Accounting in Corporate Governance of a Commercial Bank in Sri Lanka: A Multi-theoretical Perspective

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Abstract

Using a multi-theoretical perspective, this study aims to investigate the ways in which accounting facilitates corporate governance in the banking industry in Sri Lanka. Despite the interdependence nature of accounting and corporate governance, scant attention has been paid to investigate this relationship systematically and empirically. Following qualitative research methodology, the study adopts the case study research method to achieve the aim of the study. More specifically, it chooses a bank that has emerged as an exemplar of good corporate governance in the banking industry in Sri Lanka, and examines the extent to which accounting contributed such practices in that particular bank. By doing so, it further analyses how the contextual factors assist as well as obstruct the accounting's role in corporate governance in an attempt to answering why the actual role of accounting in corporate governance varies from its potential role in the case organization. The findings of this study are consistent with the notion of

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contingency theory as the effectiveness of accounting seems to depend on various contextual factors in the case organization. Also, the study finds evidence to suggest that a stakeholder view of corporate governance is more appropriate for examining the corporate governance of banks, and accounting can play an important role in this regard.

Keywords: Accounting, Corporate governance, Banks, Multi-theoretical perspective

1. Introduction

This paper documents the under-studied role of accounting in facilitating good corporate governance in banks. Despite the close relationship between accounting and corporate governance, the attention given in the existing literature to systematically investigating it is very limited. This complements the much more extensively studied corporate governance research particularly in the corporate finance literature (see Gillan, 2006).

The banking industry offers a unique setting to investigate the role of accounting in corporate governance for three reasons. First, banks operate in a high level of debt-to-equity ratio, which is different from nonbank firms. Capital structure of banks tends to have very little equity and large amounts of liabilities in the form of deposits, which are available to their creditors (depositors) on demand. On the other hand, their assets often take the form of loans that have longer maturities (Macey and O'Hara, 2003). This mismatch between maturities of deposits and loans creates a problem for banks, if they become exposed to the risk of collective action by depositors. Hence, the safeguard of depositor confidence is an important aspect of banks as a going concern, and accounting has the potential to play an important role in this regard by providing useful information related to the performance and the stability of banks.

Second, banks operate in a high level of information asymmetry[2] due to the complex nature of the transactions that are occurred within the banking industry (Nam, 2004). This situation is likely to affect adversely on the free information flow between the banks and the stakeholders affecting market interactions, and gives strong incentive to bank managers to manipulate the financial affairs of banks (Nam, 2004; Levine, 2004). Hence, the high level of information asymmetry in banks can have a negative influence on the good corporate governance of banks. As a remedial measure, laws and regulations applicable to banks are required to promote more accounting disclosures ensuring that stakeholders obtain sufficient information to scrutinize the activities of managers.

Third, the presence of high level of regulation in the banking industry is another factor that differentiates banks from firms in other industries. Governments influence activities of banks by way of prudential regulation and supervision for maintaining a stable financial sector in any country (Nam, 2004). The provision of accounting information by banks is an important source facilitating this regulatory oversight.

The banking industry in Sri Lanka offers a unique experimental setting to test the study phenomenon due to the particular importance of banks to emerging economies. Banks play an important role in emerging economies as the main financial intermediary because their capital market is less developed (Arun and Turner, 2004; Levine, 2004; Nam, 2004). To this effect, accounting can enhance the level of corporate governance in banks by providing information, facilitating various corporate governance mechanisms.

[2] For example, Nam (2004) argues that information asymmetry is high in banks than in non-banking industries due to inter temporal nature of typical financial contracts, which involves a promise to pay in the future. As a result, risk composition of the assets in banks tends to be changed within a short period of time.

The high level of regulations prevailing in the banking industry in Sri Lanka – in contrast to most of other industries in the country – provides surface credence to the idea that such provisions have been resulted in improving accounting and corporate governance as well as the role of accounting in corporate governance in the banking industry. By using qualitative research methodology, this is the proposition that the present study explore in depth through a case study of one of Sri Lanka's leading commercial banks. The case organization has been recorded impressive results in good corporate governance practices over the years, and therefore appears to represent the best possible bank in Sri Lanka to be selected in the study. However, the high level of corporate governance in the case organization does not necessarily mean that it effectively utilizes accounting in good corporate governance. Hence, the present study examines the extent to which accounting has contributed to improve the degree of corporate governance in the case organization.

Data were gathered in this research through multiple sources, including semi structured interviews of selected key individuals and study of available documents. The type of information sought mainly relates to personal experiences of key individuals on accounting practices in the case organization, and therefore semi structured interviews were the main source of data collected. Interviews were conducted from November 2008 to January 2009 with twelve participants from the organization including eight accountants and four managers. The main objectives were (a) to examine the extent to which accounting information was used by the case organization to facilitate corporate governance mechanisms and (b) to identify the influence of various contextual factors on the role of accounting in the corporate governance of the bank. Further, the review of annual reports for the period from 1997 to 2013 was undertaken mainly to assess the reporting practices of the case organization.[3]

[3] The first code of corporate governance was introduced to Sri Lanka in 1997.

Furthermore, relevant media reports were reviewed as they were seen as a useful source to corroborate with other sources of information. Data were analysed in three interactive processes, as suggested by Miles and Huberman (1994), namely data reduction, data display, and conclusion drawing and verification. In the data reduction stage, relevant data were selected, focused, simplified, abstracted and transformed from interview transcripts and documentary evidence. Such data were displayed as an organized manner in the data display stage, allowing conclusions drawing and verification. More specifically, in the latter two stages, the actual roles of accounting were compared with the potential roles, and deviations were explained by referring to contextual influences.

The remainder of the paper is structured as follows. The next section introduces the multiple theories on which the analytical framework used in this study was developed, summarizes the literature on the potential role of accounting in facilitating a number of corporate governance mechanisms, and draws attention to three levels of contextual factors that could affect the nature and the degree of this potential role. The section that follows provides a brief overview of the Sri Lankan banking industry and of accounting and corporate governance regulation applicable to the banking industry. In the penultimate section, the case organization was introduced, and the actual role of accounting in corporate governance mechanisms in the case organization was explained. The final section presents a summary and the conclusions.

2. Multiple Theories and Potential Role of Accounting in Corporate Governance of Banks

This study draws on concepts developed in the literatures on agency, stakeholder, and contingency theories, and examines, not only the potential role of accounting in corporate governance in banks, but also how that role is affected by the influences of various contextual factors.

According to agency theory, companies 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 offering appropriate incentives to managers and monitoring their activities, as strategies to limit their opportunistic behaviour (Subramaniam, 2006). These notions have direct relevance to the focus of this study.

The underlying assumption of this study 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 company is to maximize the return on investment to shareholders (Gibson, 2000). Bank failures during the recent global financial crisis had shown the negative effects on various stakeholders including shareholders, depositors, customers and governments, and highlighted the importance of protecting the interests of the depositors and other stakeholders in addition to those of the shareholders. Those incidents clearly demonstrated the significance of the use of effective corporate governance by banks for their sustainability.

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; 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; Uddin and Hopper, 2001). Consistent with these literatures, this study argues that the effectiveness of accounting in assisting various corporate governance mechanisms depends on the influence of internal and external contextual factors related to the organization.

Within the study 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 effective 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.

Accounting and corporate governance are linked closely, and play inter-dependent roles in organizations (Whittington, 1993). While accounting is able to play an important role in facilitating corporate governance, the degree of corporate governance in an organization, to a great extent, determines the quality of accounting information (e.g., Kanagaretnam, Lobo and Whalen, 2007; Koh, Laplante and Tong, 2007). This study focuses on the former relationship where accounting is seen to facilitate various corporate governance mechanisms by providing relevant information (Bushman and Smith, 2001).

Two broad areas of accounting that facilitate corporate governance have been identified as financial accounting and management accounting (Ekanayake *et al*., 2009). Information contained in annual and interim reports prepared under financial accounting could minimize information asymmetry between internal parties such as BOD and managers, and external parties such as shareholders and other stakeholders (Whittington, 1993). On the other hand, management accounting generates information for internal purposes, and such information could facilitate the monitoring of managers by the BOD (Whittington, 1993). These two areas of accounting have the potentiality to facilitate various corporate governance mechanisms, which are established within banks (i.e., BOD and managerial compensation plans) and externally (i.e., laws and regulations, shareholder and debtholder monitoring, labour and product markets) (see Ekanayake *et al*., 2009).

However, the actual role of accounting in corporate governance in banks could depend on a number of contextual factors. Ekanayake *et al.* (2009) classify such contextual factors into three categories: those that are related to (i) internal organization; (ii) organizational interface; and (iii) external environment. Factors related to internal organization such as firm characteristics, institutional process, and organizational and behavioural contexts could affect the level and the nature of accounting and corporate governance in banks (Inchausti, 1997; Adams, 2002; Archambault and Archambault, 2003). Further, factors within organizational interface, such as regulatory bodies, professional accounting bodies, capital markets, and other key stakeholders (e.g., media and formal representatives of social interest groups) could have an effect on financial reporting and corporate governance practices in banks (Hopwood, 2009; Inchausti, 1997; Archambault and Archambault, 2003). Furthermore, the organizational interface is opened to an array of economic, political, social and international pressures driven from the external environment. Those factors could also directly influence the role of accounting in corporate governance practices in banks (Salter, 1998; Hoque and Hopper, 1997; Alawattage and Wickramasinghe, 2008).

Banks in emerging economies are likely to gain a number of desirable outcomes by using accounting effectively in corporate governance mechanisms (Ekanayake *et al.,* 2009). At the organizational level, when effective corporate governance prevails, banks are more likely to be profitable and stable, achieving shareholder wealth maximization and depositor protection. At a more macro level, due to the high degree of discipline in investment decision making, resulting from effective use of accounting information in corporate governance, limited resources would be efficiently allocated helping a country's economic development (Bushman and Smith, 2003). Additionally, more disciplined banks in the country would contribute to a stable banking system, reducing room for possible financial crises.

3. Accounting and Corporate Governance within the Banking Industry in Sri Lanka

The banking industry in Sri Lanka consists of 12 domestic and 12 foreign commercial banks, and is operating through a network of 1676 branches and 3898 other service outlets (CBSL, 2013). In 2005, Sri Lanka recorded the highest branch ratio of 7.1 per 100,000 people and ATM ratio of 4.5 per 100,000 people in the South Asian region (World Bank, 2006). In addition to the commercial banks, there are 9 specialized banks, which provide specialized banking services to domestic customers. Altogether, the banking industry in Sri Lanka consists of 33 banks and dominates in the financial system, and claims for 56 per cent of the total assets of financial institutions (CBSL, 2013). Moreover, because the capital market in Sri Lanka has not grown up to its potential, the banking industry appears to be the main depository for the economy's savings, and is typically a main source of finance for majority of businesses in the country.

The adoption of most of the international financial reporting standards (IFRS) and international accounting standards (IAS), subsequent to the enactment of Sri Lanka Accounting and Auditing Standards Act (No. 15) of 1995 was expected to strengthen the levels of financial reporting of specified business enterprises in Sri Lanka including commercial banks. Further, beginning from 2012, Sri Lanka is fully compliant with the IFRSs and IASs. Hence, at present, an enterprise that asserts compliance with Sri Lanka Accounting Standards (LKASs) and Sri Lanka Financial Reporting Standards (SLFRSs) would also be automatically compliant with IASs and IFRSs. This will ensure that, not only financial statements of banks in Sri Lanka are fully comparable with those of international banks, but also they provide relevant and reliable information for the effective operation of the corporate governance mechanisms of banks.

The Central Bank of Sri Lanka (CBSL) is the key regulatory body that governs the banking industry in Sri Lanka. Among other things, the laws and regulations (e.g., the Banking Act No.30 of 1988) administered by the CBSL influence the financial reporting of banks. For instance, by the power vested through the Banking Act, the CBSL stipulates the formats to be used when preparing and publishing the financial statements of the banks (Section 38). 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 recognition of the significance of the business of banks in the economy, the CBSL issued a mandatory code of corporate governance for banks in line with global developments in the area, effective from January 2008. The CBSL also adopts prudential regulations and supervisory practices to safeguard the commercial banks in Sri Lanka. It has issued directions setting prudential norms for capital adequacy, income recognition, asset classification, provisioning for non-performing loans, and other issues such as disclosure standards. Significant changes have also been taken place recently with regards to 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 has been restricted to a maximum of 15 per cent of the issued voting equity of the domestic private banks; in 2005 the minimum capital requirement for licensed commercial banks has been increased to SLR 2.5bn from SLR 500m[4]. Effective from January 2008, the CBSL implemented the Basel II Accord to direct the banks to create formal risk management structures. Accounting and corporate governance practices in banks in the country seem to have been affected significantly by such laws and regulations in the recent past.

4. Actual Role of Accounting in Corporate Governance Mechanisms

The actual role of accounting in corporate governance in the case organization (herein after COMBANK) is discussed in this section. Currently, COMBANK is the largest private sector bank, and the third largest bank in Sri Lanka based on the assets valued at SLR 475 billion, claiming approximately a 10 per cent of the total assets held by commercial banks in Sri Lanka (Fitch Ratings, 2012). The present annual turnover and the post-tax profit of COMBANK are SLR 63 billion and SLR 10 billion, respectively in 2012 (COMBANK Annual Report, 2012:p.5). In the country, COMBANK operates through 227 branches that are linked with modern technology, and are connected on-line, facilitating customer service (COMBANK Annual Report, 2012:p.10).

The data from the field study suggests that the two areas of accounting in COMBANK have the capacity to facilitate its corporate governance mechanisms. For instance, financial reporting in COMBANK conforms to the relevant regulatory requirements, and produces the comprehensive reports on time.

[4] On 14 November 2013, the exchange rate of US dollars and Sri Lankan rupees was US$1 =SLR 129.

COMBANK has been awarded the Best Annual Report Prize by the Institute of Chartered Accountants of Sri Lanka (ICASL), the Best Presented Accounts Prize by South Asian Federation of Accountants (SAFA), and also the winner of the Corporate Governance Disclosure Award by ICASL and SAFA for most of the recent years. The management accounting system in COMBANK is capable of providing required information for internal decision making and control purposes.

The following subsections analyse the extent to which accounting facilitates the corporate governance mechanisms (i.e., BOD, managerial compensation plans, laws and regulations, shareholder and debtholder monitoring, and labour and product markets) in COMBANK.

Board of Directors

In the case of banks, BOD is regarded as the most effective corporate governance mechanism, particularly due to the limited impact of some of the external corporate governance mechanisms (Nam, 2004). However, the degree of effectiveness of this mechanism depends on the availability of information about the operations of the banks and functioning to board members, as well as their ability to use that information (Whittington, 1993) to direct the bank and monitor the activities of managers. Accounting information needed for this purpose is provided to BOD mainly through management accounting.

The interviews with the accountants in COMBANK suggest that BOD is provided with detailed management accounting information. Following are some of the comments made by them:

"*We provide a detailed set of financial statements for management on a segment basis, basically, segregating into DB (domestic banking), OSB (off shore banking) and Bangladesh operations. For each segment, we provide separate P&L, Balance sheet and ratio computations to the BOD*" (Accountant7)[5].

"*Even it (provision of management accounting) goes into the level of each and every branch's profitability and the branch's targets…*" (Accountant4).

The BOD of COMBANK appears to use management accounting information in directing the bank and monitoring the activities of the managers, as evident by the comments made by the accountants who participated in this study. First, the BOD seems to provide a strategic direction to the bank by closely involving in the budgeting process. Several accountants stated,

"*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 a particular area rather than other areas, those instructions are given*" (Accountant4).

"*Recently, we forwarded the corporate plan and budget, and the BOD wanted us to go through it again… 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*" (Accountant3).

Second, the provision of monthly financial statements giving figures for actual month and actual year-to-date, as well as budgeted month and budgeted-year-to-date provides an opportunity for the BOD to revise strategies. For this purpose, the Planning section also reviews the budgets bi-annually, and revises it

[5] Interviewees are referenced by their function or organization position (Accountant, Manager, etc.) and are numbered in chronological sequence of interview.

for the remaining half of the year. “It *(monthly financial statements)* includes a comparison with the budget. Whenever BOD feels that the bank is moving away from the budget, they come up with different strategies to be adopted in the middle of the year” (Accountant7).

Finally, there is evidence to suggest that the BOD also makes use of ad-hoc information prepared by the Accounts Department for various purposes. An interviewee commented,

> “*The BOD uses to go through each and every aspect of the feasibility reports that we submit, say for example, we produce some feasibility study… if they are not satisfied with it, they will ask for more information*” (Accountant4).

There seem to be a number of factors that led the BOD to effectively utilize management accounting information, and to play an important role in improving corporate governance in COMBANK. In particular, there is strong evidence to suggest that the inclusion of a number of qualified accountants in the BOD enhances its ability to utilize such information. An interviewee commented,

> “*BOD consists of at least a minimum of three or four accountants. The deputy chairman is an accountant, CEO is an accountant, and there are two more directors who are also accountants. Most of the time, they request for more information than what we produced*” (Accountant4).

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

It is also plausible that inclusion of the CEO in the BOD as the only executive director enhances BOD's ability in performing its fiduciary duty. Also, the observations of the present study are consistent with the findings of other studies (e.g., Linck, Netter and Yang, 2009), that the close attention of the BOD is likely to be attributable to the implementation of a mandatory code of corporate governance for banks in Sri Lanka which came into effect from 2008. It incorporates many responsibilities for BOD, and the close supervision of the regulatory authorities, such as the CBSL.

Nevertheless, there is also evidence to suggest that the Accounts Department provides only a standard type of information, limiting the potentiality of the BOD in performing as a corporate governance mechanism. An interviewee commented,

> "*I am not sure of what they (BOD) should be looking at, but what we provide them is mainly the P&L and the balance sheet. Now (for example), as we have being exposed to a hedging transaction these days, I don't know to what extent we have educated the board... that communication is not taking place*" (Accountant6).

There can be several reasons attributable to this situation. First, COMBANK lacks of a sophisticated accounting information system; the system that the bank employs at present, namely International Comprehensive Banking System (ICBS), is a banking system, which has limitations in generating accounting information. This may be a reason for the bank's inability to introduce more contemporary management accounting systems, where product and customer profitability analyses can be undertaken. In the absence of such a system, a large amount of manual work is needed in preparation of management accounting information. It seems that the efficiency of provision of accounting information is impaired by this manual intervention when the size and the level of performance of the bank are taken into consideration. Moreover, accuracy of information generated can also be hindered by manual work, specially when the level of skills of the staff, who input data into ICBS at the branch level, are considered.

Managerial Compensation Plans

Managerial compensation plans, designed to minimize goal incongruence behaviour of managers, are regarded as an important corporate governance mechanism. In particular, cash compensations (e.g., bonuses) paid based on the performance of managers can be an effective corporate governance mechanism in banks (John and Qian, 2003). In this respect, accounting could play an effective role in the corporate governance mechanism by providing appropriate key performance indicators to evaluate the performance of managers.

In COMBANK, rewards are recognized as one of the key drivers influencing employee behaviour, thereby impacting on outcome of business. An interviewee commented, “We are a highly result oriented bank. Therefore, compensation and other benefits are tied down to objectives and results” (Manager2).

The compensation package of the managers in COMBANK includes both a fixed component (i.e., a base salary), and a variable component (i.e., bonuses, stock options for the CEO and the senior management personnel and annual salary increments). The variable pay plan is determined according to the overall achievement of the bank as well as the accomplishment of per-agreed individual targets, which are based on various performance parameters (COMBANK Annual Report, 2008: p.62). The extent to which accounting information used in those parameters appears to be high, as evident by the following comments of several participants in this study. “Compensation is linked with performance, which is really financial... there are other KPIs *(Key Performance Indicators)* also, but without the financials others are a waste of time. So, financials are dominated in the KPI's” (Manager1); “Performance is basically achieving the budget, *(for instance),* how much of budget did you achieve this year? ...which means performance is measured in terms of accounting information” (Manager2).

According to COMBANK 2008 Annual Report (p.62), the level of variable pay or bonuses payable on achievement of the targets is set at a level perceived as correct to provide necessary incentives for executives at all levels including the CEO and the members of the corporate management. For example, an interviewee who represented the corporate management of the bank indicated, “It is not possible to disclose the figure *(approximate percentage of the variable component in the total compensation package)*, but is sufficiently large enough to encourage high performance”. (Manager1)

By achieving the individual targets, managers will benefit as their rewards are linked with the performance, while the shareholders and depositors will benefit from the bank achieving its predetermined targets as the individual targets are linked with the overall targets of the bank. An interviewee commented,

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

The human resources and remuneration committee of the BOD is responsible for determining the compensation and benefits of the CEO and the key management personnel, as well as setting their individual targets (COMBANK Annual Report, 2008:p.62); it also lay down guidelines and parameters of the compensation structures for all executive staff of the bank and oversee the implementation of these policies. This committee ultimately decides the bonus payable for the executive staff in the event of over or under achievement of the predetermined targets by making appropriate adjustments.

Despite COMBANK adopts a performance linked compensation system to reward executive staff, aligning the interests of the managers with those of the shareholders and possibly the depositors, inclusion of the CEO (as the executive director in the bank) in the human resources and remuneration committee can hinder the effectiveness of such a system. For instance, the CEO has the opportunity to influence bank's targets that ultimately becomes his targets as well. By contrast, the international guidelines, for example, NYSE (2003), recommend that listed companies must have compensation committee composed entirely of independent directors.

Laws and Regulations

Laws and regulations enforced to protect the stakeholders, particularly depositors, in banks have been recognised as an effective corporate governance mechanism (e.g., Levine, 2004; Alexander, 2006). Extensive regulation has become the most important external corporate governance mechanism in banks. The provision of accounting information is one of the main sources assisting regulation and supervision of banks, and thus could play an effective role in this regard.

The CBSL regulates and supervises banks in Sri Lanka. For this purpose, banks are required to submit various reports to the CBSL on a regular basis, and these reports have been the basis for on-site and off-site regulation and supervision by the CBSL. The accountants indicated that the financial reporting system of COMBANK is arranged in such a way that it fulfils the regulatory reporting requirements. Several interviewees commented,

> "*We always try to meet the statutory requirements. Whenever there is a change, say for example, classification of accounts or level of bad debt recognition, we adhere to the requirements or changes by making adjustments in the system (ICBS)*" (Accountant5).

> "*We consider all the complying requirements of the CBSL in developing the report generating systems in the ICBS*" (Accountant1).

Further, the web based off-site surveillance system introduced by the CBSL in July 2006, enabling the banks to submit reports online, appears to ease the regulatory reporting. Fulfilling the statutory requirement of CBSL, COMBANK also appointed a compliance officer in 1998 to oversee compliance function and statutory reporting requirements of the bank.

However, the recent changes in the regulatory framework that governs banking industry, for example, implementation of Basel II, demand the bank to invest in a new system fulfilling those requirements. This was noted by several participants in this study including the following:

> "*The exiting requirements are already covered. Now, the issues are with the requirements coming under Basel II and new accounting standards... IFRS 07, IAS 39 and 32*" (Accountant 7).

> "*Now you know with the change in Basel II requirements… still that is in a transition period. Banks are evolving new methods of risk assessments, accounting techniques and things like that. There are new accounting standards which are going to be*

introduced, for example, IFRS 7, where certain investments are needed to accommodate properly" (Manager 4).

The prompt submission of regulatory reports and the system established for that purpose in COMBANK have enabled the regulation and supervision of the regulatory authorities over the bank. Such actions of the regulatory authorities, particularly by the CBSL, facilitate good corporate governance of the bank. Following are some comments made by several participants in this study: "CBSL does periodical inspections... they visit the bank, especially this department *(Finance and Planning)*, and even at branch levels, they check whether we follow those regulations" (Accountant3). "Yes, because they *(CBSL)* used to visit us and give reports. Those have been discussed greatly at the board audit committee" (Accountant4). "CBSL audits the bank's accounting system annually, and makes suggestions... we make necessary changes accordingly" (Accountant7).

There is no evidence to suggest that COMBANK breaches laws and regulations, or there are lapses in relation to quality of law enforcement and supervisory role by the regulatory authorities over the bank. This is most likely to be connected with the bank's effort in abiding by laws and regulations, and its effective financial reporting system established for that purpose. The participants of this study constantly noted this point including the following:

"*Whenever there is a new regulation coming up, they (CBSL) always refer to us first. That is a good indicator... even they have appreciated the way we provide information, and the time taken to provide such information... I think that is because we have a good system established for that purpose*" (Accountant8).

"*We have been the number one bank in Sri Lanka for the last so many years. And for each and everything, they (CBSL) benchmark us. Sometimes, they call other banks* *and ask to follow our systems/procedures... and sometimes they obtain information from us. Because, they also know, to a greater extent, that we have addressed those issues...*" (Accountant6).

It appears that the financial reporting system of the bank facilitates laws and regulations to operate as an effective corporate governance mechanism.

Shareholder Monitoring

Shareholder monitoring is an important corporate governance mechanism in any organization where ownership is separated from control (Shleifer and Vishny, 1997); shareholders in banks can also operate as an effective corporate governance mechanism by monitoring the activities of BOD and managers, and participating in the making of important decisions. To a greater extent, such actions of shareholders are facilitated by the provision of accounting information.

The right to access to information by shareholders is protected by laws and regulations prevailing in the country. Accordingly, shareholders of COMBANK have a legal right to receive information by way of quarterly and annual reporting, and press releases. Because COMBANK is a licensed commercial bank, CBSL regulations require it to publish quarterly financial statements in press in main three languages, i.e., Sinhala, Tamil and English, within two months period after end of the quarter; Given the bank is a quoted public company, it is abided by the Colombo Stock Exchange (CSE) regulations, which require quarterly financial statements to be published in press, or mailed to the shareholders. The interviews with the accountants revealed that COMBANK has been complying with both these requirements, although, mailing the quarterly financial statements to the shareholders is optional. This practice of the bank beyond the minimum legal requirements is seen as a factor positively influencing shareholder monitoring.

Annual reporting to shareholders of COMBANK is mandatory by several regulations: the Companies Act and the CSE regulations (within six months after end of the financial year), and the CBSL regulations (within five months after end of the financial year). However, we noticed that COMBANK normally publish its annual reports well before these statutory deadlines (within three months after end of the financial year), facilitating shareholder monitoring.

It has been the practice of COMBANK making press releases on matters related to the bank and the market, which have any effect on the price of the shares, or where such information is considered important for investors to make decisions. The disclosure of information is made in this way according to the CSE listing rules.

Apart from complying with statutory requirements that govern the provision of accounting information to shareholders, there are several other ways that COMBANK facilitates shareholder monitoring. The accountants noted that the bank provides information to the larger shareholders such as institutional and international investors on individual basis, clarifying the matters and queries raised by them. Some of the interviewees said,

> "*We normally use to have investor relations with the foreign investors, there are some shareholders... use to come and speak to us like at least one or two per month... and they drill down to whatever an unimaginable extent*" (Accountant4).

> "*For major decisions, for example, acquisitions or mergers, bank consults its institutional shareholders, such as DFCC and Insurance Corporation. 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).

The bank's website includes a section on 'investor relations' that also provides information for shareholders, for example, it contains bank's annual reports for previous several financial years, and preceding four quarterly financial statements. However, some comments of the participants in this study suggest that it has not developed into a level that provides most of the relevant information to the shareholders. They said,

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

> "*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 fluctuate... there's other information that we could be publishing on the web that we are not doing at the movement*" (Manager1).

In addition to the rights of the shareholders to be informed about the matters related to the bank, they also have the right to participate and vote in shareholder meetings on important decisions. For instance, shareholders have the opportunity to clarify matters related to financial statements and other affairs of the bank at the AGM:

> "*Queries are dealt in the AGM, where the shareholders are provided with a time to raise their questions*" (Accountant8).

Further, where necessary, the bank holds extraordinary general meetings to get shareholder approval for important resolutions, for example, proposals for fundamental changes affecting the bank:

> "*If there is an amendment to articles, there should be a resolution passed... that means shareholders have to give their consent*" (Accountant1).

It appears, based on the above discussion, that the shareholders of COMBANK have more avenues to access information. One reason is that it is governed by additional regulations, for example, Companies Act requirements on submitting annual reports and holding AGMs. Another reason is that the bank's effort on external reporting, as reflected by the awards it received for best presented financial statements in the annual reports over a number of previous years. Several interviewees commented,

> "*To a great extent, our transparency level of disclosures is high compared to other banks... that's why we have been wining the annual reports awards*" (Accountant6).

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

Debtholder Monitoring

The high level of debt-to-equity ratio prevailing in banks makes debtholder monitoring to become an important corporate governance mechanism (Adams and Mehran, 2003; Levine, 2004). There is neither an insurance cover, nor a government guarantee for deposits in COMBANK that gives a strong incentive for depositors to monitor the bank[6] (e.g., Macey and O'Hara, 2003).

[6] Monitoring by debenture holders has been excluded from the discussion given their insignificance in COMBANK's capital structure.

Unlike shareholders, depositors do not possess a legal right to be informed about the financial results of COMBANK:

> "*We don't publish any, in the sense; there is no legal requirement to publish any specific data (for depositors)*" (Accountant5).

However, the depositors have access to quarterly financial statements of the bank, as they are published in the press in three main languages. Further, quarterly and annual financial statements are displayed at COMBANK branches for the benefit of the depositors, who visit the branches for business transactions. A participant in this study noted,

> "*We have nearly 180 branches... all these branches display quarterly accounts as well as last year financial statements in their premises. So, every customer has access to those financial statements*" (Accountant7).

Furthermore, depositors can have access to recent annual reports and quarterly financial statements available on the bank's website. However, lack of knowledge in information technology and shortage of internet facilities in the country could restrict depositors accessing to bank's website. There also seems to be a group of depositors, who access bank's website for making business transactions, rather than as a source of seeking information for monitoring purposes. These were noted by an interviewee as follows:

> "*It (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*" (Manager 1).

Finally, as discussed above, depositors have access to press releases of the bank. It appears, based on the above discussion, that limited access to financial information is a factor that restricts the ability of the depositors to monitor COMBANK. Above all, it seems that financial performance is not considered as an important tool for monitoring and decision making purposes by particularly the small scale depositors in the country. This was evident by the following comment of a participant in this study.

> "*If you take retail depositors, they are not driven by accounting ratios, rather, they are driven by interest rates. The wholesale depositors, of course, look at financial information. The market is as such*" (Manager4).

This may be due to economic conditions prevailing in the country, for example, some of the depositors seem to be solely depended on the interest income derived from their deposits. Apart from that, it could also be due to regulatory oversight of the CBSL, which can play a substitute monitoring role, as Adams and Mehran (2003) and Levine (2004) pointed out.

Labour Market

Due to the risk of dismissal from the current employment and the risk of not finding an appropriate employment in future, managers tend to engage in goal directed behaviour for the best interest of the shareholders (Jensen and Meckling, 1976). Under those conditions, performance evaluation of managers could facilitate effective functioning of labour market as a corporate governance mechanism. Financial performance is considered as an important factor evaluating performance of the CEO and the key management personnel; such information can be used effectively in labour market forces when it is tight and competitive.

COMBANK has a performance evaluation system for executive staff, which is based on the predetermined targets set at the beginning of a financial year. The extent to which financial performance is used in evaluating the performance of managers is likely to depend on the area that a manager performs, for example, apparently more financial targets are used for evaluating performance of the operational staff such as branch managers.

> "*The performance criteria for branch managers involve certain KPI's based on accounting information, for example, deposits, advances, profit figures, return on assets, and even things like non performing ratios*" (Accountant2).

Nevertheless, following quote of Manager1 suggests that financial performance criteria are important in setting targets for managers in all areas, including those who are working 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 KPIs. Those cost centres also have measurements on cost, so, it (*financial performance*) is an integral part of our performance evaluation system*".

The human resources and remuneration committee of the BOD evaluates the performance of the CEO and the key management personnel of the bank, based on the results of the performance evaluation (COMBANK Annual Report, 2008: p.62); the performance evaluation of the other executives is undertaken by their immediate supervisors with the coordination of the human resources department.

Although, COMBANK appears to use accounting information vastly in labour market forces, several concerns were raised during field study. First is related to the board structure, more specifically, inclusion of the CEO (as the executive director) in the human resources and remuneration committee of the BOD. As discussed previously in the managerial compensation plans subsection, the CEO's presence in this committee also hinders accounting's role in labour market. For example, the CEO has the opportunity to influence in target settings of the bank; whenever the targets are not challengeable, performance evaluation system tends to be ineffective hindering labour market forces.

Second is related to the organizational and behavioural context. The bank mainly uses information derives from the transfer pricing method for performance evaluation of managers, particularly in the operational areas. For instance, targets are given for deposits and advances, and actual is compared against budget in the performance evaluation. In this process, cost is an important factor that is taken into consideration. For example, a manager may achieve deposit targets by mobilising deposits at high rates at the expense of the bank. Transfer pricing method provides necessary information on such costs. However, following comment of Accountant4 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, 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*".

Third is related to human resources procedures that undermine effective use of the results of performance evaluation of managers. It appears that a manager has to work in a same grade for a certain period of time (at least four years), despite of their favourable results in performance evaluations. They may not be considered for a promotion until the expiration of that particular time period. This was noted by several participants in this study including the following:

> "*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 done for the institution, you get the preference only after four years. Except one or two, I have not come across a person getting promotion based on his/her value addition to the bank*" (Accountant5).

Finally, although the positive results of performance evaluations are favourably considered in promotions, the poor performance does not lead to demotions or dismissals, making accounting's role less effective in functioning labour market as an effective corporate governance mechanism. Several interviewees commented,

> "*Promotions, certainly yes, but not really dismissals. In this country, labour laws do not promote you to hire and fire people based on performance. I never come across a case where the courts have permitted dismissals on the basis of poor performance*" (Manager2).

> "*Well, not for dismissals actually. But, definitely for promotions. The culture here is not the culture that is practiced in the West. We only use that (results of performance evaluation) for further improvements*" (Manager4).

It also appears that managers have opportunities for advancement of their careers externally, if their performance is outstanding. Accounting has the potential to play an effective role in such situations. For example, an interviewee commented,

> *"I think if you are a kind of 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).

However, there seems to be fewer movements of managers between banks in the country. Instead, there appears to have movements of managers globally.

> *"You don't find people moving from one bank to another. There seems to be an unwritten rule. But, I think what opens up is overseas, we have seen lots of Sri Lankan bankers not at the most senior level, but certainly at say middle management level who have gone to the Middle East, Singapore, places like that"* (Manager1).

> *"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).

Product Market

Since bank managers are compelled to perform better in a highly competitive product market, it can also operate as an effective corporate governance mechanism (Baggs & Bettignies, 2007). As discussed above, performance evaluation of the CEO and the key management personnel of a bank plays an important role in motivating managers for the accomplishment of the predetermined targets so that the bank can compete successfully in the product market.

In a highly competitive product market, the performance indicators of a bank, such as profitability, cost efficiencies and market share are most likely to be depended on the appropriate selection of lending and deposit rates. In determining these rates, COMBANK seems to evaluate the market conditions as well as the cost structure of the bank, as evident by the following comments of several participants in this study.

> "*There are several methods we adopt in determining lending and deposit rates. One is of course 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).

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

Further, these two quotes provide an understanding about the level of operation of product market competition in the banking industry in Sri Lanka, and emphasize the importance of evaluating rates of competitors in deciding the rates of the bank. Furthermore, these quotes indicate the significance of analysing the cost structure of the bank in determining those rates, and thus accounting seems to play an effective role in product market competition in the case organization.

Despite the significance of having details on cost to calculate deposit and lending rates appropriately, COMBANK lacks of a proper system to provide accurate information on cost and activities, and product profitability. An interviewee commented,

> "*Today, we don't have it (information on product profitability)… there is no hard numbers to pack it up. I think there is 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).

The unavailability of such data in the bank is likely to hinder the potential role of accounting in product market competition to operate as a corporate governance mechanism.

5. Summary and Conclusions

This study examined the extent to which accounting facilitates in good corporate governance of banks in an emerging economy. More specifically, it investigated the role of the two areas of accounting (financial accounting and management accounting) in facilitating the operation of a number of internal (i.e., BOD, MCP) and external (i.e., laws and regulations, shareholder and debtholder monitoring, labour and product markets) corporate governance mechanisms of banks, drawing 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.

Using various contextual factors in the internal organization, the organizational interface and the external environment, this study explained the nature and the degree of influence of those factors on the role of accounting in corporate governance of the case organization. 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. Such factors seem to be, at times effectively promoting, and other times obstructing role of accounting in corporate governance in the case organization. It can be concluded that although COMBANK adopts best practices in corporate governance, it does not necessarily mean that the bank always utilize accounting effectively in improving corporate governance due to the influences from the context. 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).

The findings of this study also support a broader view of corporate governance, taking account of the interests of depositors (in addition to the interests of the shareholders), for governing the banks. Such findings are in consistent with the existing literature on bank governance. For example, 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. These findings are in line with the stakeholder theory. On the other hand, the traditional theories of the firm, such as agency theory which focuses on shareholder value maximization, may not be solely adequate to discuss the present day corporate governance of banks, as those theories focus only on shareholders and give limited attention to other stakeholders such as depositors. Finally, this case of COMBANK shows that accounting facilitates various internal and external corporate governance mechanisms, assisting the broader objectives of corporate governance of current day banking systems.

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