

Towards a Framework to Analyse the Role of Accounting in Corporate Governance in the Banking Sector

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Abstract

Accounting is considered as an integral part of corporate governance practices. However, limited attention has been paid in the literature to examine this issue systematically.

Drawing on agency theory, stakeholder theory and contingency theory, this study fills this gap by developing a framework to enable a comprehensive analysis of the role of accounting in corporate governance with special reference to the banking sector.

Based on an extensive survey of relevant literature, we found that (a) four areas of accounting, namely external reporting, external auditing, management accounting, and internal auditing, could assist in practices related to internal and external corporate governance of banks; and (b) such assistance would however be moderated by various contextual factors, i.e., internal organisation, organisational interface and external environment.

The findings of this paper have implications for practitioners, with a proposed checklist for governance purposes and for researchers by providing a framework that integrates the various theories that explain governance practices.

Keywords

**Corporate Governance
Accounting; Context
Banking Sector
Corporate Governance Bank Checklist**

Introduction

Over the years the subject of corporate governance has figured prominently in discussions in a number of disciplines such as economics, law, finance, accounting, management, psychology, sociology and political science. However, the term corporate governance does not have a generally accepted definition particularly in accounting or finance. Gillan (2006) suggests that corporate governance may be defined differently depending on particular views of the world, while according to Turnbull (2000), such definitions could also vary between different disciplines. *Cadbury Report* (1992) defines corporate governance as the system by which companies are directed and controlled. In this view, corporate governance may be described as the formal system of accountability of senior management to the shareholders (Keasey, Thompson, and Wright, 1997). The definition of corporate governance has also been stretched to include the entire network of formal and informal relations involving the corporate sector and their consequences for society in general (Keasey *et al.*, 1997). For instance, Gillan and Starks (1998) define corporate governance as the system of laws, rules, and factors that control operations of the company. Ratnatunga and Ariff (2005) take a holistic view of governance in terms of economic, legal and societal definitions and expectations. In both the above papers, factors such as laws and regulations, and the economic, political, market and cultural environments are treated as integrally related to corporate governance¹. Overall, the way in which corporate governance is defined determines the mechanisms that are appropriate to achieve its purpose.

Corporate governance can be seen as sector specific as the nature of governance issues that emanate in various sectors differ (Adams and Mehran, 2003; Marcey and O'Hara, 2003). For instance, compared to the manufacturing sector, banks operate under a high level of

¹ For example, anti-takeover laws are introduced to protect the rights of the shareholders and to improve corporate governance. However, they can also weaken market control mechanism and hence have a negative effect on corporate governance of firms.

debt-to-equity ratios, and therefore, it can be argued that any corporate governance system in banks should protect the interests of the depositors in addition to those of the shareholders.

More recently, corporate governance issues have been raised in analysing the causes for the Asian financial crisis in the late 1990s, high profile corporate failures in the United States (such as Enron and WorldCom) and in many other industrialised countries at the beginning of the 21st century, and the global financial meltdown caused by the sub-prime mortgage crisis in the United States. The discussions in relation to such events have frequently been revolved around the role of accounting and accountants in corporate governance practices.

Literature on corporate governance identifies various mechanisms that can be used to enhance effective governance of organisations. Although accounting can play an important role in facilitating the use of such mechanisms, limited attention has been paid by researchers to systematically examine this issue. The purpose of this paper is to fill this gap in the literature by developing a framework to enable a comprehensive analysis of the role of accounting in corporate governance with special reference to banking sector. The paper draws on agency theory, stakeholder theory and contingency theory in developing the framework.

The rest of the paper is structured into six sections. The next two sections provide a review of the literature dealing with corporate governance mechanisms and a brief discussion of the theoretical underpinnings for this paper. The fourth section identifies the potential role of accounting in corporate governance. The fifth section explains the importance of contextual specificity of accounting. The sixth section presents the proposed framework, with a summary and some concluding remarks in the seventh and final section.

Corporate Governance Mechanisms

Corporate governance mechanisms used in various organisations have been classified in the literature into two groups, i.e., internal, and external (Bushman and Smith, 2001; Gillan, 2006). The two main internal corporate governance mechanisms are board of directors

and managerial compensation plans. External corporate governance mechanisms include laws and regulations, shareholder monitoring, debt-holder monitoring, market for corporate control, labour markets, and product markets.

Internal Corporate Governance Mechanisms

Board of Directors (BOD)

The BOD is regarded as an integral part of the governance of any publicly held organisation because of its fiduciary duty to monitor the activities of managers and provide strategic direction on behalf of shareholders (*Cadbury Report*, 1992). Gillan (2006) identifies three aspects of BOD, which could have implications for corporate governance, namely structure of the board, its role, and incentives.

Adams and Mehran (2003) provide empirical evidence to show that the BOD in banks plays a relatively higher role than boards in manufacturing organisations. Accordingly, the boards in banks have more outside directors, more committees on the board, and meet more frequently than the boards of manufacturing organisations. The fiduciary duty of the board is a valuable device in the banking context because of the high level of information asymmetry prevailing in banks (Macey and O'Hara, 2003). Further, the BOD in a bank has a wider role to play, because in addition to the shareholders, other stakeholders such as depositors and regulators also have a direct interest in the performance of the bank.

Managerial Compensation Plans (MCP)

The large body of literature on executive compensation in general suggests that it is an efficient corporate governance mechanism (e.g., Leonard, 1990). However, MCP has been the subject of extensive discussion in recent years due to excessive levels of payments, especially to managers whose firms are in decline. This situation has led to questions being raised about the effectiveness of compensation contracts to align manager and shareholder interests (Carter and Lynch, 2003).

Although most findings in relation to executive compensation in firms in general could be relevant to the banking sector, there

are also bank specific issues. For instance, John and Qian (2003) argue that, since depositors are the primary claimants in banks, the objective of corporate governance is not only to align the interests of managers closely with the interests of equity holders, but also with those of debtholders. Therefore, both equity holders' and debtholders' interests need to be considered when designing managerial compensation plans in banks if such systems were to be used for corporate governance purposes. Further, as Mehran and Winton (2001) argue, because banks are highly leveraged compared to manufacturing firms, cash compensations would be more appropriate than equity based compensations. If equity based compensations are provided, managers are likely to have a strong incentive to undertake high-risk investments. Although, such behaviour could create wealth for shareholders, it could also reduce the value of the debt capital via shifting the risk from the shareholders to debtholders (Moerland, 1995).

External Corporate Governance Mechanisms

Laws and Regulations

OECD (2004) recognises the rights of shareholders², equitable treatment of shareholders (including minority and foreign shareholders), and the rights of stakeholders established by law or through mutual agreement. The studies that have focused on governance and wealth changes following changes to certain laws, have revealed the link between changes of laws related to shareholder and debtholder protection and corporate governance. For instance, Chhaochharia and Grinstein (2005) examine the impact of the governance rules of *Sarbanes-Oxley Act* (2002) of the United States on firm values, and note that in general, the rules have a positive effect on firm value, and the firms that make more changes to comply with the rules, outperform the firms that make fewer changes. Furthermore, La Porta, *et al.* (1997) argue that countries with weaker investor protection, measured by both the character of legal rules

and the quality of law enforcement, have smaller and narrower capital markets. Governments typically influence the activities in banking sector by various rules and regulations, as the stability of the financial sector in a country is largely dependent on the strength of financial institutions (Nam, 2004). These methods include prudential regulation, restrictions on bank ownerships and new entrants, regular audits (Alexander, 2006; Fan, 2004).

As a result of the extensive regulations in banks, most other external corporate governance mechanisms seem to be less effective than this mechanism. Regulation minimises information and transaction costs (Levine, 2004) and it provides safety and soundness in the financial sector (Alexander, 2006). Nevertheless, governments can attempt to use this mechanism to treat banks simply as a source of fiscal revenue. Further, managers of powerful banks can use regulations through their influence on governments to fulfil their own interests rather than the interests of other stakeholders including the wider society (Levine, 2004).

Shareholder Monitoring

Shareholders can influence important decisions of organisations by their legal right to obtain relevant information on a timely basis and by using their voting rights at annual general meetings, for instance, regarding election and removal of board members, and proposals for fundamental changes affecting the organisation.

When legal protection to safeguard the interests of shareholders is absent or weak, larger shareholders could play a significant role in corporate governance in publicly held organisations (Shleifer and Vishny, 1997). For instance, institutional investors and blockholders have substantial ownership stakes, which provide them with an incentive to monitor the management. Kang and Shivdasani (1995) reveal that firms with large shareholders are more likely to replace poor performing managers than firms without them. Further, Hartzell and Starks (2003) show that larger shareholders are associated with higher turnover of directors and also that they moderate executive compensation.

² The basic legal rights of shareholders include the right to vote on important corporate decisions such as mergers, liquidations and election of Board of Directors, and be informed regularly about performance and position of the firm.

It should however be noted that the effectiveness of monitoring by large shareholders as a corporate governance mechanism could be affected by a possible conflict with the interests of other shareholders. For example, Holderness (2003) argues that, while blockholders have the incentive and the opportunity to increase the corporation's expected cash flows that accrue to all shareholders, they may still consume corporate benefits to the exclusion of smaller shareholders.

External reporting, which contains both financial and non financial information helps to minimise information asymmetry between insiders of the firm (BOD and managers), and other interested parties (shareholders and other stakeholders). However, the opacity of banks restricts the monitoring role of shareholders (Levine, 2004), and regulations can reduce their motivation to monitor banks (Adams and Mehran, 2003). As a result, shareholders of banks do not appear to be as effective in monitoring the activities of managers as their counterparts in non-banking firms. Further, blockholders are unlikely to exist in the banking sector due to the presence of special laws and regulations which prohibit or discourage such acquisitions, and thus reduce the ability of shareholders to monitor banks (Adams and Mehran, 2003).

Furthermore, there may be barriers for shareholders of banks to monitor managers. For example, managers of banks may have more information about the quality of loans which may not be available to external stakeholders, and unlike in the manufacturing sector, gaining such knowledge is not possible due to the intangible nature of these assets (Levine, 2004).

In addition, in government owned banks, the agency problem exists between the government/tax payers and the managers/bureaucrats who control the banks. The possibilities are such that bank managers and bureaucrats can consume perks, leisure time, and staff numbers, while advancing their political careers by catering to special interest groups (Shleifer and Vishny, 1997). Although governments impose strict controls and regulations in order to prevent these possibilities, due to the dual roles of government being the owner and the regulator,

a conflict could arise in enforcing such controls and regulations (Levine, 2004). Nam (2004) identifies three criteria on which the quality of corporate governance of government owned banks depends, namely (1) whether the government owned banks are subject to the same set of regulations as private banks; (2) the degree of government intervention in banking operation; and (3) the independence and effectiveness of the BOD to which the bank management is accountable.

The opacity of banks could also provide an opportunity for their managers to manipulate financial affairs of the bank (Fan, 2004, Lavine, 2004). For instance, the poor loan quality can be hidden by extending the repayment term for those clients who are unable to service the loan according to the original debt obligations.

Debtholder Monitoring

Debtholders can play a direct as well as an indirect role in corporate governance. Loan covenants can be used by debtholders as a direct method to enforce various restraints on corporations (Whittington, 1993). For example, provisions can be made in loan agreements to repossess collaterals, to convert the loan into equity, and to appoint a member/s to the board to represent the interests of the debtholder in a poorly performing corporation. Debtholders can also play an indirect role in corporate governance which includes the pressure, exerted by their existence, on managers to generate cashflows, at least equal to meet the interest and capital obligations of the debt capital (Gillan, 2006).

However, the effectiveness of debtholders in corporate governance largely depends on the legal rights prevailing in the country in which the corporation operates. For instance, in some countries, debtholders may need a court order to enable them to repossess collateral (Shleifer and Vishny, 1997). Further, unlike shareholders, debtholders do not usually possess legal rights to participate and vote in important decisions. Hence they have limited opportunities to influence operations of corporations.

However, the opacity of banks limits the ability of debtholders to monitor banks. Further, even when the larger debtholders seek

to monitor bank managers, their incentive to do so is much restricted, due to regulations (Adams and Mehran, 2003; Levine, 2004). Furthermore, the existence of deposit insurance cover also reduces debtholders' motivation to monitor banks. As Macey and O'Hara (2003) point out, the presence of deposit insurance cover increases the risk of fraud and self-dealing in the banking sector as a result of diminished interest of debtholders to monitor the activities of the bank. On this issue, Demirguc-Kunt and Detragiache (2002) reveal a high tendency of banking crises in those countries where deposit insurance covers exist. Additionally, larger debtholders often have the ability to use their inside status to serve their own interests at the expense of the minority debtholders (Calomiris and Powell, 2001).

Market for Corporate Control

Market for corporate control appears to be the most important corporate governance mechanism for corporations as they are ultimately controlled by the market forces through the threat of acquisitions and mergers when a firm's stock is undervalued relative to its potential because of poor management (Brigham and Houston, 2001). There are several methods to gain control of corporations, i.e., the proxy fights; the direct purchase of shares; and the mergers (Manne, 1965). These methods are expected to discourage managers from diverting from shareholder wealth maximisation goal, thus reducing agency costs. They are particularly important in Anglo-American countries such as United States and United Kingdom, where large shareholders are rare (Bittlingmayer, 2000). However, Franks and Mayer (1990) point out that in continental European countries such as France and Germany, this mechanism has not been prominent due to the weak nature of the market in those countries.

The effectiveness of the market as a corporate governance mechanism for corporate control is restricted at least for two reasons. First, hostile takeovers are a politically vulnerable mechanism, since they are opposed by the managerial lobbies (Shleifer and Vishny, 1997). Second, acquisitions can lead to an increase in agency costs when bidding managements overpay for acquisitions that bring them private benefits of control. The

effectiveness of this mechanism is further reduced in banks due to the excessive levels of government interventions over banks and the opacity of banks (Levine, 2004). For example, Adams and Mehran (2003) in their study on bank holding companies reveal that state laws and banking regulations could impose substantial delays on any hostile bid, and stakeholder groups such as competitors and consumer advocates could use such delays to organise opposition to an acquisition and influence the decision of the regulatory body.

Labour Markets

Due to the threat of dismissal from the current employment and the risk of not finding an appropriate employment in future as well as the effect of dismissal on their reputation, managers tend to do their best to improve corporate performance, from which shareholders could achieve wealth maximisation goal (Jensen and Meckling, 1976). This corporate governance mechanism appears to be more effective in Anglo American countries where there is a higher level of executive dismissal (Franks and Mayer, 1990) compared to Franco-German countries and Japan where the level of executive dismissal is low. For example, in Japan, there is a high degree of internal mobility within keiretsu, and managerial failure is mostly corrected by means of internal measures (Moerland, 1995).

However, due to the high level of opacity of banks, this corporate governance mechanism is likely to be less effective as managers can easily manipulate performance to show improvements in the short run at the expense of the long run existence (Nam, 2004).

Product Markets

In highly competitive markets, managers of firms have to perform better than those that operate in less competitive markets in order to survive and to retain their market share. Baggs and Bettignies (2007), for instance, argue that competition has a positive direct effect on quality improvements and cost reductions, not only in widely held corporations, but also in sole ownership firms. Product markets in competitive industries and industries with similar firms, appear to operate as an invisible hand in ensuring goal directed behaviour in organisations leading to minimisation of

agency costs compared to less competitive industries (DeFond and Park, 1999) and heterogeneous industries (Parrino, 1997).

The effectiveness of product market competition in the banking sector is likely to be limited. Because of the opacity, banks typically form long term relationships with their clients to ameliorate the problems of information associated with giving loans, and these relationships are a barrier to competition (Levine, 2004). Further, the host of regulations in banking sector is likely to weaken the product market competition (Nam, 2004).

Comparison between non-banking firms and banks in terms of different corporate governance mechanisms are summarised in Table 1.

Theoretical Underpinnings

Agency theory states that there is an agency problem in modern corporations namely a conflict of interests between owners (principals) and managers (agents) due to the separation of ownership and management leading to a possibility that agent not performing for the best interest of the principal (Berle and Meanes, 1932; Bushman and Smith, 2001; Coase, 1937; Jensen and Meckling, 1976; Subramaniam and Ratnatunga, 2003, Subramaniam, 2006).

Consequently, organisations introduce various mechanisms, in particular, corporate governance mechanisms which includes board of directors, managerial compensation plans, laws and regulations, shareholder and debt holder monitoring, market for control, and product and labour markets, so that the interests of the managers and the owners can be aligned (Bushman and Smith, 2001, p. 238).

Banks are different from other types of organisation in many respects, such as leverage, opacity, and regulations. For instance, unlike manufacturing organisations, banks typically operate with a high level of debt-to-equity ratio and, it is necessary for banks to look after the welfare of not only its shareholders, but also its debtholders. This fits well with the stakeholder theory, which emphasises the need for organisations to

safeguard the interests of a wider group of stakeholders than suggested by agency theory.

Although accounting is perceived to have functional attributes such as the provision of relevant information for decision making, assisting rational allocation of resources, and the maintenance of institutional accountability and stewardship, these functional attributes can vary as accounting is influenced by the context within which it operates (Burchell, *et al.*, 1980; Uddin and Hopper, 2001; Alawattage and Wickramasinghe, 2008). Emphasising the contextual specificity of accounting, for instance, Burchell, *et al.* (1985) state that financial accounting information is an outgrowth of institutional processes of enormous complexity, and the use of such information for various internal and external purposes is subject to the organisational and behavioural contexts prevailing within the organisations. This view is in line with contingency theory which highlights that the role of accounting is contingent upon the influence of various contextual factors.

Role of Accounting in Corporate Governance

The importance of accounting in corporate governance is highlighted in well-known laws and international guidelines on corporate governance, such as *Cadbury Report* (1992), OECD (2004), and *Sarbanes-Oxley Act* (2002). For example, *Cadbury Report* (1992) emphasises the importance of financial aspects in good corporate governance practices. These laws and guidelines were developed following common concerns about the inadequacy of the provision of accounting information by firms as part of a wider system of corporate governance.

Corporate governance and accounting play inter-dependent roles in organisations. On the one hand, the quality of corporate governance influences the effective functioning of the role of accounting in organisations (Kanagaretnam, Lobo and Whalen, 2007; Koh, Laplante, and Tong, 2007; Whittington, 1993), and on the other hand, accounting could influence the quality of corporate governance in organisations by providing direct as well as indirect input into the successful operation of

Table 1: Efficiency of Corporate Governance Mechanisms in Non-Banking Firms vis-à-vis Banks

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

corporate governance mechanisms (Bushman and Smith, 2001).

The direct input of accounting is the provision of accounting information to facilitate the application of various corporate governance mechanisms. Indirect input to corporate governance mechanisms includes its influence on organisational culture that values truth and fairness in providing information to stakeholders. This would help mitigate the agency problem of corporations, and hence improve corporate governance. More specifically, direct input is provided through four areas of accounting, i.e., external reporting, external auditing, management accounting, and internal auditing (Whittington, 1993).

External Reporting

External reports can contain both financial and non-financial information. Financial information mainly comprises of financial statements, i.e., income statement, balance sheet, statement of changes in equity, cash flow statement, financial highlights such as financial goals and achievements, key financial ratios, and other financial information for share and debenture holders.

Shareholders and debtholders can make their decisions based on the published accounting information, e.g., retain or sell their existing shares and debentures. The market for corporate control is mainly driven by the accuracy and reliability of the provision of published accounting information (Palepu, 1986), for example, in the absence of such information, potential buyers may not be able to quote a bid for acquisitions and takeovers.

Non-financial information includes the reports of the Chairperson and the CEO, economic impact reports, knowledge management reports, corporate governance reports, community impact reports, risk management reports, and other types of information made available through websites. Such information can be used by shareholders and debtholders to monitor managers (Bushman and Smith, 2001).

External reporting also assists in competition in labour and product markets. Financial performance revealed in financial reports, for

instance, reflects on the performance of the CEO and senior executives. They may get job offers following solid performance, and similarly poor performance may be associated with subsequent difficulties in obtaining new positions (Gillan, 2006). Dann and DeAngelo (1988) argue that poor earnings performance serves as a visible evidence of managerial inefficiency that can cost the shareholder support and potentially managers' jobs.

External Auditing

External auditing, an integral part of external reporting, is one of the cornerstones of corporate governance, and provides an external and objective check on the way in which the financial statements have been prepared and presented (*Cadbury Report*, 1992). The audited financial statements are less likely to be distorted by managerial biases and errors (Bushman and Smith, 2001).

External auditing assists external corporate governance mechanisms such as shareholder and debtholder monitoring. It provides an independent opinion on the quality of financial statements, and thus limits the effects of the moral hazard problems of shareholders and debtholders (Whittington, 1993), as the work performed by the external auditor assists these parties to make a fair judgment on the financial statements. External auditing can also play a role in market for corporate control, and labour and product market competitions. Subramaniam, Hodge and Ratnatunga (2006) extend the external audit further into the realms of the 'strategic audit', and show a role for management accountants in such audits.

Further, the special reports such as management letters prepared by external auditors based on their investigations during the course of audit could assist in internal corporate governance mechanisms such as BOD (Whittington, 1993).

External auditors normally report their concerns over issues such as inappropriate accounting treatments, and lapses in internal control and risk management systems. The issues identified by external auditors during the audit process could be used by the BOD in their deliberations on future direction of the firms and the taking corrective actions.

Management Accounting Information

Management accounting systems generate information, which includes budgeting, transfer pricing, performance measurement systems and reward systems, which assists in corporate governance mechanisms such as BOD and MCP (Whittington, 1993).

For example, such information is often used as the basis for providing the strategic direction to the organisation and monitoring the work of the managers by the BOD, and information about various performance indicators often provides the basis for MCP (Bushman and Smith, 2001). Empirical evidence shows that there is a strong link between accounting measures and MCP (e.g., Jensen and Murphy, 1990).

Internal Auditing

Internal auditing could minimise the risk of frauds and errors by contributing towards improving internal corporate governance mechanisms, and validating information generated for internal purposes (*Cadbury Report*, 1992; Whittington, 1993). Most of the tests and procedures performed in internal auditing focus on management accounting reports, and thus they assist in improving the accuracy and reliability of such reports. In addition to facilitating planning, control and decision-making, regular internal audit investigations on key controls and procedures ensure that effective systems are in place in the organisation (*Cadbury Report*, 1992).

The work of internal auditing could be used by the BOD in several ways. For example, internal auditors can be directed to undertake special investigations on behalf of the audit committee as follow up of any suspicion of fraud (*Cadbury Report*, 1992). Further, the internal audit program could be reviewed and approved by the audit committee of the BOD to ascertain its extent and coverage during a specific period of time.

The above discussion shows that accounting could play an important role in improving corporate governance practices of organisations. However, the effectiveness of this role would be contingent on the context within which accounting operates.

Contextual Specificity of Accounting

Following contingency theory, it can be argued that the context within which accounting in banks operates could influence its role in corporate governance in banks. The contextual influences on accounting can be identified in three layers, namely internal organisation, organisational interface and external environment. The internal organisation refers to the organisation specific factors such as firm characteristics. The organisational interface refers to entities that have a direct link to the organisation, and consists of regulatory bodies, professional institutes, capital markets, representatives of social interests and agencies of the state. The external environment consists of much broader environmental influences such as economic, political, social and international factors.

Internal Organisation

The practice and the role of accounting in an organisation could be influenced by organisation specific factors, which can be classified into three categories, namely firm characteristics, organisational and behavioural contexts, and institutional processes (Adams, 2002). Firm characteristics include size, industry, performance, and debt/equity ratio. The size of the organisation could have a positive relationship with the level of disclosure. Large firms appear to disclose more information due to public demand for information, international resource dependence, political pressure and availability of resources (Adams, 2002; Archambault and Archambault, 2003; Inchausti, 1997; Zarzeski, 1996).

Further, firms in the same industry will disclose similar information to external parties (Inchausti, 1997), and industrial membership has been found to be related to the level of disclosure (Adams, Hill and Roberts, 1998). Moreover, the level of performance of firms also could influence their accounting practices. For example, the greater the profitability of a firm, the greater would be the level of disclosure (Roberts, 1992). Additionally, highly leveraged firms tend to disclose more information to reduce the costs of debt (Ahmed and Courtis, 1999).

Furthermore, factors such as attitudes of top management towards external reporting, corporate culture, and power and conflicts prevailing in an organisation could have a significant impact on the quality and the reliability of such information and the level of disclosure. This has been described as the “tone at the top” (*Treadway Commission Report*, 1987). Finally, institutional processes, which include organisational structure and the procedures, could also influence accounting and reporting practices. For example, the existence of an organised accounting function with clearly defined responsibilities ensures generation of accurate accounting information, which could have an impact on the quality, quantity and completeness of reporting (Adams, 2002). The presence of various accounting related committees such as audit committee also can improve the role and the practices of accounting in organisations (Dionne and Triki, 2005).

Organisational Interface

Activities of regulatory bodies affect the role of accounting as they administer laws and regulations which influence financial reporting system of a country (Archambault and Archambault, 2003). Proper implementation of laws and regulations related to financial reporting improves the standard of accounting and reporting practices of organisations. On the other hand, weak enforcement of such legislation for reasons such as lack of qualified personnel and absence of implementation guidelines could adversely affect the quality of accounting and reporting practices (World Bank, 2004).

The developments taken place in accounting and reporting practices of organisations are largely associated with the professionalization of the accounting craft, which provides an interface between the growing agencies of the state and business enterprises (Burchell *et al.*, 1980). For example, in Anglo-American countries, the emergence of accounting as an influential profession has given some measure of autonomy to accounting practice. The emergence of professional institutions provided new forums in which accounting deliberations and debates could take place, and from which changes in accounting practice could emanate.

Corporate disclosures are in general influenced by the disclosure policies of the stock exchange in which their shares are traded (Archambault and Archambault, 2003). Doupnik and Salter (1995) find that disclosure increases with capital market size, and thus corporations from countries with large capital markets tend to disclose more information than corporations from countries with small capital markets. Empirical evidence suggests that stock exchange regulations have an impact on the level of disclosure of accounting information. For example, Inchausti (1997) finds that corporations quoted in several stock exchanges disclose more information.

There can also be several other pressure groups such as media and representatives of social interest groups which exert pressure on reporting practices in organisations. Cooke and Wallace (1990) identify financial press as a factor that influences disclosures. For example, where general public desire more information on matters of interest to them, and certain newspapers promote such sentiments, organisations may have to respond by providing more information on those matters.

External Environment

The external environment that is likely to impact on accounting and reporting practices of an organisation includes domestic economic, social and political environment as well as international environment. For instance, key economic factors such as economic development, inflation, and capital market developments could influence the level of disclosures (Archambault and Archambault, 2003). The growth of corporations is closely associated with the development of the economy. As an economy develops, corporations need to raise more capital. As a result, there is a need to disclose more information due to increased competition among firms seeking to raise capital.

For example, Salter (1998) reveals that average disclosures of firms are higher in developed countries than in emerging markets. Further, large corporations, for example, multinational companies are likely to disclose more information to access foreign resources such as labor and capital (Archambault and Archambault, 2003; Zarzeski, 1996)). Meek and Saudagaran (1990) identify inflation as a

factor that influence reporting practices. Since, inflation defies the historical cost assumption that prices remain constant over time, corporations tend to increase disclosure to further assist investors (Archambault and Archambault, 2003).

Political influence is another important factor that influences corporate reporting practices. Burchell *et al.* (1985) show that value added reporting in the UK was largely influenced by the political agenda. Stoddart (2000) reveals the substantial shift in power from the professional accounting bodies to the government, and the political influences on the changes to Australian accounting standards setting process. Further, the level of disclosures in countries is seen to be linked to political freedom (Belkaoui, 1983). The main features of political freedom such as political rights³, civil liberties⁴, and political structure enhance the ability to disclose more information by corporations (Archambault and Archambault, 2003). In the absence of such features, countries could expect more political interference followed by less disclosure of accounting information. Uddin and Hopper (2001), highlighting external influences on the practice of accounting, provide evidence on how accounting systems within an organisation become marginal and ritualistic due to political interventions.

Archambault and Archambault (2003) argue that the levels of education and religious beliefs could influence corporate disclosure. For example, as the level of education increases, the number of users of accounting information would be expected to increase (Douppnik and Salter, 1995), hence the need to disclose more information. Hamid *et al.* (1993) reveal that the Islamic tradition places ethical/social activity ahead of individual profit maximisation. In societies with such traditions, trust among individuals could reduce the need for accounting as a means of financial reporting. Cultural context and ethical relativism could also have an influence on reporting practices (Adams, 2002), for example, in cultures which are characterised

³ Ability to participate in the political process through such means as voting

⁴ Individual freedom from state control

by secrecy, disclosure levels of firms would be low.

In recent years, international pressures have become an important factor influencing the role of accounting in organisations. In particular, the adoption of International Financial Reporting Standards (IFRS) by many countries could influence greatly the accounting practices of organisations. Susela (1999) in her study on the conflicts and tensions within the Malaysian accounting profession in the accounting standard setting process identifies the interaction of four factors which influenced, and is influenced by the accounting standard setting process, namely the state, the profession, the market, and the community within the local and global context.

Overall, it can be concluded that although accounting could potentially play an important role in assisting corporate governance practices, the nature of its role could be influenced by various contextual factors that are related to the internal organisation, organisational interface, and external environment.

Proposed Framework

The proposed framework depicted in Figure 1 focuses on corporate governance mechanisms in banks and the potential role of accounting in implementing them. It identifies two internal corporate governance mechanisms, i.e., BOD and managerial compensation plans (as suggested by the Basel Committee on Banking Supervision, 2006) and five external corporate governance mechanisms, i.e., laws and regulations, shareholder monitoring, debtholder monitoring, labour markets and product markets. The market for corporate control has not been considered as an external corporate governance mechanism due to the excessive level of government intervention (e.g., ownership restrictions) over banks.

As outlined earlier, the BOD oversees the activities of the managers and provides strategic guidance to the banks, and managerial compensation plans are often used to align the interests of the managers with those of shareholders in banks. Laws and regulations are considered as a main external corporate governance mechanism in the

banking sector due to the importance of the sector to the financial systems and the economy in general. As explained earlier, laws and regulations (e.g., the Companies Act) could require management to undertake certain activities and follow procedures to ensure proper corporate governance is maintained. Shareholder monitoring is another important corporate governance mechanism. Similar to other public companies, shareholders in banks have rights and opportunities to ensure that management decisions are made for the best interest of the shareholders. For instance, as discussed earlier, they can use voting rights at the annual general meeting regarding fundamental changes affecting the bank.

Debtholders in banks, largely comprising of depositors and debenture holders, also have a strong interest in monitoring the banks in the absence of a deposit insurance cover, as they normally place money in banks without a collateral. There are certain measures that debtholders can take to prevent the bank taking actions that are not in their interest. For instance, as noted earlier, they can use loan covenants to enforce various restraints on banks. Furthermore, labour markets for CEOs and senior executives make them more conscious about their reputation in terms of the present employment as well as career development. As such, as noted earlier, managers tend to do their best to improve corporate performance.

Finally, product markets also have the potential to influence corporate governance in banks. As previously outlined, a highly competitive product market could force banks to provide amalgamated banking services to customers at least cost by using modern technology.

The framework also shows how accounting could assist in various corporate governance mechanisms through external reporting, external auditing, management accounting, and internal auditing. Whist, management accounting and internal auditing mainly provide information to assist internal corporate governance mechanisms (namely board of directors and management compensation plans), external reporting and external auditing mainly facilitate the external corporate governance mechanisms (namely laws and

regulations, shareholder and debtholder monitoring, and labour and product markets).

Further, the framework suggests that the role of accounting in corporate governance mechanisms can be moderated by various contextual factors, namely internal organisation, organisational interface and the external environment. For example, internal organisational factors such as the size of the bank, the level of performance of the bank, and its corporate culture could influence the accounting practices of that bank. In the organisational interface, several key players such as regulatory bodies, professional accounting bodies, capital markets, and other key stakeholders could influence and, at times, exert pressure on financial reporting and corporate governance practices of banks. Furthermore, both the internal organisational factors and the organisational interface, in turn, are open to an array of political, social, economic and international pressures from the external environment.

Finally, as depicted in the proposed framework, the efficient use of accounting in implementing internal and external corporate governance mechanisms could lead to a number of desirable outcomes in banks. At the organisational level, an efficient role played by accounting in corporate governance would ensure that the interests of, both, the shareholders and depositors are well served. At the macro level, effective corporate governance, assisted with the efficient use of accounting, would assist in a country's economic development through the efficient allocation of limited resources and the stability of its financial sector.

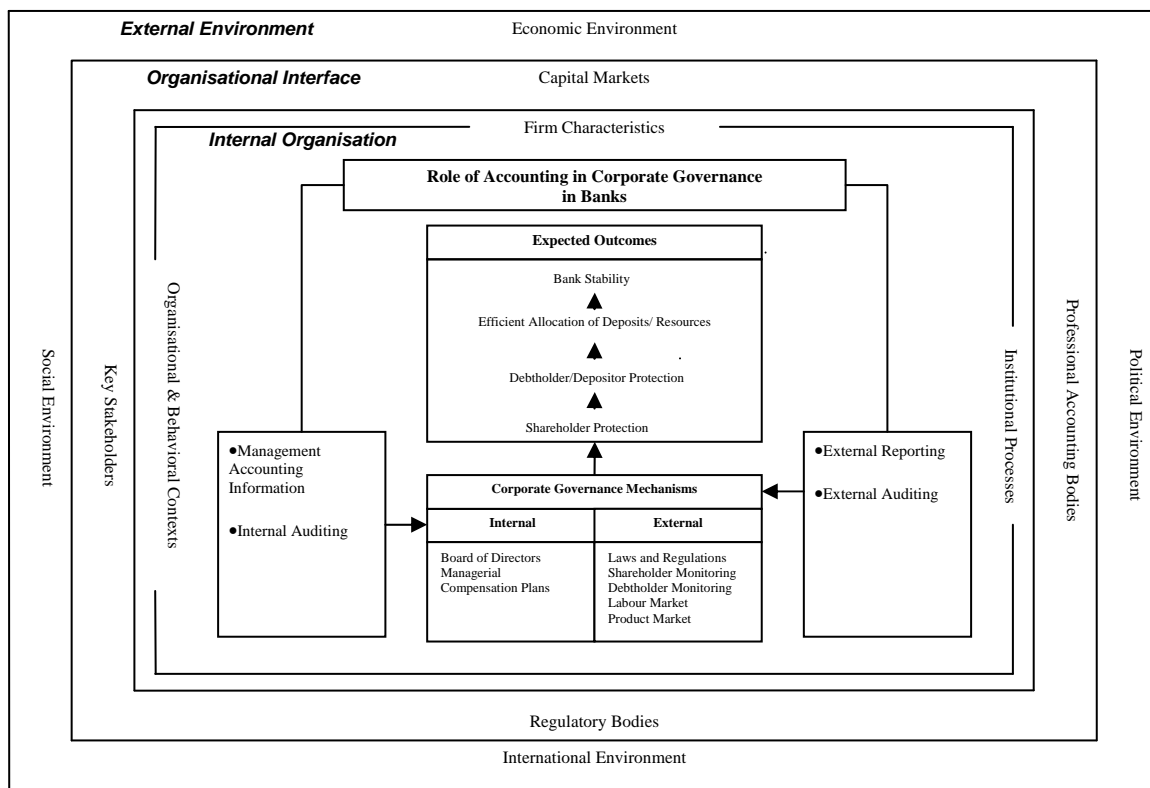
Summary and Conclusions

This paper presents an analytical framework to examine the role of accounting in corporate governance, highlighting the specific corporate governance issues pertaining to banks. Drawing on agency theory, stakeholder theory and contingency theory, the framework has been developed based on a survey of three streams of literature, namely literature on internal and external corporate governance mechanisms, the roles of internal and external accounting information, and contextual factors influencing the role of accounting.

The proposed framework highlights the importance of external reporting, internal and external auditing, and management accounting in assisting various corporate governance mechanisms in banks. The checklist in Appendix 1, developed on the basis of the framework, could be used to assess the role of accounting in corporate governance in banks. Further, the proposed framework has wider applications; Although developed for the banking sector, with minor adjustments, it could be used to examine the role of

accounting in corporate governance in firms in other sectors as well. Finally, based on the discussion in this paper, the proposition that “Accounting could play an important role in corporate governance practices” has been developed, and can be examined in future research using the proposed framework. As discussed earlier and shown in Figure 1, the nature of this role would however be contingent upon the context within which accounting operates.

Figure 1: A Framework to Analyse the Role of Accounting in Corporate Governance of Banks



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Appendix 1

A Checklist to Assess the Role of Accounting in Corporate Governance in Banks

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

Does the board receive and review “Management Letters” prepared by the external auditors?	
Does the external auditor attend the board meetings when audit issues are discussed in the board/audit committee meetings?	
(2) Managerial Compensation Plans	
Are managerial compensation plans in the bank based on a “pay for performance” system?	
Are managerial compensation plans designed to align the interest of depositors in addition to the shareholders?	
Do managerial compensation plans include more cash compensation than equity based compensation?	
Is the CEO’s reward based on the performance measured relative to the market or industry?	
Are financial performance indicators used in setting CEO’s/managers’ compensation plans?	
Does internal audit validate the managerial compensation plans?	
Does the report prepared by the external auditor comment on whether the managerial compensations are legal, reasonable and are not in excessive?	
(3) Laws and Regulations	
Is the country’s banking legislation effective? (A ‘yes’ answer would indicate that, for example, laws and regulations provide safety and soundness in the financial sector and minimise the information and transaction cost of shareholders and depositors; the regulatory bodies have enough regulatory powers to supervise the banks; and the law enforcement is of high quality and efficient)	
Is the bank required to report to the regulator on a regular basis? (Note: Regulatory reporting may include various accounting and non accounting statements to be submitted on daily, weekly, monthly, quarterly and annual basis)	
Does the law specify rules, formats, contents and disclosure requirements of the accounting reports submitted to the regulator?	
Does the bank submit required accounting reports on a timely basis?	
Does the regulator verify the accuracy of the information submitted by the bank?	
Does the regulator make effective use of reports submitted by the bank in regulating and supervising the bank?	
Is the bank required to submit audited financial statements to the regulator?	
Is there a system to share the external auditor’s information with the regulator?	
Does the regulator use information gathered from the external auditor to regulate and supervise the bank effectively?	
(4) Shareholder and Debtholder Monitoring	
Does the law recognise the rights and the equitable treatment of shareholders? (A ‘yes’ answer would indicate that, for example, the shareholders have the right to participate and vote in shareholder meetings on important decisions such as election or removal of members of the board, and proposals for fundamental changes affecting the bank; and the shareholders have the right to be informed about the affairs of the bank via annual and quarterly reporting)	
Does the law recognise the rights of debtholders? (A ‘yes’ answer would indicate that, for example, the debtholders have a basic right to specified interest and capital redemption payments; and to restrict the actions of managers and board of directors through loan covenants)	
Does the bank publish annual and quarterly reports for external reporting purposes on a timely basis? Are they made available to the debtholders?	
Does the bank’s policy regarding disclosure of accounting information comply with the minimum statutory/professional requirements?	

Does the bank's policy include the disclosure of related party transactions, major transactions, and other material events? Is it implemented strictly?	
Is the bank required to provide non financial information? Does the bank comply with the minimum statutory/professional requirements in this regard?	
Can the present external auditor be regarded as independent? (A 'yes' answer would indicate, for example, the external auditor does not provide non audit services to the bank; there are regulations that prevent non-audit services by external auditors; and the external auditor is rotated)	
Does the external auditor have appropriate business expertise to audit the bank?	
Does the annual report of the bank include auditor's report to the shareholders?	
Does the external auditor attend the annual general meetings to answer queries of the shareholders?	
(5) Labour Markets	
Does the bank have a performance measurement system for managers?	
Does the board/remuneration committee formally evaluate the performance of the CEO?	
Is accounting information used in evaluating performance of the CEO/managers? (Note: The extent to which accounting information is used in performance evaluation can be varied based on the goals set for each manager.)	
Is the information on performance of managers used in promotions?	
Is the information on performance of CEO/managers used in demotions/dismissals?	
Is financial performance considered as a factor used in evaluating performance of the CEO/managers in shareholder meetings?	
(6) Product Markets	
Does the bank operate in a highly competitive market? (A 'yes' answer would indicate that, for example, there are number of banks competing in the country; and domestic private and foreign banks are permitted to operate and are present in the market)	
Is the bank free from policy lending due to social and political reasons?	
Is the banking industry free from entry barriers, and restrictions on services provided, interest rates and branching?	
Is accounting information used in evaluating performance of the CEO/managers compared to the peers in the industry?	
Is financial performance considered as a factor used in evaluating performance of the CEO/managers in shareholder meetings?	
Note: Banks can use the checklist to assess the extent of their use of accounting in corporate governance. While "Yes" answers suggest an effective use of accounting in corporate governance, "No" answers indicate the weak areas that may require improvements in the role of accounting in corporate governance	