CONTEXTUAL RELATIVITY OF THE ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE: EVIDENCE FROM THE BANKING INDUSTRY IN SRI LANKA

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ABSTRACT

Accounting and corporate governance failures have figured prominently in discussions of the possible causes of bankruptcy of financial institutions in recent times. These discussions suggest that accounting has failed to play an effective role in facilitating good governance of those organizations. Using Ekanayake *et al.* (2009), this paper argues that whilst accounting could assist corporate governance in banks, the effectiveness of its role in corporate governance is influenced by a number of contextual factors which are likely to vary between developing and industrialized countries. Based on the data gathered from a wide range of documents, and interviews of several key personnel related to the banking industry in a developing country, the paper reveals how the role of accounting in corporate governance in banks could be facilitated as well as obstructed by various factors in the environment.

Key words: Role of accounting, Corporate governance, Banking industry, Sri Lanka

INTRODUCTION

The recent global financial crisis has led to the failure of numerous financial institutions in a number of industrialized countries including the United States and members of the European Union. Accounting and corporate governance failures as well as regulatory weaknesses have figured prominently in discussions of the possible causes of this crisis (Kirkpatrick, 2009; Clarke and Klettner, 2009). It was often noted that boards and managers of banks failed to manage the risks, and shareholders and depositors did not get accurate information to monitor the activities of managers (Clarke and Klettner, 2009). The need for additional precautionary measures has also been highlighted in those discussions (Kirkpatrick, 2009).

Banks in developing countries to a large extent operate 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) found 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 practices, such as Basel Committee reports, OECD recommendations, and International Financial Reporting Standards (IFRSs). Adoption of regulatory frameworks similar to certain industrialized countries is an outcome of the influence of the donor agencies, such as the World Bank, in granting financial aids and facilities to developing countries (Hopper and Hoque, 2004; Tsamenyi and Uddin, 2008).

Despite the use of international laws and best practices, it is hard to state that corporate governance practices in the banking industry in developing countries are adequate and effective. There have been instances where financial institutions in such countries becoming subject to criticisms due to their mismanagement, negligence, and lack of proper governance (Arun and Turner, 2004; Nam, 2004). For example, banks and other financial intermediaries were at the heart of the Asian financial crisis in 1997 (Nam, 2004). In Sri Lanka, the Central Bank of Sri Lanka (CBSL) had to intervene to overcome a financial distress situation of a large private sector bank in December 2008 (Sunday Observer, 25.01.2009).

Accounting has the potential to facilitate various internal and external mechanisms that are established to improve the level of corporate governance in banks (e.g., Bushman and Smith, 2001). In the absence of accurate and reliable financial information, most corporate governance mechanisms in banks, such as Board of Directors (BOD), managerial compensation plans, laws and regulations, shareholder and debtholder monitoring, labour and product markets, might not be activated to their potential levels.

This paper argues that the role of accounting in corporate governance in banks in developing countries is likely to be different from that of industrial countries because of the nature of the context within which banks operate. The impact 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 existing body of literature on corporate governance in banks in developing countries has mainly focused on corporate governance issues in general, and only limited attention has been given to systematically examine the factors that influence the effective role of accounting in corporate governance. For instance, Arun and Turner (2004) focus on banking reforms required to improve corporate governance of banks in developing economies, and Nam (2004) and Levine (2004) respectively examine corporate governance issues in banks in developing countries, and establishing good corporate governance in banks in such countries. These papers do not provide any systematic analysis of factors influencing the role of accounting in corporate governance. Focusing on the banking industry in Sri Lanka, this paper aims to examine the contextual relativity of the role of accounting in corporate governance in banks using data gathered from various documents, such as key governing laws, reports applicable to accounting and corporate governance in the banking industry in Sri Lanka, and interviews of several key personnel who were able to provide information useful for this study.

Accounting is increasingly seen as a social rather than a pure technical phenomenon as it is implicated in both organizational and social contexts (e.g., Hopwood, 1978; Burchell, Clubb and Hopwood, 1985). Following this notion, this study is motivated by the desire to understand whether the potential role of accounting in corporate governance is different from its actual role due to the complexities in the banking environment, particularly in a developing country context. A study of this nature is mostly important in relation to developing countries, because banks are typically the main depository for the economy's savings, and play a significant role in economic development as an important source of finance for business (Arun and Turner, 2004; Levine, 2004; Nam, 2004). For instance, in Sri Lanka, banks dominate in the financial system claiming 58 per cent of the total financial institutions assets (CBSL, 2008a). This paper would offer useful insights to policy makers on the factors that affect the effective use of accounting in corporate governance in banks. Such insights may be useful in introducing further measures to improve the usefulness of accounting in corporate governance in different contexts.

The remainder of the paper is organized as follows. Next section briefly outlines the potential role of accounting in corporate governance in banks with reference to Ekanayake, Perera and Perera (2009). The two sections that follow examine respectively the influence of the organizational interface and the external environment on the role of accounting in corporate governance in the banking industry in Sri Lanka. The paper concludes with a discussion of significant findings, and suggestions for future research.

POTENTIAL ROLE OF ACCOUNTING IN CORPORATE GOVERNANCE

Accounting and corporate governance plays inter-dependent roles in organizations (Whittington, 1993). While accounting could play an important role by facilitating corporate governance, the level of corporate governance in an organization, to a great extent, determines the quality of accounting information (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).

Ekanayake *et al.* (2009) draw attention to the role that accounting could play in corporate governance in banks. As shown in Figure 1, they identify four broad areas of accounting that facilitate corporate governance, namely external reporting, external auditing, management accounting and internal auditing. Information contained in annual and interim reports prepared for external reporting purposes could minimize information asymmetry between internal parties such as board of directors (BOD) and managers, and external parties such as shareholders and other stakeholders (Whittington, 1993). External auditing is one of the cornerstones of corporate governance that could provide an external and objective check on the way in which the financial statements have been prepared and presented (Cadbury Report, 1992). External auditing could ensure that financial statements are less distorted by managerial reporting biases and errors (Bushman and Smith, 2001). Management accounting systems generate information for internal purposes, and such information could facilitate the monitoring of managers by the BOD (Whittington, 1993). Finally, internal auditing could validate information generated through the accounting system and assist in improving the reliability of decision making by the BOD and managers (Cadbury Report, 1992; Whittington, 1993).

Insert Figure 1 here

The four areas of accounting can facilitate various corporate governance mechanisms. In Figure 1 they are classified into two categories, namely internal corporate governance mechanisms which are established within banks (i.e., BOD and managerial compensation plans) and external corporate governance mechanisms which are established externally (i.e., laws and regulations, shareholder and debtholder monitoring, labour and product markets).

Drawing on contingency theory, Ekanayake *et al.* (2009) also argue that the role of accounting in corporate governance (hereafter ROA in CG) in banks depends on a number of contextual factors. Figure 1 classifies 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 behavioral contexts could affect the level and the nature of accounting and corporate governance in banks. 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 (Burchell *et at.*, 1985; Inchausti, 1997; Archambault and Archambault, 2003). Furthermore, as shown in Figure 1, the organizational interface is open to an array of economic, political, social and international pressures driven from the external environment. Those factors could also directly influence the ROA in CG practices in banks.

As depicted in Figure 1, the efficient use of accounting in assisting internal and external corporate governance mechanisms could lead to a number of desirable outcomes in banks. 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 efficient use of accounting information in corporate governance, limited resources would be efficiently allocated assisting in a country's economic development. Additionally, more disciplined banks in the country would contribute to a stable banking system, reducing the room for possible financial crises.

The framework presented in Ekanayake *et al.* (2009) is useful in examining, not only the potential ROA in CG, but also how that role is affected by various contextual factors. Using Ekanayake *et al.* (2009) framework, this study examines the influence of various contextual factors on the potential ROA in CG in the banking industry in Sri Lanka.

INFLUENCE OF ORGANIZATIONAL INTERFACE ON THE ROLE OF ACCOUNTING

Organizational interface of the banking industry in Sri Lanka provides the institutional and legislative framework within which accounting operates in banks. The nature and the extent of influence of the organizational interface would vary depending on the type of bank. For instance, there are differences in such influences between private sector banks and public sector banks, as well as the banks listed in the Colombo Stock Exchange (CSE) and those that are not listed in the CSE. Table 1 illustrates the governing institutions in the organizational interface, their primary functions, key governing laws and regulations, and their major influences on the ROA in CG in banks in Sri Lanka.

In Table 1, the influences of the factors in the organizational interface on accounting are identified only for external reporting and external auditing because such influences on the other two areas of accounting viz. management accounting and internal auditing appears to be negligible. The following sub sections discuss the impact of each factor in the organizational interface on the ROA in CG in banks in Sri Lanka.

Regulatory Bodies

The laws and regulations enforced by the 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 ROA in CG in banks in Sri Lanka is influenced by several regulatory bodies, namely the Central Bank of Sri Lanka (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 and there are laws and regulations administered by the CBSL that influence the ROA in CG in banks in both private and public sectors. For instance, Part V of the Banking Act

(No.30) 1988 (here after BA), amended by Act (No.33) 1995, specifies the provisions for accounting and auditing of banks[1]. By the power vested through BA, the CBSL stipulates the formats to be used when preparing and publishing banks' financial statements. The uniformity of presentation of financial statements is intended to improve the comparability of the performance among banks. Improved comparability facilitates shareholder and debtholder monitoring of the bank which in turn enhances the bank's corporate governance.

In accordance with the requirements of BA, every licensed commercial bank must publish its annual audited financial statements, and transmit to the CBSL within 5 months after the end of the financial year. The availability of these statements on a timely basis is expected to increase the effectiveness of the regulatory oversight by the CBSL. Additionally, CBSL requires the publication of quarterly financial statements in the three main languages used in the country, namely Sinhala, Tamil and English in the newspapers within two months of the end of each quarter.[2] 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 governance mechanisms in Sri Lankan banks in a number of ways. Availability of information on a regular basis makes shareholder and debtholder monitoring possible on a timely basis, and by publishing such information in the three main languages, shareholders and debtholders who come from different ethnic backgrounds are enabled to perform their monitoring role effectively.

Furthermore, as stipulated by the BA and directions, circulars and guidelines issued by the CBSL from time to time, commercial banks are required to submit various reports on 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 Rs.500,000 and risk-based capital calculations), and annual basis (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 auditors from time to time to audit the banks. The list issued in 1998 consisted of ten audit firms including three of the "big four" audit firms.[3] 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.

[1] 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.

[2] If the bank publishes its annual audited financial statements within three months from the end of the financial year, the requirement to publish the financial statements for the fourth quarter would not be mandatory (CBSL, 2008b).

[3] Deloitte, one of the big 4 audit firms, does not operate in Sri Lanka.

External auditors of banks in Sri Lanka are provided with certain guidelines by the CBSL relating to their statutory duties under the BA. These guidelines cover the areas such as audit planning, scope of audit, internal control systems, assessment of bank automation, branch audits and review of financial statements. The CBSL is also empowered by the BA 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, making banks provide reliable financial information for governance purposes.

Another CBSL guideline that ensures effective audits of banks relates to protecting auditor independence. External auditors are prohibited to undertake 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 systems design and implementation, actuarial services, internal audit outsourcing services, management functions and legal services to the bank[4]. Such guidelines introduced by the CBSL to guard auditor independence have made a positive contribution to corporate governance in banks in Sri Lanka.

The Registrar of Companies

The Registrar of Companies administers the Companies Act (No.7) of 2007[5] (here after CA). CA, among other things, specifies provisions on accounting and auditing to be adopted by the companies incorporated in Sri Lanka. These requirements specified in CA influence corporate governance in private sector commercial banks in Sri Lanka as they are incorporated as limited liability companies.

CA outlines certain accounting obligations for limited liability companies. The 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 CA, signatures, with dates, of two directors on behalf of the BOD, and making them available within six months after the balance sheet date (Section 150). These provisions have a positive impact on corporate governance of private sector banks also. For example, the increased reliability of financial statements due to their certification by the chief financial officer and two members of the BOD enhance effective shareholder and debtholder monitoring of the bank.

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[4] These restrictions exclude tax consultancies.

[5] This Act superseded the Companies Act (No.17) 1982.

Except in the year of incorporation[6], the BOD of private sector banks should hold an annual general meeting (AGM) of shareholders in each calendar year, not later than six months after the balance sheet date of the company, and not later than fifteen 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 fifteen 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 on the AGM, not only facilitate, but also encourage shareholder monitoring of the bank's activities.

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

The Department of Public Enterprises (DPE)[7]

As public enterprises, public sector banks in Sri Lanka are required to abide by the guidelines developed and issued by the Department of Public Enterprises (DPE) which is the governing authority for administering laws and regulations, and developing and issuing guidelines 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 (DPE, 2003). The General Treasury also 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 its stakeholders. These laws and regulations have an impact on the ROA in CG in the public sector banks.

As per the 1978 Constitution of Sri Lanka and the Public Finance Act (No. 38) of 1971, the Auditor General should be the auditor for every public enterprise. The final 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 (DPE, 2003). These requirements on external reporting and external auditing improve the efficacy of reporting practices in public sector banks, facilitating their corporate governance mechanisms.

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[6] A company is not required to hold its first annual general meeting in the calendar year of its incorporation, but it requires holding the meeting within eighteen months of its incorporation (Section 133).

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

Professional Accounting Bodies

Professional accounting bodies influence the functioning of accounting in a country, thereby influence the accounting practices of organizations within that country (e.g., Burchell, Clubb, Hopwood, Hughes and Nahapiet, 1980). The ROA in CG in banks in Sri Lanka is mainly influenced by the activities of the Institute of Chartered Accountants in Sri Lanka (ICASL)[8]. The ICASL is the 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 (Here after AASA). The application of these standards is mandatory for Specified Business Enterprises (SBEs), which include banks as defined in AASA.

AASA also provides the basis for the establishment of Sri Lanka Accounting Standards Committee (ASC) and Sri Lanka Auditing Standards Committee (AuSC), and Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB). The ASC and the AuSC make recommendations and assist the ICASL in the adoption of accounting and auditing standards. The SLAASMB is an independent corporate body, which monitor the SBEs (which banks are part of) to ascertain their conformity with SLASs and SLAuSs in preparation and audit of the financial statements.

The ICASL has approved a policy that SLASs will be fully compliant with respective IFRSs effective from 2011 (IAS Plus, 2007). Hence, in future, a company that complies with SLASs would also be automatically compliant with IFRSs. Since, banks are required to follow all relevant SLASs when preparing and presenting financial statements, the new developments that accompanied the IFRS compliance requirement has further strengthen the level of external reporting of banks, with implications for shareholder and debtholder monitoring.

External audit function of banks are influenced by SLAuSs which are based on 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. AASA requires SBEs to take all necessary measures to ensure that their accounts are audited in accordance with the SLAuSs.

Capital Markets

Capital market regulations influence the reporting practices of companies listed in the share market (e.g., Archambault and Archambault, 2003). The Securities and Exchange Commission of Sri Lanka (SEC) and the Colombo Stock Exchange (CSE) govern the capital market in Sri Lanka. These two organizations have issued various requirements on accounting practices in listed companies under the power vested through the Securities and Exchange Commission of Sri Lanka Act (No.36) 1987. Banks listed on the CSE need

[8] 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) has been established in 1987 to fulfill the shortage of accounting technicians in the country.

to follow these requirements. Following sub sections discuss the influences of these regulatory authorities on accounting practices in banks separately.

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 to adopt. However, only some of these are mandatory. These regulations and guidelines influence the ROA in CG in listed banks.

All listed banks are required by 1990 SEC rules to submit their annual reports certified by auditors to the stock exchange and make them available to the public. Also they are required to report to shareholders regularly as required by the stock exchange, and to announce the provisional results of the financial year within four months of the end of the financial year. These reports should also contain information in relation to the occurrences or events, which may materially affect the affairs of the bank, such as the nature of business, objectives, and stability. Listed public banks must also prepare interim financial statements and submit them to shareholders and the stock exchange within ninety days of the end of six months of the financial year in a format prescribed by the stock exchange. All these requirements that aim at making external reports comprehensive, reliable and timely in turn aid the effective use of a number of corporate governance mechanisms including shareholders and debtholders.

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 that such declaration be included in the annual report. These requirements that aim at improving the reliability of financial statements can have a positive impact on corporate governance of listed banks.

The SEC also influences external auditing, thereby ROA in CG in listed companies. 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 partner[9] and a concurrent review partner; (b) the engagement partner be rotated at least once in every five years, and should not be reappointed in that capacity for two years; (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 ten percent of the total audit fees received by the auditors in the previous financial year); and (d) the auditor is not allowed to

[9] A fellow member of the ICASL with a minimum of three years post qualification audit experience after obtaining the associate membership or an associate member of the ICASL who have a minimum of ten years audit experience qualify for this post.

provide non-audit services[10]. These guidelines are designed mainly to ensure auditor's independence.

The Colombo Stock Exchange (CSE)

The CSE was established in 1985 and has issued a number of listing rules including the rules 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 preparation and submission of interim financial reports, and circulation and content of annual reports. For example, the interim financial reports should be prepared in conformity with SLAS 35 Interim Financial Reporting on a quarterly basis within two months after the end of the quarter by the banks listed in the main board, and half yearly financial statements within two months after the end of the half year by the banks listed in the secondary board and the debt securities board, and submit to the shareholders/holders of debt securities. Further, listed banks are required to circulate their audited annual reports to the CSE and shareholders/holders of debt securities within six months from the close of the financial year. For this purpose, financial statements should be prepared and presented in accordance with the SLASs. These listing rules of the CSE aim to enhance the timeliness and relevance of external reporting, hence have implications for corporate governance of listed banks.

Additionally, the listing rules require immediate disclosure of information on 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. Such disclosure is also required where such information is considered important for investors when making decisions. These may include: information on a joint venture, merger, acquisition or takeover; a decision either to declare or not declare dividends; and any changes to the controls, directors, company secretary, and auditors. These requirements enhance transparency and the level of disclosure in external reporting, in turn facilitating good corporate governance.

Key Stakeholders

Although the key stakeholders, including media, formal representatives of social interest, depositors' associations, and customers'/borrowers' associations, could have an impact on the ROA in CG (e.g., Cooke and Wallace, 1990; Adams, 2002), these parties appear to have only a limited impact on such role in banks in Sri Lanka.

The review undertaken to examine the organizational interface in the banking industry in Sri Lanka reveals that the presence of a number of institutional arrangements have a positive influence on the ROA in CG in the banking industry. The rulings and the requirements generated in the organizational interface not only facilitate, but also reinforces accounting's role in corporate governance in banks.

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[10] This list has the same restricted non-audit services, as the restricted non-audit services list enforced by the CBSL.

INFLUENCE OF EXTERNAL ENVIRONMENT ON THE ROLE OF ACCOUNTING

The factors in the external environment, namely economic, political, social and international, can have a direct impact on the ROA in CG in banks, and an indirect effect through their influence on the elements in the organizational interface. The nature and the extent of influence of the factors in the external environment could vary depending on the type of bank (i.e., whether it is a private sector or a public sector bank, or listed or an unlisted bank). Table 2 illustrates key issues identified in relation to each factor in the external environment and their implications for the ROA in CG in banks in Sri Lanka.

While the issues highlighted in Table 2 could have significant influence on external reporting and external auditing in banks, they could also have some influence on management accounting and internal auditing.

Economic environment

The ROA in CG in banks could be influenced by key economic variables, such as economic development (e.g., Salter, 1998), inflation (e.g., Meek and Saudagaran, 1990), and capital market development (e.g., Doupnik and Salter, 1995).

Sri Lanka is a developing country with per capita GDP of US $1617 in 2007 (World Bank, 2007). It recorded a 6.65 per cent average annual growth in GDP since 2005, which was the highest over last 30 years in the country (FitchRatings, 2007). The Sri Lankan banking industry has grown in line with the GDP. For example, the contribution of financial services to GDP has steadily increased from 6.7 per cent in 1997 to 9.17 per cent in 2007 (ADB, 2007). It managed to maintain a sustained profitability via stable net interest margins, and short term nature of the assets and liabilities that allows to quick re-pricing them within a short period of times (FitchRatings, 2007). The growth in the banking industry means raising more capital by way of share issues and deposits. This has led to the need to disclose more information (e.g., Archambault and Archambault, 2003) to enable shareholder and 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 wide trade gaps, and fiscal deficits. The inflation measured in terms of the consumer price index has recorded a rapid 10 percent annual increase from 2003 (5.8 percent) to 2007 (15.8 percent) (ADB, 2007). Although inflation affects banks' performance negatively, it could influence reporting practices favorably as banks may increase disclosures to further assist investors to understand the effects of inflation on financial reporting (e.g., Meek and Saudagaran, 1990).

Political environment

Political factors, such as policies of the ruling party (e.g., Burchell *et al.*, 1985; Stoddart, 2000), and political freedom in a country (e.g., Belkaoui, 1983) could have an impact, not only on organizations within the country, but also on the ROA in CG in a country. Additionally, rational decision making and enterprise accountability may be superseded by political factors in state owned enterprises (e.g., Hoque and Hopper, 1997), including government owned banks.

Sri Lanka is a Democratic Socialist Republic. It gained independence in 1948, after nearly one hundred and fifty years of British rule. Due to Sri Lanka's close relationship with Britain, the accounting system in the country has been primarily influenced by the British system. Cooke and Wallace (1990) identify colonial history as one of the factors which determines the level of corporate financial disclosure regulation in many developing countries.

The present constitution passed in 1978 aims at freeing the economy from excessive government controls and promoting the private sector as the engine of growth[11]. These amendments resulted in rapid increase in the number of companies including foreign owned firms, which created a new demand for accounting and corporate governance practices in the country. As a result, many new developments have introduced to the institutional (e.g., establishment of the Securities and Exchange Commission) and regulatory (e.g., Companies Act (No.17) 1982) framework that govern accounting and corporate governance in the country.

Over the years the ROA in CG in public enterprises, including public sector banks, has often been subject to political intervention. There have been many instances where chairman and BOD of public sector enterprises were political appointees with poor technical and management skills (Karunatilake, 1986). Further, public enterprises have been used by politicians and trade union leaders to achieve short term political objectives, such as providing jobs for party supporters and favoring party financiers by rewarding credits/tenders (Dheerasekera, 2007). Hence, consistent with the findings of other studies (e.g., Hoque and Hopper, 1994; Hopper and Hoque, 2004), the role of accounting in those organizations appears to be marginalized, especially because the ruling party uses its considerable powers for political gains rather than for economic ends.

However, unlike the other public enterprises, public sector banks have been able to record positive financial performance, mainly because of the healthy net interest margins prevailing in the banking industry in Sri Lanka over the years. It appears that the inefficiencies due to political interferences as discussed in this section are overshadowed by the large interest margins in the banking industry.

Social environment

The social environmental factors such as the level of education (e.g., Doupnik and Salter, 1995) and cultural factors, such as commercial values of people in a society (e.g., Adams, 2002; Hamid, Craig and Clarke, 1993) could influence the ROA in CG in organizations located within a country. Such role in banks also could be influenced by the social environment.

[11] The previous constitution passed in 1972 focused on developing the country through central state planning.

Although Sri Lanka records relatively low performance across a number of macroeconomic indicators, its accomplishments in the area of social policy surpass most developing countries (World Bank, 2006). According to the World Bank (2005), Sri Lanka has made stellar progress on the millennium development goals. The country has maintained an impressive record in education. The overall literacy rate of Sri Lanka is 92.5 per cent (94.5 per cent for men and 90.6 per cent for women), and the country has already attained universal primary education and completion, and has achieved gender parity at primary and secondary education levels (CBSL, 2008a). The high level of education has a positive impact on the ROA in CG of banks as 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 in recent years due to rapid expansion of bank branches and facilities, and advertising campaigns by different banks about their banking facilities, interest rates and safety of deposits. The following comment made by a manager of a private sector bank 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)[12].

The failure of a number of financial institutions/informal deposit takers (e.g., Golden Key, Sakvithi, Danduwam Mudalali) has also made customers more vigilant, particularly about the safety of deposits. This situation has led depositors and other interested parties to demand more information from banks.

International environment

Global developments in accounting influence setting of accounting practices of a country. Factors such as convergence of financial reporting (e.g., Susela, 1999; Cooke and Wallace, 1990), operation of multinational companies (e.g., Archambault and Archambault, 2003), and pressure of financial agencies (e.g., Hopper and Hoque, 2004) are likely to influence the ROA in CG in developing countries such as Sri Lanka.

The laws and regulations applicable to the banking industry in Sri Lanka are largely based on international laws and codes of best practices in accounting and corporate governance, such as Basel Committee reports, OECD recommendations, and IFRSs. In particular, SLASs and SLAuSs have been aligned with the respective international standards for financial reporting and auditing. Moreover, effective from January 2008, the CBSL has implemented the Basel II Accord to direct the banks to create formal risk management structures (Fitch Ratings, 2007). These changes have also been influenced

[12] Participants of 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 (Manager3–PRIB was the third manager interviewed from the private sector bank).

by the requirements of aid agencies and international financial institutions such as the World Bank.

The changes in laws and regulations including SLASs and SLAuSs 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 introduce 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 lot of changes in the accounting system (Accountant2–PUB).

> IFRS 7 about disclosure of financial instruments; IAS 37; and IAS 39, are going to have a tremendous impact in the banking industry. I think there will be 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).

These changes also have created a demand for more technically qualified accounting personnel in the banking industry. Currently, it is common in the banking industry that bankers undertake accounting functions rather than accountants, particularly in public sector banks. The need for a change in this regard has been recognized by a number of interviewees. The following represents such a view:

> It's really a brand in new accounting we are doing here. We have lot of new regulations and accounting standards. What we are doing now is not what we did five years back (Accountant6–PRIB).

The review undertaken to examine the external environment in the banking industry in Sri Lanka reveals that the potential ROA in CG is influenced by various factors in the economic, political, social and international environments, at times effectively promoting, and other times obstructing such role in banks.

DISCUSSION AND CONCLUDING REMARKS

Contingency theorists have established 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. The findings of this study, which examined the influence of the factors in the organizational interface and the external environment on the role of accounting in corporate governance, are consistent with this notion. The study reveals that various institutional arrangements exist in the organizational interface in the banking industry in Sri Lanka that produces laws and regulations to ensure effectiveness of the ROA in CG of banks. However, the existence of such laws and regulation does not necessarily ensure the desired outcomes. There have 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. 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, 2008b). These problems seem to have arisen due to the lapses in the law enforcement mechanisms, for instance, delays in identifying and enforcing penalties in such situations. The absence of a requirement to audit the quarterly financial statements published in the press may be another reason leading to the above situations.

Further, there have been failures of a number of financial institutions and a savings bank in recent time (FitchRatings, 2003), and a leading commercial bank owned by a group of companies getting into a financial distress situation in 2008 (Sunday Observer, 25.01.2009). In the latter two situations, the CBSL enforced its legal powers to safeguard the banks, thereby its depositors. Such intervention by the CBSL raises doubts about the ability of the external auditors in preventing and detecting such situations at an earlier stage.

Furthermore, poor institutional capacities also appear to hinder the effectiveness of such regulations. Although AASA requires every SBE to submit its annual accounts to the SLAASMB to determine whether the accounts have been prepared in accordance with the SLASs, and have the power to take action against the SBEs that contravene the act, due to the shortage of technical staff the SLAASMB reviews only a selection of financial statements (World Bank, 2004).

The study also reveals that stakeholders such as media, formal representatives of social interest, depositors' associations, and customers/borrowers' associations have very limited influence on corporate governance of the banks in Sri Lanka. These parties seem not to operate to a level similar to industrialized countries hence their existence have no implication for the ROA in CG.

The study found that the factors in the external environment are having both positive and negative influences on the ROA in CG in banks in Sri Lanka. Economic factors, such as economic growth and inflation appears to have a favorable effect on the ROA in CG in banks because of the increased demand for information.

The political environment of the country does not seem to be conducive to ensuring an effective ROA in CG, particularly in public sector banks. The instances where the government's undue influence is visible include granting of loans to government projects; granting of facilities to party supporters and promoting employees who are political supporters. Interviewees consistently noted this situation.

> We are a government bank. So, when the government needs funds for certain projects, they take the money from the bank, because, this is their bank. (BOD1–PUB).

> There are few sighted cases where there are political influences, for example, to promote a person, or there may be influences to grant a loan. (Accountant1–PUB).

The multiple roles held by the government in public sector banks as the owner, directorate, main borrower, main beneficiary of banks investments, auditor, and regulator also seems to adversely affect the quality of corporate governance and the relevance of accounting for corporate governance of such organizations.

The culture in Sri Lanka also seems to adversely affect the role that accounting can play in corporate governance. The society, which is mainly based on Buddhism and quietism, seems to value trust in relationships than information about stewardship. This appears to reduce the need for accounting information as a means of accountability. Moreover, majority of the population is in the low income level category, and their involvement in the share market activity is limited. As a result, demand for accounting information is minimal compared to the industrialized countries.

Accounting and corporate governance regulations and guidelines in Sri Lanka are also largely based on international standards and guidelines. One of the interviewees noted as follows the need for the regulatory authorities to be cautious in adopting them 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, the implementation of Basel II… most of the reports we have seen, even the US finds difficulties to invest on the Basel II technology. Because, you need to have so much sophisticated operation and comprehensive systems. *(*Accountant6–PRIB).

Tsamenyi and Uddin (2008) also note this issue and state that the applicability of the laws and regulations which are largely based on those developed in the West is questionable because developing countries operate under different set of structural conditions.

In summary, this study found that, there are various institutional and regulatory arrangements designed to improve the ROA in CG in the banking industry in Sri Lanka. In particular, recent changes in accounting regulation related to banks in the country seem to have a favorable impact on its role in corporate governance. However, certain areas in the institutional and regulatory framework need improving, especially with regard to strengthening institutional capacities and introducing effective enforcement mechanisms of laws and regulations. These issues are commonly seen as obstacles in using accounting effectively in achieving a high standard of corporate governance in banks in developing countries.

The external environmental factors seem to have both positive and negative influences on the ROA in CG in banks. The influence of the international environment is found to be more significant in recent times, particularly in developing accounting and auditing standards in the country. The study reveals that the unwarranted political interference in the operations of banks is an issue undermining the potential ROA in CG in public sector banks in Sri Lanka.

It can be concluded that although accounting could play an important role in corporate governance in banks, the effectiveness of its role would depend on the nature of the factors in the organizational interface and in the external environment, and thus supports the contingency view (e.g., Chenhall and Chapman, 2006). Such factors have the potential to promote as well as obstruct the ROA in CG in the banking industry. Hence, the study provides a basis to understand the actual ROA in CG in banks. This paper offers useful insights to policy makers on the factors that affect the effective use of accounting in corporate governance in banks. Such insights may be used in introducing further measures to improve the usefulness of accounting in corporate governance in different contexts. The insights offered also would be useful to banking practitioners in their attempts in improving corporate governance in banks.

The study has several limitations. It did not examine the direct influences of the contextual factors on corporate governance in banks but focused on the influences on the ROA in CG. Further, although the factors in relation to internal organization, such as firm characteristics, institutional processes, and organizational and behavioral contexts could influence the accounting and reporting practices of banks (see Figure 1), they were not discussed in this paper as they are specific to each bank. Hence, future research may extend this study by examining the impact of the three categories of contextual factors depicted in Ekanayake *et al. (2009)* in order to understand the actual role played by accounting in corporate governance in a selected bank. Future research may also refine the analytical framework used in the current study.

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Table 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 and Auditing in Banks
1. Regulatory Bodies		
The Central Bank of Sri Lanka (CBSL) *(Applicable to private and public sector banks)* • Administers the Banking Act • Approves bank auditors • Approves accounting and auditing standards for banks • Determines formats and disclosure requirements for financial statements	• 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	**External Reporting:** Formats of financial statements; Continues reporting system; Publication of quarterly financial statements **External Auditing:** List of qualified auditors; List of restricted non-audit services; Guidelines for external auditors
Registrar of Companies (ROC) *(Applicable to private sector banks)* • Administers the Companies Act	• Companies Act (No. 7) 2007	**External Reporting:** 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 **External Auditing:** Appointment of external auditor; Details of external audit report
Other Government Agencies: ***The Department of Public Enterprises (DPE), Strategic Enterprise Management Agency, and Public Enterprise Reform Commission*** *(Applicable to public sector banks)* • Provides institutional framework for Public Enterprises	• 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	**External Reporting & External Auditing:** Time frames for preparation of audited financial statements; Appointment of external auditor
2. Professional Accounting Bodies		
The Institute of Chartered Accountants of Sri Lanka (ICASL) *(Applicable to both private and public sector banks)* • Approves accounting and auditing standards • Supports the activities of the ASC and AuSC	• Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995	**External Reporting:** Requirements on SLASs, which are based on IFRSs **External Auditing:** Requirements of SLAuSs based on IASs; and SLAPSs based on IAPSs

Accounting Standards Committee (ASC) • Develops accounting standards	• Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995	**External Reporting:** Develop SLASs based on the respective IFRSs
Auditing Standards Committee (AuSC) Develops auditing standards	Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995	**External Auditing:** Develop SLAuSs based on the respective ISAs; Develop SLAPSs based on IAPSs
Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) • Monitors the application of accounting and auditing standards	• Sri Lanka Accounting and Auditing Standards Act (No. 15) 1995	**External Reporting & External Auditing:** Monitor the SBEs to ascertain their conformity with SLASs and SLAuSs
3. Capital Markets		
Securities and Exchange Commission (SEC) *(Applicable to banks registered in the CSE official list)* • Administers the Securities and Commission of Sri Lanka Act • Oversees the Colombo Stock Exchange	• Securities and Exchange Commission of Sri Lanka Act (No.36) 1987 amended by Act (No. 26) 1991 and Act (No.18) 2003	**External Reporting:** Routine and non routine disclosures; Declaration of CEO and CFO ensuring true and fair view of financial statements **External Auditing:** Criteria in relation to qualifications, appointment, rotation of partners, and independence of auditors
Colombo Stock Exchange (CSE) *(Applicable to banks registered in the CSE official list)* • Monitor the listing rules	• Colombo Stock Exchange Listing Rules	**External Reporting:** Rules on continues reporting requirements
4. Key Stakeholders (Applicable to both private and public sector banks)		
Media	• None	**External Reporting and External Auditing:** Publication of quarterly financial reports; Provide financial and other information of banks
Formal representatives of social interest	• None	Not significant
Depositors associations	• None	Not significant
Customers/Borrowers ***The Ceylon Chamber of Commerce; The Federation of Chambers of Commerce and Industry of Sri Lanka***	• None	**External Reporting:** Represent ASC **External Auditing:** Represent AuSC

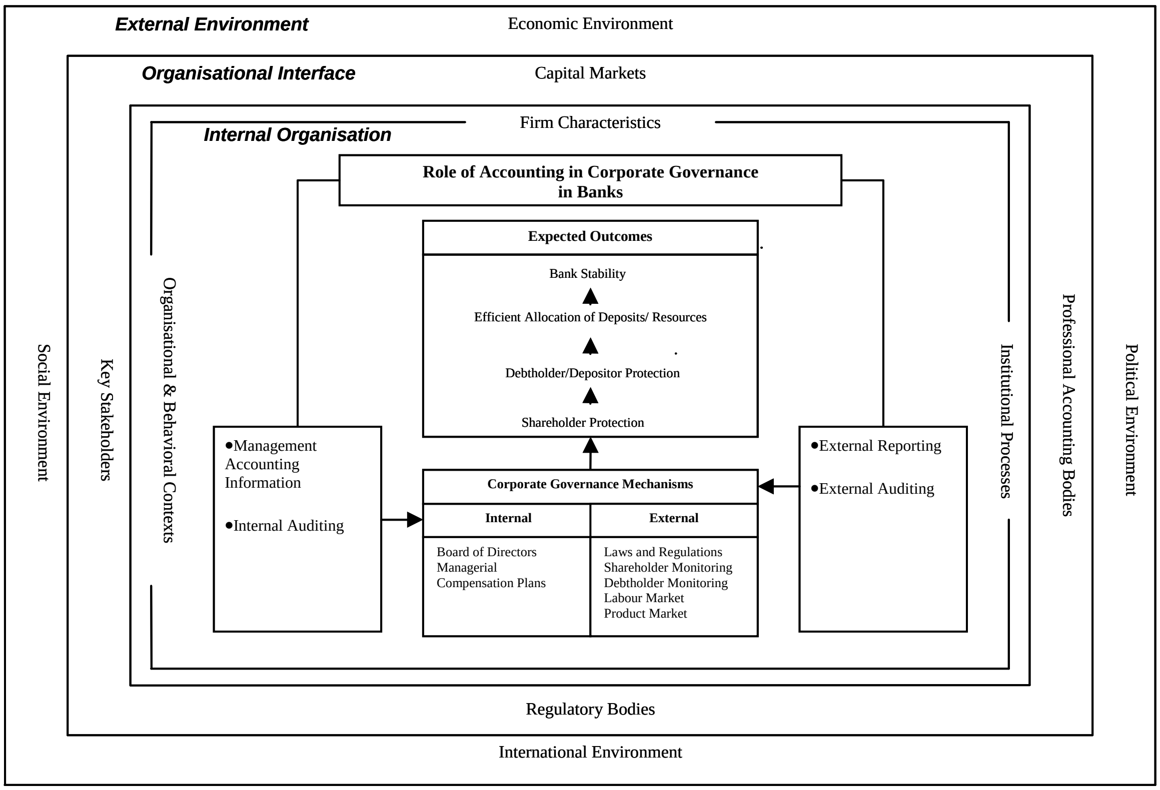
Table 2: Features of the External Environment of the Banking Industry in Sri Lanka

Elements in the External Environment	Important Issues	Major Implications on role of Accounting in Corporate Governance of Banks
Economic Environment	• High level of economic development • High level of Inflation • Capital market development[13]	• Growths of companies are closely associated with economic development, and there is a need to disclose more information to raise more capital. • Inflation violates the historical cost assumption leading companies to increase disclosures to further assist investors • The nature of capital markets influences the information requirements of investors
Political Environment	• Political influences on setting accounting and corporate governance regulation • Political influences on operational decisions	• The formation of accounting and corporate governance regulation in the country is closely associated with the political policies adopted by the ruling governments. • The rational decision making and enterprise accountability may be superseded by political factors in the government owned banks.
Social Environment	• High level of education and customer awareness • Cultural context	• The literacy rate and customer awareness could influence the level of disclosure of information • The existing culture may not have a significant impact on commercial values of people in the society, which in turn minimizes the influences of people on issues that banks would select worthy of reporting.
International Environment	• Global development of accounting and corporate governance • The requirements of the donor agencies	• Global developments of accounting and corporate governance have a significant influence on the accounting and corporate governance practices • The requirements of the donor agencies influence regulatory requirements, and best practices in accounting and corporate governance in the banking industry.

[13] Discussed in the previous section

FIGURE 1

A Framework to Analyse the Role of Accounting in Corporate Governance of Banks



Source: Ekanayake *et al.*, 2009