The role of accounting in corporate governance in a developing country: institutional political economy perspective

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Abstract: Conceptualisation of corporate governance in mainstream accounting research seems to be based on the assumption of pure economic type governance which is characterised by control systems and political neutrality. This study examines institutional and socio-political dynamics of the role of accounting in corporate governance in a government-owned commercial bank in a developing country. Using data from semi-structured interviews and document analysis, the study draws on the theory of institutional political economy to examine the socio-political and institutional complexities associated with using accounting as a mechanism of governance. Findings reveal that although the bank meticulously complied with various professional and regulatory requirements in internal and external reporting in response to normative, coercive and mimetic pressures, such compliance was mainly to gain legitimacy, appearance and society’s support, rather than to enhance good governance. Further, the paper clearly demonstrates the political complexity of corporate governance in developing countries and how accounting becomes less effective within such political complexities.

Keywords: role of accounting; corporate governance; banks; government business enterprises; Sri Lanka; developing countries; socio-political; institutional complexities; institutional political economy theory; new institutional theory.


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1 Introduction

Accounting and corporate governance failures and regulatory weaknesses of banks have figured prominently in discussions and debates on the possible causes leading to various financial crises in the recent past. It has been suggested that while boards and managers failed to manage risks associated with banks, other stakeholders such as shareholders, depositors and regulators were unable to scrutinise the behaviour of bank management effectively due to lack of reliable accounting information (Clarke and Klettner, 2009; Nam, 2004; Kirkpatrick, 2009; Rost and Osterloh, 2010).

Accounting has been recognised as an effective mechanism of corporate governance (Seal, 2006). Continuing attempts to tighten the regulatory requirements for corporate disclosure (e.g., Sarbanes-Oxley Act 2002 in the USA) is an indication of such recognition. The increased demand for accounting information for corporate governance purposes is reflected in the recent regulatory changes (e.g., Basel Committee, 2010) and the high level of community expectations concerning the accountability of the board of directors (BOD) for corporate decisions (Leo et al., 2012).

The effectiveness of various corporate governance mechanisms identified in the literature, including the BOD, shareholder and debt-holder monitoring, managerial compensation plans, and labour and product markets depends to a large extent on the availability of relevant and reliable accounting information (Gillan, 2006; Bushman and Smith, 2001). Ekanayake et al. (2009) identify four broad areas of accounting that facilitate corporate governance, namely internal auditing, external auditing, management accounting and external reporting. While internal auditing assists in improving the reliability of decisions made by the BOD and managers by validating the information generated through the accounting system (Cadbury Report, 1992; Whittington, 1993), external auditing, regarded as one of the cornerstones of corporate governance, provides an external and objective check on the way in which financial statements have been prepared and presented to its stakeholders (Cadbury Report, 1992; Whittington, 1993). Such audits aim to eliminate or minimise the possibility of distortions in financial statements due to managerial reporting biases and errors as implied in agency theory (see also Bushman and Smith, 2001). Management accounting systems that generate information for internal purposes facilitate the monitoring role of the BOD (Whittington,
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1993) and the decision making role of managers. Numerous practices that are generally associated with management accounting are implicated in corporate governance (Seal, 2006). Information contained in annual and interim reports prepared for external reporting purposes helps to minimise information asymmetry between internal parties (such as BOD and managers) and external parties (such as shareholders and other stakeholders) (Whittington, 1993). Further, financial reports produced on a timely basis enable BOD and various stakeholders, including shareholders and debt-holders, to monitor the operations of the organisation. In essence, efficient and effective utilisation of these four broad areas of accounting could considerably enhance corporate governance in organisations (Ekanayake et al., 2009).

The way in which corporate governance is conceptualised (be consistent) in the literature is not without controversy. Gordon (2002), for instance, suggests that effective corporate governance is based on myths promulgated by practitioners and academics. Consistent with neo-liberal conception of corporate governance, Denis and McConnell (2003, p.2) define corporate governance as those mechanisms “that induce the self-interested controllers of a company to make decisions that maximise the value of the company to its owners”. However, under such conception a very ‘apolitical’ view of corporate governance is upheld, and politically neutral, detached and a pure economic type governance and control systems are assumed. Such conception has been subject to criticisms in recent times mainly because of its narrow focus and the failure to capture socio-political and institutional dynamics of corporate governance (see Chang, 2002; Chang and Evans, 2005). Cadbury (2008) notes that firms exist not just for the profit of their owners, but to fulfil a wider social responsibility. In support of such concerns, research findings also reveal significant gaps between the desired objectives of accounting control system implementations and the actual outcomes achieved (e.g., Bhimani, 2012).

Turnbull (2008) expands what constitutes corporate governance from market oriented publicly traded firms by including all types of firms irrespective of their legal status, ownership, and whether they are privately or publicly traded. He also argues that market-based theory of the firm tends to become less relevant since economic transactions of firms are typically mediated by various factors including cultural priorities, business related associations, trade, vocational, family, social and political networks. Research findings also demonstrate that the effectiveness of accounting controls and governance mechanisms depends on the context within which they are being used (e.g., Hopwood, 1978, 1983; Burchell et al., 1980, 1985), and are affected by the socio-political and institutional complexities associated with their implementation (Alawattage and Wickramasinghe, 2008; Wickramasinghe and Hopper, 2005; Wickramasinghe et al., 2004; Reaz and Arun, 2006; Waweru et al., 2011).

The applicability of the functionalist, neo-liberal view of corporate governance to government business enterprises (GBEs), in particular, is questionable for a number of reasons. Firstly, government as the owner of GBEs has multiple objectives, and fulfilling social obligations would be as much important to them as achieving financial objectives. Attempts to maintain the balance between multiple objectives often give rise to tensions (Wickramasinghe and Hopper, 2005). Further, the degree of intervention of the owner of GBEs (the government) in decision making is relatively higher than that of shareholders of public companies. Such interventions, while needed at times, often have ramifications for managerial autonomy (Chang, 2002). Additionally, political interference and
unwarranted influence of powerful groups in the community on the functioning of GBEs are not uncommon in developing countries, resulting in decisions being made without giving due regard to corporate governance arrangements including information generated from accounting systems (Wickramasinghe et al., 2004). McGee (2009), for instance, argues that special characteristics in developing countries, such as dominance of government ownership, make the implementation of corporate governance mechanisms questionable. Waweru et al. (2011) suggest that certain cultural features of developing countries (e.g., highly collectivist) may entail different corporate governance arrangements. As a consequence, the political reality of corporate governance (including accounting) in public sector entities in developing countries is often more complicated than what is suggested by the functionalist view.

Further, the banking sector in many developing countries is faced with a high risk of misappropriation as a result of heavy government ownership and interferences, deficiencies in prudential regulation and poor implementation, weak legal protection and the presence of special interest groups (e.g., see Reaz and Arun, 2006). Such characteristics have implications for the way in which corporate governance mechanisms are implemented and their impact on the functioning of the banking sector. This is evidenced by various criticisms against corporate governance practices in the banking sector in developing countries despite the adoption of international laws and best practices of corporate governance (Arun and Turner, 2004; Nam, 2004).

Focusing on a major government owned commercial bank in Sri Lanka this paper examines the role of accounting in corporate governance in order to understand the socio-political and other institutional dynamics in using accounting. Such an understanding would provide insights into how and why its actual role differs from the expected role implied in the functionalist view. Using data gathered from semi-structured interviews and document analysis, the study draws on institutional political economy theory to analyse and explain socio-political and institutional complexities associated with the use of accounting in corporate governance in the case organisation. This study also draws on new institutional theory to explain various influences on the role of accounting in corporate governance in the case organisation. In doing so, this paper adds to the literatures on corporate governance in banks in developing countries with particular reference to the role of accounting. A study of this nature is important because banks in developing countries are typically the main depository for the economy’s savings, playing a significant role in economic development as an important source of finance for businesses (Arun and Turner, 2004; Levine, 2004; Nam, 2004). In Sri Lanka, for instance, banks dominate in the financial system claiming 68% of the total assets of the financial institutions [Central Bank of Sri Lanka (CBSL), 2011]. This study also offers useful insights to academics, professionals, and policy makers in developing countries. Such insights in turn would be useful when designing and implementing policies and systems relevant to corporate governance in the banking sector, and in providing new research directions.

The remainder of the paper is organised as follows. Section 2 briefly describes the theoretical approach adopted in this study. Section 3 outlines the research method and introduces the case organisation. Findings of the study are presented in Sections 4 and 5; Section 4 first describes various professional forces that require the generation of accounting information in banks in Sri Lanka, and then explains how accounting is used in the case organisation. Section 5 provides an analysis of the socio-political complexities
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associated with the actual role of accounting in the case organisation. Section 6 provides the conclusions of the study.

2 Theoretical approach

In order to understand accounting’s role in corporate governance in a public sector enterprise in a developing country, this study draws on new institutional theory (e.g., Meyer and Rowan, 1977; DiMaggio and Powell, 1983; Scott, 1991) and institutional political economy theory (e.g., Chang, 2002). While the new institutional theory is used mainly to explain the influences on the role of accounting in corporate governance in the case organisation, institutional political economy theory is applied to analyse and explain the socio-political and institutional complexities associated with the role of accounting in corporate governance within that organisation.

Institutional theory suggests that organisations often adopt various institutional arrangements (e.g., governance procedures and systems) not only to enable efficient decision making and better outcomes, but also to maintain appearances in order to help them gain legitimacy (Meyer and Rowan, 1977). Accounting can be regarded as an institutionalised practice within organisations (Scapens, 1994; Carruthers, 1995; Burns and Scapens, 2000) as it embodies ‘programmed actions’ [Berger and Luckmann, (1967), p.75], and is drawn upon by members of an organisation regularly and commonly [Burns and Scapens, (2000), p.3]. Accounting practices are seen to help an organisation gain support from society, and therefore legitimacy (Scapens, 1994). Covaleski et al. (1996, p.11), for instance, suggest that accounting may be seen as “a ceremonial means for symbolically demonstrating an organisation’s commitment to a rational cause of action”.

The existence of institutionalised practices such as accounting in organisations may be explained in terms of three types of pressures (DiMaggio and Powell, 1983):

1. coercive isomorphism (e.g., formal and informal pressure exerted by individuals and organisations)
2. mimetic isomorphism (e.g., modelling on other organisations to reduce uncertainty)
3. normative isomorphism (e.g., pressure to conform to set norms and rules developed by professional and occupational groups).

However, the existence of such practices in an organisation does not necessarily suggest their effective use for the intended purposes because their effectiveness tends to depend on various socio-political and institutional factors (Hopper et al., 2009).

The proponents of the institutional political economy theory (IPE) (e.g., Veblen, 1919; Chang, 2002) have criticised the neo-liberal theory of the market for its failure to recognise the fundamentally political nature of the market, and argue that the neo-liberal assumption of market supremacy should be abandoned. Further, while emphasising the institutional complexity of the market, they point out that in order to understand how the market works, it is necessary to understand the range of institutions that affect and are affected by it (Chang, 2002). Veblen (1919, p.239) considers customs and ‘settled habits of thought common to the generality of man’ as institutions. Chang and Evans (2005, p.99) define institutions as “systematic patterns of shared expectations, taken for granted assumptions, accepted norms and routines of interactions that have robust effects on
shaping the motivations and behaviours sets of interconnected social actors”. In neo-liberal and classical economic theories, institutions are “taken for granted, denied, or explained away” [Veblen, (1909), p.622]. The recognition of the importance of institutions was “precluded from economic lines of inquiry as a consequence of the stale, lifeless notion of isolated economic man (Ford, 2011). IPE does not consider human motivation as given (as opposed to the neo-liberal view that individuals are motivated by self-interest), ‘but as being fundamentally shaped by the institutions surrounding the individuals. Further, they state that operating under the institutions which embody certain ‘values’ (e.g., world views, morals), individuals inevitably internalise some of these values, thereby altering themselves [Chang, (2003), p.54]. According to the institutional political economy theorists, it is necessary, not only to bring politics explicitly into the analysis of the market but also to consider various institutions that affect and are affected by the market.

The relevance of institutional context in understanding corporate governance behaviour is increasingly recognised in the literature (e.g., Groenewegen et al., 1995; Davis, 2005). Davis (2005), for instance, argues that the most relevant and promising corporate governance research seeks to understand the institutional context in which it occurs rather than adopting agency theory or transaction cost perspective.

3 Research method: the case organisation and data collection

3.1 The case organisation

The case organisation of this study is the oldest government owned commercial bank in Sri Lanka (hereafter PUB), and was established by a special statute in 1938. During a period in which economic activities were focused on the plantation sector, PUB was initially established to assist import-export trading businesses by providing funds on reasonable terms (Sanderatne, 1989). In 1961, PUB was nationalised, and since then used often by the government as a means to influence the economic development of the country (Sanderatne, 1989).

PUB is the largest bank in Sri Lanka, based on assets valued at SLR484 billion, claiming approximately a quarter of the total assets held by commercial banks in the country and 20% market share of the country’s banking sector. Its diversified business segments and product lines include retail banking (e.g., consumer lending and finance, micro finance, leasing, pawning), corporate banking (e.g., debt-based products, transaction services), and international and treasury services (e.g., foreign exchange, money market, correspondent banking). In 2008, PUB generated a profit after tax of SLR 3.6 billion, which is 1.13% of return on assets and 16.13% of return on equity.

PUB is governed by a BOD headed by a chairperson and a team of management led by a CEO. The CEO of PUB is appointed by the BOD subject to the approval of the Minister of Finance. The Minister of Finance appoints members to the BOD for a period of three years subject to renewal. The Minister also selects one of the appointed directors as the chairperson of the BOD. In 2008, the BOD of PUB consisted of six members; all of them were non-executive, and all but one (the member who represents the Ministry of Finance) were independent. Several sub-committees are formed with the members of the BOD, namely the audit committee, nomination and corporate governance committee, human resources and remuneration committee, and integrated risk management
committee. Over the years, PUB has continuously emphasised its commitment to good corporate governance. For instance, prior to the implementation of the mandatory code of corporate governance for banks in 2008 by the CBSL, it had produced and followed its own code of best practice in corporate governance. PUB has also won several awards in recent times for its accounting practices, such as the Annual Report Competition gold award for its annual report in 2007, a gold award for the best presented public sector accounts by the South Asian Federation of Accountants, and a bronze award for financial reporting in the banking sector by the Institute of Chartered Accountants of Sri Lanka.

3.2 Data collection

Data for the study were gathered from two sources: semi-structured interviews and publicly available documents. Fifteen semi-structured interviews were conducted over a period of four weeks. The participants of the study included members of the board (3), accountants (8) and managers (4) in the case organisation. Semi-structured interviews were conducted based on an interview guide, which had a series of questions designed to address the issues of interest in the study. Interviews lasted between 60 and 90 minutes, and were tape recorded in most cases. Where tape recording was not permitted, handwritten notes were taken by one of the researchers. Table 1 provides details of the participants of the study. The documents examined for this study included key governing laws, media reports, parliamentary Hansards, and reports applicable to accounting and corporate governance in the banking sector in Sri Lanka. The data were analysed in three interactive processes as suggested by Miles and Huberman (1994), namely data reduction, data display, and conclusion drawing and verification.

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Note: *The exact number of years of service is not given in order to disguise identity.
4 Forces influencing accounting’s role in banks and the role it plays in PUB

4.1 Forces influencing accounting’s role in banks

Banks, in general, are subject to stringent controls mainly because of their role as the depository and the guardian of wealth of the patrons. Accounting is one such control mechanism used to ensure good governance. The nature of controls used, and the way in which they are used in a GBE could result from three types of pressures namely coercive, mimetic, and normative pressure (Meyer and Rowan, 1977). In the banking context, the degree of influence of each of these seems to vary; while mimetic pressure appears to play a limited role, coercive and normative pressures generally play a significant role (Munir et al, 2011). In Sri Lanka, various regulatory requirements enforced by institutions such as the Central Bank of Sri Lanka (CBSL), the Institute of Chartered Accountants in Sri Lanka (ICASL), the Securities and Exchange Commission of Sri Lanka (SEC) and the Colombo Stock Exchange (CSE) have a considerable influence on accounting and its role in corporate governance.

4.1.1 Central Bank of Sri Lanka

The CBSL is the key regulatory body that governs the banking sector in Sri Lanka. Part V of the Banking Act (No. 30) 1988, amended by Act (No. 33) 1995, specifies the provisions for accounting in banks in both private and public sectors. By the power vested through the Banking Act, the CBSL stipulates the formats to be used when preparing and publishing banks’ financial statements (Section 38(3)). The uniformity of presentation of financial statements is intended to improve the comparability of the performance and stability among banks. In accordance with the requirements of the Banking Act, every licensed commercial bank must publish its annual audited financial statements and lodge those reports with the CBSL within five months after the end of the financial year (Section 38(3)). In preparing financial statements, PUB, the case organisation, employs an information system known as ‘International Comprehensive Banking System’ (ICBS), which has been designed after taking into account the requirements of the CBSL (Accountant-7). Reports generated by ICBS are seen as comprehensive, regular, and on time. The availability of these statements on a timely basis is expected to increase the effectiveness of the regulatory oversight by the CBSL. Additionally, the CBSL requires the publication of quarterly financial statements of banks in the media within two months of the end of each quarter in Sinhala, Tamil and English, the three main languages used in Sri Lanka (CBSL, 2008). These statements would contain summarised financial statements and a selected number of performance indicators. The availability of information on a regular basis in the three main languages is expected to assist effective shareholder and debt-holder monitoring of banks’ activities.

Furthermore, as stipulated by the Banking Act and directions, circulars and guidelines issued by the CBSL from time to time, commercial banks are required to submit various reports daily (e.g., foreign exchange position and liquidity data), weekly (e.g., interest rates), monthly (e.g., assets and liabilities, liquid assets, and income and expenditure), quarterly (e.g., non-performing assets exceeding SLR500000 and risk-based capital calculations), and annually (e.g., assets and liabilities, income and expenditure, and calculations of capital adequacy ratios). The provision of such information is expected to
facilitate the regulatory oversight in preserving banking sector stability in the country. The CBSL also enforces certain regulations particularly designed to safeguard the interests of depositors as there is no government guarantee for bank deposits in Sri Lanka. According to an interviewee, “because banks are based on customer deposits, the CBSL always comes out with new guidelines on reporting aiming to protect the depositors” (Accountant-2). The CBSL periodically carries out audits and inspections and reports on the findings. An interviewee stated “as we upload reports onto the web, CBSL checks them very quickly, and if there are discrepancies they inform us then and there” (Accountant-6).

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 (Section 38A). Banks are required to appoint their auditors from this list, and this requirement is intended to ensure that banks are subject to high quality audits. Under the Banking Act (Section 39) the CBSL provides certain guidelines to external auditors of banks on their statutory duties. These guidelines cover areas such as audit planning, scope of audit, internal control systems, assessment of bank automation, branch audits and review of financial statements. The CBSL is also empowered by the Banking Act to extend the scope of audits or to appoint auditors to perform additional audits in special circumstances. Additionally, the CBSL guidelines (Section 39) prohibits external auditors of banks from undertaking consultancy or other non-audit services with a bank contemporaneously with the external audit to ensure auditor independence.

4.1.2 The Institute of Chartered Accountants of Sri Lanka

The US SEC (2000) states that a transparent and comparable financial reporting system, which can lead to better governance of banks, depends on a sound infrastructure which encompasses high quality accounting standards, independent audit and creditable oversight. The ICASL which is a member of international professional accounting bodies such as the IFAC is the sole authority in Sri Lanka for setting accounting and auditing standards under the Accounting and Auditing Standards Act (No. 15) 1995. This Act also provides the basis for the establishment of the Accounting Standards Committee (ASC), the Auditing Standards Committee (AuSC), and the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB). The ASC and AuSC make recommendations and assist the ICASL in the adoption of accounting and auditing standards (Sections 8 and 9). The SLAASMB is an independent corporate body which monitors Specified Business Enterprises (SBE), including banks to ensure their conformity with the Sri Lanka Accounting Standards (SLAS) and Sri Lanka Auditing Standards (SLAuS) in the preparation and audit of financial statements (Section 11).

4.1.3 The Securities and Exchange Commission of Sri Lanka and the Colombo Stock Exchange

The SEC and the CSE govern the capital market in Sri Lanka. These two institutions have issued various requirements involving accounting practices under the power vested through the Securities and Exchange Commission of Sri Lanka Act (No. 36) 1987. For example, SEC rules issued in 1990 stipulate submission of annual and interim financial statements together with information in relation to events which may materially affect the
functioning of banks. Further, the SEC guidelines issued in 2008 contain provisions on the appointment of external auditors, which include criteria for the qualifications, appointment, rotation of partners, and independence of auditors. Furthermore, various requirements and guidelines of SEC are designed to make external reports comprehensive, reliable and timely, and they are expected to aid shareholder and debt-holder monitoring of organisations.

The CSE, established in 1985, has issued a number of listing rules, including those related to accounting and reporting in order to facilitate the maintenance of an orderly and fair market. Banks listed on the CSE are also required to comply with those rules. The rules on preparation and submission of interim financial reports and annual reports are aimed at enhancing the timeliness and relevance of external reporting. The CSE also has issued rules that require immediate disclosure of information about the affairs of companies and/or about events or conditions in the market which could have a significant effect on the price of the securities. Such rules are aimed at facilitating good corporate governance.

4.1.4 International influences

The laws and regulations applicable to the banking sector in Sri Lanka are largely influenced by international laws and codes of best practice in accounting and corporate governance, such as Basel Committee reports, OECD recommendations, and International Financial Reporting Standards (IFRS). In particular, SLAS and SLAuS have been aligned with the respective international standards for financial reporting and auditing by the ICASL. Moreover, the CBSL implemented the Basel II Accord with effect from January 2008 to establish formal risk management structures in banks (Fitch Ratings, 2007). It was expected that the implementation of Basel II Accord would result in disciplining the banks in the market due to its high level of disclosure requirements (CBSL, 2007).

Further, international developments in corporate governance, such as the Cadbury Report (1992), Sarbanes Oxley Act (2002), OECD Principles of Corporate Governance (1999; 2004), and NYSE Rules on Corporate Governance (2003), have been incorporated into the regulatory framework that governs corporate governance practices in Sri Lanka. For instance, the mandatory Code of Corporate Governance for Licensed Banks in Sri Lanka is based mainly on the Basel Committee’s 2006 report on enhancing corporate governance for banking organisations. A participant of this study commented, “Now we are in the process of implementing it (Basel II reporting). In addition, the bank has to comply with international accounting standards. For these, we did a lot of changes in the accounting system” (Accountant-2).

As revealed in the above discussion, the accounting function in banks in Sri Lanka, such as PUB, is influenced to a large extent by coercive and normative pressures exerted mainly by professional and regulatory bodies. Consistent with the current literature, the study shows that CBSL’s coercive pressure in particular makes PUB follow various guidelines meticulously in preparing and reporting accounting reports (Munir et al., 2011). In addition, mimetic pressure also plays a role in shaping the role of accounting in the banking sector (Munir et al., 2011). While the CBSL is the main source of coercive pressure on PUB, it is also subject to such pressure from various pressure groups such as media and formal representatives of social interests. For instance, Cooke and Wallace
(1990) and Miller (2006) identify the financial press as a factor that influences disclosure practices. In the recent past, the media in Sri Lanka has played an active role in highlighting the fall of a number of financial institutions due to lack of proper monitoring and transparency. Such actions coerced banks to adopt monitoring and controlling mechanisms that are perceived to be effective in order to secure the appearance of having good governance systems. Efforts of PUB to follow the advancements in developed countries (e.g., Basel II reporting) reflect both normative pressure and mimetic pressure. Introducing such developments is seen by the bankers as a way to gain legitimacy as well as the appearance of a modern bank that keep up with the developments in developed countries.

Overall, this study reveals that in response to normative, mimetic and coercive pressures, PUB embraced various professional and regulatory requirements which compelled it to generate reliable and relevant accounting information on a timely basis. Such adherence, although it helped to gain legitimacy and appearance, did not necessarily resulted in effective use of accounting information and/or lead to good governance in the bank.

4.2 Accounting’s role in PUB as a governance mechanism

Accounting can play an important role in corporate governance of banks by providing relevant information to the BOD (Basel Committee, 2006; Whittington, 1993) as well as to other stakeholders such as shareholders and debt-holders. The BOD, in particular, has a fiduciary duty to shareholders and other stakeholders to monitor the activities of managers and to provide strategic direction to the bank (Basel Committee, 2006; Cadbury Report, 1992). More specifically, the BOD monitors managers to ensure goal congruent behaviour, and reports to the shareholders and other stakeholders on its stewardship in accordance with the regulatory requirements.

This study found that PUB seldom had any issues in relation to its conformity with the professional and regulatory requirements. Accounting reports were prepared in accordance with the requirements set by the professional bodies, and internal auditing function was used to ensure that valid and reliable information is generated through the accounting system. Further, a major accounting firm in Sri Lanka was employed to provide an external check on the way in which financial statements were prepared and presented to its stakeholders. The management accounting system at PUB generated detailed monthly and quarterly financial statements showing actual and budgeted figures, a quarterly compliance report providing details of the bank’s compliance with statutory requirements, and a number of key accounting ratios to assist various decisions. Additional information, such as project appraisal, non-performing assets, write-offs, and details of new and loss making branches, was also provided.

Despite the thorough compliance with professional and regulatory requirements, certain recent incidents in the banking sector in Sri Lanka have raised doubts about the effective use of accounting and governance in banks. For instance, there have been instances where accounting information as well as the scrutiny of the BOD were overlooked and disregarded in public sector banks (e.g., Daily News, 28.10.2009). Further, in 2009 the CBSL was forced to intervene to overcome the financial distress of a large private sector bank due to the bankruptcy of a finance company within the group to which that bank belonged (Sunday Observer, 25.01.2009).
With regard to PUB, the members of the BOD who participated in the study were generally satisfied with the level of information received. For example, a board member noted, “The information is timely presented. The BOD has access to whatever information they require” (BOD-2). However, often the information generated through the accounting system was not used effectively, or was disregarded. For instance, despite the Banking Act (No.30) 1988 stipulation that the maximum amount a bank can lend to a corporate or individual client is 30% of the capital of the bank, PUB had granted loans that exceeded that limit (see Parliamentary Hansard, 1997). Although the CBSL is the regulatory authority administering the Banking Act, 1988, there is no evidence of CBSL investigating or questioning this discrepancy. The failure of the CBSL to take necessary actions where corporate governance procedures are violated begs the question whether corporate governance has been configured into a complex system of political patronage.

In addition to facilitating the role of BOD, accounting also can play a role in corporate governance by providing relevant information for shareholder and debt-holder monitoring of banks’ activities. Since the government was the only shareholder of PUB, the Annual Reports of PUB did not contain the same amount of information similar to a private sector bank with diverse shareholders. More specifically, a participant of this study stated, “If you compare with private sector banks, we have not gone to that much of disclosures up to now. The reason is that the government is the sole owner, and there is no need to disclose information widely. Also, directors’ interests in bank’s outside contracts and related party transactions are minimal compared to private sector banks” (Accountant-2).

The Ministry of Finance monitored PUB on a regular basis on behalf of the government (the owner), and was represented on the BOD through the appointment of one member as indicated in the following comment: “The Ministry of Finance is working very closely with us. We have regular meetings with the Ministry chaired by the Secretary to the Ministry. The senior management of PUB has to participate in these meetings and report the progress” (BOD-1). Another interviewee stated “We have to submit our summarised financials to the Ministry on a quarterly basis. Based on that, they undertake some performance analysis for all the state banks” (Accountant-2).

Nevertheless, such procedures appear to be adopted by the bank to gain legitimacy rather than to ensure proper corporate governance, reflecting a more ceremonial use of governance mechanisms in the case organisation (see Meyer and Rowan, 1977). Not only the degree of use of such reports, but also the extent of the monitoring activities of the ministry was less than what would be regarded as effective corporate governance. For instance, there was no evidence to suggest how the reports lodged with the Ministry of Finance were used and the actions taken based on them. The Committee on Public Enterprises (COPE) had also raised concerns over the effectiveness of the monitoring role performed by the Ministry of Finance, as indicated in the following comment: “The COPE also expressed its dissatisfaction to the officials of the Ministry of Finance as they have failed to perform their obligation and duties to minimise the losses incurred by PUB” [Report of the COPE, (2007), p.9].

Due to the high level of debt-to-equity ratio, debt-holder monitoring could be regarded as an important corporate governance mechanism in banks. In view of the absence of a government guarantee or insurance cover for deposits, depositors of banks in Sri Lanka have a strong incentive to monitor their banks’ activities (see e.g., Macey and
O’Hara, 2003). However, unlike the shareholders, depositors do not possess a legal right to be informed about their bank’s financial results. Quarterly financial statements published in the press in the three main languages were the main source of accounting information accessible to depositors. A participant of this study commented, “There is no separate publication for depositors, however, I believe that quarterly publication in newspapers fulfils their information needs” (Accountant-2).

Depositors also had the opportunity to access recent annual reports and quarterly financial statements on their bank’s website. However, as highlighted by the participants of this study in the following statements, on the one hand, access to such information was restricted, and on the other hand, small scale depositors in particular were not overly concerned about the financial performance of their bank: “There is information on the web, but the people in the rural areas have to come to the branch for whatever they need to know as they don’t have knowledge or access to internet” (Accountant-3); “If you take retail depositors, they are not driven by accounting ratios...” (Manager-4)

Consistent with Adams and Mehran (2003), and Levine (2004), the lack of interest in monitoring PUB’s performance could also be due to depositors’ confidence on the regulatory oversight of the CBSL. The high level of regulation and the government ownership appear to have led to depositors’ lack of interest in monitoring PUB. For instance, there seemed to be some degree of belief among depositors that there was a government guarantee for their deposits, although such guarantee did not exist in reality. An interviewee stated: “Being a government bank it gives a sense of security to people... the government authorities are constantly monitoring us and there is nothing to worry for people. But, there is no government guarantee given to the deposits” (BOD-1). This observation is consistent with the views of Macey and O’Hara (2003) who argue that the notion of a deposit guarantee reduces the interest of depositors to monitor banks.

In PUB, accounting did not play a role in managerial compensation plans, which is regarded as an effective corporate governance mechanism. Managers in PUB were paid a fixed remuneration, and their performance was not measured usually for the purpose of determining their compensation. An interviewee said, “We, being a state bank, don’t have a performance-based differentiated remuneration system. Our remuneration packages are common to the grade. Although I perform better than my colleagues, I don’t get anything more than them” (Accountant-1). Agency theory suggests that performance related incentive systems motivate goal directed behaviour (Garen, 1994; Locke, 1968; Bonner and Sprinkle, 2002). Lack of a performance-based managerial compensation system at PUB leaves room for managers to engage in self-serving behaviours.

The above discussion reveals that despite the strong presence of various professional bodies and regulatory requirements that compelled the generation of relevant and reliable accounting information on timely basis, the degree to which accounting information was used in PUB for corporate governance did not do justice to its potential use. The strict adherence to various requirements, more or less reflects, a ceremonial presence of accounting within the bank than for effective governance. Additionally, certain pressures applied to advance good governance, particularly the coercive pressure exerted by the CBSL, seem to have been politicised making the case bank rather a political entity than a commercial bank.
5 Complexities associated with the role of accounting in corporate governance

This section provides an understanding of the complexities associated with using accounting for corporate governance in a GBE in a developing country by focusing specifically on the institutional and socio-political environment of PUB.

5.1 Institutional and socio-political environment

In general, PUB as a GBE had certain ‘systematic patterns of shared expectations’ (for instance, how it should operate as a commercial entity while serving public welfare obligations) and ‘taken for granted assumptions’ (for example, how it should respond when the government as the owner has particular preferences). Further, it had accepted norms and routines of interactions that have robust effects on shaping the motivation and behaviour of interconnected social actors’ [see, Chang and Evans, (2005), p.99]. This was particularly evident with regard to the inter-relationships (and accountability relationships) between PUB (management) and the government (the owner); it was an accepted norm that the government can use PUB to satisfy certain public interests when needed (e.g., provide employment). Making employment related decisions mainly based on political affiliations rather than on qualifications and credentials was not uncommon in GBEs such as PUB, and were seen almost as a routine practice. Such practices, which were driven by political interferences, not only had put pressure on the management of PUB, but also affected their motivation and behaviour. The influence of such institutions (shared expectations, taken for granted assumptions, norms and routines), could make the actual practices of a business enterprise different from those based on the belief of a ‘lifeless notion of isolated economic man’ (see Ford, 2011).

The actual role of accounting in corporate governance in a GBE such as PUB can also vary from its ideal role (implied under functionalist view) due to the influence of numerous socio-political factors. Existing literature provides ample evidence of socio-political influences on the implementation of various policies, procedures and systems in a country. Chang (2002) suggests that political economy argument must be applied not only in the analysis of the state but also in the analysis of the market (e.g., operations of business organisations). 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 organisations within the country, but also on the efficient use of corporate governance mechanisms and other related control tools in that country. Hoque and Hopper (1997) suggest that rational decision making and enterprise accountability could be superseded by political factors in state owned enterprises, including government owned banks. Over the years public enterprises in Sri Lanka, including public sector banks, have often been subject to political interventions. There were numerous instances where politically connected personnel with poor technical and management skills being appointed as chairpersons and members of BOD of public sector enterprises (Karunatilake, 1986). Furthermore, public enterprises were often being used by politicians and trade union leaders to achieve short term political objectives, such as providing jobs for party supporters and favouring party financiers by rewarding through credits/tenders (Dheerasekera, 2007).

This study identified a number of institutional and socio-political environmental factors that influenced the role of accounting in corporate governance in PUB. These
factors include the influence of the government, the nature of owner’s monitoring, the capacity of the BOD to perform its role, shared expectations, taken for granted assumptions, norms and routines as well as social and cultural values prevailing in the country.

5.1.1 Influence of the government

This study revealed that the multiple roles played by the government in PUB with conflicting objectives (economic, political, and social), and its unwarranted political influences obstructed and undermined the role of accounting in corporate governance in the bank. The government intervened in PUB’s decisions as its owner, the main borrower and the beneficiary of the bank’s investments. PUB often had to depart from its normal banking procedures when dealing with the government, and had to be flexible, often by loosening its controls and procedures. Such intervention however violated one of the criteria used in determining the quality of corporate governance in government owned banks, namely the level of government intervention in banking operations (e.g., Nam, 2004).

There were instances where the government used PUB to finance various government projects by borrowing money at very low rates (Accountant-1). Also, when the government needed funds for certain projects, they basically took the money from the bank (BOD-1). Further, an interviewee stated that the “lending rates to development banking are really far below the financing cost of the funds” (Accountant-2). The Report of the COPE (2007, p. 9) reveals that the cost to revenue ratio of the bank had gone up to 74% at a time when the said ratio in the private sector banks was below 56%. A contributing factor for this situation was the increasing staff costs resulting from the recruitment of excessive number of personnel whenever a new government came into power (e.g., Rajapakse, 2001).

The lack of control on the part of PUB on the overdraft facilities given to the government was noted by another interviewee as follows: “The government overdrafts are very difficult to control. Today it may be SLR 10 billion. Tomorrow, it may be SLR 20 billion” (Accountant-3). The following note made in the Parliamentary Hansard was another evidence of the receipt of a large overdraft by the government: “The amount of bank overdrafts obtained by the Treasury of Sri Lanka from PUB in January, 2009 was SLR 11,797 million” [Parliamentary Hansard, (2009b), p.584]. Such incidents clearly demonstrate the politicisation of governance procedures making PUB rather a political entity that serves the government requirements than a business entity with different set of goals.

The government often used PUB to achieve its social and political objectives at the expense of commercial viability. Political interventions under certain circumstances may be needed and may not always be damaging (Chang, 2002). An interviewee stated “We have to obey the social and policy lending requirements of the government, such as credit to the agricultural sector. These loans are granted at very concessionary rates, which are often below the cost of funds of the bank” (Accountant-1). Another interviewee commented “There are cases such as development purposes and national interests, where we are giving loans at statutory rates. Because we must think about the corporate social responsibility as a state bank” (Manager-2). Rajapakse (2001) makes a similar point by stating that “The branch expansion was sometimes not based on commercial criteria, but on social and political considerations” (p.4).
The room for good governance and for effective utilisation of information for that purpose becomes restricted when political and social needs are given priority over commercial objectives in any business entity. There have been instances where, due to political pressure, large loans were granted by PUB without adequate security, leading to their subsequent write off as bad debts. The default of such government directed loans had resulted in huge losses being incurred by PUB over the years, threatening its stability on many occasions (see Parliamentary Hansard, 2008; Rajapakse, 2001). PUB’s large non-performing loans portfolio of SLR 12 billion in 2008 had attracted the attention of the Advisory Committee to the Committee on Public Enterprises (COPE), and their suspicion of the possibility of the bank being influenced by powerful groups is reflected in the following comment appeared on Parliamentary Hansard (2009a, p.350): “It must also be ascertained through the examination whether any of these loans have been granted under external pressure, subverting normal banking procedures”. Participants of this study consistently noted this situation. For instance, “There are political influences, for example, to hire or to promote a person, or influences to grant a loan” (Accountant-1). Although the CBSL as the regulator revealed such situations through its normal investigations, its regulatory powers to take action against the perpetrators were often constrained by undue political influences. These circumstances clearly demonstrate the way in which corporate governance has politically configured into a complex system of patronage.

The study also revealed that the government at times made major decisions without giving due regard to the advice of the BOD and the management of PUB. Recently, the President of Sri Lanka ordered all public sector banks to bring down their interest rates on loans granted to customers to accelerate economic revival in the country (Daily News, 28.10.2009). Such occurrences suggest that the nature of the political environment could nullify organisational control systems, including accounting controls, in decision making, resulting in undesirable consequences for the governance of public sector banks. Hopper and Hoque (2004) and Hoque and Hopper (1994) also found the role of accounting in GBEs becoming marginalised in developing countries, especially when the ruling party uses its powers for political gains rather than for economic ends. Arun and Turner (2004) also note that corporate governance in banks in developing countries is a complex issue due to extensive political intervention, largely because of the government ownership of banks.

5.1.2 The nature of owner’s monitoring

As the sole owner of PUB, the government relied on the Ministry of Finance as its representative to monitor the activities of PUB. Therefore, the effectiveness of monitoring of the bank depended on the level of commitment of the employees at the Ministry.

The standard of monitoring by the Ministry was not always seen to be adequate. The COPE had raised concerns over the effectiveness of the monitoring role performed by the Ministry of Finance by stating that the Ministry of Finance had failed to perform its obligation and duties to minimise the losses incurred by PUB [Report of the COPE, (2007), p.9]. Although the ministry represented the government as the owner, the staff in the Ministry who undertook the relevant tasks on behalf of the government performed
those activities merely as public sector employees with relatively limited concern about the overall performance of PUB (see also Arun and Turner, 2004).

5.1.3 The capacity of the BOD to perform its role

Another factor that affected the extent of use of accounting information for corporate governance in PUB was the degree of freedom and ability the BOD had to effectively perform its role. At times the BOD was unable to function because the members of the BOD were appointed by the government. Often the BOD lacked the power and the strength to contravene government requests for lending. Additionally, appointees to the BOD of public sector banks were often politically affiliated (e.g., Karunatilake, 1986). They were consistently seen to be inclined to pursue their own interests or the interests of pressure groups. Further, due to their political affiliations, granting of large loans to their political supporters was not uncommon. Such loans often became non-performing. Occurrences of this nature had caused heavy losses to the bank. For example, the Committee on Public Enterprises reported, “When examined on 13th November 2006 the Committee observed that PUB had granted loans amounting to SLR 314 million and overdrafts of SLR 300 million to a local firm by obtaining inadequate security valued only up to SLR 40 million. This was a blatant violation of the banking rules and procedures. These loans remained unpaid.” [Report of the Committee on Public Enterprises, (2007), p.9] These events clearly reveal how loans were approved without proper evaluation, indicating not only the inadequate governance role played by the BOD, but also the lack of consideration given to control systems including management accounting systems when making those decisions.

5.1.4 Shared expectations, taken for granted assumptions, norms and routines

The way in which accounting came to be used for governance purposes in PUB was influenced by, among other things, shared expectations, taken for granted assumptions, and norms and routines. For instance, depositors had the expectation and the belief that they will be looked after by the government if the bank experienced any financial difficulty (According to a participant of the study, “…being a government bank, it gives a sense of security to people”). As such, depositors did not have the motivation to monitor the operations of the bank and/or to use accounting information for that purpose. Further, certain taken for granted assumptions in relation to the government’s position as the owner of PUB made accounting’s role complex, and at times irrelevant. For instance, when the government needed money for projects, either no project evaluation was carried out, or the outcomes of such evaluations were disregarded, and they basically took the money from the bank (BOD-1). Moreover, certain norms and routines created an environment which made any emphasis on financial performance of PUB questionable, and the stringent use of accounting controls debatable. For instance, although PUB was expected to be a commercially viable government enterprise, when the government had to fulfil social and policy lending obligations (e.g., credit to agricultural sector), lending the requested fund seven below its cost had become a norm at PUB. Further, providing employment when the government requested, even when the bank was excessively over staffed, was seen as a normal occurrence, and such practices had almost become routinised. In these instances, PUB not only disregarded the financial ramifications of such decisions, but also overlooked the existing corporate governance procedures.
5.1.5 Social and cultural context

The literature suggests that social and cultural features of a country could influence the way in which various control systems are used within that country (e.g., Uddin and Choudhury, 2008; Wickramasinghe and Hopper, 2005). For instance, Archambault and Archambault (2003) argue that the level of education and religious beliefs can influence corporate disclosure. As the level of education increases, the number of users of accounting information would increase (Doupnik and Salter, 1995). Further, religious beliefs can have an impact on the accounting and reporting practices. For example, Hamid et al. (1993) reveal that the Islamic tradition places ethical/social activity ahead of individual profit maximisation. In such societies, trust underlies relationships, reducing the need for accounting as a means of financial reporting. Additionally, cultural factors such as commercial values of people in a society could have an impact on the degree to which they monitor their financial interests (e.g., Adams, 2002; Hamid et al., 1993).

The accomplishments in the area of social policy in Sri Lanka surpass most developing countries (World Bank, 2006). The overall literacy rate of Sri Lanka is 92.5%, and the country has already attained universal primary education and completion, and has achieved gender parity at primary and secondary education levels (CBSL, 2008). Despite such developments, access to information for most stakeholders seems to be restricted, due to the limited knowledge of information technology and the shortage of internet facilities in the country. These aspects of social environment in the country were noted by an interviewee when he stated that although there was information on the web, people in rural areas had to come to the branch as they did not have knowledge or access to internet (Accountant-3). Depositors often used banks’ websites merely to conduct business transactions rather than to find information for monitoring purposes. Additionally, a comment made by an interviewee suggested that small scale depositors in particular were more interested in variations in interest rates than about the financial performance of their bank as they seemed to be solely dependent on the interest income derived from their deposits (Manager-4).

Certain values and beliefs of Sri Lankans also help to understand the less aggressive use of accounting information for corporate governance purposes in PUB. Generally, Sri Lankans are not forceful enough to fight for their rights, and as a result even when the government adopted policies which were likely to violate citizens’ fundamental rights, they tended to take a passive attitude towards it, and did nothing. For instance, stakeholders of the bank seldom took a genuine interest to analyse costs and benefits of certain actions taken by the bank even when media reports highlighted various anomalies and lack of accountability. Examples include, providing employment in PUB to political supporters and opening of new branches without any financial justification. When characterised by such attitudes and behaviours, individuals are more likely to take things as ‘given’ and accept the status quo, rather than questioning the status quo based on available information. The lack of interest to critically examine the current state of affairs would lead to a relatively low level of the use of accounting information as a means of monitoring and accountability. Findings of this study revealed evidence to demonstrate that effective use of accounting information by stakeholders of PUB such as depositors and debt-holders was very limited.
6 Conclusions

Drawing on institutional theory and theory of political economy, this study examined the role of accounting as a corporate governance mechanism in a public sector bank in a developing country. The evidence gathered from the case organisation revealed that PUB meticulously complied with various professional and regulatory requirements in internal and external reporting. While coercive and normative pressures urged such conformity to a great extent, mimetic pressure played a relatively limited role. This finding is consistent with Munir et al. (2011) who found similar types of pressure to change performance measurement systems in a bank in Pakistan. The observations made in the study, however, suggested that most requirements were adopted mainly to gain legitimacy, appearance and society’s support, rather than to enhance good governance. Basically, accounting appeared as a ceremonial means for symbolically demonstrating PUB’s commitment to a rational cause of action (Covaleski et al., 1996).

The study also revealed that the way in which accounting information was used at PUB did not demonstrate accounting, either as a politically neutral, detached and a pure economic type of governance mechanism as suggested in the functionalist view, or as a mechanism that strictly focused on inducing the self-interested administrators to make decisions for maximising the value of the entity to its owners (Denis and McConnell, 2003). Instead, the study found a governance system within which accounting played a lesser role than its expected role due to various institutional and socio-political influences. This study not only highlighted the political and other institutional dynamics of corporate governance related to a GBE in a developing country, but also exposed a system of governance where ‘third world politics’ played a significant role in framing corporate governance, negating the expected role of accounting. This finding is consistent with the existing literature (e.g., Hoque and Hopper, 1997; Hopper and Hoque, 2004; Arun and Turner, 2004). The paper clearly demonstrates the political complexity of corporate governance in developing countries and how accounting becomes less effective within such political complexities.

Chang (2002) suggests that there are times where government intervention in economic activities of public sector organisations is necessary, for instance, when such interventions are meant for the common good. This study revealed instances where PUB submitted to the government’s requests when they were seen as pure necessity for the government to achieve its social and economic objectives (e.g., forcing banks to bring down interest rates; branch expansions not based on commercial criteria). Any attempt to use accounting controls in such situations, purely to achieve financial goals, would be seen as resulting in negative social and economic consequences. These circumstances clearly demonstrate the problematic nature of the role of accounting in corporate governance in GBEs, particularly in developing countries. Chang (2002) points out that excessive politicisation could be harmful. Findings of this study show the failure to use relevant governance mechanisms such as accounting when confronted with unwarranted political interventions had damaging effects on corporate governance of PUB.

This study makes both theoretical and practical contributions. It draws on multiple theories developed in sociology and economics to examine the stated research issue, and highlights the efficacy of using multiple theories when examining complex issues. By providing insights into institutional and socio-political dynamics of corporate governance in a GBE in a developing country, the study helps various stakeholders as well as
accounting practitioners to understand why certain governance mechanisms, including accounting, fail to perform its expected role in such a context. Policy makers may use these insights to introduce further measures to improve effective use of accounting for corporate governance, for example, by requiring justifications or explanations when decisions are made outside the normal banking procedures, and making banks accountable for any departures from the regulatory requirements.

Future research may examine the research question addressed in this study in a private sector bank. Since government interferences in private sector banks seem to be lower than in public sector banks (Ekanayake, 2011), investigating the extent to which accounting facilitate corporate governance in such a context would be worthwhile. Further, by replicating this study in a public sector bank setting in a developed country, future research may shed light into the importance of political interferences as a dominant factor in explaining why the actual role of accounting in public sector banks in developing countries tend to differ from its expected role. Such research may also identify differing institutions that influence the role of accounting in banks in developed countries.

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