. The Minister also selects one of the appointed directors as the chairperson of the BOD.

The current BOD of PUB consists of six members; all of them are non-executive, and all but one (the member who represents the Ministry of Finance) are independent. Further, the BOD has several sub-committees, namely the audit committee, nomination and corporate governance committee, human resources and remuneration committee, and integrated risk management committee. Furthermore, the chairperson of the audit committee in PUB is a chartered accountant. According to PUB's Debenture Issue Prospectus 2008, its board meetings are held fortnightly, and the average attendance of individual directors at these meetings is 86 per cent.

The CEO of PUB is appointed by the BOD subject to the approval of the Minister of Finance. It has been the practice of PUB that the CEO is selected from the bank. This is

similar to the *keiretsu* system in Japan where there is a high degree of internal mobility within the business organization (Moerland, 1995). This practice, however, has restricted new blood coming into the bank (see e.g., Borokhovich and Parrino, 1996; Rosenstein and Wyatt, 1997). Moreover, unlike in its private sector counterpart, the CEO of PUB is not part of the BOD. Dismissal of the CEO must be on a resolution of the BOD passed by a two third majority and approved by the Minister of Finance (Anthonisz, 1989).

5.2.2. The private sector bank

Background

PRIB is a leading privately owned commercial bank in Sri Lanka. It was the first privately owned domestic commercial bank in the country. Although it was incorporated in 1969, its origin can be traced to a foreign commercial bank (hereafter the “parent company”) established in 1920 – *Annual Report, 2008*. In 1961, the government of Sri Lanka (then Ceylon) forbade foreign banks to accept deposits from Ceylonese nationals. As an alternative option PRIB was duly incorporated, with the parent company holding 40 per cent of its equity – *Annual Report, 2008*. In 1973, PRIB acquired another foreign commercial bank’s branches in three major cities in Sri Lanka, namely Kandy, Galle and Jaffna, as part of a deal that removed the government’s limit on accepting deposits. In 1971, the parent company amalgamated with two other foreign banks, forming a new bank in 1975. This bank divested its 40 per cent stake in PRIB due to changes in local regulatory requirements in 1997 (Fitch Ratings, 2009).

PRIB rapidly expanded its branch network, particularly after liberalized economic policies were introduced in 1977. This seems to be a main reason for its increased focus on personal banking in the total portfolio, although the bank’s traditional focus had been corporate banking with a strong franchise in trade finance (Fitch Ratings, 2009). The liberalized economic policies also provided opportunities for the bank to enter into new ventures. For instance, PRIB formed its foreign currency banking unit in 1979, promoting off-shore banking business. During this period PRIB invested in modern technology (e.g., automated teller machines, electronic fund transfer facilities) and introduced new products (e.g., credit cards, financial derivatives) in order to meet the increased competition in the liberalized banking environment. It also acquired the

operations of a bank in Bangladesh in 2003, becoming the first Sri Lankan bank to establish operations outside the country.

Currently, PRIB is the largest private sector bank and the third largest bank in Sri Lanka, based on assets valued at SLR 281 billion at the end of 2008, claiming approximately 15 per cent of the total assets held by commercial banks in the country (Fitch Ratings, 2009). The annual turnover of PRIB in 2008 was SLR 44 billion, representing nearly 15 per cent market share of the banking industry in the country – *Annual Report, 2008*. In Sri Lanka, PRIB operates through 181 branches that are linked by modern technology and are connected on-line, facilitating customer service – *Annual Report, 2008*. In Bangladesh, PRIB has 11 branches located in the main cities, and their operations account for 8 per cent of assets and 13 per cent of turnover of the bank (Fitch Ratings, 2009).

PRIB offers a broad range of banking and financial services, including corporate banking (e.g., debt financing, fee-based services), personal banking (e.g., current, savings and fixed deposit accounts, personal loans), and treasury (e.g., foreign exchange dealings) to customers within and outside of Sri Lanka. The advances of the bank at the end of 2008 totalled SLR 187 billion, representing 13 per cent of the total advances of all commercial banks in the country (Fitch Ratings, 2009). PRIB generated a profit after tax of SLR 4.3 billion in 2008, which was 1.55 per cent of return on assets and 17.13 per cent of return on equity – *Annual Report, 2008*.

The capital structure of PRIB consists largely of deposits and other liabilities, with a smaller equity balance. The deposit base of the bank is SLR 200 billion, which is 13 per cent of the total deposits of all banks in the country – *Annual Report, 2008*. PRIB has also issued debentures, and SLR 4.4 billion balance remained payable at the end of 2008 – *Annual Report, 2008*. The capital and reserves balance at the end of 2008 stood at SLR 26.3 billion, leaving the debt-to-equity ratio at a high value of 91 per cent (Fitch Ratings, 2009). The current total capital adequacy ratio of PRIB of 13.1 per cent is higher than the minimum statutory requirement.

Governing structure

PRIB is governed by a BOD headed by a chairperson, and a team of management led by a CEO. The nomination committee of the BOD is required to make recommendations to the BOD for new appointments and re-election of board members. All members appointed to the BOD, other than the nominee directors, are subject to re-election by shareholders at the first general meeting after their appointment – *Annual Report, 2008*. The BOD selects one of its members as the chairperson of the board.

The current BOD of PRIB consists of nine members. All the directors except the CEO are non-executive; one of them is also independent. Further, the BOD has several sub-committees, namely the audit committee, human resources and remuneration committee, integrated risk management committee, nomination committee, credit committee, and strategic planning committee. Furthermore, the chairperson of the audit committee is a chartered accountant. Normally the bank's board meetings are held monthly; there were 15 meetings in 2008, and all members attended over two-thirds of these meetings – *Annual Report, 2008*.

The CEO of PRIB is appointed by the BOD and is responsible for the implementation of strategy and for day-to-day management of the bank. The CEO of PRIB is also represented in the board. Selection of the CEO may be either from within or outside of the bank, depending on the requirements of the bank and the availability of a suitable person inside the bank. Dismissal of the CEO is also based on a decision made by the BOD.

The key factors discussed in this section related to these two banks are summarized in Table 5.1. It shows that over time PUB and PRIB have turned into large organizations with complex and wide ranging operations. The figures related to their performance and position also show their current level of operating success and stability. More specifically, the above description clearly indicates that the two banks selected for this study as case organizations are the leading public and private sector banks in Sri Lanka. With their size and complex operations, these banks have needed well developed accounting and information systems to assist their corporate governance. The following section details the role of accounting in the corporate governance of these two banks.

Table 5. 1: Summary of key information relating to the public sector bank vis-à-vis the private sector bank

Description	PUB	PRIB
<i>Background</i>		
Established	1938	1969
Nationalized	1961	
Assets base (market share)	SLR 484 billion (25%)	SLR 281 billion (15%)
Annual turnover (market share)	SLR 60 billion (20%)	SLR 44 billion (15%)
Number of branches	309	181
<i>Services provided</i>		
Personal banking	√	√
Corporate banking	√	√
International banking	√	√
Government projects	√	
Total advances (market share)	SLR 281 billion (20%)	SLR 187 billion (13%)
Profit after tax	SLR 3.6 billion	SLR 4.3 billion
Return on assets	1.13%	1.55%
Return on equity	16.13%	17.13%
Deposit base	SLR 316 billion	SLR 200 billion
Debentures	SLR 4.2 billion	SLR 4.4 billion
Total equity	SLR 23 billion	SLR 26.3 billion
Debt-to-equity ratio	95%	91%
Total capital adequacy ratio	15.9%	13.1%
<i>Governing Structure</i>		
Governing body	BOD	BOD
Members appointed by	Minister of Finance	Nomination committee/ BOD
Chairperson appointed by	Minister of Finance	BOD
CEO appointed by	BOD/ Minister of Finance	BOD
Chairperson/CEO duality	√	√
Members of the BOD	6	9
Executive directors	None	1 (CEO)
Non-executive directors	6	8
Independent directors	5	1
<i>BOD appointed committees</i>		
Audit	√	√
Human resources and remuneration	√	√
Nomination	√	√
Integrated risk management	√	√
Credit		√
Strategic planning		√

Source: Annual reports of PUB and PRIB, 2008.

5.3. Role of accounting in corporate governance of banks

The objective of this section is threefold. First, it examines the actual role of accounting in corporate governance of the two selected banks; second, it discusses how that role varies from the potential role due to contextual influences; and third, it compares and contrasts the role accounting plays in the corporate governance of these two banks. For the purpose of analysis, the classifications provided in the analytical framework

developed in Chapter 2 are used. Accordingly, in the following sub-sections, the roles of four areas of accounting (external reporting, external auditing, management accounting and internal auditing) in facilitating the functioning of various corporate governance mechanisms (BOD, MCP, laws and regulations, shareholder and debtholder monitoring, and labour and product markets) in the two banks are discussed. The variations identified in relation to the role of accounting in corporate governance (i.e., actual vs. potential, and PUB vs. PRIB) are analysed with reference to the contextual influences arising from internal organizational factors and the factors in the organizational interface and external environment outlined in the analytical framework.

5.3.1. External reporting

Information provided through external reporting mainly facilitates operation of the external corporate governance mechanisms, namely laws and regulations, shareholder monitoring, debtholder monitoring and labour market.

5.3.1.1. Laws and regulations

A high level of regulation is necessary for banks to avoid failures and to protect the rights of diverse stakeholders, including shareholders, debtholders, customers and the government. Recall from Chapter 4 that banks in Sri Lanka are subject to various laws and regulations enforced by regulatory authorities. The regulations enforced by the CBSL, for instance, are particularly designed to safeguard the interests of depositors as there is no government guarantee for bank deposits in Sri Lanka. An accountant of PUB stated, “Because banks are based on customer deposits, the CBSL always come out with new guidelines on reporting that aim to protect the depositors” (Accountant2 – PUB). This observation is consistent with the findings of other studies related to banks in developing countries (e.g., Arun and Turner, 2004; Levine, 2004; Nam, 2004). They note that, in developing countries, prudential regulation and supervision (e.g., banks being examined on an on-site and off-site basis by the banking supervisors) are important in the absence of government provided deposit insurance cover to protect depositors. Hence, the external reporting systems of banks in Sri Lanka could play an important role in this corporate governance mechanism in achieving the expected outcomes highlighted in the analytical framework, for example, establishing debtholder/depositor protection.

The external reporting systems of the two banks examined in this study are designed to fulfil the regulatory reporting requirements in a similar manner. They both employ an information system, known as the 'International Comprehensive Banking System' (ICBS) which generates reports that include both financial and non-financial information to be submitted to the regulatory authorities on a regular basis. The accountants interviewed from the two banks noted how the two banks fulfil this requirement: "The ICBS is designed after taking all the requirements of the CBSL into account. When we define the parameters in the system, we have taken all the classifications of the CBSL into consideration" (Accountant7 – PUB); "We always meet the statutory requirements. Whenever there is a change, say for example, classification of accounts or level of bad debt recognition, we adhere to these requirements by making necessary adjustments in the ICBS" (Accountant5 – PRIB).

It was also noted that the web-based off-site surveillance system introduced by the CBSL in July 2006 enabling the banks to submit reports on-line eased the regulatory reporting. A compliance officer was appointed in the two banks in 1998 to oversee compliance and statutory reporting requirements.

Reports generated by the ICBS system appear comprehensive, regular, and on time, and also seem to satisfy the requirements of the regulatory authorities whose intention is to implement proper supervision over banks. Since PUB moved to this system from a manual system more recently (2004) than PRIB (1993), interviewees from PUB tend to have a clear idea about the comparative advantages of the new system. For instance, they believe that the new organizational setup and the web-based system to despatch information to the regulator allow the bank to provide information efficiently. One interviewee stated,

Earlier, we used to send reports manually. It was hard. We had to get down things from the branches and amalgamate to prepare reports. Now, sending reports to the CBSL is much easier... There is no paperwork involved. So, I can say that there are improvements. (Accountant6 – PUB)

Another accountant commented, "The ICBS is very responsive. On a regular basis we are reporting on all kinds of things... It is regular, comprehensive and... there is no numbers that are left out" (Accountant3 – PUB).

The prompt submission of regulatory reports by the two banks enables the CBSL to perform its regulation and supervision on a timely basis. According to interviewees, the CBSL periodically carries out audits and inspections, and issues reports on the findings. Among other things, such activities of the CBSL encourage good corporate governance of banks, as reflected in the following comments made by interviewees from the two banks: “As we upload reports onto the web, CBSL checks them very quickly and if there are discrepancies they inform us then and there. Because they can view the reports at once and they don’t want to go through the papers” (Accountant6 – PUB); “If CBSL needs, they come and conduct audits, they also do reviews... and they are mainly concerned about bank’s risk management” (Accountant5 – PUB); “CBSL does periodical inspections... they visit the bank, especially Finance and Planning department, and even at branch levels, they check whether we follow those regulations” (Accountant3 – PRIB); “CBSL annually audits the bank’s accounting system, and makes suggestions... we make necessary changes accordingly” (Accountant7 – PRIB).

Nevertheless, the degree of application of regulation and supervision by the CBSL appears to vary between the two banks. For instance, the quality of law enforcement as well as the nature of the monitoring role by the regulatory authorities over PUB seem questionable at times. Despite the Banking Act (No.30) 1988 stipulation that the maximum amount a bank can lend to a corporate or individual client is 30 per cent of the capital of the bank, PUB has granted loans that exceeded this limit (see parliamentary Hansard, 1997). Although the CBSL is the regulatory authority administering this Act, there is no evidence that the CBSL questioned this departure from the limit stipulated by the Banking Act or instructed PUB to take corrective measures.

Further, unwarranted political influences could be a factor that negatively affects the effectiveness of regulation and supervision in PUB. There were instances where, due to political pressure, large loans were granted by PUB without adequate security, and subsequently had to be written off as bad debts. For example, parliamentary Hansard (2009a, p. 350) highlights granting of substantially large facilities to three organizations on grossly inadequate security. The following comment of the Advisers’ Committee to the Committee on Public Enterprises (COPE) of the Parliament, in response to PUB’s current large non-performing loans portfolio of SLR 12 billion, also indicates the

possibility of the bank being influenced by powerful groups. “It must also be ascertained through the examination whether any of these loans have been granted under external pressure, subverting normal banking procedures” (Parliamentary Hansard, 2009a, p. 350). Although the CBSL reveals such situations through its normal investigations, its regulatory powers to take action against the perpetrators could be subverted by undue political influences from the external environment.

Furthermore, the weak regulation and supervision of PUB are closely associated with the dual roles played by the government as its owner and regulator. Since the regulator (i.e., CBSL) represents the owner of PUB (i.e., the government), the regulator could have difficulty in performing its role independently. For instance, the CBSL was not able to exercise its regulatory powers against the excessive government borrowing in PUB. The default of such government directed loans has resulted in huge losses being incurred by PUB over the years, threatening its stability in many occasions (see Parliamentary Hansard, 2008; Rajapakshe, 2001:p.4).

In contrast, there is no evidence to suggest that PRIB breaches laws and regulations or experiences lapses in the quality of law enforcement and supervision by the regulatory authorities over this bank. The CBSL appears to have the freedom to undertake any investigation required over PRIB. For instance, the interviewees of PRIB stated that political and government influences on their bank are minimal. “PRIB is not exposed to political influences to that extent. When comparing with government banks, such influences are negligible” (Accountant2 – PRIB); “We are a private bank. It is the policy of the bank that we do not undertake any government projects” (Manager2 – PRIB). Hence, it is more likely that the CBSL can perform its regulatory and supervisory activities more independently, while effectively utilizing the regulatory reports generated through the external reporting system to ensure good corporate governance in PRIB.

The effectiveness of regulation and supervision of the CBSL over PRIB could also be attributed to the bank’s effort to abide by laws and regulations and its external reporting system established to fulfil the regulatory requirements. The interviewees from PRIB constantly noted this point.

Whenever there is a new regulation coming up, CBSL always refer to us first. That is a good indicator... even they have praised us for the way that we provide information, and the time that we take to provide such information... (Accountant8 – PRIB)

Another interviewee further elaborated as follows:

We have been the number one bank in Sri Lanka for the last so many years. And for each and everything, the CBSL benchmark us. Sometimes, they ask other banks to follow our procedures... and sometimes they get information from us. Because, they also know, to a greater extent, that we have addressed those issues... So, we have maintained our reputation and they have the faith on us. (Accountant6 – PRIB)

As shown in the analytical framework, having a well organized external reporting system fulfilling the regulatory reporting requirements is an important internal organizational factor that contributes to corporate governance of banks.

5.3.1.2. Shareholder monitoring

Shareholders in banks can operate as an important corporate governance mechanism by monitoring the activities of the BOD and managers, and participating in the important decisions. However, the effectiveness of such roles depends on the adequacy and efficiency of the systems established for that purpose.

Because the government of Sri Lanka is the sole owner of PUB, it has the ability as well as an incentive to monitor PUB. On the government's behalf, the Ministry of Finance monitors PUB on a regular basis and is represented on the BOD through the appointment of one member, as reflected in the following comments: "There are frequent meetings with the Ministry, as the shareholder is the Ministry of Finance. When there are issues, they call us for ad-hoc meetings" (Manager3 – PUB); "The government of Sri Lanka has a permanent representative on the board. They attend board meetings, and therefore, there is a very good information flow to the government especially through the Ministry of Finance" (Accountant3 – PUB); "The Ministry of Finance is working very closely with us. We have regular meetings with the Ministry chaired by the Secretary to the Ministry. The senior management of PUB has to participate in these meetings and report the progress" (BOD1 – PUB).

The external reporting system of PUB assists the monitoring role of the Ministry of Finance by providing relevant reports in a timely manner. For instance, PUB is required

to provide to the Ministry of Finance its financial statements quarterly and annually. The following comments show that the Ministry of Finance uses the information provided through the external reporting system to monitor the bank. “There is a regular monitoring by the Ministry of Finance based on the reports submitted on a quarterly basis. So, we come under a quite thorough inspection by these people” (Accountant3 – PUB); “We have to submit our summarized financials to the Ministry on a quarterly basis. Based on that, they undertake some performance analysis for all the state banks” (Accountant2 – PUB); “They monitor and review accounts and reporting issues, and whether those mandatory requirements are complied with and I would say to some extent the performance of the bank” (BOD2 – PUB).

However, not only the degree of use of such reports, but also the extent of the monitoring role of the ministry appear to be less than what would be regarded as essential in corporate governance. For instance, although the general view of the interviewees was that the reports lodged with the Ministry of Finance were used to some extent, there is little documentary evidence to support this view. In particular, it is not easy to understand how these reports are used and what actions have been taken based on them. The COPE has also raised concerns over the effectiveness of the monitoring role performed by the Ministry of Finance, as follows: “The COPE also expressed its dissatisfaction to the officials of the Ministry of Finance as they have failed to perform their obligation and duties to minimize the losses incurred by PUB” (Report of the COPE, 2007, p. 9). This situation may be due to lack of capacity and motivation of the staff to undertake this activity more effectively. Although the ministry represents the government as the shareholder and engages in activities required to monitor PUB, staff undertake those tasks merely as public sector employees, with relatively limited interest in improving PUB’s performance (see e.g., Arun and Turner, 2004).

In contrast, it is possible that PRIB shareholders are more vigilant about the affairs of that bank than their counterparts in PUB, i.e., government officials attached to the Ministry of Finance, because the former have a financial interest by investing their personal savings in the bank. The views of the interviewees from PRIB suggest that such monitoring role is more visible among large shareholders than with the minority shareholders. For example, an interviewee commented,

Over 50 per cent of our shareholding is in the hands of institutional investors. So, they are certainly represented in the AGM, and closely monitored the performance and the stability of the bank. But, you know, as long as the results are good, small shareholders don't bother to attend the AGM. However, if you have a bad year, even they will come and scream. (Manager2 – PRIB)

It was also revealed that to facilitate shareholder monitoring in PUB, various accounting reports are submitted to the Parliament of Sri Lanka and the COPE on a regular basis. One of the mechanisms for making PUB accountable to its owner, the government of Sri Lanka, is the requirement to obtain parliamentary approval for its annual accounts. An interviewee commented, “We as a government bank need to send our annual reports to the Parliament to get the approval. Before we send it to the Parliament approval, it also has to be presented to the Cabinet” (Accountant2 – PUB).

The COPE investigates the affairs of all government owned enterprises, including PUB. For this purpose, it uses financial and non-financial information provided by these entities. Additionally, PUB must provide relevant information to the Minister of Finance to allow parliamentary questions with regard to the performance of PUB to be answered. An interviewee stated, “We are sending regular information to the COPE... whatever they request, and when they ask something, we have to answer. Sometimes, Ministers, MPs, raise various questions in the Parliament” (Accountant3 – PUB).

On the other hand, shareholders of PRIB have a right, which is protected by the laws and regulations, to receive information by way of quarterly and annual reporting, and through press releases. Because PRIB is a licensed commercial bank, CBSL regulations require it to publish quarterly financial statements in the press in the main three languages used in Sri Lanka, Sinhala, Tamil and English, within 2 months after the end of the quarter. As the bank is a quoted public company, it is required by the Colombo Stock Exchange (CSE) regulations to publish quarterly financial statements in the press, or to mail them to shareholders. The interviews with the accountants revealed that PRIB complies with both these requirements, although mailing the quarterly financial statements to the shareholders is not mandatory. This practice of the bank enables PRIB shareholders to monitor the bank more effectively.

Annual reporting to shareholders of PRIB is mandated by several regulations: the Companies Act (reporting required within 6 months after the end of the financial year),

the CSE regulations and the CBSL regulations (reporting required within 5 months after end of the financial year). However, PRIB normally publishes its annual reports well before these statutory deadlines (within 3 months after end of the financial year), improving the relevance of the information provided to shareholders. Hence, shareholders who have an incentive to monitor the bank's activities have access to both quarterly and annual reports. Further, in accordance with the provisions of the Companies Act, PRIB makes available its financial statements at the registered office for inspection by shareholders. Moreover, according to the CSE listing rules, PRIB has followed the practice of issuing press releases on matters related to the bank and the market that have implications for investors' decision making. Recall from the analytical framework that the laws and regulations administered by the institutions in the organizational interface, such as the CBSL, the ICASL and the CSE, have a favourable impact on the role of accounting in the corporate governance of banks.

The PRIB's website includes a section on 'investor relations' that also provides information for shareholders. It contains the bank's annual reports beginning with the financial year 2000, and the preceding four quarterly financial statements. However, several comments of the participants suggest that there is still room for development.

I think that is one of the areas which we may be able to improve a bit. If you have a web site, you always concentrate or disclose things on it as most of the international banks do. I don't think we have that, and mostly it is our accounting reports publish there. (Accountant4 – PRIB)

We could do a lot more. It would be good for people to see the share price, get some information on how the share price is moving... there's other information that we could be publishing on the web that we are not doing today. (Manager1 – PRIB)

It appears that the shareholders of PRIB have more opportunities to access information compared to PUB, mainly due to the additional regulations that have been established for that purpose, for example, Companies Act requirements on submitting annual reports and holding AGMs. In addition, the high level of disclosures in PRIB's external reporting seems to play an important corporate governance role. For example, an interviewee commented on the quality of external reporting as follows: "To a great extent, our transparency level of disclosures is high compared to others... that's why we have been winning the annual report awards" (Accountant6 – PRIB). The high level of transparency would have a favourable effect on shareholder monitoring of the bank.

Another interviewee further elaborated:

The way we look at these reports... invariably, apart from going for these awards, we aim at providing information to the public at large. So, as a result, we have been improving the report structure... like by way of giving some additional information, or by way of adding some valuable information to the stakeholders. (Accountant8 – PRIB)

In PUB, given that the government of Sri Lanka is the only shareholder, there is no need to publish information in the annual report to the same extent as for a private sector bank with diverse shareholders. This view was expressed by an interviewee of PUB:

If you compare with private sector banks, we have not gone to that much of disclosures up to now. The reason is that the government is the sole owner, and there is no need to disclose information widely. Also, directors' interests in bank's outside contracts and related party transactions are minimal, compared to the private sector banks. (Accountant2 – PUB)

The study also reveals that the government of Sri Lanka, which is the sole shareholder of PUB, is often involved in making major decisions in the bank, undermining the level of corporate governance as well as the role of accounting in the corporate governance of PUB. Although shareholder participation in important decisions is a characteristic of good corporate governance (e.g., OECD, 2004), the situation in PUB appears to be different. In particular, decisions with significant implications for the government are often made by the government rather than by the BOD and the management of PUB. Such decisions are often made without due regard to relevant information such as the results of project evaluations and the details of cost of funds. The government can intervene in PUB's decisions in this way mainly because of the multiple roles it plays in PUB as the owner, the main borrower and the beneficiary of the bank's investments. This violates one of the criteria Nam (2004) identified in determining the quality of corporate governance in government owned banks, namely the degree of government intervention in banking operations. A number of participants noted such possibilities. For example, a manager stated:

There are certain things that we have to negotiate with the government because it is the owner. It has borrowed from us. So, then we have to decide on the rate we have to offer and payment term. There are some bonds issued by it on renewal basis. So, after the renewal, we have to negotiate with it about the rates, dividends, and also taxes. (Manager3 – PUB)

The lack of control on the part of PUB on the overdraft facilities given to the government was noted by an interviewee as follows: “The government overdrafts are very difficult to control. Today it may be 10 billion. Tomorrow, it may be 20 billion” (Accountant3 – PUB). The documentary evidence also supports this view: “The amount of bank overdrafts obtained by the Treasury of Sri Lanka from PUB in January, 2009 was SLR 11,797 million” (Parliamentary Hansard, 2009b, p. 584).

In PRIB, in contrast, major decisions are made by the BOD and senior management, and are then approved by shareholders in shareholder meetings. For this purpose, shareholders are provided with relevant information. Furthermore, shareholders have the opportunity to clarify matters related to accounts and other items in shareholder meetings such as AGMs: “Queries are dealt in the AGM, where the shareholders are provided with a time to come up with their questions” (Accountant8 – PRIB). The bank also holds extraordinary general meetings to obtain shareholder approval for important resolutions, such as proposals for fundamental changes affecting the bank: “If there is an amendment to articles, there should be a resolution passed... that means shareholders have the opportunity to clarify their issues on such proposals before giving the consent” (Accountant1 – PRIB). Most of these procedures are in accordance with the regulatory provisions such as the requirements of the Companies Act.

Apart from complying with statutory requirements that encourage shareholder participation in important decisions as discussed above, there are several other ways that PRIB facilitates shareholder monitoring. A number of interviewees noted that the bank provides information to large shareholders such as institutional and international investors on individual basis, clarifying the matters and queries raised by them. “We normally have investor relations with the foreign investors, like there are some shareholders, at least one or two per month, come and speak to us... and they drill down information to a great extent” (Accountant4 – PRIB).

For major decisions, for example acquisitions and mergers, bank consults its institutional shareholders. No minority shareholders do involve at the initial stage of such decisions, but whenever the bank makes such a decision, there will be a shareholder meeting to get their approval. (Accountant7 – PRIB)

Such procedures in PRIB, which are beyond the statutory requirements, effectively enhance the role of accounting as well as shareholder monitoring of the bank.

5.3.1.3. Debtholder monitoring

The high level of debt-to-equity ratio prevailing in banks makes debtholder monitoring an important corporate governance mechanism. In view of the absence of a government guarantee or insurance cover for deposits, depositors of banks in Sri Lanka have a strong incentive to monitor their banks' activities (see e.g., Macey and O'Hara, 2003). Debenture holders of the two banks in this study also have the motivation to monitor their banks as the debentures are unsecured. As well as motivation, however, such parties also need the ability to undertake that monitoring role. That is, they should have access to relevant information and also have the knowledge to use such information.

Depositors in the two banks have similar opportunities to access accounting information about their respective banks. Unlike shareholders, depositors do not possess a legal right to be informed about their bank's financial results: "There is no legal requirement to publish any specific data for depositors, and we don't publish any information specifically for depositors" (Accountant5 – PRIB). Quarterly financial statements appear to be the main source of accounting information accessible to depositors, as they are published in the press in the three main languages of the country in accordance with statutory requirement of the CBSL. An accountant of PUB commented, "There is no separate publication for depositors, however, I believe that quarterly publication in newspapers fulfils their information needs" (Accountant2 – PUB).

Further, quarterly and annual financial statements are displayed at the banks' branches for the benefit of depositors who visit the branches for business transactions. A participant from PRIB noted, "We have nearly 180 branches... all these branches display quarterly accounts as well as last year financial statements at their premises. So, every customer can check those financial statements" (Accountant7 – PRIB).

Depositors also have the opportunity to access recent annual reports and quarterly financial statements on their bank's website. However, the degree of access to such information seems to be restricted, due to the limited knowledge of information technology among most depositors and the shortage of internet facilities in the country. These aspects of social environment in the country were noted by an accountant of PUB as follows: "There is information on the web, but the people in the rural areas have to come to the branch for whatever they need to know as they don't have knowledge or

access to internet” (Accountant3 – PUB). Some depositors seem to use banks’ websites merely to conduct business transactions rather than to find information for monitoring purposes. That point was noted by an interviewee from PRIB, “The use of bank’s website is more for online banking rather than for information gathering. But, it could also be that we are not making the information easily available, presentable to our stakeholder community” (Manager1 – PRIB).

It appears that limited access to financial information is a factor that restricts the ability of the depositors to monitor the banks in Sri Lanka. However, above all, it seems that small scale depositors in particular are not overly concerned about the financial performance of their bank, but are more interested in variations in interest rates. For instance, according to a manager of PRIB, “If you take retail depositors, they are not driven by accounting ratios, rather, they are driven by interest rates. The wholesale depositors, on the other hand, may look at financial information in making their investment decisions” (Manager4 – PRIB).

This feature may be due to economic conditions prevailing in the country. For example, some depositors seem to be solely dependent on the interest income derived from their deposits and are not concerned about how much profit the banks make, or how well the banks are performing. As Adams and Mehran (2003), and Levine (2004) have pointed out, it could also be due to the fact that they have confidence on the regulatory oversight of the CBSL, which plays a substitute monitoring role. When there is high level of regulation, depositors might not be particularly motivated to use any monitoring measures.

Further, government ownership also appears to affect depositors’ level of interest in monitoring PUB. Since PUB is a government owned bank, there seems to be some degree of belief among depositors that there is a government guarantee for their deposits, although such guarantee does not exist in reality. As an interviewee stated, “Being a government bank it gives a sense of security to people... the government authorities are constantly monitoring us and there is nothing to worry for people. But, there is no government guarantee given to the deposits” (BOD1 – PUB). This observation is consistent with the views of Macey and O’Hara (2003) who argue that the notion of a deposit guarantee reduces the interest of depositors to monitor banks.

Unlike depositors, debenture holders of the two banks have the right to receive annual reports and interim financial statements, in accordance with the listing rules of the CSE. Hence they have more opportunity to monitor closely the activities of their banks compared to depositors. As well, both depositors and debenture holders can use press releases to monitor the activities of their banks.

5.3.1.4. Labour market

High competition prevailing in the banking industry in a country makes it necessary for accounting to play an important role in the labour market. For example, the CEO and key management personnel of a bank may need to perform efficiently in order to retain their positions as well as to advance their careers. Information provided in external reporting, for instance, can signal managers' level of performance in the bank.

The following comments suggest that managers of banks in Sri Lanka have ample opportunities for advancement of their careers externally, if their performance is outstanding, "I think, because there is a high competition in the banking industry, easily the managers have access to other banks depending on their performance" (BOD2 – PUB); "I think if you are a talented guy, maintain your asset quality base, and have the capability to mobilize huge amount of deposits, then there will be a high demand for you. So, others will try to grab you" (Accountant4 – PRIB). These statements also indicate the importance of bank managers' concerns about reputation, which has been described as an important element of labour market forces in the banking industry. For example, Meacy and O'Hara (2003) note that managers invest their non-diversifiable human capital in their employment. The reputation that managers gain, particularly at the most senior levels such as the CEO and key management personnel, is largely attributed to the performance of those managers as reflected in the financial statements.

However, the culture in the banking industry, which provides limited encouragement for movements of managers between banks, seems to hinder the effectiveness of the labour market as a corporate governance mechanism as well as the potential role of accounting in labour market. Interviewee comments suggest that the labour market operating within the banking industry in Sri Lanka is similar to *keiretsu* system operating in Japan, where managerial turnover is very limited: "You don't find people moving from one bank to

another. There seems to be an unwritten rule” (Manager1 – PRIB); “Past few years, we have seen lots of opportunities in the Middle East. Otherwise, sort of lateral movements within the country would have been very few” (Manager3 – PRIB). There is also no evidence to suggest any significant differences in the level of operation of the labour market in the public and the private sector banks in Sri Lanka.

5.3.2. External auditing

The information generated by the external auditors is used by the BOD, regulatory authorities and shareholders in scrutinizing the activities of managers, resulting in a favourable impact on the corporate governance of banks.

5.3.2.1. Board of directors (BOD)

The role of external auditing in proper functioning of the BOD in the two banks is mainly influenced by the regulatory requirements that govern corporate governance of banks in Sri Lanka. In particular, the mandatory code of corporate governance for licensed banks in 2008 includes rules concerning the appointment and activities of the audit committee to the BOD, which is the main internal body responsible for the proper functioning of the external auditing in banks. Among other things, this code requires that the audit committee of a bank monitors the effectiveness of the external audit process, discusses with the external auditors the nature and scope of the audit as well as issues arising from the external audit, and reviews the external auditor’s management letter.

Such regulations, on the one hand, have led the audit committees of the two banks to closely follow up the external auditor’s work for good corporate governance. The BOD of PUB, for example, appears to take immediate corrective measures on audit issues, as expressed by a board member, “The audit committee and the Auditor General want to work as a team so that mistakes are not continued, and mistakes are rectified without any delay” (BOD3 – PUB). In PRIB, the importance placed by the BOD on audit issues is reflected by the following comment of an interviewee: “Certainly, follow-up actions on audit issues include a very rigorous process. It’s something that we take very seriously because banks are highly regulated” (Manager1 – PRIB).

On the other hand, such regulations have directed the banks in the public and the private sectors to adopt similar types of procedures in utilizing the external auditor's work for corporate governance of their banks. For instance, the BODs of the two banks in this study have access to information provided by external auditors through the audit committee. Management letters prepared by the external auditors, for example, are used by the audit committees for the purpose of monitoring activities of the managers and directing their banks. An audit committee member of PUB made the following comment.

The audit committee looks at the management letters which generally point out the shortcomings or non-compliances or issues that we should rectify. So, we use that extensively for rectifying the systems and other issues. And also we look at the Auditor General's report submitted to the Parliament, which highlights the audit issues. (BOD2 – PUB)

Another audit committee member of PUB further elaborated the importance placed by the audit committee on the management letters prepared by the external auditors: "The audit committee thoroughly go through the management letters of external auditors for long hours... and corrective actions are taken immediately" (BOD3 – PUB). The audit committee of PRIB also reviews the management letters from the external auditors together with the management's responses thereto, in order to take corrective measures and perform follow-up procedures on outstanding issues – *Annual Report, 2008*.

Further, the external auditors make a contribution to BOD's role in corporate governance by their presence at audit committee meetings in the two banks. A board member of PUB pointed out, "As a practice, we invite the Auditor General to the audit committee meetings so that we can clear the issues then and there" (BOD3 – PUB). The audit committee of PRIB reviews the audited financial statements in the presence of external auditors – *Annual Report, 2008*. Such procedures assist the BOD to identify areas that need improving, to provide necessary instructions for managers, and to undertake follow-up procedures, ensuring that compliance reporting is adhered to, systems are streamlined, and errors are rectified. In this way, the external auditors assist audit committee meetings with their knowledge and experience related to the audit issues discussed in those meetings (e.g., Cadbury Report, 1992).

This study, however, finds certain differences in the two banks with regard to the effectiveness of external auditing. For instance, a number of issues came into light in the study in relation to external auditing at PUB, which could have negative implications for corporate governance. First, the BOD of PUB has no input to the selection of the external auditor. The Constitution of Sri Lanka requires the Auditor General to be the external auditor of PUB. Second, given that the Auditor General is the external auditor by statute, there is no possibility for the BOD to review the performance of the external auditors and no power to recommend a change of the external auditor. Finally, the Auditor General's status as a government authority could have an impact on the auditor's independence, as the government is also the owner of PUB.⁴⁰

In contrast, the audit committee of PRIB reviews the external audit programme and the external auditor's work, and recommends to the BOD the reappointment of external auditors for the next financial year subject to the approval of shareholders at the AGM – *Annual Report, 2008*. These activities of the audit committee ensure proper corporate governance in PRIB. For instance, audit committee meetings with the external auditors prior to the commencement and at the conclusion of the audit, to discuss the audit scope, approach and methodology to be adopted and the findings of the audit, ensure proper conduct of external audit. Consequently, the audit findings resulting from this process can provide useful information for the BOD to direct the bank and monitor the activities of managers. Moreover, at the time of this study the external auditor of PRIB is a big four audit firm, a factor that is likely to enhance the audit quality, as reflected in the following comments: "I think they have appropriate business expertise to audit the bank. They do a lot of bank audits in Sri Lanka" (Accountant5 – PRIB); "They have necessary skills. They are internationally recognized" (Accountant7 – PRIB).

5.3.2.2. Laws and regulations

The regulations require that banks submit their annual audited financial statements to the CBSL. Hence, the external auditor's report on the annual financial statements of the banks assists the CBSL in performing its supervisory duties. For example, based on this

⁴⁰Although this is generally applicable to all public sector enterprises in any country, the situation here would be different, in which the appointment of the Auditor General (appointed by the President of Sri Lanka) as well as the BOD (appointed by the Minister of Finance) are heavily influenced by the ruling party of the government.

report, the CBSL checks whether the banks meet the regulatory and compliance requirements. Moreover, Sri Lanka Auditing Practice Statement 7 on the relationship between bank supervisors and external auditors provides necessary guidelines for bank supervisors to share information generated by the external auditors in facilitating bank supervision.

5.3.2.3. Shareholder monitoring

Due to the dissimilarities in the ownership structure of PUB and PRIB, there are differences in the use of the external auditor's reports for monitoring purposes by the shareholders of the two banks. In PUB, the Ministry of Finance uses the reports prepared by the external auditors (e.g., management letters) in performing a monitoring function of the bank. For example, an interviewee commented, "Apart from the numbers, the Ministry of Finance has looked at other things such as the audit reports and management letters. They give a lot of comments and explanations based on these reports" (Accountant3 – PUB). The investigations undertaken by the COPE on the affairs of PUB also depend largely on the external auditor's report. This view was expressed by an interviewee as follows. "COPE's examinations are mainly based on the Auditor General's reports, which are about things such as where we have gone wrong, where we have made mistakes. COPE will ask explanations on such issues" (BOD2 – PUB).

On the other hand, the shareholders of PRIB have access to the audit report published in the annual report. Hence, those shareholders who have an incentive to monitor the bank's activities are in a position to utilize such information for monitoring purposes. Additionally, the attendance of the external auditor at annual general meetings also implies the auditor's role in corporate governance of the bank.

5.3.3. Management accounting

Management accounting systems in banks generate information for the operation of a number of corporate governance mechanisms, namely BOD, MCP, labour and product markets.

5.3.3.1. Board of directors (BOD)

The two banks in this study have implemented management accounting systems that provide certain information to the BOD on a regular basis to direct the bank and monitor the activities of managers. Management accounting systems in both banks generate detailed monthly and quarterly financial statements indicating actual and budgeted figures, a quarterly compliance report providing details of the banks' compliance with statutory requirements, and key accounting ratios applicable to banks. Additional information, such as project appraisals, non-performing assets (NPA), write-offs, and details of new and loss making branches, is also provided on request.

It's basically financial information that we produce on a monthly basis to evaluate the bank's profitability. This includes the budgeted figures and explanations for significant variations. In addition, quarterly financial information includes a comparison of financial performance with our main competitors. (Accountant2 – PUB)

We provide management accounts on a segment basis, basically, segregating into domestic banking, offshore banking and Bangladesh operations. For each segment, we provide separate P&L, balance sheet and ratio computations to the BOD on a monthly basis. These statements include actual as well as budgeted figures. (Accountant7 – PRIB)

The members of the BOD of PUB who participated in the study were generally satisfied with the level of information received. For example, a board member noted, "The information is timely presented. The BOD has access to whatever information they require" (BOD2 – PUB). Given that all the members on the BOD of PUB are non-executive, their comments also suggest that the non-executive directors have sufficient access to information. Another board member commented, "If anybody wants further clarification on a matter, this is possible even outside the board. Independent professional advice could also be sought on requirement basis" (BOD1 – PUB).

The BODs of the two banks also seem to use such information for governance purposes. For instance, the study reveals that the board members in PUB use management accounting information, not only to direct the bank but also to monitor the activities of the bank and the managers. For instance, they use such information to evaluate the performance of the bank in terms of profitability, performance of loans, recovery of bad debts, and also in guiding the bank in addressing its weak areas. BOD2 – PUB stated, "The major areas that the board reviewed recently include the profitability issues, and non-performing loans and recovery issues". According to another board member,

Monthly financial statements first come to the audit committee, and then to the board. Audit committee completely goes into details with all these financial statements and the compliances, where we went wrong, where we have overspent etc. And they are discussed, and specially all the ratios are thoroughly reviewed... and wherever the weak areas, we give warning to management. (BOD3 – PUB)

The following comments by other interviewees in PUB also confirm the degree of use of management accounting information by the BOD: “Based on our financial review, BOD sometimes queries and instructs respective divisions to take corrective actions to rectify those issues” (Accountant2 – PUB); “Sometimes, the DGMs, the AGMs and the compliance officer are called for board meetings, if they have any concern” (Accountant4 – PUB); “Sometimes BOD also attends the management meetings when quarterly financial statements are reviewed.” (Manager1 – PUB).

Similarly, the accountants in PRIB also stated that the BOD of their bank uses such information in performing its fiduciary duties. For instance, the BOD of PRIB provides strategic directions to the bank through its close involvement in the budgeting process.

The BOD reviews the budgeted figures, and the strategies and the challenges of the bank in achieving those targets. Then, in that particular point of time, say for example, if they really feel that we need to concentrate on this area rather than other areas, those instructions are given. (Accountant4 – PRIB)

Recently, we forwarded the corporate plan and the budget, and the BOD wanted to relook at it... BOD wanted us to adjust the efficiency part of what we have projected. They need to enhance the efficiencies in projections for non-performing ratios and interest recoveries etc. (Accountant3 – PRIB)

Further, the Finance and Planning department of PRIB seems to review the budget bi-annually, and revise it for the remaining half year based on the strategic changes recommended by the BOD.

The contents of monthly financial statements are compared with the budget. Whenever BOD feels that the bank is moving away from the budget, they come up with different strategies usually at the end of the first half of the year. (Accountant7 – PRIB)

The management accounting system in PRIB often provides information on an ad-hoc basis in response to the BOD’s requests. There is evidence to suggest that the BOD’s decisions are made after critically analysing that information. For example, an interviewee commented, “The BOD goes through each and every aspect of the feasibility

reports that we submit, say for example, some feasibility study... if they are not satisfied with it, they will come back and ask for more information” (Accountant4 – PRIB).

The effective utilization of management accounting information is connected to several factors—some common to both banks, and others specific to one bank. In particular, similar to what was discussed in the previous section, the high degree of usage of management accounting information by the BODs in the two banks is mainly attributable to the influence of the regulatory bodies in the organizational interface. For example, the implementation of the mandatory code of corporate governance for banks in 2008 incorporates many responsibilities for BOD, and additionally the close supervision by regulatory authorities such as the CBSL has led the BODs to act in a prudent manner achieving a high level of performance and stability of the bank.

With the latest changes in the corporate governance regulation, the BOD is given a number of responsibilities. Therefore, the board members are really concerned about performance and stability of the bank – they closely monitor whether corrective actions are taken, and checks and control have been maintained. For these purposes, they now seek more information. (Accountant2 – PUB)

Consequently, the level of involvement of the BOD in performing its duties as well as the role that accounting plays in proper functioning of the BOD appear to have increased, with lengthy discussions on critical issues leading to prolonged board meetings. An interviewee commented, “Sometimes board meetings go for 5–6 hours” (Accountant3 – PUB). The favourable impact of laws and regulations on the effectiveness of BOD is consistent with the findings of other studies (e.g., Chhaochharia and Grinstein, 2005; Hagendorff, Collins and Keasey, 2010; Linck, Netter and Yang, 2009).

Some other factors related to board structure seem to have led to an increased use of management accounting information by the BOD, playing an important role in improving the corporate governance of PRIB. In particular, the inclusion of a number of qualified accountants in the BOD has been noted as a factor that enhances its ability to utilize that information. For example, an interviewee commented,

BOD consists of at least 3–4 accountants minimum. The deputy chairperson is an accountant, CEO is an accountant, and there are two more directors who are accountants.

All the time, mostly I can see, a lot of information they need, rather than what we produce. (Accountant4 – PRIB)

This observation is consistent with the international guidelines on corporate governance. For example, NYSE (2003) states that the board members should be competent in accounting and finance.

Further, the inclusion of the CEO in the BOD of PRIB as an executive director seems to enhance the BOD's ability to perform its fiduciary duties, with favourable implications for corporate governance as well as for the role of accounting in corporate governance. For example, executive directors can provide their specialized knowledge of the business in board meetings, and also can ensure proper utilization of management accounting information for board decisions (Cadbury Report, 1992). In contrast, the BOD of PUB does not include the CEO or any other executive director, which is identified as a structural weakness of the BOD in that bank.

Nevertheless, the effectiveness of the BOD to function as a corporate governance mechanism appears to be constrained in the two banks, due to the failure of the existing management accounting systems to generate sufficient and needed information. For example, the systems mainly produce information about bank/branch profitability, for which the head of each department or branch manager is accountable. An accountant in PRIB commented,

I am not sure what the BOD look at, but what we provide them is mainly a P&L and a balance sheet on a monthly basis, including the actual and budgeted figures. For example, as we have exposed to a hedging transaction these days, but I'm not sure whether our reports are of any use to the BOD in getting information about these transactions. (Accountant6 – PRIB).

This deficiency could be due to the lack of a sophisticated accounting information system in these banks. The ICBS has limitations in generating adequate accounting information. This partly explains the banks' inability to introduce more contemporary management accounting systems, such as activity-based costing where product and customer profitability analyses can be undertaken. This is the reason why a large amount of manual work is needed to produce the relevant management accounting information. An accountant in PUB stated, "In ICBS... so far we are able to calculate the branch profitability only. The other types of profitability, such as customer and product

profitability... still we have to calculate manually” (Accountant2 – PUB). A similar situation was described by a manager in PRIB, “At present, there is no proper mechanism to review product profitability... there may be products which are obsolete, or there may be products which do not make any profits or contributions” (Manager4 – PRIB). The large degree of manual intervention in the calculation of product and customer profitability could affect the efficiency and accuracy of information generated by the existing management accounting systems. As argued in Chapter 2, the existence of a proper accounting system to generate management accounting information is an important internal organizational factor that facilitates corporate governance.

Apart from the above weakness that is common to both banks, specific issues in PUB suggest that information systems are not always viable in public sector banks, as they tend to be marginalized in order to serve the interests of the government. For instance, at times the BOD is not in a position to function as an independent entity, and as a corporate governance mechanism. There have been instances where management accounting systems as well as the scrutiny by the BOD were overlooked and disregarded to fulfil certain needs of the government. For example, sometimes the bank was compelled to grant credit to the government to support various government projects, without any project evaluation. The following statement by an accountant confirms the nature of this issue.

As a state bank, we are obliged to undertake projects in the masses, such as fisheries, agriculture, small and medium industries, micro-finance and housing on government’s request at very concessionary rates. Apart from that, government directly borrows money from the bank. That is also again at very concessionary rates. So, although the cost of funds, mobilizing cost is equal to other banks, lending rate is not so. Our lending rates to development banking are really far below the financing cost of the funds. (Accountant1 – PUB)

Often, the BOD lacks the power to contravene government requests for lending⁴¹ and would be hesitant to do so, mainly because the members of the board are appointed by the government. For example, a board member commented, “We are a government bank. So, when the government needs funds for certain projects, they take money from the bank. Because this is their bank” (BOD1 – PUB). It appears in this study that the

⁴¹ For example, the Minister of Finance is empowered, after consultation with the board, to give to the board general or special directives in writing as to the transaction of the business of the bank, and the board is obliged to give effect to such directions (Anthonisz, 1989).

high level of government interference in bank's operations and the resulting disregard of management and control systems and the consequent impact upon the BOD's function impede the role of accounting in the corporate governance of PUB (e.g., Nam, 2004).

Moreover, appointees to the BOD of PUB are often politically affiliated, resulting in the granting of large loans to political supporters. Such loans often become non-performing. For example, the report of the COPE (2007, p.9) reported,

When examined on 13th November 2006 the Committee observed that PUB had granted loans amounting to SLR 314 million and overdrafts of SLR 300 million to a local firm by obtaining inadequate security valued only up to SLR 40 million. This was a blatant violation of the banking rules and procedures. These loans remained unpaid.

This evidence also suggests that most such loans were approved without proper evaluation, indicating the lack of consideration given to the existing control systems including management accounting systems. This observation is consistent with Arun and Turner (2004) who note that corporate governance in banks in developing countries is a complex issue due to extensive political intervention, largely because of the government ownership of banks.

There is also documentary evidence suggesting that there is limited use of management accounting information in managing costs and activities in PUB. For instance, the report of the COPE (2007, p. 9) reveals that the cost to revenue ratio of this bank had gone up to 74 per cent at a time when the said ratio in the private sector banks was below 56 per cent. One factor contributing to this situation is the high staff cost largely associated with excessive staff numbers recruited whenever a new government came into power (e.g., Rajapakshe, 2001). However, there was no evidence to show the BOD expressing concerns formally or making any recommendations based on the information provided by the management accounting systems.

5.3.3.2. Managerial compensation plans (MCP)

The MCP is a corporate governance mechanism that is typically based on the performance of managers. Chapter 2 mentions that financial performance is an important criterion in setting MCP.

The operation of MCP in the two banks differs remarkably. As the managers in PUB are paid a fixed remuneration, this bank does not normally measure managerial performance for the purpose of determining managerial compensation. Hence accounting seems to play no role in this regard. The lack of a performance-based managerial compensation system creates opportunities for managers at PUB to serve their own interests at the expense of the interests of the shareholder and the depositors. However, the lack of such systems seems to be typical in public sector organizations in Sri Lanka. An accountant said,

We, being a state bank, don't have a performance based differentiated remuneration system. Our remuneration packages are common to the grade. Although I perform better than my colleagues, I don't get anything more than them. Salary increases and other increments are equal. (Accountant1 – PUB)

According to the interviewees from PUB, there is a proposal to introduce a performance-linked remuneration system for managers in the future. However, the efficacy of such a system could be affected by the multiple and the frequently changing economic, social and political objectives of the bank. For instance, due to the conflicting nature of such objectives (i.e., economic versus political and social), managers may find it difficult to achieve all these objectives at the same time through the operation of the bank (see e.g., Rainey and Bozeman, 2000). Further, the government's attempt to accommodate diverse interest groups in this manner could exacerbate the agency problem between the government (or general public) and the managers, since outcomes of managerial decisions become more difficult to measure and monitor (Estrin and Perotin, 1991). In such a situation, the use of financial indicators to evaluate the performance of managers in PUB can be questionable, as their economic performance is likely to be undermined by factors such as political expediency and intervention by pressure groups.

In PRIB, on the other hand, rewarding performance is recognized as one of the key drivers influencing employee behaviour, thereby impacting on business results. An interviewee commented, "We are a highly result-oriented bank. So compensation and other benefits are tied down to objectives and results" (Manager2 – PRIB). The compensation package of the managers in PRIB includes both a fixed component (i.e., a base salary), and a variable component (i.e., bonuses, stock options for the CEO and

senior management, and annual salary increments). The variable pay plan is determined according to the overall achievement of the bank as well as the accomplishment of predetermined individual targets, which are based on various performance parameters – *Annual Report, 2008*. The extent of use of financial measures⁴² in those parameters appears to be high, as commented by several participants. For example, “Compensation is linked with performance, which is really financial... There are other KPI⁴³ also, but without the financials others are a waste of time. So, financials dominate the KPI” (Manager1 – PRIB).

The variable pay or bonuses payable on achievement of the targets at PRIB are set at levels perceived as appropriate to provide necessary incentives for executives at all levels, including the CEO and the members of the corporate management – *Annual Report, 2008*. Further, an interviewee who represented the corporate management of the bank said, “Probably can’t disclose the figure, but the variable component in the total compensation package is sufficiently large enough to encourage high performance” (Manager1 – PRIB). Because their rewards are linked to performance, managers benefit by achieving the individual targets, and shareholders and depositors benefit at the same time, as the individual targets are linked to the overall targets of the bank. The same manager commented,

The individuals on the management committee work with the CEO in determining the KPI and from that point onwards the KPI are drilled down. So, it’s all aligned ultimately and the KPI are linked with the business plan that we have here. (Manager1 – PRIB)

PRIB’s performance-linked compensation system is supported by the organizational arrangements. The human resources and remuneration committee to the BOD is responsible for determining the compensation and benefits of the CEO and key management personnel, as well as setting their individual targets – *Annual Report, 2008*. It also lays down guidelines and parameters of the compensation structures for all executive staff of the bank and oversees the implementation of these policies. This committee ultimately decides the bonus payable to executive staff in the event of over- or under-achievement of the predetermined targets by making necessary adjustments.

⁴² The term ‘financial measures’ seems to have a broader meaning in banks. For example, it includes quality of assets (e.g., maintaining non-performing asset ratios, recovery of bad debts), and is not limited to profit and its components, revenues and costs.

⁴³ Key performance indicators

The involvement of the human resources and remuneration committee in designing and implementing the performance-linked compensation system at PRIB could enhance the degree of corporate governance in the bank. Because this committee mainly consists of non-executive directors, it is likely that the MCP designed and implemented by the committee align the interests of shareholders and managers effectively. However, there is a possibility that the inclusion of the CEO in the committee might hinder the independence of that committee and also the effectiveness of the performance-linked compensation system. For instance, a powerful CEO could influence the human resources and remuneration committee to set unchallengeable targets, thereby requiring the payment of excessive compensation to the CEO. In contrast to the practice seen in PRIB, international guidelines such as NYSE (2003) recommend that listed companies must have a compensation committee comprised entirely of independent directors.

5.3.3.3. *Labour market*

In a tight and competitive labour market, performance appraisal of the CEO and key management personnel could lead to good corporate governance, as poor performance could result in demotion and dismissal. However, despite the high competition prevailing in the banking industry in Sri Lanka, operation of the labour market as a corporate governance mechanism for the CEOs of the two banks in this study appears to be weak due to bank specific factors. For instance, although appraisal of the CEO is a requirement of PUB⁴⁴ as well as the corporate governance regulation in the country (e.g., Mandatory Code of Corporate Governance for Licensed Banks in Sri Lanka, 2008; Code of Best Practice on Corporate Governance, 2008), there is no evidence to show such assessment taking place in PUB. For example, “So far, there’s no formal evaluation of CEO, I think we are considering of having a formal evaluation on the performance of the CEO” (BOD2 – PUB). Since the CEO’s performance is not formally assessed in PUB, only limited action can be taken in the case of under-performance. Similar views have been expressed by Weisbach (1988) and Warner, Watts, and Wruck (1988). This situation in turn could hinder the labour market’s ability to operate as a corporate governance mechanism, as well as the role that accounting could play in the labour market via adoption of a formal performance evaluation system.

⁴⁴ For example, PUB’s Debenture Issue Prospectus (2008: p. 31) stated that periodic performance evaluation of the CEO and the key management personnel against the set targets and goals is a requirement of the human resources and remuneration committee to the BOD.

On the other hand, although PRIB has a system to evaluate the performance of the CEO, the inclusion of the CEO in the human resources and remuneration committee leads to questioning of its efficacy. The current practice of the bank is that the human resources and remuneration committee evaluates the performance of the CEO – *Annual Report, 2008*. At the commencement of each financial year, the human resources and remuneration committee in consultation with the CEO establishes performance parameters in setting the targets that the CEO should achieve during the year. At the end of the financial year, the CEO's performance is evaluated by this committee to ascertain whether those targets have been met and if not, whether the failure to meet such targets was reasonable under the circumstances. Similar to the discussion in relation to the MCP, the CEO's presence in the human resources and remuneration committee also hinders the role of accounting in the labour market in PRIB. For example, the CEO has the opportunity to influence target setting by the bank, and could have the incentive to set targets that are not too difficult to achieve. If targets are too easy to achieve, appraisal of CEO's performance would be ineffective as a corporate governance mechanism because there is no threat of dismissal for poor performance.

The two banks have a formal performance evaluation system for key management personnel and other executive staff, based on predetermined targets set at the beginning of a financial year. At the end of the financial year, the performance of the key management personnel is evaluated by the human resources and remuneration committee, and that of other executive staff by their immediate supervisors in conjunction with the human resources department.

The system in the bank is that the targets are set at the beginning of the year. The performance targets are given to managers based on the annual budget. We give financial as well as non-financial goals ranging from five to eight. Based on that, we evaluate the performance of managers at the end of the year. (Manager1 – PUB)

Targets for the executive staff are given based on the budget. For instance, a branch manager is responsible for their allocation from the budget, which is then allocated to the executive officers within the branch. Actual performance is measured at the end of the year. So, the human resources department or the managers, whoever evaluating the performance, has to match these two. (Accountant8 – PRIB)

The extent to which financial measures are used in such evaluations depends on the area that a manager operates. Apparently more financial targets are used for evaluating performance of operational staff such as branch managers. An interviewee of PRIB

commented, “The performance criteria for branch managers involve certain KPI based on accounting information, for example, deposits, advances, profit figures, return on assets, and even things like non-performing asset ratios” (Accountant2 – PRIB).

Nevertheless, a manager at PRIB suggested that financial performance indicators are important in setting targets for managers in all areas, including those who work as back office managers in the bank. “We have a very formal evaluation method... certainly all our profit centres have revenue and profitability as key KPI. Those cost centres also have measurements on cost, so financial performance is an integral part of our performance evaluation” (Manager1 – PRIB).

Positive results of performance evaluations are favourably considered in promotions and in determining other employee benefits such as salary increments, training and scholarship opportunities, and thus promote good governance by motivating goal directed behaviour. The following comments show satisfaction with the system: “There is a marking scheme for promotions and certain marks are allocated based on the results of the performance evaluation” (Accountant7 – PUB); “We use the results of the performance evaluation for promotions, scholarships, grading and salary increments etc.” (Manager3 – PUB); “Our performance appraisals are linked to the salary increments” (Accountant4 – PRIB); “The results of performance evaluation are basically used for performance bonuses, salary increments and promotions” (Manager3 – PRIB).

In contrast, no actions such as demotions or dismissals are taken against underperforming managers, making the role of accounting less effective in the labour market to operate as a corporate governance mechanism.⁴⁵ This appears to be largely due to employee protection laws and the culture prevailing in the banking industry in Sri Lanka. “So far, I have never come across a situation of dismissal based on performance” (Accountant7 – PUB); “For dismissal there is a separate mechanism... when there is a complaint or a fraud, there is an investigation on it. In that investigation, we recommend dismissal or interdiction or whatever... it is not based on the performance” (BOD3 –

⁴⁵ Although a good performance evaluation system is not meant to be used to demote or dismiss managers, continued poor performance of managers, particularly at the most senior level, could encourage or force them to resign from their posts (e.g., Gibbons and Murphy, 1990).

PUB); “In this country, labour laws don’t allow you to hire and fire people based on performance. I have never come across a case where the courts have permitted dismissals on the basis of poor performance” (Manager2 – PRIB).

Several other concerns were raised by the interviewees with regard to the performance evaluation system of the executive staff at PRIB. The existing organizational procedures and managerial behaviour appear to weaken the effectiveness of such a system. For instance, in evaluating the performance of managers, particularly in operational areas, targets are given for deposits and advances, and the actual result is compared against their budget to assess the level of performance. In this process, cost is an important factor taken into consideration. For example, managers are not expected to achieve deposit targets by mobilising deposits at high rates. Funds transfer pricing⁴⁶ provides the necessary information on such cost allocations. However, the following comment by an accountant suggests that this involves a political process, where more powerful managers can influence the allocation of costs.

We have transfer pricing mechanisms and through that a lot of arguments are coming through, even say, for example, the managers themselves challenge the system. Now, one manager says that “my cost allocation is not that”, then you need to argue with them. If you try to give it up to them, then some other manager within the organization will have to compensate, because that particular cost which is not allocated to him should be allocated to somebody else. So in this particular process, as you always see, who is mostly politically powerful can get less cost allocation. (Accountant4 – PRIB)

Further, practices implemented by the human resources department seem to undermine the use of the results of the performance evaluation system at PRIB. It appears that a manager must work in the same grade for a certain period of time (at least 4 years), despite a high level of performance as revealed through performance evaluations, and may not be considered for a promotion until the completion of that time period. This was noted by several participants, for example,

I have experienced that when you are climbing the ladder from the low level, there is a certain period you have to stay in each grade. Whatever qualification you have, or whatever the value addition you have contributed for the institution, you get the preference after 4 years. Except one or two, I have not come across a person getting promotion based on his value addition to the bank. (Accountant5 – PRIB)

⁴⁶ Funds transfer pricing is an internal mechanism in which the total cost of funds of the bank is allocated to cost and profit centres by considering each and every deposit and loan mobilized/granted by the respective units.

5.3.3.4. Product market

The high competition in the banking industry encourages good corporate governance of banks, as managers in a bank, for instance, need to ensure that the bank functions in a responsible manner and also provides products and services that the customers desire, in an efficient manner. In such a context, the performance of a bank in terms of profitability, cost efficiency and market share is most likely to be dependent on the proper selection of lending and deposit rates. In determining these rates, both banks in this study seem to evaluate market conditions as well as the cost structure of their respective banks. Financial information appears to be a main determinant of the lending and deposit rates of the two banks, as indicated in the following comments:

We take treasury bill rate as the benchmark to change the deposit rates. The lending rates, for corporate customers, are based on Average Weighted Prime Lending Rate declared by CBSL on a weekly basis. We add a risk premium based on a rating of customers. For others, we look at the cost of mobilizing deposits, administrative cost of the bank and market conditions to decide the cost of funds, and based on that we determine the mark-up. (Manager1 – PUB)

There are several methods we adopt in determining lending and deposit rates. One is market surveys... just to find out what our competitors are offering. Because, there are homogenous products, so simply you can't decide the price. Then the second thing, of course, is our cost of funds. That plays a very important role. (Accountant2 – PRIB)

Broadly speaking, the interest rates are determined based on the CBSL rates, what the competition is offering, and also the brand loyalty. But, having said that we also look at cost structure. I mean it's a central part of it, because ultimately we have to make a profit. (Manager1 – PRIB)

The above quotes also provide an understanding of the level of operation of product market competition in the banking industry in Sri Lanka, and emphasize the importance of evaluating competitors' rates in deciding the bank's rates. Furthermore, these quotes indicate the significance of analysing the cost structure of the bank in determining those rates, and thus the important role accounting plays in product market competition in banks.

However, although the two banks consider their cost structures in deciding lending and deposit rates, the lack of a more efficient system to generate accurate information on cost and activities and on product profitability appears to undermine the effectiveness of the product market to operate as a corporate governance mechanism. This was noted by the interviewees from both banks:

The customer and product profitability has to be calculated manually. The system can generate branch-wise profitability reports only. Whenever we require, we need to manually figure it out the profitability of a product that we offer. It is time consuming... also there can be errors in the computations. (Accountant2 – PUB)

Today, we don't have information on product profitability... there is no hard numbers to pack it up. I think there's a very good sense of what is costing more and what is not, however we need the numbers, and I think product profitability will do exactly that. (Manager1 – PRIB)

This limitation of the existing management accounting systems in the two banks results in accounting playing a limited role in assisting product market competition to operate as a corporate governance mechanism.

There have also been instances when conflicting objectives of the government negatively impacted on the effectiveness of product market competition in PUB. For instance, the government often made use of PUB to achieve its social and political objectives, at the expense of commercial viability. The following comments of two interviewees support this view: “We have to obey the social and policy lending requirements of the government, such as credit to the agricultural sector. These loans are granted at very concessionary rates, which are often below the cost of funds of the bank” (Accountant1 – PUB); “There are cases such as development purposes and national interests, where we are giving loans at statutory rates. Because we must think about the corporate social responsibility as a state bank” (Manager2 – PUB). Rajapakshe (2001) makes a similar point, stating that “The branch expansion was sometimes not based on commercial criteria, but on social and political considerations” (p. 4).

The situation described above is consistent with the claim by Nam (2004) that the social and political nature of policy lending and regulations on interest rates and branching weaken product market competition, particularly in the government owned banks, undermining the role that accounting can play in supporting product market competition as a corporate governance mechanism.

5.3.4. Internal auditing

The internal auditing function helps the BOD to perform its corporate governance responsibilities over a bank. As in the discussion in relation to external auditing, the role

of internal auditing in assisting the BOD to function as a corporate governance mechanism is also influenced by regulatory requirements. The 2008 mandatory code of corporate governance for licensed banks requires the audit committee of the BOD to take certain steps with regard to the internal audit function of the bank, including reviewing the adequacy of the scope, functions and resources, reviewing the internal audit programme, and considering the major findings of internal audit investigations and the management's response. Since these requirements are applicable to both public and private sector banks, the BODs of the two banks in this study seem to follow a similar procedure in utilizing information generated by the Internal Audit department. For instance, the BODs of both banks have access to internal audit reports via the audit committee. The use of such reports by the BOD/audit committee is facilitated by having a well organized and proper system in place. For instance, a BOD member of PUB stated,

The internal audit department sends a report to the audit committee on a monthly basis, providing a summary of the internal audits carried out during the previous month. The audit committee, after reviewing this report, prepares its own report to the BOD, giving its observations and recommendations, which provides the basis for the BOD to take corrective measures to rectify any issues of concern. (BOD2 – PUB)

In PRIB, the audit committee on behalf of the BOD discharges responsibilities in corporate governance by following up internal audit findings. The audit committee adopts the necessary procedures to ensure that it closely monitors all audits conducted by the Internal Audit department. An interviewee from PRIB commented,

For each and every investigation report submitted to the audit committee, action points are discussed and minuted. Next meeting, it reviews whether you have done anything with regard to the action points. If some are not done, again they are minuted... and it will make sure everything is properly implemented. (Accountant4 – PRIB)

The use of internal audit findings by the audit committee at PRIB is reflected in the fact that the committee examined over 250 audit and inspection reports during 2008 – *Annual Report, 2008*.

The use of internal audit information by the audit committees in the two banks is also closely associated with the structure of those audit committees. In PUB, for instance, the chairperson of the audit committee is an experienced chartered accountant. A member of the audit committee commented, “the chairperson of the audit committee contributes

to the effectiveness of the activities performed by the audit committee and the effectiveness of the internal audit function as well” (BOD3 – PUB). Moreover, having non-executive directors as members of the audit committee adds value to the internal audit function in PUB.

Similarly, several features of the PRIB audit committee contribute positively to its effectiveness and to the effectiveness of the internal audit function. That committee has an experienced chartered accountant as the chairperson, a senior practising chartered accountant in the capacity of a consultant, and only non-executive directors as members of the audit committee. For example, the monitoring role of the chairperson of the audit committee is reflected in the following comment made by an interviewee:

The chairperson goes through all the minutes. The way that he comes back and asks questions... some of the reports he needs summaries and trend analyses, like how one particular thing happened... say some excess cash at ATM, what's the error rate and number of things. (Accountant4 – PRIB)

Most of these procedures are in line with the recommendations of international corporate governance guidelines, such as Cadbury Report (1992: Appendix 4) and NYSE (2003: Section 7).

Internal audits of the two banks also ensure adherence to procedural requirements, which assist in producing a well organized and proper system of information. The internal audit charter, including the annual audit plan for the following year and the details of the functions of Internal Audit department, is subject to the approval of the audit committee. Hence, the audits carried out by the Internal Audit departments of the two banks are expected to provide useful information for the BOD to monitor the activities of managers as well as direct the bank. A member of the audit committee of PUB stated,

We have about 300 branches; they give us a schedule of their audit plan at the beginning of a financial year, and it is approved by the audit committee. So, every time when their report comes they indicate how many branches have been audited, what are the findings, and the main accounting issues etc. All those are reported to the audit committee. (BOD3 – PUB)

Having an audit charter and an annual audit plan approved by the audit committee is regarded as a good corporate governance practice in international corporate governance

guidelines (e.g., NYSE Corporate Governance Rules, 2003). Moreover, the unrestricted access of the head of internal audit to the audit committee ensures the independence of the internal audit function in both banks (e.g., Cadbury Report, 1992).

Additionally, in PRIB, the Internal Audit department is required to submit a risk management paper to the BOD bi-annually, indicating the internal audit issues raised during that period and specifying the steps that have already been taken as well as the steps to be taken in the future, providing specific time frames. That paper provides a basis for the BOD to ensure that all audit issues are addressed and followed up. An interviewee of PRIB noted, “The risk management paper includes a summary of the audit issues and the steps taken to address such issues. It’s kind of an action plan. Each half a year, BOD uses it for follow-up procedures” (Accountant1 – PRIB).

However, several factors related to organizational procedures and behavioural context in PUB appear to weaken the effectiveness of internal auditing, thereby limiting its role in the BOD as a corporate governance mechanism. Interviewees stated lack of qualified staff as a factor that seems to affect the quality of PUB’s internal audit function.⁴⁷ Moreover, in PUB, attempts to recruit a professionally qualified person as the chief internal auditor had failed, mainly due to resistance from a trade union. A board member of PUB stated,

The trade union was very reluctant to allow an internal auditor from outside. Then they went to court, but the court dismissed the case. Still the bank has not been able to appoint a professionally qualified person because the thinking behind this is that they want the bankers to be promoted to become the internal auditor. (BOD2 – PUB)

This observation is consistent with that of Wickramasinghe, Hopper and Rathnasiri (2004), who note the important role played by trade unions in influencing organizational decision making in public sector enterprises in Sri Lanka.

Further, the audit committee of PUB meets only six times per year. This is thought to be inadequate to perform a sufficient supervisory role over the Internal Audit department, as an interviewee of PUB stated: “The internal auditor’s work is basically supervised by

⁴⁷ Although interviewees of PRIB made similar comments, the impact of this weakness appears to be minimized in that bank due to the outsourcing of internal audit assignments to external firms of chartered accountants.

the audit committee and not by the board” (BOD1 – PUB). On the other hand, the audit committee at PRIB held nine meetings in the 2008 financial year (compared to four meetings in the preceding year), providing more opportunities for the audit committee to follow up internal audit issues.

Furthermore, a lack of risk-based audits seems to be a factor undermining the value of the internal audit function in PUB. An accountant of PUB commented, “What internal auditors do is, by their experience, they conduct some audits in a traditional way, but they need to improve... For instance, they haven’t so far focused on risk-based audits” (Accountant2 – PUB). In contrast, PRIB’s annual internal audit program prepared by its Internal Audit department is based solely on an assessment of risk associated with auditable areas and activities. A participant of PRIB who serves in the Internal Audit department stated,

The internal audits and follow-up procedures are entirely based on risk. We rate lapses and deviations according to high, medium and low risks. For example, if it is high, its cycle automatically falls into 6 months. There is another category called critical, where we do immediate follow-ups. (Manager4 - PRIB)

In conclusion, the discussion in this section suggests that although accounting seems to play an important role in corporate governance of the two banks, the effectiveness of that role is largely influenced by the context within which accounting operates. The main contextual factors identified as influencing the role of accounting in the corporate governance of PUB vis-à-vis PRIB are summarized in Table 5.2. As shown in the table, contextual factors related to internal organization, the organizational interface and the external environment can have a positive as well as a negative influence on the role of accounting in the corporate governance of banks. Table 5.2 also shows that the influences of some contextual factors are specific to each bank, whereas some other factors are applicable to both. In particular, it shows how the multiple roles played by the government in PUB, with conflicting objectives (economic versus political and social), and the unwarranted political influences tend to obstruct and undermine the role of accounting in the corporate governance of that bank. This finding is consistent with that of Nam (2004). The study clearly highlights the need for the banks to be cognisant of the negative effects of the context in order to effectively utilize accounting information in improving the level of corporate governance.

Table 5. 2: Contextual factors that influence the role of accounting in the corporate governance of banks

Factor	Corporate Governance Mechanism*	Effect		Remarks**
		Positive	Negative	
PUB:				
<u>Internal Organizational Factors</u>				
Multiple roles played by the government – Sole owner, directorate, regulator, auditor, main borrower and main beneficiary of bank's investment	BOD/L&R/SHM		√	ER/EA/MA
Lack of financial interest of officials attached to Ministry of Finance who undertake shareholder monitoring role	SHM		√	ER
Government ownership	DHM		√	ER
Conflicting objectives of the government (i.e., economic versus social and political)	PM		√	MA
Absence of a performance linked compensation system for managers	MCP		√	MA
Absence of a formal performance evaluation of the CEO	LM		√	MA
Lack of risk-based internal audits	BOD		√	IA
Non-use of/inability to use management accounting information to control costs	BOD		√	MA
Resistance from trade unions	BOD		√	IA
Political appointments to the BOD	BOD		√	MA
<u>External Environment</u>				
Political influences over granting loans	BOD/L&R		√	MA/ER
PRIB:				
<u>Internal Organizational Factors</u>				
Financial interest of the owners	SHM	√		ER
An organized external reporting function	SHM	√		ER
Attitudes of top management towards external reporting	SHM	√		ER
A big four audit firm as an external auditor	BOD	√		EA
Review of external auditor's work by the audit committee	BOD	√		EA
Inclusion of qualified accountants in the BOD	BOD	√		MA
Combination of executive and non-executive directors in the BOD	BOD	√		MA
Presence of a performance linked compensation system for managers	MCP	√		MA
Inclusion of the CEO in the human resources and remuneration committee	MCP/LM		√	MA
Practices implemented by the human resources department over promotion of managers	LM		√	MA
Managerial behaviour regarding allocation of costs	LM		√	MA

Table 5.2 (Continued)

Factor	Corporate Governance Mechanism*	Effect		Remarks**
		Positive	Negative	
COMMON:				
<u>Internal Organizational Factors</u>				
Attitudes towards external auditing	BOD	√		EA
Structure of the BOD/audit committee	BOD	√		IA
Audit committee oversight of the internal audit function	BOD	√		IA
Unrestricted access of the head of internal audit to the audit committee	BOD	√		IA
Use of performance evaluation to encourage goal directed behaviour	LM	√		MA
Lack of an accounting system that generates information on costs and activities	BOD/PM		√	MA
Lack of qualified staff in the internal audit department	BOD		√	IA
Limited use of accounting information to take action against underperforming managers	LM		√	MA
<u>Organizational Interface</u>				
Regulatory requirements	BOD/L&R/SHM/DHM	√		ER/EA/MA/IA
<u>External Environment</u>				
Shortage of ICT facilities in the country	DHM		√	ER
Limited knowledge of ICT among people in the country	DHM		√	ER

*The corporate governance mechanisms effected: BOD: Board of Directors; MCP: Managerial Compensation Plans; L&R: Laws and Regulations; SHM: Shareholder Monitoring; DHM: Debtholder Monitoring; LM: Labour Market; and PM: Product Market

**The areas of accounting influenced: ER: External Reporting; EA: External Auditing; MA: Management Accounting; and IA: Internal Auditing

5.4. Summary and conclusions

This chapter examines the role of accounting in corporate governance in a public and a private sector bank in Sri Lanka. The examination is carried out on the basis of the framework developed in Section 2.8, which highlights the potential role of accounting in facilitating the operation of a number of internal and external corporate governance mechanisms, and draws attention to three levels of contextual factors that could affect the nature and the extent of this role.

The study shows the extent to which the four broad areas of accounting contribute to corporate governance mechanisms in PUB and PRIB. In sum, external reporting in these banks conforms to the applicable regulatory requirements, and produces the relevant reports appropriately and on time. The management accounting systems in both banks provide some regular information, mainly about branch/bank profitability and stability, but are unable to generate information about cost and activities for internal decision making and control purposes. The two banks also have a well organized internal auditing function, and the interviewees appear satisfied with the services provided by their external auditors.

The study provides sufficient evidence to show how the role of accounting in corporate governance of the two banks is influenced by various contextual factors, including internal organizational factors and factors in the organizational interface and the external environment. Some of these factors seem to have a favourable influence on the role of accounting in corporate governance of these banks by providing the necessary guidelines and the background, promoting use of accounting for improving corporate governance. The study finds that various regulatory requirements enforced by a number of institutions in the organizational interface, such as the CBSL, the ICASL and the CSE, not only facilitate but also reinforce the use of accounting in corporate governance mechanisms in banks. For example, the high degree of usage of internal and external auditing information by the BODs in performing their corporate governance responsibilities in the two banks is largely attributable to the regulatory requirements enforced by the CBSL.

The study also finds evidence to suggest that a number of other contextual factors limit the contribution that accounting could make in corporate governance of the two banks. For example, the study reveals a number of instances where PUB had to make certain decisions and take certain actions without giving due regard to accounting information, mainly because of the multiple roles played by the government and because of influences from political and pressure groups in that bank. Further, in PUB, although the relevant accounting systems are in place, some are not used effectively or not used at all, due to the inherent culture of public sector organizations. For instance, although PUB has a performance measurement system, it does not have a managerial compensation system linked to performance. This seems to limit PUB's ability to prevent managers from engaging in behaviours that serve their own interest at the expense of the shareholder's interest. The limited use of the existing performance measurement system by both banks is also evidenced by the failure to use it to take action against under-performers. In PRIB, certain factors internal to the bank obstruct the role of accounting in corporate governance, for example, the structure of the board committees.

Given that the internal organizational factors are specific to each bank, and the extent of influences from the external environment varies between the two banks, the degree to which accounting assists corporate governance seems to differ between PUB and PRIB. Overall, these findings show that although there is the potential for accounting to play an important role in the corporate governance of banks, the effectiveness of that role depends on various contextual factors.

The above findings suggest that, even when banks are subject to the same regulatory requirements, and adopt similar systems, practices and procedures, the outcomes (i.e., the role of accounting in corporate governance in this study) are likely to vary depending on the context within which they operate. Although this finding, which is consistent with the contingency view, is based on the comparison between public and private sector banks in Sri Lanka, this may also be applicable to banks operating in other developing countries.

CHAPTER 6

SUMMARY AND CONCLUSIONS

6.1. Introduction

This chapter is structured as follows. The next section provides a summary of the study, and the subsequent section concludes the thesis by reporting the findings of the study and their implications. The limitations of the study and suggestions for future research are also outlined in that section.

6.2. Summary

The aim of this study was to examine how accounting contributes to the corporate governance of banks in Sri Lanka. To achieve this aim, the study set the following five objectives: (a) to conduct a comprehensive literature review in order to explore the ways in which accounting could facilitate corporate governance of banks; (b) to analyse the actual role that accounting plays in the corporate governance of banks; (c) to explain the contextual relativity of the role of accounting in corporate governance of banks; (d) to examine the differences in the role of accounting in the corporate governance of public and private sector banks; and (e) to make recommendations for enhancing the role of accounting in corporate governance in the banking industry.

More specifically, this study investigated the role of four areas of accounting (external reporting, external auditing, management accounting, internal auditing) in facilitating the operation of a number of internal (i.e., board of directors (BOD), managerial compensation plans (MCP)) and external (i.e., laws and regulations, shareholder and debtholder monitoring, labour and product markets) corporate governance mechanisms of banks. It also drew attention to three levels of contextual factors (i.e., internal organizational factors, and factors in the organizational interface and external environment) that affect this role.

The study was primarily motivated by the importance attributed to accounting in corporate governance, particularly in recent corporate collapses, including the failures of banks during the recent global financial crisis.

Following the qualitative research approach, this study adopted the case study research method. Two major banks in Sri Lanka, representing a public sector bank (PUB) and a private sector bank (PRIB), were selected as the case organizations. Data collection and analysis were guided by the analytical framework developed in this study. The framework shows areas of accounting that could facilitate the operation of various internal and external corporate governance mechanisms leading to a number of desirable outcomes, and how this process could be influenced by various contextual factors. Data were gathered using multiple methods. Twenty-seven semi-structured interviews were conducted with key people who included accountants, members of the board and managers in the two case organizations. The selection of interviewees from different categories, and the selection of multiple participants from each category enabled to gain alternative views of the issues concerned. The differing views that emerged were carefully analysed and interpreted before arriving at conclusions. Further, various documents were collected and reviewed for the period 1997–2009, including laws and regulations applicable to the banking industry in Sri Lanka, annual reports of the two banks, and publicly available documents such as media coverage and parliamentary Hansards. The use of multiple sources of evidence in this manner allowed corroboration and data validation.

Data were analysed in three interactive processes as suggested by Miles and Huberman (1994), namely data reduction, data display, and conclusion drawing and verification. Data were coded using NVivo software in the data reduction stage. The potential roles of accounting as highlighted in the analytical framework were linked to the actual roles at the data display stage. In the conclusion drawing and verification stage, these links were interpreted and explained with reference to the contextual influences.

6.3. Conclusions

6.3.1. Findings

(a) The potential role of accounting in corporate governance of banks

The thesis developed an analytical framework outlining the potential role of accounting in the corporate governance of banks. The framework was developed based on an extensive literature review, and the study first identified various mechanisms that could be used for corporate governance of banks. In the framework, these mechanisms are classified into two groups, internal (i.e., BOD and MCP) and external (i.e., laws and regulations, shareholder and debtholder monitoring, labour and product markets). The market for corporate control, although mentioned in the literature, was not considered as an external corporate governance mechanism in this framework due to the high level of government intervention (e.g., ownership restrictions) over banks. The framework highlights the potential contribution that accounting could make to enhance the operation of such corporate governance mechanisms in banks in the areas of external reporting, external auditing, management accounting and internal auditing.

The framework also shows the outcomes which are expected to be achieved via the influences of accounting on the corporate governance of banks. At the organizational level, efficient use of accounting in corporate governance would ensure that the interests of both shareholders and depositors are well served. At the macro level, this would assist in economic development of the country through the efficient allocation of limited resources and the stability of its financial sector.

(b) The actual role of accounting in corporate governance of banks

The actual role of accounting in corporate governance of banks was examined by conducting case studies of the two selected banks. The analysis based on the case studies found that accounting plays an important role in the corporate governance of these organizations. In particular, the study reveals that the BOD, which is mentioned as an important corporate governance mechanism in banks by the Basel Committee on Banking Supervision (2006), is the main internal corporate governance mechanism benefiting from the information generated through management accounting systems and through internal and external auditing.

The study also found that the prudential regulation and supervision of the banks by the regulatory authorities (mainly the Central Bank of Sri Lanka (CBSL)) are highly facilitated by the information generated through external reporting and external auditing in the two banks. In the absence of a government guarantee or an insurance cover for bank deposits in Sri Lanka, the contribution made by external reporting and external auditing in corporate governance is regarded as high, because such information is used to ensure banks' stability, thereby protecting mainly the depositors, which is a primary objective of the corporate governance of banks.

There was little evidence, however, to show how the two banks made use of external reporting in product market competition, external auditing in labour and product markets competition, and internal auditing in MCP. Further, the study reveals that the actual role of accounting in corporate governance differs from the potential role due to complexities of the context in which accounting operates. These findings are reported in the following sub-section.

(c) The contextual relativity of the role of accounting in corporate governance of banks

The findings of this study suggest that the actual role of accounting in corporate governance differs from its potential role due to influences of various contextual factors. This is consistent with the proposition made in the analytical framework that the role of accounting in corporate governance mechanisms is likely to be moderated by various contextual factors related to internal organization, organizational interface and external environment. The study found that such factors at times effectively promote, and at other times obstruct, the role of accounting in corporate governance in the two case organizations.

The findings show that a number of internal organizational factors influence the role of accounting in the corporate governance of banks. Such factors include the ways in which these two banks have evolved over time, and the ensuing effects on the development of accounting and information systems. These processes highlight how internal organizational factors such as size, complexity of operations (e.g., branch networks, products, services and facilities offered) and the technology used by the banks influence their accounting and information systems, thereby influencing their roles in

corporate governance of the banks. For example, the findings of this study suggest that the size and the complexity of operation of the case organizations were two main reasons for them to invest in the International Comprehensive Banking System (ICBS). The study shows that the ICBS satisfactorily fulfils the regulatory reporting requirements of the CBSL in both banks, and helps accounting to play an important corporate governance role. On the other hand, the study reveals that lack of its ability to generate information on costs and activities and on product/customer profitability limits the role of accounting in corporate governance in the case organizations.

Further, the findings suggest that some of the internal organizational factors identified in this study promoting the role of accounting in corporate governance mechanisms in the two banks were the requirements/characteristics of good corporate governance. For instance, requirements for the formation of audit and remuneration committees to the board, and the structure of the BOD and BOD-appointed committees with a majority of non-executive and independent directors were in line with the corporate governance regulations in the country. These requirements ensure, on the one hand, that banks prepare useful accounting information for corporate governance purposes (e.g., the requirement for the audit committee to discuss with external auditors the nature and the scope of the audit before the audit commences), and on the other hand, that such information is effectively utilized in corporate governance mechanisms (e.g., the requirements for the audit committee to discuss with external auditors and take necessary actions on issues, problems and reservations arising from the audits). Hence, in addition to demonstrating the influence of internal organizational factors on the role of accounting in corporate governance, these factors also provide evidence to show the integral and interdependent nature of accounting and corporate governance in the organizations (i.e., in the above examples, accounting is facilitated by corporate governance requirements in assisting corporate governance mechanisms).

Furthermore, the findings show that the organizational interface, which consists of the institutional and regulatory framework that governs the accounting and corporate governance in the banking industry in Sri Lanka, has a favourable influence on the role of accounting in the corporate governance of banks in both sectors. Regardless of certain weak institutional capacities and lack of enforcement mechanisms in the organizational interface, the study clearly shows how various regulatory requirements

enforced by the key players such as the CBSL, the Institute of Chartered Accountants of Sri Lanka (ICASL) and the Colombo Stock Exchange (CSE) in the organizational interface promote the use of accounting in corporate governance of the banks. Most of these laws and regulations are in line with the related international laws and regulations and codes of best practice in corporate governance (see Table 4.3), and are found to facilitate effectively as well as reinforce the role of accounting in corporate governance of banks. For example, the mandatory code of corporate governance for licensed banks in 2008 requires the BOD of banks to utilize effectively internal and external auditing information for governance purposes.

Moreover, the findings suggest that the external environment has a direct influence on the role of accounting in the corporate governance of banks, and an indirect influence through its influence on factors in the organizational interface. In relation to the former, the study shows, among other things, influences from the social environment on the role of accounting in corporate governance. For example, the general level of education seems to have a favourable impact, whereas the commercial values of people in the society appear to have an unfavourable impact on this role. In relation to indirect influences, the study demonstrated, for instance, how economic and political policies adopted by each government changed the accounting regulations, and also the extent to which the international environment has influenced the setting of accounting and corporate governance regulations in the organizational interface.

Overall, various contextual factors in the internal organization, the organizational interface and the external environment were highlighted in the discussion to explain the nature and the degree of influence of those factors on the role of accounting in corporate governance of the banks. The influence of such contextual factors also explained why there was a gap between the potential and the actual role of accounting in corporate governance of the banks. The findings of this study are therefore consistent with the notion of contingency theory, which argues that the effectiveness of accounting and control systems depends on various contextual factors, as their functionality is influenced by such factors in different ways and to different degrees (e.g., Chenhall and Chapman, 2006).

(d) The role of accounting in corporate governance of public and private sector banks in Sri Lanka

The findings of this study reveal a number of similarities as well as differences in the role that accounting plays in the corporate governance of public and private sector banks in Sri Lanka.

The similarities of the role of accounting in the corporate governance of PUB and PRIB were largely attributable to the influence of factors in the organizational interface. More specifically, the study found that the differences in the institutional and regulatory frameworks that govern accounting and corporate governance in the public and the private sector banks have been gradually diminishing in the recent times. For instance, the laws and regulations enforced by the CBSL and the ICASL are equally applicable to both types of bank. Such laws and regulations not only reinforce the role of accounting in the corporate governance of banks but also are consistent with most of the laws and regulations enforced by the other institutions in the organizational interface, such as the Registrar of Companies (RC) and the CSE. Following the issue of debentures in 2008, PUB was also required to abide by the Securities Exchange Commission (SEC) and the CSE rules, just like private sector banks listed on the CSE. Overall, these rules and regulations have had a favourable effect on the role of accounting in corporate governance, particularly in PUB, which was more likely to make more changes to comply with such rules and regulations (e.g., additional disclosures in annual and quarterly reporting, and press releases) than its private sector counterpart.

Although both public and private sector banks are largely subject to the same regulations, the study reveals significant differences in the role of accounting in corporate governance between PUB and PRIB. This is mainly due to the influence of various contextual factors associated with each bank. The first is related to ownership and governance structures. The multiple roles played by the government in PUB, including owner, directorate, main borrower, main beneficiary of bank's investments, auditor, and regulator, adversely affect the quality of corporate governance as well as the role of accounting in corporate governance of that bank. The study demonstrated how the government's holding of such roles has rendered the accounting systems inoperative, and placed considerable pressure on the probity and corporate governance of PUB. Differences were also found in relation to the nature and the extent of

shareholder monitoring. Lapses in the monitoring activities performed by the staff attached to the Ministry of Finance over PUB suggest their lack of interest and/or knowledge to undertake such activities in an effective manner. In contrast, large shareholders of PRIB were found to have utilized accounting information effectively for monitoring purposes. This could be due to the interest and the ability of those shareholders to do so.

The study also found that the high level of political influence on PUB affected adversely its corporate governance. There were a number of situations where PUB had to make certain decisions and take certain actions without giving due regard to accounting information, mainly because of political pressure. For example, the large non-performing assets portfolio and the high staff cost of PUB are closely associated with political influence. The findings of this study suggest that political influence has been evidenced in the form of political affiliations of the BOD, politically influenced trade unions, and external political and pressure groups. These situations have also led to undermining the role that accounting could play in promoting good corporate governance in that bank. By contrast, no evidence was found to suggest such influences on PRIB.

Finally, it was found that the culture prevailing in public sector organizations in Sri Lanka affects the use of accounting in corporate governance. For instance, although PUB had a performance measurement system, it was not linked to the managerial compensation system, a linkage which is considered important in enhancing corporate governance. In contrast, PRIB had a managerial compensation system linked to performance.

In sum, the above findings show that while both the public and the private sector banks have access to similar types of accounting information as a result of working under the same regulatory requirements, the degree to which such information is used for corporate governance purposes appears to differ. This is mainly because of the multiple roles played by the government in PUB and the high level of political influence on it.

6.3.2. Implications

The findings of this study have implications for researchers, policymakers and banking practitioners, as well as for international organizations and donor agencies.

For researchers

This study has made a major theoretical contribution by developing an analytical framework to examine the role of accounting in the corporate governance of banks. This framework can be used in future research to investigate similar research phenomena. The framework was developed by analysing systematically the ways in which accounting could facilitate the operation of various corporate governance mechanisms of banks, and the three levels of contextual influences that could moderate the use of accounting in corporate governance. There is a dearth of research on some of the roles of accounting proposed in the framework, such as the role of management accounting in corporate governance. The framework developed in this study can make a contribution to future research undertaken to fill such gaps in the literature.

The checklist developed in this study also provides researchers with an understanding of important contextual attributes associated with the role of accounting in the corporate governance of banks. For instance, the questions asked in the checklist help to assess the bank-specific factors (i.e., internal organization) and the institutional and regulatory framework that govern accounting and corporate governance of banks in a country (i.e., organizational interface). Such factors would largely determine the extent to which accounting contributes to the corporate governance of banks in the country. Hence the checklist could be used by researchers to assess the role of accounting in the corporate governance of banks, for example, in pilot studies, as well as in developing questionnaire instruments for that purpose.

For policymakers in developing countries

The analytical framework and the checklist developed in this study offer useful insights into policy making on the way in which accounting could be used to assist the corporate governance of banks. More specifically, they show how four areas of accounting can be used effectively in enabling the internal and external corporate governance mechanisms of banks to achieve desirable outcomes. Such insights will be useful in developing guidelines on corporate governance mechanisms in banks.

The study also provides insights into how contextual factors can hinder the use of accounting in the corporate governance of banks in a developing country. Policymakers may consider introducing additional precautionary measures to minimize the impact of those factors that obstruct the role of accounting in the corporate governance of banks. In particular, findings of this study suggest the importance of enabling public sector banks to operate without undue political influences that affect the credibility of corporate governance as well as the utilization of accounting information in corporate governance. This is particularly important for policymakers in countries where public sector banks compete with private sector banks. In such situations, public sector banks need to have a work environment similar to their private sector counterparts in order to compete effectively and to be profitable and stable.

Further, this study found the significance of establishing adequate institutional capacities as well as effective enforcement mechanisms to support the role of accounting in the corporate governance of banks. The study shows that weak institutional capacities and poor enforcement mechanisms impede the potential for accounting to play an important role in the corporate governance of banks. These are common issues related to banks in many developing countries. Such insights may indicate the advisability of introducing policies to strengthen institutional capacities and provide effective enforcement of laws and regulations.

For banking practitioners

The study provides an understanding of the extent and the ways in which accounting facilitates corporate governance of both public and private sector banks in a developing country such as Sri Lanka, and offers useful insights to banking practitioners in those countries on the factors impinging upon the use of accounting in corporate governance. Such insights would be useful to banking practitioners in their attempts in improving the level of corporate governance of banks. For instance, banks can promote factors which facilitate the role of accounting in corporate governance and take measures (wherever possible) to minimize the impact of unfavourable consequences from the factors that impede this role.

Banking practitioners could use the checklist developed in this study to assess the extent of their use of accounting in the corporate governance of banks. The checklist could

provide useful insights for banking practitioners about the areas that might require improvement to enhance the effectiveness of corporate governance as well as the use of accounting in supporting various corporate governance mechanisms in banks. In particular, such insights would be useful for introducing measures to ensure the utilization of accounting in the corporate governance of their banks.

For international organizations and donor agencies

The findings of this study also have implications for international organizations and donor agencies which influence the creation of international laws and regulations applicable to accounting and the corporate governance of banks in developing countries such as Sri Lanka. On the one hand, the findings provide insights into how the recent changes in accounting regulation related to banks in Sri Lanka have a favourable impact on the role of accounting in corporate governance. On the other hand, they would help to identify improvements needed in certain areas in the institutional and regulatory framework, such as strengthening the institutional capacities and enforcement mechanisms necessary for proper functioning of such laws and regulations. The findings of this study also draw attention to the applicability of some of the laws and regulations based on those in industrialized countries to the banking industry in developing countries such as Sri Lanka. When proposing further measures to improve the corporate governance of banks in developing countries, international organizations and donor agencies should consider both the favourable and the unfavourable effects found in this study in relation to the implementation of international laws and regulations.

6.3.3. Limitations

The thesis relies heavily on the analytical framework developed in the study to explain the role of accounting in the corporate governance of banks. For instance, the preparation of the interview guides was entirely based on the potential roles of accounting in corporate governance mechanisms as predicted in the analytical framework, and the data collection and analysis were carried out to investigate such relationships empirically. The adoption of an analytical framework helped ensure objective assessment of the issues associated with clearly defined roles of accounting in corporate governance. While considerable thought was put into the development of the framework by drawing on a variety of concepts discussed in a range of literature and

proposed in several theories, there may still be room to refine the framework and make it more suitable in interpreting and providing an understanding of the role of accounting in the corporate governance of banks. For instance, there could be other contextual factors that affect the role of accounting in the corporate governance of banks in other developing countries.

The case study method adopted in this thesis has certain inherent limitations, as discussed in Section 3.2, such as personal bias of the researcher in interpreting the context, and difficulty in managing massive amount of data. Although certain strategies were employed to minimize the effects of such limitations and to maintain the validity and reliability of the study (e.g., the use of an analytical framework to reduce investigator bias, and maintaining proper case study notes to manage the large amount of data collected for the study and the time spent on data analysis), the study might still suffer to some degree from those limitations.

The findings of this study based on two case studies may not be applicable to all banks. However, as discussed in Section 3.2, case studies are generalizable to the theoretical propositions made rather than to populations. Furthermore, the selection of the two banks for this study was the result of following a non-probability sampling method known as extreme sampling (which is a part of purposive or purposeful sampling). Since this method involves selecting cases based on the richness of information (in this study, because of their outstanding success in corporate governance practices), the findings of this study might not be applicable to a typical bank in Sri Lanka or in any other developing country. However, the findings of this study can provide an example for banks in both categories, i.e., banks with a reputation for good corporate governance, and those that do not have such reputation.

Finally, the sources of data in this study were limited to the perceptions of the bank officials and publicly available information. The interviews were conducted only with internal bank staff, namely accountants, members of the board of PUB, and senior managers. Although measures were taken to ensure that accurate and adequate information was collected from these interviewees to reach valid and reliable conclusions, and that the data gathered from the different categories of interviewees were triangulated to check validity, there is still a potential for bias in the data collected

through the interviews. For instance, there is the possibility of the accountants who were interviewed for this study not disclosing weaknesses and lapses in the accounting and information systems of their banks due to a possible effect on their reputation. However, by interviewing a number of accountants, this possibility was minimized. This possibility could have been further minimized if interviews had been extended to external parties such as the external auditors of the banks and the regulator (i.e., CBSL), and/or if an in-depth analysis of internal accounting reports or any other internal records had been conducted for the study. Such analysis could also have provided additional insights into the research phenomenon of the study. Several factors, however, such as the time frame of the study and lack of access to competitor sensitive information, precluded such depth.

6.3.4. Future research

The current study can be extended in a number of ways. These would also address some of the limitations of this study identified in the previous section. The analytical framework used in the current study could be further refined in future research by the addition of related factors (e.g., corporate governance mechanisms and contextual factors specific to some other countries), leading to wider applicability of the model, such as the ability to explain the role of accounting in the corporate governance of banks in other developing countries as well as industrialized countries. Future studies may also refine the analytical framework so that it is suitable for use in examining the role of accounting in the corporate governance of non-banking organizations. For instance, the market for corporate control via takeovers and acquisitions could be included in an analytical framework that investigates the role of accounting in the corporate governance of non-banking organizations. The market for corporate control is an important corporate governance mechanism in such organizations, which largely depends on the availability of relevant accounting information (e.g., for making takeover bids).

Future studies could also use a cross-sectional survey method to examine the same research question to test the wider applicability of the model and arrive at more generalizable findings. For this purpose, the interview guides of this study could be used with some amendments to prepare the survey questionnaires, and statistical tests could

be undertaken on certain implicit propositions made in such studies. Finally, future research could combine qualitative and quantitative methods to examine the role of accounting in the corporate governance of banks, and could benefit by triangulating such methods to reach more valid and reliable findings.

APPENDIX 1

COUNTRY PROFILE

Sri Lanka is a small island of rich natural beauty in the Indian Ocean. It is located south-east of India in a strategic location near major Indian Ocean sea lanes. The total area of the country is 65,610 square kilometres, of which the land area is 62,705 square kilometres and the rest is water. The mid-year population in 2009 was estimated by the Central Bank of Sri Lanka at 20,450,000, with a growth rate of 1.1 per cent per annum. The population density in 2009 was estimated to be 326 per sq km. The largest ethnic group is Sinhalese, constituting 74 per cent of the total population; Tamils and Muslims are 18 per cent and 7 per cent respectively. The balance represents a number of other small communities such as Burghers and Malays. Buddhists constitute nearly 70 per cent of the total population in the country; 15 per cent are Hindus, 8 per cent are Muslims and 7 per cent are Christians. The 1978 Constitution recognized Sinhala as the official language and Tamil as a national language. However, English is commonly used as the language of industry in the country.

The history of Sri Lanka goes back to the 6th century BC when the earliest Indo-Europeans arrived in the country. Later arrivals from India brought Buddhism to the country, beginning about 240 BC, and they developed a great civilization in cities such as Anuradhapura and Polonnaruwa before the western coastal plains were conquered by the Portuguese in the early 16 century. The Dutch took control of those areas in the middle of the 17th century and governed the country for more than 100 years. They introduced plantation agriculture, developed trade, and left a legacy that includes Roman-Dutch law in Sri Lanka. Later the British laid claim to Sri Lanka (by that time, Ceylon) at the end of the 18th century, and by 1815 the entire island was united under British rule. The British introduced coffee, tea, rubber and coconut plantations, and efficient administration into the country. The British ruled the country for nearly 150 years before it became a self-governing dominion within the British Commonwealth in 1948.

The political system adopted after independence was a bicameral legislature with a House of Representatives and a Senate of appointed members, and a Governor General who represents the Queen as Head of the British Commonwealth (Yapa and Perera,

2005). This system remained until 1972, when a new constitution was passed in the country to become a Sovereign Republic. It continued until the present Constitution in 1978, under which Sri Lanka became a Democratic Socialist Republic.

Sri Lanka is a developing country. The development strategies that shaped its economy over the last 6 decades since the independence may be distinguished under two eras. The first era covers the period between 1948 to 1976, during which economic policies were aimed at import substitution oriented industrialization. The second era is the post-1977 period, during which the economy marked a shift towards a free market strategy. The aim was to liberalize the economy from excessive government controls, with the private sector chosen as the engine of growth while the economy was opened to international competition.

In 2009 Sri Lanka recorded US\$ 42 billion in the GDP with the *per capita* GDP of US\$ 2053. The GDP is driven primarily by services (59 per cent), industry (29 per cent) and agriculture (12 per cent). Sri Lanka also achieved the status of a middle-income country in 2004, when its *per-capita* GDP reached above US\$ 1000 (World Bank, 2007). The economy grew by 3.5 per cent in 2009, and is estimated to grow by 6 and 7 per cent respectively in the next two years (ADB, 2010). This level of growth is largely supported by the end of 3 decades of civil war which had created a series of negative consequences on the economy. However, the country still suffers from major economic threats, such as high inflation of 7 per cent, a large budget deficit of 8 per cent of GDP, and a trade deficit of 2 per cent of GDP (ADB, 2010).

Although Sri Lanka records relatively low performance across a number of macroeconomic indicators, its accomplishments in the area of social policy surpass those of most developing countries (World Bank, 2006). According to the World Bank (2005), Sri Lanka has made stellar progress on the millennium development goals. For instance, the country has already attained universal primary education and completion, and has achieved gender parity at primary and secondary education levels. The current literacy rates are 92.8 and 90.0 per cent for males and females, respectively. Further, Sri Lanka's child and infant mortality rates are unusually low relative to other developing countries, and compare favourably with those in some middle income countries.

APPENDIX 2

A CHECKLIST TO ASSESS THE ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE OF BANKS

The banks may use this checklist to assess the extent of their use of accounting in corporate governance. While “Yes” answers suggest an effective use of accounting in corporate governance, “No” answers indicate the weak areas that may require improvements in the role of accounting in corporate governance.

Corporate Governance Mechanisms	Assessment (Y/N)
(1)Board of Directors	
Does the bank have written policies or bi-laws referring to the conduct of the board of directors? Are there any statutory/professional requirements/guidelines regarding the performance of the board of directors?	
If yes, do they describe the board's fiduciary duty to: <ul style="list-style-type: none"> - shareholders - depositors - regulators 	
Does the bank maintain Chairman-CEO duality?	
Does the board have a good mix of members? (A 'yes' answer would indicate the inclusion of executive directors with relevant qualifications and knowledge of the business, and non-executive directors who can bring a broader view of the activities of the bank)	
Does the board have more non-executive directors than executive directors? Are the majority of non-executive directors independent?	
Are the independent directors: <ul style="list-style-type: none"> - provided with relevant information well in advance the board meetings? - permitted to access business records and accounts? - expected to have meetings without the presence of executive directors? - allowed to obtain services of outside professional advisors at the bank's expense? 	
Does the board have at least one member who is qualified in Accounting and Finance?	
Does the board have an audit committee?	
Is the Chairman of the audit committee a qualified accountant?	
Do the functions of the board include approval of the following? <ul style="list-style-type: none"> - budgets and business plans - internal control and risk management systems - annual/quarterly financial statements, disclosures and communications 	
Does the board have access to accurate and relevant information on a timely basis?	
Does the board use accounting information to provide strategic direction to the bank?	
Does the board use accounting information to monitor the activities of managers?	
Are the board meetings effective? (A 'yes' answer would indicate that: a sufficient number of board meetings was held last year; the average length of a board meeting was substantial; the average attendance rate was satisfactory; and the level of preparedness of members for the board meetings was reasonable)	
Is the head of the internal audit qualified in accounting/auditing?	
Does the head of internal audit report directly to the audit committee?	

Does the internal audit department have an approved audit charter?	
Is the annual internal audit plan/program reviewed and approved by the board?	
Does the board/audit committee receive and review internal audit reports regularly?	
Does the board ensure that the follow-up actions are taken on the basis of the recommendations contained in the internal audit reports?	
Does the board/audit committee review and monitor the effectiveness of the external audit process?	
Does the board receive and review “Management Letters” prepared by the external auditors?	
Does the external auditor attend the board meetings when audit issues are discussed in the board/audit committee meetings?	
(2) Managerial Compensation Plans	
Are managerial compensation plans in the bank based on a “pay for performance” system?	
Are managerial compensation plans designed to align the interest of depositors in addition to the shareholders?	
Do managerial compensation plans include more cash compensation than equity based compensation?	
Is the CEO’s reward based on the performance measured relative to the market or industry?	
Are financial performance indicators used in setting CEO’s/managers’ compensation plans?	
Does internal audit validate the managerial compensation plans?	
Does the report prepared by the external auditor comment on whether the managerial compensations are legal, reasonable and are not in excessive?	
(3) Laws and Regulations	
Is the country’s banking legislation effective? (A ‘yes’ answer would indicate that, for example, laws and regulations provide safety and soundness in the financial sector and minimize the information and transaction cost of shareholders and depositors; the regulatory bodies have enough regulatory powers to supervise the banks; and the law enforcement is of high quality and efficient)	
Is the bank required to report to the regulator on a regular basis? (Note: Regulatory reporting may include various accounting and non accounting statements to be submitted on daily, weekly, monthly, quarterly and annual basis)	
Does the law specify rules, formats, contents and disclosure requirements of the accounting reports submitted to the regulator?	
Does the bank submit required accounting reports on a timely basis?	
Does the regulator verify the accuracy of the information submitted by the bank?	
Does the regulator make effective use of reports submitted by the bank in regulating and supervising the bank?	
Is the bank required to submit audited financial statements to the regulator?	

Is there a system to share the external auditor's information with the regulator?	
Does the regulator use information gathered from the external auditor to regulate and supervise the bank effectively?	
(4) Shareholder and Debtholder Monitoring	
Does the law recognize the rights and the equitable treatment of shareholders? (A 'yes' answer would indicate that, for example, the shareholders have the right to participate and vote in shareholder meetings on important decisions such as election or removal of members of the board, and proposals for fundamental changes affecting the bank; and the shareholders have the right to be informed about the affairs of the bank via annual and quarterly reporting)	
Does the law recognize the rights of debtholders? (A 'yes' answer would indicate that, for example, the debtholders have a basic right to specified interest and capital redemption payments; and to restrict the actions of managers and board of directors through loan covenants)	
Does the bank publish annual and quarterly reports for external reporting purposes on a timely basis? Are they made available to the debtholders?	
Does the bank's policy regarding disclosure of accounting information comply with the minimum statutory/professional requirements?	
Does the bank's policy include the disclosure of related party transactions, major transactions, and other material events? Is it implemented strictly?	
Is the bank required to provide non financial information? Does the bank comply with the minimum statutory/professional requirements in this regard?	
Can the present external auditor be regarded as independent? (A 'yes' answer would indicate, for example, the external auditor does not provide non audit services to the bank; there are regulations that prevent non-audit services by external auditors; and the external auditor is rotated)	
Does the external auditor have appropriate business expertise to audit the bank?	
Does the annual report of the bank include auditor's report to the shareholders?	
Does the external auditor attend the annual general meetings to answer queries of the shareholders?	
(5) Labour Markets	
Does the bank have a performance measurement system for managers?	
Does the board/remuneration committee formally evaluate the performance of the CEO?	
Is accounting information used in evaluating performance of the CEO/managers? (Note: The extent to which accounting information is used in performance evaluation can be varied based on the goals set for each manager.)	
Is the information on performance of managers used in promotions?	
Is the information on performance of CEO/managers used in demotions/dismissals?	

Is financial performance considered as a factor used in evaluating performance of the CEO/managers in shareholder meetings?	
(6) Product Markets	
Does the bank operate in a highly competitive market? (A 'yes' answer would indicate that, for example, there are number of banks competing in the country; and domestic private and foreign banks are permitted to operate and are present in the market)	
Is the bank free from policy lending due to social and political reasons?	
Is the banking industry free from entry barriers, and restrictions on services provided, interest rates and branching?	
Is accounting information used in evaluating performance of the CEO/managers compared to the peers in the industry?	
Is financial performance considered as a factor used in evaluating performance of the CEO/managers in shareholder meetings?	

APPENDIX 3

DISSEMINATION OF RESEARCH FINDINGS

Publications:

Scholarly journals:

“Towards a Framework to Analyse the Role of Accounting in Corporate Governance in the Banking Sector” in the *Journal of Applied Management Accounting Research*, 2009, 7(2) – (Based on Chapter 2)

Conference proceedings:

“Towards a Framework to Explain the Role of Accounting in Corporate Governance: With Special Reference to the Banking Sector in Sri Lanka” at the 20th *Asian-Pacific Conference on International Accounting Issues* in Paris, France. November 2008 – (Based on Chapter 2)

“Contextual Relativity of the Role of Accounting in Corporate Governance” at the 6th *Asia Pacific Interdisciplinary Research in Accounting Conference* in Sydney, Australia. July 2010 – (Based on Chapter 4)

“Accounting and Corporate Governance Environment within the Banking Industry in Sri Lanka” at the 4th *International Research Conference on Management and Finance*, in Colombo, Sri Lanka. December 2009 – (An earlier version of Chapter 4)

“Accounting and Corporate Governance in the Banking Industry: Case Study of a Public Sector Bank in Sri Lanka” at the 50th *Accounting & Finance Association of Australia and New Zealand Conference* in Christchurch, New Zealand. July 2010 – (Based on part of Chapter 5)

“Accounting in Corporate Governance: Evidence from a Commercial Bank in Sri Lanka” at the 22nd *Asian-Pacific Conference on International Accounting Issues* in Gold Coast, Australia. November 2010 – (Based on part of Chapter 5)

APPENDIX 4

THE ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE OF BANKS IN A DEVELOPING COUNTRY: EVIDENCE FROM SRI LANKA

INTERVIEW GUIDE FOR ACCOUNTANTS

Thank you for agreeing to take part in this interview. It will take approximately 60 to 90 minutes. The discussion is intended to obtain your views and experience about the accounting, auditing and corporate governance practices of (name of the bank) and the context in which the bank operates. Enclosed is a set of questions for which I may seek your responds during the interview.

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1. Accounting and corporate governance practices

1.1 The management accounting information system of the bank

- a) Do you have an accounting system that generates information for internal purposes?
- b) What type of information does it produce? (For instance, does the bank prepare budgets; performance evaluations; standard costing reports; capital expenditure reports?)
- c) Are they prepared on a regular basis? If so, how often?
- d) What type of information is provided on an ad-hoc basis?
- e) What are the strengths of the system?
- f) What are the weaknesses of the system?

1.2 The information availability to the Board of Directors

- a) Is the board provided with accounting information? How often?
- b) (If yes) What types of accounting information are provided to the board?
- c) What types of accounting information are provided on an ad-hoc basis?
- d) How do you think the board uses such information? (For instance, is that information used to develop and revise strategies? Is that information used to assess performance of the bank and the managers?)
- e) Is that information used for any other purpose by the board? If yes, can you elaborate?

1.3 The use of accounting information in managerial compensation plans

- a) Does the bank have a performance measurement system for managers?
- b) How is performance of managers measured?
- c) To what extent is accounting information used in evaluating performance of the managers?
- d) For what purpose is that information used? For instance, is such information used in promotions and dismissals?
- e) (If no) What are the reasons for not using such information in promotions and dismissals?
- f) Is the performance measurement system linked with the managerial compensation plans?
- g) What is the nature of the market for bank managers?

1.4 The external reporting system of the bank

- a) What are the ways in which the bank publishes accounting information?
- b) What is the time taken to publish such information, for instance, to publish quarterly reports, annual reports?
- c) What is the policy of the bank regarding disclosure of accounting information? For instance, is it focused on providing a true and fair view of the performance and results, or compliance with statutory and professional requirements?
- d) Does the bank's policy exceed the minimum statutory requirements (Companies Act; Accounting Standards; and Stock Exchange listing requirements)? How?
- e) Does the bank's policy include the disclosure of related party transactions, major transactions and other material events?
- f) (If yes) Is it implemented rigorously?
- g) What are the issues faced by the bank when implementing such a policy?
- h) What is the bank's policy of incorporating non financial information in external reports?

- i) Are there any requirements to provide non financial information?
- j) Does the bank exceed the minimum statutory requirements in this regard? How?
- k) What are the strengths of bank's external reporting system?
- l) What are the weaknesses of the bank's external reporting system?
- m) What steps have been taken in recent years to improve the quality of accounting information?

1.5 Shareholder oriented information

- a) How does the bank communicate with shareholders?
- b) How long before the AGM are Annual Reports sent to the shareholders?
- c) Are the shareholders informed about decisions concerning fundamental changes to the bank (such as amendments to article of incorporation, authorization of additional shares and extra ordinary transactions)? How?
- d) What steps have been taken recently by the bank to improve dissemination of information to shareholders on a timely basis?

1.6 Depositor oriented information

- a) What specific information does the bank publish for the benefit of the depositors regularly?
- b) In what way is this information disseminated?

2. Auditing and corporate governance practices

2.1 Internal auditing

- a) What are the main functions of the internal audit department?
- b) Do they make recommendations to improve the accounting information system? (If yes) What are some of the recent examples?
- c) Does the internal audit department issue a report after an investigation?
- d) Is follow-up action taken on the basis of the recommendations contained in such reports? Please elaborate.
- e) What are the strengths of the internal audit department?
- f) What are the weaknesses of the internal audit department?

2.2 External auditing.

- a) How are the external auditors appointed?
- b) Are they rotated? If yes, how often?
- c) Is there any concern about the present auditor's independence?
- d) Do the external auditors provide other non-audit services to the bank?
- e) (If yes) What are the types of non audit services provided by the bank's external auditor? What is the payment for such services?
- f) Are there any regulations that prevent such non-audit services by external auditors?
- g) Do the external auditors have appropriate business expertise to audit the bank?

3. Context of the bank

3.1 The internal organization.

3.1.1 Firm characteristics

- a) How have the following firm characteristics influenced the bank's accounting information system?
 - a. Nature of the banking industry
 - b. Size of the bank
 - c. Performance of the bank
 - d. Use of technology

3.1.2 The institutional process

- a) What are the main sections of the finance department?
- b) Is each section headed by a qualified accountant?
- c) How many qualified accountants are working in the finance department?
- d) Are there staff designated "accountants" working in the branches?
- e) (If not) Who is responsible for branch accounting?
- f) Are there staff development/support systems for accountants? Can you elaborate?

3.1.3 The organizational and behavioural contexts

- a) Does the finance department get sufficient support from the board and senior management?
- b) Does the board always approve the investments in finance department such as latest technology and accounting software where necessary? Can you provide some recent examples please?
- c) Is it possible to work independently in your job and maintaining professional ethics? Can you elaborate please?
- d) In general, is the staff of the bank value the accounting information? Why?
- e) Are there any instances where managers disregarded accounting information when making decisions? Can you elaborate?

3.2 The organizational interface

3.2.1 Regulatory oversight

- a) To what extent has the bank considered the Central bank's regulations in developing the existing accounting information system?
- b) Are the regulation and supervision of the Central Bank considered important in generating high quality accounting information by the bank?

3.2.2 Professional accounting bodies

- a) What are the accounting/auditing standards applicable to the banking sector?
- b) What are the changes that the Institute of Chartered Accountants of Sri Lanka has made recently with regards to the accounting practices of banks?

3.2.3 Capital market regulations

- a) What are the listing requirements of the Colombo Stock Exchange applicable to banks?
- b) Does the bank's accounting system satisfy these requirements?

3.2.4 Key stakeholders (other than shareholders and depositors)

- a) What accounting information is provided specifically for the borrowers?
- b) Are the other social groups considered when providing accounting information?
Please provide some examples.

3.3 The external environment

3.3.1 Economic environment

- a) How has the economic situation in Sri Lanka influenced the banking industry in recent times?

3.3.2 Political environment

- a) How has the political environment in Sri Lanka influenced the activities of the bank?
- b) Have there been any instances where the bank could not perform independently because of the political influences? Can you provide some examples please?
- c) Are the banks activities influenced by trade unions?

3.3.3 Social environment

- a) What is your view of the current depositors' and borrowers' banking knowledge and awareness of the market for banking services?
- b) Have you seen any improvements of the awareness of depositors and borrowers in the recent time?
- c) (If yes) Can you provide some examples?

3.3.4 International environment

- a) How has the international environment influenced the activities of banks?
- b) What international factors have influenced the accounting practices of banks in recent times?
- c) To what extent does the bank adopt Basel Committee recommendations in developing its accounting system?

This is the end of the interview. Thank you very much for your valuable time.
I greatly appreciate your assistance in this research project.

APPENDIX 5

THE ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE OF BANKS IN A DEVELOPING COUNTRY: EVIDENCE FROM SRI LANKA

INTERVIEW GUIDE FOR BOARD OF DIRECTORS

Thank you for agreeing to take part in this interview. It will take approximately 60 to 90 minutes. The discussion is intended to obtain your views and experience about the accounting, auditing and corporate governance practices of (name of the bank) and the context in which the bank operates. Enclosed is a set of questions for which I may seek your responds during the interview.

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1. Background

- a) How are the members of the board appointed?
- b) Are there any statutory/professional requirements/guidelines regarding the performance of directors?
- c) How often, and for how long, does the board meet each year? (For example, how many board meetings were held last year? On average, how long did a board meeting last? What was the average attendance rate for board meetings?)
- d) How much of your time is taken for preparing for participating in board meetings?
- e) Does the bank have any written policies or bi-laws specifically referring to the conduct of the Board of Directors?
- f) What is the board's process for setting the agenda of topics to be covered at meetings?
- g) Do the functions of the board include approval of the followings?
 - business strategy
 - performance/ performance objectives
 - salaries and benefits
 - control systems
 - quality of accounting framework, financial reporting systems
 - disclosure and communications
 - budgets and business plans
 - capital expenditure
 - internal and external audit
 - governance practices

2. The responsibility of the board with regard to the accounting information system of the bank

- a) Are there statutory/professional requirements for the bank to disclose financial and non-financial information? Can you elaborate please?
- b) Does the bank disclose such information?
- c) What is the responsibility of the board in ensuring that the bank complies with those requirements? How does the board discharge that responsibility?

3. The availability of information for the board for directing and monitoring of the bank

- a) Does the board have access to accurate, relevant and timely information?
- b) Can you elaborate the procedure for receiving such information please?
- c) What type of accounting information is received on a regular basis?
- d) How often does the board receive this information?
- e) What type of information is received on an ad-hoc basis?
- f) Does the board receive copies of communications between the bank and the regulators (e.g. Central Bank of Sri Lanka)?
- g) Does the board receive "Management Letters" (Deficiency Letters or "Letters of Recommendations") prepared by external auditors?
- h) What is the nature of access to information for independent directors?
- i) Do they have access to business record and accounts?
- j) Are they provided with relevant information well in advance before every board meeting?
- k) Are they expected to have separate meetings with managers?
- l) Are they allowed to obtain services of outside legal, financial and other professional advisors at the bank's expense?

4. The extent to which the board uses accounting information for directing and monitoring of the bank

- a) Does the board use accounting information to develop and revise bank's strategies and /or to assess performance of the bank managers?
- b) Is that information used for any other purpose by the board?
- c) How often does the board review financial statements?
- d) To what extent does the board review financial statements during its meetings?
- e) What types of accounting issues has the board considered or reviewed recently?
- f) What significant recommendations were made or guidance provided on the basis of accounting information by the board to management during the last year?

5. The use of accounting information in managerial compensation plans.

- a) Does the bank have a performance measurement system for managers?
- b) To what extent is accounting information used in evaluating performance of the CEO and other top managers, and managerial compensation decisions?
- c) For what purpose is that information used? For instance, is such information used in promotions and dismissals?
- d) (If no) What are the reasons for not using such information in promotions and dismissals?
- e) Does the board or compensation committee formally evaluate the CEO's performance?
- f) Is the performance measurement system linked with the managerial compensation plans?
- g) How are incentives determined?
- h) What is the nature of the market for bank managers?

6. Shareholder oriented information

- a) How does the bank communicate with shareholders?
- b) How long before are shareholders provided with information on the agenda items of the shareholders' meetings?
- c) How long before the AGM are Annual Reports sent to the shareholders?
- d) How much time is allocated for shareholders to ask questions and raise issues at the shareholders meeting, for example, related party transactions?
- e) Are the shareholders informed about decisions concerning fundamental changes to the bank (such as amendments to article of incorporation, authorization of additional shares and extra ordinary transactions)? How?
- f) What steps have been taken recently by the bank to improve dissemination of information to shareholders on a timely basis?

7. Depositor oriented information

- a) What specific information does the bank publish for the benefit of the depositors regularly?
- b) In what way is this information disseminated?

8. How the board oversees the bank's audit function

- a) Does the board receive and review the internal audit reports?
- b) Is there a system to ensure follow-up action is taken by the responsible managers on the recommendations of internal audit reports? Please elaborate.
- c) What process does the audit committee have for overseeing or monitoring the work of internal auditors?

- d) What are the audit committee's procedures for reviewing major accounting issues, potential audit risks, and the quality of internal control systems?
- e) What are some examples of recent decisions this committee has taken in regard to the company's accounting practices and internal control processes?
- f) What is the role of the audit committee in appointing and reviewing the work of external auditors?

9. The environmental context in which the bank operates and its impact on the bank's accounting and reporting system

9.1 The internal organization.

- a) How much support does the board extend to the operation of the finance department?
- b) Does the board always support the investments in finance department such as latest technology and accounting software where necessary? Can you provide some recent examples please?
- c) How does the board allow the finance department to work independently and maintain their professional ethics?
- d) Does the board value accounting information? Can you please elaborate?
- e) Are there any instances where the board disregarded accounting information when making decisions?

9.2 The external environment

9.2.1 The economic environment

- a) How has the economic situation in Sri Lanka influenced the banking industry in recent times?

9.2.2 The political environment

- a) How has the political environment influenced the activities of the bank?
- b) Have there been any instances where the bank could not perform independently because of the political influences? Can you provide some examples please?
- c) Is the bank's performance influenced by decisions made by trade unions?

This is the end of the interview. Thank you very much for your valuable time. I greatly appreciate your assistance in this research project.

APPENDIX 6

THE ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE OF BANKS IN A DEVELOPING COUNTRY: EVIDENCE FROM SRI LANKA

INTERVIEW GUIDE FOR MANAGERS

Thank you for agreeing to take part in this interview. It will take approximately 60 to 90 minutes. The discussion is intended to obtain your views and experience about the accounting, auditing and corporate governance practices of (name of the bank) and the context in which the bank operates. Enclosed is a set of questions for which I may seek your responds during the interview.

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1. The availability of accounting information for the managers for planning, control and decision making purposes

- a) Do you have access to accurate, relevant and timely information?
- b) Can you elaborate the procedure for receiving such information please?
- c) What type of accounting information is received on a regular basis?
- d) How often do you receive this information?
- e) What type of information is received on an ad-hoc basis?
- f) Do you believe such information is useful? Why?

2. The managers' use of accounting information for planning, control and decision making purposes

- a) Do you use accounting information for planning, control and decision making purposes?
- b) How often do you review financial information in management meetings?
- c) What types of accounting issues has the management considered or reviewed recently?
- d) What significant decisions were made or guidance provided in management meetings on the basis of accounting information?

3. The use of accounting information in managerial compensation plans

- a) Does the bank have a performance measurement system for managers?
- b) How is performance of managers measured?
- c) To what extent is accounting information used in evaluating performance of the managers?
- d) For what purpose is the information about performance of managers used? For instance, for promotions and dismissals?
- e) (If no) What are the reasons for not using such information for promotions and dismissals?
- f) Is the performance measurement system linked with the managerial compensation plans?
- g) Who is responsible for setting managerial compensation plans?
- h) What are the basic components of managerial compensation plans?
- i) What is the approximate percentage of the incentive component in the total compensation package?
- j) How are incentives determined?
- k) What is the nature of the market for bank managers?

4. The use of accounting information in product market competition

- a) How does the bank determine the lending rates and deposit rates?
- b) To what extent is accounting information used in determining these rates?
- c) How does the bank use accounting information to improve its financial performance? (i.e., what measures are taken to improve revenue? What measures are taken to improve cost efficiencies?)
- d) Does the bank use accounting information to improve its general performance (i.e. to improve performance of non financial aspects)? How?

5. The extent to which accounting information fulfils information needs of shareholders and depositors

- a) How does the bank communicate with shareholders?
- b) What steps have been taken recently by the bank to improve dissemination of information to shareholders on a timely basis?
- c) What specific information does the bank publish for the benefit of the depositors on a regular basis?
- d) In what way is this information disseminated?

6. How the management makes use of audit reports?

- a) Does the management receive and review the internal audit reports?
- b) Does the management receive and review “Management Letters” (Deficiency Letters or “Letters of Recommendations”) prepared by external auditors?
- c) Does the management receive and review copies of communications between the bank and the regulators (e.g. Central Bank of Sri Lanka)?
- d) Is there a system to take follow-up actions on the recommendations of these reports? Please elaborate.

7. The environmental context in which the bank operates and their impact on the bank’s accounting and reporting system

7.1 The internal organization

- a) How much support does the management extend to the operation of the finance department?
- b) Do you allow the finance department to work independently and maintain their professional ethics?
- c) In general, do the managers of the bank value accounting information? Can you please elaborate?
- d) Are there any instances where the managers disregarded accounting information when making decisions?

7.2 The external environment

7.2.1 The economic environment

- a) How has the economic situation in Sri Lanka influenced the banking industry in recent times?

7.2.2 The political environment

- a) How has the political environment influenced the activities of the bank?
- b) Have there been any instances where the bank could not perform independently because of the political influences? Can you provide some examples please?
- c) Is the bank’s performance influenced by trade unions?

7.2.3 The social environment

- a) What is your view of the current depositors’ and borrowers’ banking knowledge and awareness of the market for banking services?
- b) Have you seen any improvements of the awareness of depositors and borrowers in the recent time?
- c) (If yes) Can you provide some examples?

7.2.4 The international environment

- a) How has the international environment influenced the activities of banks?
- b) To what extent does the bank adopt Basel Committee recommendations in developing its accounting system?

This is the end of the interview. Thank you very much for your valuable time.
I greatly appreciate your assistance in this research project.

APPENDIX 7

FINAL ETHICS APPROVAL LETTER

TITLE OF PROJECT:

**THE ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE
OF BANKS IN A DEVELOPING COUNTRY:
EVIDENCE FROM SRI LANKA**

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22 September 2008

Mr Athula Ekanayake
Department of Accounting and Finance
Macquarie University

Reference: HE26SEP2008-D06094

Dear Mr Ekanayake

FINAL APPROVAL

Title of project: "Role of Accounting in Corporate Governance: A Study of Banking Industry in Sri Lanka"

Thank you for your recent correspondence. Your response has addressed the issues raised by the Committee and you may now proceed with your research.

Please note the following standard requirements of approval:

1. Approval will be for a period of twelve (12) months. At the end of this period, if the project has been completed, abandoned, discontinued or not commenced for any reason, you are required to submit a Final Report on the project. If you complete the work earlier than you had planned you must submit a Final Report as soon as the work is completed. The Final Report is available at: http://www.research.mq.edu.au/researchers/ethics/human_ethics/forms
2. However, at the end of the 12 month period if the project is still current you should instead submit an application for renewal of the approval if the project has run for less than five (5) years. This form is available at http://www.research.mq.edu.au/researchers/ethics/human_ethics/forms. If the project has run for more than five (5) years you cannot renew approval for the project. You will need to complete and submit a Final Report (see Point 1 above) and submit a new application for the project. (The five year limit on renewal of approvals allows the Committee to fully re-review research in an environment where legislation, guidelines and requirements are continually changing, for example, new child protection and privacy laws).
3. Please remember the Committee must be notified of any alteration to the project.
4. You must notify the Committee immediately in the event of any adverse effects on participants or of any unforeseen events that might affect continued ethical acceptability of the project.
5. At all times you are responsible for the ethical conduct of your research in accordance with the guidelines established by the University
http://www.research.mq.edu.au/researchers/ethics/human_ethics/policy

If you will be applying for or have applied for internal or external funding for the above project **it is your responsibility** to provide Macquarie University's Research Grants Officer with a copy of this letter as soon as possible. The Research Grants Officer will not inform external funding agencies that you have final approval for your project and funds will not be released until the Research Grants Officer has received a copy of this final approval letter.

ETHICS REVIEW COMMITTEE (HUMAN RESEARCH)
LEVEL 3, RESEARCH HUB, BUILDING C5C
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http://www.research.mq.edu.au/researchers/ethics/human_ethics

Yours sincerely



Dr Margaret Stuart
Director of Research Ethics
Chair, Ethics Review Committee (Human Research)

Cc: Associate Professor Sujatha Perera, Department of Accounting and Finance

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