

A Comparison of Reported and Disclosed Corporate Governance Compliance Status in the Banking Sector of Bangladesh

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Abstract:

The main objective of this study is to investigate the corporate governance status in the banking sector of Bangladesh. In doing so, we have compared the reported and disclosed corporate governance compliance reporting in the published annual reports of the banks. The finding of the study revealed that, for some banks there is a gap between reporting made in the SEC notification and disclosure made in the their annual reports. Finally, the study concluded that, both the management and auditors should take more care in order to ensure the transparency and accuracy of the data presented in the annual reports.

Keywords: Corporate governance, Banks, Securities and Exchange Commission, Bangladesh

1. Introduction

The banking sector of Bangladesh is severely faced with the challenge of developing good governance practices because of its dominance in the entire financial system of the country. The financial system in Bangladesh continues to be predominantly bank based, with bank assets to GDP ratio of 56% . Good corporate governance (CG) for banks, therefore, becomes critical in ensuring solvency and stability of the financial system as effectively governed banks are most efficient and cautious in directing their resources. Also banks in Bangladesh are highly leveraged. They lend money borrowed from depositors and must be

accountable to these depositors. The CG framework should, therefore, ensure aligning the interests of the management with equity and debt holders. Ensuring good governance at corporate level helps in protecting bank's interest by upholding operational and financial discipline. Again the ownership and group structure of banks in Bangladesh is highly varied. The banking sector comprises of foreign controlled, private, specialized and some state-owned banks with each type of ownership structure posing its peculiar governance challenges. Moreover, some banks operate as part of commercial groups while a large number of them have exposure to the non-bank financial sector through ownership and control. Hence, banks need to adopt good governance practices and customer service standards in order to build public confidence in creditability of their operations .

Now the question is how far Bangladeshi banks are adapting these good governance practices ? With this background and evident question, the objective of this paper is to examine the corporate governance status in the banking sector of Bangladesh by comparing the reported and observed compliance reporting in the published annual reports of the banks .

2. Data and Methods

Data were collected form secondary sources. Annual reports of 30 banks listed in Dhaka Stock Exchange were used as a source of data. Finally 21 banks were short listed as for 9 other banks data were not available .

As a methodology for comparison, we have graded the banks according to the notification made by them to Securities and Exchange Commission (SEC) regarding corporate governance compliance and compared with disclosure made by them in annual reports regarding the same conditions mentioned in the SEC notification .

3. Corporate Governance and Banking Sector of Bangladesh

In Bangladesh most of the companies depend on the banks as their major source of financing. Capital market in Bangladesh is still at an emerging stage with market capitalization amounting to only 6.5% of GDP with low investor confidence on corporate governance and financial disclosure practices in many companies listed in the stock exchanges. The neighboring countries are well ahead of Bangladesh in terms of depth of capital market. For example, in India, Pakistan and Sri Lanka, the market capitalization is 56% , 30% and 18% of their respective GDP .

The financial system of Bangladesh consists of Bangladesh Bank (BB) as the central

bank, 4 State Owned Commercial Banks (SCB) , 5 government owned specialized banks , 30 domestic private banks , 9 foreign banks and 29 non-bank financial institutions. Moreover, Micro-credit Regulatory Authority (MRA) has so far given license to 298 Micro-credit Organizations. The financial system also embraces insurance companies, stock exchanges and co-operative banks.

The commercial banking system dominates the financial sector with limited role of Non-Bank Financial Institutions in the capital market. The Banking sector alone accounts for a substantial share of assets of the financial system. The banking system is dominated by the 4 State Owned Commercial Banks, which together control more than 30% of deposits and operates 3383 branches (50% of the total) as of June 30 , 2008.

Out of the 5 specialized banks , 2 (Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank) were created to meet the credit need of the agricultural sector while the other two (Bangladesh Shilpa Bank (BSB) & Bangladesh Shilpa Rin Sangtha (BSRS) are for extending term loans to the industrial sector of Bangladesh.

As in many developing countries, banks play a vital role in Bangladesh economy, as the dominant financier for the industrial and commercial activities. Since the independence in 1971 , the government until 1982 , when the ' ownership reform ' measures started in the financial sector, had carried out the regulation and ownership of all the financial institutions. During the reform period, two out of six National Commercial Banks (NCBs) were denationalized and private commercial banks were allowed to operate in the country. Despite the expansion, the operational efficiency of the banking institutions has continued to be dismal (Sayeed , 2002; Raquib , 1999) . The sector witnessed decreasing profitability, increasing non-performing assets, provision and capital shortfalls, eroded credit discipline, rampant corruption patronized by political quarters, low recovery rate, inferior asset quality, managerial weaknesses, excessive interference from government and owners, weak regulatory and supervisory role etc. (Hassan , 1994; USAID , 1995) Internal control system along with accounting and audit qualities are believed to have been substandard (Raquib , 1999; CPD , 2001) . Many of the problems have been attributed to lack of sound corporate governance among the banks. The reports by the Banking Reform Commission (BRC ,1999) and BEI (2003) raises serious concerns on the banking sector and criticize the quality of governance that prevails in the banking sector in Bangladesh.

Given the important financial intermediation role of banks in an economy, their high degree of sensitivity to potential difficulties arising from ineffective corporate governance and the need to safeguard depositors' funds, corporate governance for banking organizations is of great importance. The Basel Committee on Banking Supervision published guidance in

1999 to assist banking supervisors in promoting the adoption of sound corporate governance practices by banking organizations in their countries. This guidance drew from principles of corporate governance that were published earlier that year by the Organization for Economic Co-operation and Development (OECD) with the purpose of assisting governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for financial market regulators and participants in financial markets.

The need for a competent financial sector is important to stimulate and support economic growth through efficient resource allocation. Good CG practices are essential to the effectiveness, competitiveness and safety and soundness of financial institutions.

4. SEC Notification on Corporate Governance

On January 2006 , Securities and Exchange Commission (SEC) issued a notification to all the public listed companies to fill up corporate governance (CG) compliance form. Details of this form and its description are provided in **Table 1** . This form has 37 conditions to be disclosed. If any company fails to comply any condition (s) , explanation should be provided. The objective of this notification is to obligate listed firms to disclose their corporate governance status and to motivate them to meet the set governance standards. As shown in the table, these CG conditions include: size of the Board of Director (BOD) , formation of audit committee, Chief Financial Officer (CFO) and Head of internal audit and company secretary, reporting to the audit committee and external / statutory auditors etc .

Table 1: Format and Description of the Corporate Governance Compliance Report as per SEC Notification

Condition No:	Title	Condition
1.1	Board's size	Not less than 5 and more than 20
1.2(i)	Independent Director	At least one tenth (1/10) of the total number of the company's board of directors
1.2(ii)	Appointment of Independent Director	The independent director(s) appointed by the elected directors.
1.3	Chairman of the board and CEO	Chairman elected among the directors of the company and BOD clearly defines roles and responsibilities of the Chairman.
1.4(a)	Fairness of financial statements	Financial statements present fairly its operations prepared by the management.
1.4(b)	Maintenance of proper books of accounts	Proper books of account of the issuer company have been maintained.

1.4(c)	Appropriate accounting policies	Appropriate accounting policies applied in preparation of the financial statements and estimates are based on reasonable judgment.
1.4(d)	Compliance with international accounting standards	International Accounting Standards have been followed in preparation of the financial statement.
1.4(e)	Soundness of internal control system	System of internal control is sound in design, effectively implemented and monitored.
1.4(f)	Bank's abilities to continue as a going concern	There are no significant doubts upon the issuer company's ability to continue as a going concern.
1.4(g)	Changes in operating results	Significant changes from last year in operating results should be highlighted and explained.
1.4(h)	Three years financial data	Financial data of at least preceding three years should be summarized.
1.4(i)	Declaration of Dividend	If the issuer company has not declared dividend for the year, the reasons should be given.
1.4(j)	Details of Board meeting	The number of Board meetings and attendance by each director should be disclosed.
1.4(k)	Shareholding pattern	The pattern of shareholding should be reported to disclose the aggregate number of shares.
2.1	Appointment of CFO Company Secretary Head of internal audit	The company should appoint a CFO a Head of Internal Audit and a Company Secretary and should clearly define their respective roles.
2.2	Attendance of CFO Company secretary in Board meeting	The CFO and the Company Secretary of the companies should attend meetings of the BOD.
3.1(i)	Consulting of Audit Committee	The Audit Committee should be composed of at least 3 members.
3.1(ii)	Inclusion of independent Director on the Audit Committee	The BOD should appoint members of the Audit Committee who should be directors of the company and include at least one independent director.
3.1(iii)	Filling of casual vacancy in the audit committee	When the term of service of the Committee members expires the BOD should appoint the new Committee member immediately not later than 1 (one) month from the date of vacancy
3.2(i)	Chairman of the committee	The BOD should select 1 member of the Audit Committee to be Chairman of the Audit Committee.
3.3.1(i)	Reporting of the Board of Directors	The Audit Committee should report on its activities to the Board of Directors.
3.3.1(ii) (a)	Reporting of conflict of interest to the Board	The Audit Committee should immediately report to the BOD on conflicts of interests.

3.3.1(ii) (b)	Reporting of any fraud or irregularity to the Board	The Audit Committee should immediately report to the BOD on suspected fraud in the internal control system.
3.3.1(ii) (c)	Reporting of violation of any laws to the Board	The Audit Committee should immediately report to the BOD on suspected infringement of laws, including securities related laws, rules and regulations.
3.3.1(ii) (d)	Reporting of any other matter to the Board	The Audit Committee should immediately report to the BOD on any other matter which should be disclosed.
3.3.2	Reporting to the concerned authorities	Audit Committee has reported to the BOD about anything which has material impact on the financial condition and results of operation.
3.4	Reporting to the shareholders and general investors	Report on activities carried out by the Audit Committee should be signed by the Chairman of the Audit Committee and disclosed in the annual report.
4.00(i)	Non-engagement in appraisal or valuation	The issuer company should not engage its external/statutory auditors to perform appraisal or valuation services or fairness opinions.
4.00(ii)	Non-engagement in designing of financial Information System	The issuer company should not engage its external/statutory auditors.
4.00(iii)	Non-engagement in Book keeping	The issuer company should not engage its external/statutory auditors to Book-keeping or other services related to the accounting records or financial statements.
4.00(iv)	Non engagement in Broker dealer service	The issuer company should not engage its external/statutory auditors to Broker-dealer services
4.00(v)	Non-engagement in actuarial services	The issuer company should not engage its external/statutory auditors to Actuarial services.
4.00(vi)	Non-engagement in internal audit	The issuer company should not engage its external/statutory auditors to Internal audit services.
4.00(vii)	Non-engagement in any other service	The issuer company should not engage its external/statutory auditors to other service that the Audit Committee determines.

Source: Compiled from SEC , 2006

5. Findings of the Empirical Study on Corporate Governance Compliance

We have undertaken an empirical study to investigate the status of CG following the indicators given in SEC's notification. To do so we have first selected banks enlisted with SEC and chosen 2006 as the base year because, there was no indicator for measuring compliance status before 2006 . On the basis of information of 2006 we have selected 30 Private Commercial Banks (PCB) for measuring their status of CG but information was available only

for 21 banks as per their respective annual reports .

5.1 Compliance as Reported in the SEC Notification

As a first step for our analysis we have graded the notifications published by the selected banks by allocating 5 points for *compliance* and 0 for *non-compliance*. In this way, a bank can have a score of maximum 185 (37 conditions X 5 points) and minimum 0 score. Accordingly, we have graded all the banks according to this grading standard. The result of this grading for 21 banks is presented through **Figure 1** . From the figure we can see that, Bank 8 is having a highest score of 180 , while Bank 15 is having a lowest score of 115.

On the basis of their score or points then we have classified the banks into four stages: thinker, starter, mature and advanced. The standing of the banks after this classification is shown by **Table 2** and **Figure 2** .

Table 2: Grading of Banks

Description	Grade Range	Grade	No. of Banks
Thinker	Below50	1	0
Starter	51-100	2	0
Mature	101-150	3	8
Advanced	151 and above	4	13

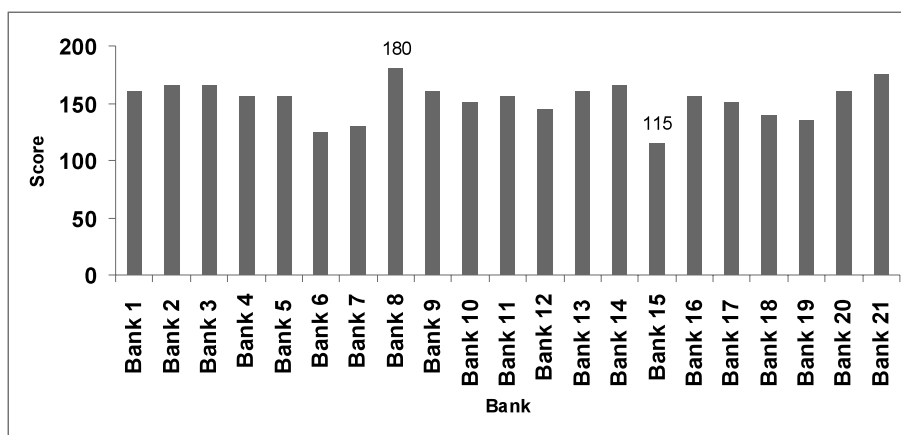


Figure 1: CG Compliance score of banks

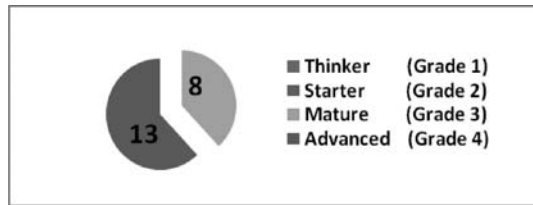


Figure 2: Grading of Banks

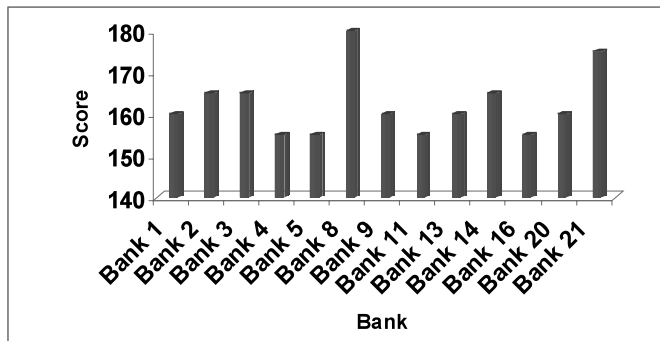


Figure 3: Advance level status banks

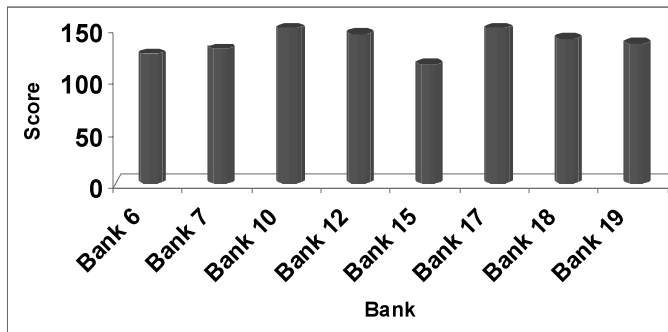


Figure 4: Matured level status banks

From the table and figure we can see that among 21 banks 13 are in advanced stage and 8 banks are in matured stage. They belong to grade 4 and 3 respectively and none of the banks are in thinker and starter stages (see Figure 2). Score for the advanced and mature stage banks are shown by Figures 3 and 4. Hence from the grading of the notification results reported by banks it can generally be commented that, banks in Bangladesh are highly corporate governance standard compliant. But is it really so?

5.2 Compliance as Revealed through Further Investigation

From the above scenario we can see that most of the banks exist in the advance level in measuring CG in Bangladesh. But the overall governance scenario suggests otherwise. In order to get the true picture as far as possible we have further investigated all the banks and graded them according to the disclosures made by the banks in their annual reports regarding the same conditions reported by them in the SEC notification .

At this stage again we have allocated 5 points for complied status and 0 point for non compliance or partial compliance. For example, in the notification there was a condition that consecutive three years financial data should be published in the annual reports. In this case we have assigned 5 points to the banks that had provided the full information and assigned 0 point to the banks providing 2 years data. Accordingly, our second grading based on the disclosure in the annual reports changed the ranking for some banks which are presented through Figure 5.

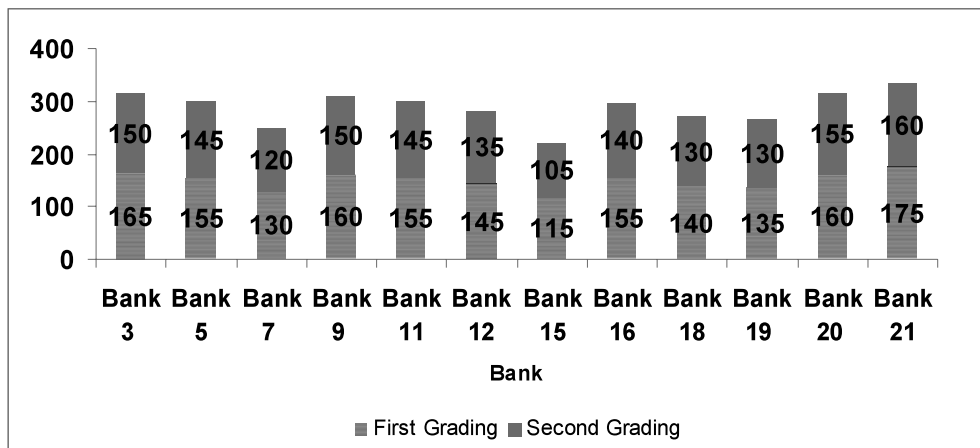


Figure 5: Comparison between 1st & 2nd Grading

From the above, we can see that out of 21 banks, 12 banks changes their score and 9 banks remained unchanged. Among them 3 banks shifted their status from advanced status to matured status i.e. Bank 6, 11 and 16.

6. Discussion

In this particular study we have taken a modest attempt to investigate the corporate governance status in the banking sector of Bangladesh by comparing the reported and ob-

served compliance reporting in the published annual reports of the banks. The finding of the study can be summarized and concluded as follows:

Firstly, most of the banks notified a very high level of corporate governance compliance status in the notification report submitted by them to the SEC and published in the annual reports (see Table 2 and Figure 1) . This is quite contradictory to the findings of several studies conducted on the status of corporate governance in Bangladesh (Iqbal , 1997; Raihan , 2003; BEI , 2003 and 2004; Ahmed and Yusuf , 2005; Ahmed and Uchida 2009) .

Secondly, the above finding led us to further investigation and accordingly the derived second grading revealed that there is a gap between reporting made in the SEC notification and disclosure made in their annual reports (see Figure 5) .

Thirdly, this difference indicates that notification by the banks to SEC regarding corporate governance compliance does not ensure that these banks have actually fulfilled the condition.

Finally, as a policy guideline it can be recommended that, quality of reporting both financial and organizational, needs to be improved. Facts reported in the annual reports, should not be conflicting with other reports and must reflect the true and fair position of the company. In this connection both the management and auditors have greater role to play in terms of transparency and ethics for the interest of all the stakeholders.

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