Discriminatory Related Party Transactions and Corporate Governance Reform: Evidence from Bangladesh

A thesis submitted in fulfilment of the requirement for the degree of Doctor of Philosophy

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2013
DECLARATION

I certify that except where due acknowledgement has been made, this thesis is sole done by me and has not been submitted previously, in whole or in part, to qualify for any other academic award. The content of this thesis is the result of research which has been carried out since the official commencement date of my PhD programme.

Mohammad Tareq

Date: 24.11.2003
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ACKNOWLEDGEMENTS

I would like to express my deep gratitude to my principal supervisor, Professor Dennis Taylor, who has prudently guided and supported me for doing this research. He has been an unwaveringly dedicated advisor and meticulous reader of the manuscript, without whose encouragement and support, I might never do this work.

I would like to express my gratitude to my second supervisor, Professor Clive Morley for his valuable comments and advice on this research. Moreover, I would like to express my gratitude to Professor Sheila Bellamy for her valuable comments on this research. I would like to thank her for giving me encouragement for doing this research.

I also thank all of my fellow doctoral students and staff at the School of Accounting at RMIT University. Finally, I thank my lovely wife, Sejuti and my parent for their encouragement for my study and research.
ABSTRACT

Discriminatory related party transactions (DRPTs) are non-arm’s length transactions with related parties of controlling shareholders for private benefit at the cost of other shareholders. This is a governance issue between controlling shareholders and minority shareholders in both developed and developing countries. However, most studies on DRPTs are in developed countries with the few exceptions of studies in China, India and Mexico.

In 2006, listed companies in Bangladesh were subjected to corporate governance reforms through the SEC/CMRRCD/2006-158/Admin/02-08 order issued by the Securities and Exchange Commission of Bangladesh. The reforms have potential to curb DRPTs. However, prior studies on the effectiveness of corporate governance reform in protecting minority shareholders from DRPTs in a developing country have been limited. The few evaluations undertaken in China and India have been narrowly focused. Therefore, this area of literature is open to further development. Moreover, there has been limited systematic effort to develop a sound measures for such discriminatory transactions at the company level. One notable measure is the Anti-self Dealing Index which is a comprehensive index to measure DRPTs at the country level. At the company level, several researchers simply use total dollar amount of RPTs as a proxy for DRPTs. Alternatively, some other researchers use selected RPTs or some derivatives of related party transactions as a measure of DRPT. However, all of these company level measures are based on weak theoretical underpinnings and therefore prone to high measurement error.
Considering the limited research on these two related areas of the measurement of DRPTs and the effectiveness of corporate governance reforms in curtailing DRPTs, this thesis develops two objectives. The first objective is to develop a new improved measure for DRPTs. To achieve the first objective, this thesis develops and tests a measure that seeks to distinguish the proportion of transactions in total RPTs that is discriminatory from the proportion that is based on legitimate business motives. Type 1 and Type 2 error rates and power of the new measurement are compared with an existing measure using computer simulated and real data. The capital market sensitivity of the new measure is also tested and compared with an existing measure. The new measure is found to be superior to the existing measure.

The second objective of the thesis is to investigate the effectiveness of Bangladesh’s 2006 reforms for protecting minority shareholders from DRPTs. For this Oliver Williamson’s *Market and Hierarchy* model is used as a theoretical framework. Using this framework, several research questions are developed and tested.

A mixed methods approach is used to obtain evidence to address the research questions. Panel data regression modes and growth curve models are run using quantitative data collected from annual reports for a sample of companies and from a publication of the stock exchange. Then semi-structured interviews with directors, independent directors and audit committee members are undertaken and the transcripts are qualitatively analysed.

Both the quantitative and qualitative methods identify the limitation and factors that affect the implementation and enforcement of the governance requirements as set out in the 2006 reform for controlling DRPT practices in Bangladesh. The panel data regression results of the quantitative analysis section show no improvement of the corporate governance variables in
reducing DRPTs in the post reform period. However, growth curve modelling results shows that independent directors are becoming significantly effective in reducing DRPTs over the post-2006 period of years under study.

The interviews reveal perspectives of key players about flaws in the selection of independent directors and inexperience of independent directors in their role. They reveal that most of the independent audit committee members are either retired bureaucrats or academics. Many of them frankly acknowledge their deficiencies in accounting knowledge and experience. Moreover, the interviews with directors suggest that many independent directors do not speak out to protect minority shareholders’ interests mainly because of their friendly relationship with the chair or controlling shareholders group who recruited him/her to the board. The results of both the qualitative and quantitative analysis show that a lack of accounting education and experience hinders the audit committee’s activities. The interviews further reveal that independent directors are motivated to learn the job in concern for their social reputation. This motivation does indicate potential improvement in their performance over coming years. The inference from quantitative and qualitative findings is that independent directors in Bangladesh are currently in learning phase and have the potential to become effective in protecting minority shareholders in the future.
CHAPTER 1

INTRODUCTION

1.1 Introduction

Within the last decade, shareholder activism has drawn attention to the plight of minority shareholders who claim to experience behaviour by controlling shareholders that is oppressive, prejudicial and discriminatory. Such behaviour is most notably manifest in discriminatory related party transactions (hereafter DRPTs) that are pursued for the self-interest of the controlling shareholders. The term ‘discriminatory’ is used in the dictionary sense of ‘setting up exceptional treatment against or in favour of particular groups’ (Oxford Dictionary 2013). The groups to which this term is applied in this study are controlling shareholders and minority shareholders. DRPTs are non-arm’s length transactions by a company with its own controlling shareholders or their associated parties, and have the effect of favouring controlling shareholders at the cost of the minority shareholders. Empirical research confirms that controlling shareholders resort to DRPTs for private benefit at the cost of minority shareholders (Gao and Kling 2008, Cheung et al. 2006, Atanasov 2005, Dow and McGuire 2009, Peng et al. 2010, Dahya et al. 2008). DRPTs are found to erode firm value (Peng et al. 2010, Atanasov et al. 2010, Jiang et al. 2010) and many of the notorious

1 Various terms, such as tunnelling, self-dealing transactions, minority shareholder expropriation have been used for such behaviour of controlling shareholders to the minority shareholders. However, no unique term has been used in literature to describe this discriminatory behaviour of controlling shareholders. ‘Discretionary Related Party Transaction’ is used in this thesis to describe this behaviour of the controlling shareholders of a company.
corporate collapses in the twenty-first century are associated with DRPTs (Ge et al. 2010, Gallery et al. 2008). Considering the significance of curbing DRPTs, many countries have reformed their corporate sector to give better protection to minority shareholders from such transactions through preventative mechanisms and various remedies. Although studies on DRPTs have been undertaken in many developed countries (e.g. Gallery et al. 2008, Kohlbeck and Mayhew 2010, Kohlbeck and Mayhew 2005, Gordon et al. 2004), there is a dearth of research on DRPTs in developing countries. A few notable exceptions to studies of related-party transactions in developing countries are studies in China (Gao and Kling 2008, Cheung et al. 2009a, Peng et al. 2010, Ge et al. 2010, Jiang et al. 2010), in Mexico (Silanes et al. 2003) and in India (Bertrand et al. 2002, Black and Khanna 2007).

Minority shareholder protection from discriminatory related-party transactions (DRPTs) by controlling shareholders is the issue of focus in this study. Two particular areas of deficiency in the body of research on this issue are addressed. They are the development and validation of an improved measure of DRPTs, and the establishing of evidence on the degree of effectiveness of corporate governance reforms for controlling DRPTs in an emerging economy, Bangladesh.

In 2006, listed companies in Bangladesh were subjected to corporate governance reforms through an order, SEC/CMRRCD/2006-158/Admin/02-08, issued by the Securities and Exchange Commission of Bangladesh. These reforms, which are detailed later in this thesis, require a listed company to: (a) appoint independent directors to its board, (b) publish a directors’ certification about the fairness of financial statements prepared by management and the soundness of the internal control system, (c) form an audit committee, (d) restrict external auditors in the provision of non-audit services, and (e) implement various other governance-

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2 The order stipulates that the reforms should be complied with by all listed companies; if not complied with, companies should give an explanation for that.
related mechanisms. All these reforms are new to Bangladesh and have potential to curb DRPTs. It can be argued that corporate governance reform initiatives are only meaningful if they achieve their objectives. Post-implementation reviews of reform initiatives can highlight the need for modification in particular requirements that are found to be ineffective or dysfunctional. Such reviews need to be well-informed and evidence-based. Although some studies have been undertaken into corporate governance either during or after the implementation of the 2006 reforms in Bangladesh, with the exception of two studies (Siddiqui 2010, Azim and Rahman 2008), none of these prior studies focus on the 2006 corporate governance reforms. In his study of the 2006 reforms, Siddiqui (2010) questions the suitability of the reforms in Bangladesh, but does not investigate the effectiveness of the reforms in general or evaluate the reforms from the perspective of DRPTs. The study by Azim and Rahman (2008) only surveys the reform compliance reporting in its first year of implementation.

Reform compliance imposes an additional cost on companies. If the reforms aimed at protecting minority investors fail to significantly reduce discriminatory transactions or other discriminatory behaviour of controlling shareholders, then the reform costs involved for a company means that minority investor are in a worse situation than they were in the pre-reform period. Past studies have investigated the cost and benefit of Sarbanes-Oxley Act 2002 to US companies (Zhang 2007, Doyle et al. 2007, Iliev 2010, Ashbaugh-Skaife et al. 2009, Ashbaugh-Skaife et al. 2008), and corporate governance reform effectiveness in some other countries (Mengoli et al. 2009, Mukherjee-Reed 2002, Hutchinson et al. 2008). There have also been studies on the effectiveness of governance reform in preventing DRPTs in developed countries mainly the USA (Chhaochharia and Grinstein 2007) and Australia (Gallery et al. 2008). However, no study has investigated how effective corporate governance reforms have been in protecting minority shareholders from DRPTs in a developing country, other than a cursory evaluation in India by Jiang et al (2010). Therefore, this area of
investigation on the effectiveness of governance reforms in developing countries remains largely untapped.

In quantitative research, accurate measurement of variables is pivotal. Error in measurement of variable may lead to biased and inconsistent estimation of coefficients in regression analysis (Wooldridge 2003). Though there are several studies on DRPTs in developed countries, there is a dearth of systematic effort to develop a measurement for such discriminatory transactions except for one notable exception, the Anti-self Dealing Index by Djankov et al. (2008) which is a comprehensive index to measure DRPTs. However, this index is developed to measure minority shareholders protection from DRPTs at the country. For measurement at the company level, several researchers use the total dollar amount of related party transactions (RPTs) as a proxy for DRPTs (Gordon et al. 2004, Kohlbeck and Mayhew 2005, Kohlbeck and Mayhew 2010). Some other researchers use selected RPTs or some derivatives of related party transactions as a measure of DRPT (Cheung et al. 2009a, Cheung et al. 2006). However, all of these measures are based on weak theoretical underpinnings, and therefore are prone to high measurement error. As mentioned in a later chapter, empirical studies have to date found inconsistent relationships between/among DRPTs and other variables which may be due to poor construct validity of current DRPT measures. A precise DRPT measure with improved construct validity may resolve these anomalies in this area of literature.

1.2 Objectives and Significance of the Study

Considering the importance of minority shareholders protection from DRPTs and the deficiencies in the research in this area, the present study seeks to achieve the following objectives:
Objective 1:

To develop and validate a new measure for the concept, *discriminatory related-party transactions* (DRPTs), as an improved estimation of the extent to which controlling shareholders use RPTs to unfairly prejudice minority shareholders rights.

Objective 2:

To assess the effectiveness of the 2006 corporate governance reforms in Bangladesh in terms of the impacts of various governance mechanisms required by the reforms on minority shareholders’ protection from DRPTs by controlling shareholders.

Given the potential significance of the 2006 reforms for protecting minority shareholders from DRPTs, it is both timely and important to investigate the extent to which the reforms have been effective to curb DRPTs in Bangladeshi companies. The contribution of the research lies in the fact that no study has been done so far that investigates the post-reform governance practices of listed companies in Bangladesh in a way that seeks to evaluate the effectiveness of the reforms from the perspective of DRPTs. It is expected that this study will be informative to policy-makers in both Bangladesh and other developing countries in respect of the refinement of existing governance requirements/guidelines and their implementation by listed companies. It is also expected to contribute to the research literature on minority shareholder protection by establishing a more valid and precise measure of the discriminatory component of RPTs.

Measuring DRPTs is important both for theoretical and practical purposes. Minority shareholder protection has been recognised as a major factor associated with capital market development which, in turn, positively affects economic development. A sound measure of DRPTs at the country level can help international investors make their investment portfolio allocation decision among countries. At a company level, this measure helps investors’
decisions on the allocation of equity investments among companies. Apart from these practical implications, a more precise and valid DRPT measure can lead to improved modelling and testing of theoretical relationships between various corporate governance and other company-specific variables and the extent to which minority shareholders are discriminated against by controlling shareholders through the primary vehicle of RPTs.

1.3 Motivation of the Study

The significance of this study has been discussed above in terms of, first, identifying a deficiency in the literature concerning the measurement of the DRPT construct and, second, providing new evidence about the effectiveness of the corporate governance reforms in Bangladesh and, by inference, other developing countries. These two matters also form the motivation for this study.

To elaborate, the primary motivation is to make a contribution to the under-researched area of corporate governance that deals with minority shareholder protection. The importance of this area has been established due to the emergence of evidence that diffuse corporate ownership around the world is relatively uncommon and that most corporations are controlled by large blockholders (LaPorta et al. 1998, Holderness 2009, Berkman et al. 2009). Consequently, the primary concern of corporate governance has shifted from mitigating the agency conflicts between firm managers and diffuse shareholders (Berle and Means 1932, Jensen and Meckling 1976) to protecting minority shareholders from expropriation by the controlling blockholder(s) and their management team (Shleifer and Vishny 1997, Johnson et al. 2000). In developing economies where State-based organizations and/or families are large blockholders, the protection of minority shareholders should be regarded as a major
regulatory objective of those responsible for controlling the securities market (Tomasic and Neil 2007).

Underlying this primary motivation is the need for an improved measure in the literature of the extent of discriminatory actions by controlling shareholders against minority shareholders through related-party transactions. The measurements used in the literature for distinguishing between the discriminatory and non-discriminatory related party transactions have been weak in face validity and, in this sense, are high in measurement error. The construct validity of a measurement scale is a pre-requisite for making sound statistical inferences. Quantitative researchers using measures with high measurement error, due to the poor validity or reliability of the measure, are subject to bias and inconsistency in their results.

A further motivation for this study is that the findings can have practical consequences. First, they can provide insights to Bangladeshi capital market policy makers. Bangladesh, a south Asian country struggling for poverty reduction and economic development, has a smaller less developed capital market than its neighbouring countries (Siddiqui 2010). A more developed capital market can aid a country’s economic growth by turning domestic savings into investment as well as attracting foreign investment. Market economists provide argument and evidence of positive relationships between a developed stock market, economic growth and capital accumulation (Levine and Zervos 1998, Levine 1997). Investor protection is considered one of the key criterion for developing a capital market, serving to boost investor confidence particularly amongst minority shareholders (Atanasov et al. 2010, Black and Khanna 2007). Second, the findings of this study can potentially guide Bangladeshi economic policy makers on foreign investment. Land, capital, organization and labour are the four basic ingredients for production. Though Bangladesh lacks the first three, it has a comparative advantage in labour. With a total population of 160 million, Bangladesh’s labour cost on average is about one third of that in China (Chowdhury 2012). Bangladesh has a comparative
advantage in labour cost compared to many other countries in the world. Therefore, Bangladesh could develop its economy with the help of foreign investment and knowhow. Bangladesh has taken the initiative to attract foreign investments. But investor protection is crucial to attract foreign investment. If a country’s corporate governance and capital markets regulators cannot ensure that foreign investors’ money will not be eroded by illegitimate tunnelling of asset by local controlling shareholders, then foreign investors will be less likely to invest in that country. This research can shed light on what specific aspects of the 2006 reforms, if any, have been effective in limiting the extent of DRPTs in Bangladeshi companies, and what potential modification may be needed to make these reforms more effective.

1.4 Thesis Structure

This thesis consists of seven chapters. Chapter two surveys the focal literature on corporate governance reform and DRPTs. This chapter focuses mainly on literature from three topic areas: corporate governance reform, the phenomenon of tunnelling and RPTs, and measurement of DRPTs. The first part of this chapter discusses recent corporate governance reform around the world and the 2006 reform in Bangladesh. It also details the major reforms related to disclosure of RPTs around the world. The second part focuses on the concept and practice of DRPTs. It details the current literature on motivation and techniques for DRPTs by controlling shareholders and safeguards for preventing DRPTs in a corporation. The last part of the chapter details the current available measures of DRPTs and explains the rationale for development of a new measure.

The investor incentive scheme for foreigners includes tax benefit and other facilities for foreign investors. For example, full income tax exemption for foreign technician employed in foreign companies for three years, full repatriation of capital investment, Bangladeshi citizenship for investor of US$500,000 and permanent residency for investor of US$ 75,000 and so on. Bangladesh Bank 2012. 'Investment facilities.' http://www.bangladeshbank.org/investfacility/invesfac.php.
Chapter three explains the models used in this research, the rationale for their use and other related theories in this area of research. It then goes on to outline the research questions for the thesis and develops the quantitative models for answering those questions.

Chapter four is on the research methods of the thesis. It contains broadly two parts: quantitative methods using secondary data from company reports and the share market, and qualitative methods using primary data from the text of management interviews. Both sections discuss sample size, sample selection procedure, and other research methods. The quantitative section further explains parameter estimation methods and measurement of variables used in the various models in the thesis.

Chapter five is dedicated to the development of the new DRPTs measure. It explains the new measurement model, details the simulation procedure for testing it, and compares this new measure with a popular existing measure.

Chapter six presents the result of the study. It contains two sub-parts: quantitative results and qualitative results. The quantitative section explains the results of the model developed to answer the research questions. The qualitative section provides insight on one of the research questions which cannot be addressed using quantitative methods. Chapter seven concludes the thesis and provides directions for future research.
CHAPTER 2

REVIEW OF LITERATURE ON CORPORATE GOVERNANCE REFORMS AND RELATED PARTY TRANSACTIONS

2.1 Introduction

This chapter reviews relevant focal literature for the thesis. There are three main sections in this chapter: corporate governance reform, concepts and practices associated with DRPTs, and measurement of DRPTs. The first section reviews related literature on major corporate governance reform in countries around the world including Bangladesh and identifies the factors that influence violation of corporate governance safeguards for protecting minority shareholders. It shows the current evidence in the literature on how and why corporations do not comply with reforms. The second part reviews literature on DRPT focusing on motivators for DRPTs, safeguards against DRPTs, and quality and enforcement of DRPTs. The last section reviews the current measures for DRPTs and their limitations.
2.2 Corporate Governance Reforms

2.2.1 Reforms around the World

Corporate governance reform initiatives date back to the late twentieth century, for example, the Cadbury Report (1992) and Greenbury Report (1995). At the beginning of the 1990s, the abuse of power, fraud, and pilferage of minority shareholders assets by Robert Maxwell at Maxwell Communication and Mirror Group newspapers gave the impetus for corporate governance reform in the UK. The Cadbury Report (1992) is considered as the first systematic approach to explicitly documenting the best practices of corporate governance that were implicit in many UK companies (Solomon 2007). After the Cadbury Report, there were corporate governance recommendations from several committees, for example, Greenbury Report (1995), Hample Report (1998) and Turnbull Report (1999). None of these reports were legislative reforms and therefore compliance with them was not mandatory for companies.

Because of the demise of some giant corporations at the beginning of the twenty first century, mainly because of greed and power of some corporate management and controlling shareholders, many minority shareholders lost their investment in those companies. Many countries made legislative reforms of their corporate governance systems to protect investors, and others were influenced by international organization to reform their corporate sector. One of the major corporate governance reforms is the Public Company Accounting Reform and Investor Protection Act (popularly known as the Sarbanes Oxley Act, or SOX 2002). The winding up of Enron, the world biggest energy company, and the collaboration of its auditor Arthur Anderson in Enron’s governance malpractices, highlighted the need for US minority shareholders’ protection. SOX 2002 came into force in July 2002 and introduced several mechanisms aimed at protecting minority shareholders from DRPTs. These mechanisms included a ban on loans to executives and disclosures for purchase of securities by any directors or a shareholder holding more than ten percent shares. Apart from the specific
safeguards for DRPTs, SOX 2002 has some general safeguard. For example, it requires a listed company to appoint a majority of independent directors to its board, to require disclosure of CEO and CFO certifications about the fairness of financial statements prepared by management, to ensure the evaluation of the internal control system and the auditor’s attestation to this evaluation, to form an audit committee comprising independent directors, and to restrict external auditors in the provision of non-audit services.

Like Enron in the USA, the HIH demise is considered the biggest corporate collapse in Australia. The fraud by one of the controlling shareholders Rodney Alder and some top level management led to billions of dollars of losses to minority shareholders. The Australian response to this corporate collapse was the promulgation of the Australian Securities Exchange’s (ASX) Corporate Governance Guidelines 2003 and the Federal Government’s Audit Reform and Corporate Disclosure Act 2004 (arising from what is know as CLERP 9) (Hutchinson et al. 2008). Unlike SOX, CLERP 9-based legislation and ASX guidelines do not provide any specific safeguard from DRPT. However, they provide general safeguards for protection of minority shareholders. The CLERP 9-based legislation restricts the maximum hours of non-audit services by auditors, requires the CEO and CFO to give their opinion on proper compliance of accounting standards and maintenance of financial records of the company, and mandates directors to prepare a ‘Directors Report’ in the annual report in such a way that users can make assessment of the operation, financial position, business strategies and financial prospect for the next financial years. It further gives shareholders the right to participate in voting on the adoption of the remuneration report by directors and to ask questions about the remuneration report. Shareholders are also allowed to submit questions to the auditor about the audit. ASX guidelines add protection to minority shareholders on top of this legislation CLERP by requiring listed companies to appoint a majority of independent directors and have an independent chair of the board. The guidelines also require that the CEO and chair of the board should be two separate persons; companies should establish a
nomination committee for the directors and disclose the process for evaluating the performance of the board, its committees and individual directors. It also requires listed companies to establish an audit committee consisting of three non-executive directors, a majority of independent directors, and chaired by an independent director who is not the chair of the board. The ASX Corporate Governance Guidelines were released in March 2003 and there have been several subsequent amendments. The latest version of the guideline came into effect on 1 January 2011. Unlike CLERP 9, the ASX guideline has some flexibility in compliance. If a company cannot comply with any guideline, it should give an explanation.

Recently, UK corporate governance was changed from voluntary compliance to mandatory compliance from 29 June 2010. All UK and foreign companies listed on the London Stock Exchange (LSE) must follow Corporate Governance Code 2010; in the case of non-compliance, companies must explain the reason for that. Like CLERP 9-based legislation and ASX guidelines, the LSE’s 2010 code does not provide specific protection for DRPTs but gives several general protections for minority shareholders. The rule requires, among other thing, the role of chairman and chief executive should not be exercised by the same individual and forming an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. The reform mandates the chair of a board to discuss governance and strategy with shareholders and to ensure that the views of shareholders are communicated to the board as a whole and to arrange the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend.

Apart from the USA, Australia and the UK, other countries also reformed their corporate governance in the last decade to protect minority shareholders. Tareq et al. (2011) present recent reforms to protect minority shareholders in different countries. They report that many countries have increased the disclosure requirement in general and particularly disclosure of related party transactions. Many countries have reformed the related party transaction (RPT)
approval procedure, some countries now require shareholders’ approval of RPTs (e.g. Israel, New Zealand, Norway, Slovenia) while others have the requirement of pre-review of RPTs by an external independent party (e.g. Egypt, Tajikistan, Tunisia), and many countries have made it easier for minority shareholders to sue directors for misconduct (e.g. Germany, India, Mexico, Tanzania). These reforms are summarized in Table 2.1.

Table 2.1: Corporate Governance Reform around the World (2005-2010)

<table>
<thead>
<tr>
<th>2005-06</th>
</tr>
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<tbody>
<tr>
<td>Mexico, Peru, Poland, Romania, Sweden – increase disclosure requirement for companies.</td>
</tr>
<tr>
<td>Germany, India, Mexico, Tanzania – make it easier to sue directors.</td>
</tr>
<tr>
<td>China, Hong Kong and Tunisia – amend law to require companies to open books for shareholders inspection.</td>
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<tr>
<td>Israel and New Zealand – require approval by shareholders for related party transactions.</td>
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<table>
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<tr>
<th>2006-07</th>
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<tbody>
<tr>
<td>Belarus, Colombia, Georgia, Iceland, Indonesia, Vietnam – increase disclosure requirement.</td>
</tr>
<tr>
<td>Georgia, Mozambique and Portugal – define duties for directors and controlling shareholders.</td>
</tr>
<tr>
<td>Norway and Slovenia – require approval of shareholders for related party transactions.</td>
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<thead>
<tr>
<th>2007-08</th>
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<tbody>
<tr>
<td>Albania, Azerbaijan, Egypt, Saudi Arabia and Tajikistan – increase disclosure requirements.</td>
</tr>
<tr>
<td>Albania, Botswana, Greece, Slovenia, Kyrgyz Republic and Thailand – make it easier to sue directors by the shareholders.</td>
</tr>
<tr>
<td>Albania, Azerbaijan and Tajikistan – require approval of related party transactions by shareholders. Egypt introduces prior review of related party transaction by external party.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2008-2009</th>
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</thead>
<tbody>
<tr>
<td>Dominican Republic, Indonesia, Macedonia, Rwanda, Sierra Leone, Tajikistan, Tunisia and Ukraine – increase disclosure requirement.</td>
</tr>
<tr>
<td>Dominican Republic, Macedonia, Rwanda, Sierra Leone, Tunisia and Ukraine – require shareholders’ approval for related party transactions. Tajikistan and Tunisia - introduced prior review of related party transactions by external party.</td>
</tr>
</tbody>
</table>
Colombia, Dominican Republic, Macedonia, Rwanda and Tajikistan – make it easier to sue directors. Dominican Republic and Rwanda - allow access of company book by shareholders.

2009-10

Kazakhstan, Morocco, Swaziland and Tajikistan – reform for higher disclosure by companies.

Chile, Swaziland and Sweden – require approval of related party transaction by shareholders. Sweden – also requires prior review of related party transaction by external parties.

Georgia, Swaziland and Tajikistan – make it easier to access corporate information.

Source: Tareq et al. (2011)

2.2.2 Reforms of 2006 in Bangladesh

The corporate governance reforms of 2006 in Bangladesh were initiated by the World Bank and IMF (Siddiqui 2010). Though Bangladesh has a history of extreme minority shareholder oppression by controlling shareholders (Uddin and Choudhury 2008), Bangladesh did not have a well formulated corporate governance guideline before the reform. According to section 45(1) of the Bank Company Act 1991, Bangladesh Bank (the central bank of Bangladesh) issues circulars for monitoring and regulating banks. Bangladesh Bank has issued several corporate governance circulars for commercial banks. However, some of these circulars were never followed by the commercial banks because of the influence of powerful founder shareholders. For example, BRPD circular no. 12 of 2003 requires commercial banks to have a maximum of 13 directors on their board and sets the maximum tenure of directors at six years (Bangladesh Bank 2003). However, powerful sponsor directors in many banks ensure banks seldom follow that guideline, have more than 13 directors on their board and directors hold their office for decades (Ahmed 2012a). Some guidelines may be followed but these have not been compatible with international guidelines and are seen to be ineffective in protecting minority shareholders. For example, BRPD circular no 12 of 2002 requires every commercial bank to form an audit committee without any requirement of independence and qualification of the members (Bangladesh Bank 2002a). The corporate governance guidelines
2006, which have similarities with other big reforms in the USA, Australia and UK, is the first initiative to bring good governance in the corporate sectors in Bangladesh. These 2006 guidelines had the potential to protect minority shareholders from DRPTs. This legislative reform was influenced by international agencies to make Bangladesh’s corporate sector compatible to the developed world (Siddiqui 2010).

Although some studies have been undertaken into corporate governance both during and after the implementation of the 2006 reforms in Bangladesh, with the exception of two studies (Siddiqui 2010, Azim and Rahman 2008) none of the research focuses on the 2006 corporate governance reforms. For example: Amin and Tareq (2006) look at corporate governance disclosure; Imam and Malik (2007) investigate the link between ownership structure and firm performance; Farooque et al. (2007) examine the effect of board ownership on firm performance; Uddin and Choudhury (2008) explore the suitability of the Anglo-American model of corporate governance in a less developed country like Bangladesh; Azim (2010) investigates the link between corporate monitoring mechanism and firm performance; and Kabir et al. (2011) examine the effect of big four audit affiliation on accrual quality of listed companies.

Azim and Rahman (2008) study the 2006 reforms using corporate governance compliance reports in the annual reports of listed companies. Their study mainly focuses on how many companies complied with the reform requirements in the first year of implementation. They also explain the reforms’ importance for the Bangladeshi corporate sector. However, they do not evaluate the 2006 reforms’ effectiveness.

In his study of the 2006 reforms, Siddiqui (2010) questions the suitability of the reforms in Bangladesh. His view has similarities with Mukherjee-Reed (2002) and Uddin and
Choudhury (2008) who opine that western style corporate governance is unsuitable for developing countries. Using DiMaggio and Powell’s (1983) institutional isomorphism perspective, Choudhury (2008) argues that coercive and mimetic pressures have influenced corporate governance reform. His contention is that the stockholder model of corporate governance implemented in Bangladesh is not consistent with the country’s socio-economic condition. Siddiqui proposes instead the stakeholder model for the Bangladeshi corporate sector. The main difference between the stockholder model and the stakeholder model lies in the philosophical position concerning in whose interest a company should act when doing business. According to the stockholder model, a company should serve the interests of the stockholders. In contrast, the stakeholder model posits that a company should be run in the best interests of its stakeholders. Siddiqui goes as far as to propose that there should be a representative from a bank and a labour union on the board of directors to implement a stakeholder based model, arguing that:

*Bangladesh has not been affected by the first phase of [the] global financial crisis, it is probable that it will be affected by the second phase of the crisis and export and remittances will suffer. This will deteriorate the unemployment rate, [the] wage rate and will affect [the] financial sector. Therefore, to protect the interest of employees and banks, there should be representatives from them in the corporate board (Siddiqui 2010: Page 270).*

However, this argument is weak for two reasons. First, the corporate governance model of a country cannot be based on a temporary phenomenon like the global financial crisis, significant though that may be. Second, the proposal to adopt a stakeholder based model is based on the researcher’s fear of a future economic downturn in the country's prosperity. Moreover, his argument lacks any empirical evidence and does not consider the fact that without proper enforcement corporate governance safeguard is not effective.
2.2.3 Background of the Reform 2006

As mentioned in the earlier section, the 2006 corporate governance reforms in Bangladesh were initiated by the World Bank and IMF. The background of the international agencies initiative is associated with the context of Bangladesh’s socio-economic condition, its historical background, and its growing importance and integration to the world economy.

Bangladesh was a British colony for 190 years before it became independent from colonial rule in 1947 along with India and Pakistan. The Indian subcontinent which comprised of India, Pakistan and Bangladesh was divided in two countries based on religion: India and Pakistan. Bangladesh being a place with majority Muslim became a province of Pakistan. But after 24 years of economic and political discrimination and dominance of Pakistan, Bangladesh became an independent country through a bloody nine months long war in 1971. However, its political turbulence continued after independence. It was mainly governed by military rulers till 1990 when democratic government came to power through an election. It gradually started connecting with the rest of the world through open market economic policy in relatively more stable political condition than earlier. Its economy has grown at around 6% p.a. in recent years, specially its textile sector viewed as a tremendous development with the leverage of cheap labour. Many developed countries are now linked with Bangladesh as the buyer of textile products. Bangladesh is now the second largest garment exporters in the world followed by China. Moreover, many foreign investors have invested in textile and other sectors to use the cheap labour of Bangladesh. Therefore, its connection and integration with the rest of the world has increased a lot in recent years.

Despite the trade and investment integration with other countries, the corporate sector in Bangladesh is in its infancy. The development of local corporate business in Bangladesh is very recent. Most of the big corporations were owned by Pakistan before independence in 1971. After independence, Bangladeshi entrepreneurs started to set up their own corporate
businesses. Many multi-national companies have also opened their branches in Bangladesh. However, the local public corporations have yet to develop a pervasive corporate culture. Most of the local public companies are still run for the sole interest of founder shareholders. The minority shareholders’ interests are often ignored in corporations, and the SEC – the monitoring agency for public corporation – is weak (Kabir et al. 2011).

Historically Bangladesh has suffered from various socio-political problems such as corruption, dominance and discrimination in society, as well as poor governance in private and public sectors in the pre- and post- independence periods (Belal and Cooper 2011). But Bangladesh lacks resources and expertise to solve these problems by itself alone. Development agencies including the World Bank and IMF are working in Bangladesh to mitigate these problems for the development of the country. In the backdrop of the growing integration of the Bangladesh economy with rest of the world and dependence on international assistance, the World Bank and IMF initiated the corporate governance reform in 2006 through the SEC. The intention of the reform was to align the corporate governance of Bangladeshi companies with that of the developed countries.

2.2.4 Decoupling in Reform Compliance
The above two sections describe different corporate governance reforms around the world, including Bangladesh, to protect minority shareholders. However, the appearance of adoption of reforms by corporations may be achieved, even though actual practice is only loosely coupled to the formal requirements of the system concerned. Deviation of real practice from prescribed practice is common in organizations (Uddin and Choudhury 2008, Tilesik 2010).

The degree of potential power and the opportunity for private benefits of controlling parties in an organization are two major factors that can prevent that organization from adopting reform.
As an illustration, state and local government accounting was reformed in the US in 1979. This reform required all state and local governments to change their exiting cash-based accounting to an accrual basis. The state of Delaware pretended to accept and used the accrual accounting system for years while using cash-based systems till the early nineties. Powerful bureaucrats in the Delaware state government used this strategy for their self-interest (Carpenter and Feroz 2001). Similar deceptive behaviours are seen in the adoption of corporate governance practices too. In the 1970s and 1980s a substantial number of large US firms adopted long term compensation plans for CEOs but did not actually put them into practice (Wetphal and Zajac 1994). A long term performance-based compensation plan is designed to align the CEO’s and shareholders goals. The long-term compensation plan has the effect of curtailing the power of CEOs to manipulate quarterly or annual performance reporting and, therefore, their compensation bonuses. Power and self-interest had allowed company CEOs to manipulate performance-based compensation plans in the 70s and 80s. Such opportunistic management behaviours in organizations are sometimes so deep rooted that it persists even after major governance reform. For example, during the Soviet Union’s regime, funds were allocated to government organizations according to discretionary decisions of powerful bureaucrats, which were not transparent. After the fall of the communist regime, Russian organizations introduced a transparent formula for allocating budgets to different subsidiary organizations. However, because of the influence of powerful bureaucrats, organizations continued to use the old system and adopted the new transparent systems merely symbolically (Tilcsik 2010).

Many corporations in Bangladesh are run by politically-connected powerful members of the sponsor’s family who make all major decisions, while following state laws as a matter of formality (Uddin and Choudhury 2008). The effectiveness of the 2006 corporate governance
reforms lies in their potential to curtail the opportunistic behaviour of controlling
shareholders, usually a controlling family group.

An annotated summary of decoupling of laws and regulations from their implementation is
given in Table 2.2. A common finding arising from these studies is the deviation of real
practice from required practice which is common in many organizations. This deviation is
mainly due to the high power and private benefits of the powerful actors (i.e. controlling
shareholder-director, chairperson, CEO) in the organizations.
<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Country</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wetphal and Zajac (1994)</td>
<td>USA</td>
<td>This paper investigates CEOs’ influence on board for adopting long term compensation plan for CEOs. Using data collected from 570 big US firms, the researchers find that substantial number of firms adopted long term compensation plan of CEOs but did not actually practice that for three reasons: power of CEOs to enhance their legitimacy while minimizing risk in their compensation contract, stakeholder impression management and the increasing legitimation of long term compensation contract.</td>
</tr>
<tr>
<td>Carpenter and Feroz (2001)</td>
<td>USA</td>
<td>This paper investigates how the four US state governments, New York, Michigan, Ohio, and Delaware, response to the reform of accounting system from cash basis to accrual basis. Interviewing several key state government officials of the four state governments, the researchers report that three of the state adopted the accrual accounting system. Delaware state government, however, used a manipulative strategy of pretending to accept the new change but practicing the old one to protect the interest of the powerful bureaucrats in that state government.</td>
</tr>
<tr>
<td>Author(s)</td>
<td>Country</td>
<td>Findings</td>
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<tr>
<td>Fiss and Zajac (2004)</td>
<td>Germany</td>
<td>This study investigates factors that influenced the adoption of US style shareholder value based corporate governance system in Germany in 1990s and whether the firms really practiced the US corporate government system or decoupled from the real practice. Using data from 1990 to 2000 of 112 companies the investigators find that owners groups (e.g., banks, institutional investors, governments, and families) and CEO education are positively related to US style corporate governance adoption in German. The researchers also find that German firms decouple from the standard governance system.</td>
</tr>
<tr>
<td>Tilcsik (2010)</td>
<td>Russia</td>
<td>This paper investigates why organizations deviates actual practice from rules in Russia. Using interviews and document analysis the researchers reports that ideology and personal interest of powerful organizational member leads to deviation of actual practice from organizational rules in Russia.</td>
</tr>
</tbody>
</table>
2.3 Discriminatory Related Party Transactions

2.3.1 Different DRPTs for Private Benefit

In the above section, it is suggested that controlling shareholders, particularly influential founder families, would be able to continue their legacy of attaining excess private-benefit from the company as they had been doing in the pre-reform period. The most widely research method through which controlling shareholders can expropriate private benefits from their company is transactions with related-parties. Such transactions can ‘tunnel’ the company’s cash and assets to related parties by way of non-arm’s length company sales at a discount, purchases at a premium, loans at no/low interest or private equity placements at a discount. Selling an asset at lower price or acquiring an asset at higher price from related parties of the controlling shareholders will benefit controlling shareholders while causing a reduction in the company’s profitability, net cash position and net assets, thereby, unfairly prejudicing the company’s returns to and net wealth for minority shareholders.

Prior studies have provided evidence of this discriminatory practice. Examples of this phenomenon are found in several studies. First, the study by Cheung et al. (2009b) finds that listed companies in Hong Kong sell assets to related parties at much lower price than similar arm’s length transactions; and when these companies buy asset from related parties they pay more than market price. A similar scenario is revealed by Ge et al. (2010) in China that shows Chinese listed firms sell assets to related parties at unfavourable terms which affects their market value. Companies buy/sell not only assets but also goods at favourable terms to related parties. Empirical research shows that companies give favourable terms to related parties in selling at a price below fair value, and purchase of goods at a price above fair value, for the
benefit of controlling shareholders at the cost of minority shareholders (Cheung et al. 2009a, Cheung et al. 2006).

Second, related party lending is another common way of private benefit for controlling shareholders in developing countries. The study by Silanes et al. (2003) shows that Mexican banks loan to a related party enjoys on average about four percent lower interest rate and lower credit worthiness than that other loans. Jiang et al. (2010) finds evidence of non-arm’s length deals in related party loans in China. The study reveals that Chinese firms related parties’ loans significantly affect their market value, which indicates Chinese companies provide favourable loan terms to related parties. A similar picture is unveiled by Kahle and Shastri (2004) in the USA and Gallery et al (2008) in Australia.

Third, controlling shareholders may resort to private placement of equities for private benefit. Private placement of equity is shares issued to a particular investor(s) generally chosen by the controlling shareholders of a company. In the case of a private placement the controlling shareholders may sell shares to a related party at a lower price than the market (for listed companies) or the net asset value of the company (for private companies and non-listed companies) which not only changes the ownership structure but also tunnels out resources at the expense of the minority shareholders. A recent investigation by the Ministry of Finance in Bangladesh demonstrates that there had been significant transfer of shareholders wealth from companies to controlling shareholders through private placement of shares at prices significantly less than the market price (Ministry of Finance Bangladesh 2011).

See Table 2.3 for a summary of relevant empirical studies on this phenomenon of DRPTs.
Table 2.3: Summary of Salient Research on Different Types of DRPTs

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Country</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Silanes (2003)</td>
<td>Mexico</td>
<td>Analysing 1500 sample loans of 17 Mexican banks, the researchers find that loan to related party enjoys on average about four percent lower interest rate and have lower credit worthiness than that of other loans.</td>
</tr>
<tr>
<td>Gordon et al. (2004)</td>
<td>USA</td>
<td>Using 878 transactions from 112 publicly traded companies the study shows nature and type of RPTs in the US. The result shows the maximum number of the related party transactions is with non-executives directors followed by chair of the board. The transactions types are: goods or service provided or received, sale or purchase of asset, loan and investment with related parties.</td>
</tr>
<tr>
<td>Kahle and Shastri</td>
<td>USA</td>
<td>The result finds that loan given to executives have interest rate below the market rates. This suggests tunnelling minority asset by RPT loans.</td>
</tr>
<tr>
<td>Gallery et al. (2008)</td>
<td>Australia</td>
<td>Using companies listed on ASX the researchers conclude that controlling shareholders tunnel out resources from company through related party payments and loans.</td>
</tr>
<tr>
<td>Chueng et al. (2009b)</td>
<td>Hong Kong</td>
<td>Comparing 254 related party and arm’s length transactions the researchers show that companies in Hong Kong sell assets to related parties at much lower price than similar arm’s length transaction. But when these companies buy asset from related parties they pay more than market price.</td>
</tr>
<tr>
<td>Author(s)</td>
<td>Country</td>
<td>Findings</td>
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<tr>
<td>Ge et al. (2010)</td>
<td>China</td>
<td>Using data from top 100 listed firms in China, the researchers show that Chinese firms tunnel out minority shareholders asset through sale of goods and assets to related parties.</td>
</tr>
<tr>
<td>Jiang et al. (2010)</td>
<td>China</td>
<td>Using a data of 1377 firms from 1996 to 2004 the researchers find that Chinese firms’ loans to related parties significantly affect market value of those companies.</td>
</tr>
</tbody>
</table>
2.3.2 Other Techniques for Private Benefits by Controlling Shareholders

Though related party transactions are primarily used by controlling shareholder for their private benefit, literature shows that they (controlling shareholders) sometimes use some other techniques for their private benefit which discriminate minority shareholders. These techniques are described in this section.

The seminal finance theory of Miller and Modigliani (1961) states that in a well-functioning market and tax and transaction costless world, the dividend payout ratio has no effect on corporate value. In practice the dividend decision is made taking into consideration many factors, for example, the effect of the dividend rate on share price, the tax effects of paying dividends and so on. Of late, researchers have seen the dividend payout decision as a means of expropriating from minority shareholders (Faccio et al. 2001, La Porta et al. 2000). Controlling shareholders (who in many cases are the directors of a company or control the directors of a company) keep the dividend payout ratio low to retain profit within the company. This retained profit can be used by controlling shareholders to invest in projects that yield private benefits, or to tunnel monies out to firms where they have higher ownership. This idea is supported by the empirical finding which shows that dividend rates are lower in countries where there are more controlling shareholders and more family firms—for example, in Asian countries (Faccio et al. 2001); on the other hand countries with higher legal protection for minority shareholders, such as common law countries, have higher dividend payout ratios than civil law countries (La Porta et al. 2000). The investigation by the Ministry of Finance of Bangladesh reveals that many companies do not provide cash dividend to shareholders even through in their opinion they have enough liquidity for paying out dividend. Many companies give stock dividends to shareholders just to maintain the market price high (Ministry of Finance Bangladesh 2011).
Propping up a company is another technique which has potential to discriminate minority shareholders. Though propping transactions apparently seems to be beneficial to minority shareholders, the benefit of transactions are complex to judge because of the clandestine nature of the transaction (Friedman et al. 2003, Dow and McGuire 2009). Moreover, propping may be motivated by the controlling shareholders’ future expropriations (Bertrand et al. 2002). Therefore, propping transactions have the potential to benefit controlling shareholders at the cost of minority shareholders. Dow and McGuire (2009) study propping in Japanese firms. The study is based on a data set on Japanese companies from 1991 to 2001 in mainly Keiretsu groups. Many Japanese companies belong to Keiretsu – a type of business group many of which date back to pre - World-War II. Stronger firms in a Keiretsu prop up weaker firms during recessions and tunnel out resources in a good economic environment through related party transactions (Dow and McGuire 2009).

Discriminatory terms and conditions for minority shareholders is another ways to discriminate minority shareholders. For example, shareholders in many countries have the pre-emptive right to participate in a right Share or new equity issue by a company. However, sometimes conditions for exercising a pre-emptive right are so strict that minority shareholders cannot participate in an equity issue. For example, in Bulgaria minority shareholders could participate in a new equity issue before 2002. However, at that time the condition to exercise their pre-emptive right in new equity issues was strict. The notice period for purchasing a new issue was short and the equity was non-tradability. Therefore, many minority shareholders could not participate in the new equity issue even if the issue was at a discount. Controlling shareholders used to purchase a majority of the equity issued at a discount and thus ownership of existing shareholders become diluted and their stake in the company was eroded. The 2002 amendment of Bulgarian security law requires companies to issue one warrant for each share, to give shareholders at least one month to exercise their right and to allow trading of those
warrants in the stock market. These amendments allowed more minority shareholders to participate in equity issues in Bulgaria and restricted controlling shareholders from diluting minority stakes in Bulgarian companies (Atanasov et al. 2010). The 2002 pre-reform period in Bulgaria has a similar effect to the attempt to sue controlling shareholders by minority shareholders in Bangladesh. The terms and conditions for suing controlling shareholders by the minority shareholders are so strict that they (minority shareholders) virtually can never sue controlling shareholders for their discriminating behaviour against them. According to Section 233 of the Company Act 1994, minority shareholders in aggregate must have at least 10% of the company’s shares in order to appeal to the court if they think that any decision is taken against their interest, or the company is run against their interest. This percentage of shareholders is so high that it makes controlling shareholders immunized from any legal actions by minority shareholders.

2.3.3 Conditions that Motive DRPTs

When controlling shareholders face lower cash flow rights and greater power (or voting control), then they will be experiencing two primary conditions that will motivate them to engage in DRPT practices. Formally, a 50%+ share of a company is required to control it. However, in reality, a 20% (or even 10%) ownership of a company can be sufficient to control its board and top management decisions. For example, Bill Gates (23.7%) of MicroSoft Corporation, Mark Zuckerberg (22%) of Facebook, Mitsui Group (12.1%) of the Toyota Motor Corporation, Deutsche Bank (24.4%) of Deamler-Benz AG are all perceived as controlling shareholders. Such powerful shareholders are found to retains control in three ways: issuing dual class share, creating a pyramid ownership structure, and having crossholdings (Bebchuk et al. 2000, Johnson et al. 2000). Using these controlling mechanisms, a shareholder can gain control of a company with a minimum of cash flow rights. This
discrepancy between control and cash flow rights motivates controlling shareholders to expropriate minority shareholders’ rightful cash and assets through related party transactions (Bertrand et al. 2002, Bebchuk et al. 2000, Jiang et al. 2010). These three mechanisms for control are further explained below.

(i) **Cross holding.** If firm $F_1$ and $F_2$ hold $n\%$ of share of each other, then shareholder $S$ can have majority control of both companies by having $(51-n)\%$ of shares of each company.

![Figure 2.1: Control by crossholding of share](image)

The cross holding of shares among companies is a mechanism of more control with less cash flow right. There is evidence that these cross holding firm structures are conducive to DRPTs (Dow and McGuire 2009, Bertrand et al. 2002). Industrial groups, for example, Japanese Keiretsu and Korean Choibol, are examples of cross holding of shares among related companies.

(ii) **Dual class share.** Control can be retained by issuing dual class shares. Controlling shareholders can issue shares with reduced or no voting rights to outside shareholders and thus can finance the company without losing control. Dual class shares allow controlling shareholders to fully control a company holding only a low percentage of cash flow right in a company. This disparity between control and ownership creates a conducive atmosphere for DRPTs by controlling
shareholders (Nenova 2003, Dyck and Zingales 2004). For example, the dual class share in News Corp. allows Rupert Murdoch to own 39% voting shares with only 15% ownership of the company.

(iii) **Pyramidal ownership.** This is a mechanism for controlling many companies by just holding controlling shares of the parent company and creating subsequent subsidiary companies. For example, if a shareholder, $S$, owns at least 51% of company $F_1$ and $F_1$ holds at least 51% of $F_2$, and $F_2$ holds at least 51% share of $F_3$, then $S$ also controls $F_2$ and $F_3$ holding 26.01% share of $F_2$ and 13.27% share of $F_3$. This way $S$ can control firms by holding less shares down the chain. $S$ can have majority control over $F_n$ firm just by holding at least $(0.51)^n$ shares of that company.

![Diagram](image-url)

**Figure 2.2: Control by Pyramidal ownership**
Therefore, with a small number of shares, one party can control other companies by using a pyramidal ownership structure. Enriques and Volpin (2007) find that powerful shareholders use the pyramidal structure to control a company with far less cash flow rights in that company. For example, in Italy, using the pyramidal ownership technique, Tronchetti Provera controls 18 percent of votes in Telecom Italia with only 0.7 percent cash flow rights in the company. This excess of voting control over cash flow rights motivates controlling shareholders to engage in self-interested transactions that supplement their cash flow rights (Riyanto and Toolsema 2008).

2.3.4 Safeguards for DRPTs in Corporate Governance Reform

Protection of minority shareholders from DRPTs and other oppressive and prejudicial behaviour of controlling shareholders is the main intention of corporate governance mechanisms that deal with the principal-principal problem, rather than the more common principal-agent problem. The common corporate governance safeguards against DRPTs and other discriminatory behaviour by powerful individuals are: competitive market mechanism, independent board members, the audit committee, an independent external auditor, and minority shareholders’ participation in financial decisions of the company that directly affect them. Many countries now require companies to install these safeguards though corporate governance reforms. Each type of safeguard is discussed in turn below.

(i) Market Mechanism

Market mechanisms can protect minority shareholders from controlling shareholders discriminatory behaviour, including DRPTs. Market mechanisms, such as a hostile takeover, can remove inefficient or corrupt management from corporations. Furthermore, the market can signal inefficiency and discriminatory behaviour of controlling shareholders by affecting the share price negatively. Market mechanisms could allow tunnelling out of resources by
taking excessive compensation (Borokhovich et al. 1997) and causing inefficiencies in the labour market for executives (Garvey and Gordon 1999). For efficient functioning of securities and labour markets, information asymmetry among corporate stakeholders needs to be reduced. Credibility of publicly available corporate information is pivotal. Stakeholders who use information for decision making may be mislead by biased or even fraudulent information that can distort the market. While an efficient market is a means of safeguarding minority shareholders from discriminatory transactions of controlling shareholders, in many countries (especially in developing countries) the securities market does not have the size, diversity or enforceability of regulatory controls to be efficient. Therefore, these securities markets seldom give strong protection to minority shareholders from the discriminatory behaviour of controlling shareholders.

(ii) Managements’ Legal Liability

There is an incentive for managers to distort and/or hide information to achieve bonus payments for themselves (Watts and Zimmerman 1978, Watts and Zimmerman 1986). Likewise, there is an incentive for controlling shareholders to distort or hide information for their private benefit (La Porta et al. 2006). However, the controlling shareholders or top executives may not be brought to justice if they deny their association with any misconduct concerning the supply of information. Considering the importance of the certification by directors and top executives of corporate information disclosures, many countries have introduced requirements for certification of financial statements and assessment of internal control systems by top management. Section 302 of SOX requires chief executive officer’s (CEO) and chief financial officer’s (CFO) certification about the true and fair presentation of accounting information and maintaining a sound internal control system in the organization. Like SOX, CLERP 9 increases the responsibility of top management and directors in Australia. Two sections of the Corporations Law brought these new changes: Section 295(A)
and 299(A). According to section 295(A), the CEO and the CFO are required to give their opinion on the proper maintenance of financial records in the company, on the true and fair view of financial statements and on compliance with accounting standards and other related laws in the preparation of financial statements. Section 299(A) of the law requires directors to prepare the ‘Directors Report’ of the annual report in such a way that users can make assessment of the operations, financial position, business strategies and financial prospects for the next financial year.

Like SOX in the USA and CLEPR 9 in Australia, the reform of 2006 in Bangladesh stipulates that directors should certify on the soundness of the internal control system, the appropriateness of accounting policies and accounting estimates, the application of the International Financial Reporting Standards (IFRSs) in the preparation of financial statements, and the fairness in presentation of the financial statements by management. Prior evidence indicates that the evaluation and certification of the internal control system increases the information quality in the US (Doyle et al. 2007, Iliev 2010) and in Australia (Hutchinson et al. 2008). However, no studies to date have directly investigated the relationship between the certification of internal controls and the incidence of DRPTs.

(iii) Independent Directors

The issue of the independence of directors, which can perhaps be traced back to the US Investment Company Act 1940, has been a theme of many corporate governance advocates (Farrar 2001). Independent directors neither hold executive positions nor have any pecuniary relationship with the company where they sit on the board. Therefore, they work as watchdogs of discriminatory behaviour including DRPTs of controlling non-independent directors. Past empirical studies support this idea. Most past studies document that
independent directors reduce DRPTs significantly. For example, Gallery et al. (2008), Gao et al. (2008), Dahya et al. (2008) and Cheung et al. (2009a) find an inverse relationship of related party transactions (RPTs) with number of independent directors on the board. However, Chung et al. (2006) find no relationship between the two.

Considering the importance of independent directors in the protection of minority shareholders, many countries now require some independent directors on a listed corporation’s board. US public companies must have a majority of independent directors on their board. ASX guidelines add protection to minority shareholders by requiring listed companies to appoint a majority of independent director on their board.

The corporate governance reform of 2006 in Bangladesh mandates the appointment of at least ten per cent, or at least one, independent director on the board. This number is not comparable to that in corporate governance guidelines on independent directors in most other reforms. There is no study that evaluates the effect of independent directors in curbing DRPTs in Bangladeshi corporations.

(iv) Audit Committee

Audit committees were first introduced in the USA in 1978 as a general requirement by the recommendation of the New York Stock Exchange and the SEC (Farrar 2001). The main responsibility of an audit committee is to monitor the integrity of the financial affairs of a company. Independence and competence, among other attributes, are required for proper functioning of an audit committee. Research suggests that having an effective independent audit committee can significantly improve information quality (Xie et al. 2003, Davidson et al. 2005, Hutchinson et al. 2008) and financial integrity (Lary and Taylor 2012, Abbott et al. 2004, Farber 2005). Therefore, an independent and capable audit committee is effective in improving the financial integrity and financial information quality of companies.
Though researchers have studied the effects of audit committees on financial integrity and financial statement quality, there is a lack of studies on the relationship between DRPTs and audit committees. It can be claimed that DRPTs are unscrupulous business transactions. Therefore, if the audit committee is fulfilling its role of monitoring financial integrity, it should prevent DRPTs in an organization. Two notable studies have investigated the effect of an audit committee on DRPTs; however, their results are inconsistent. The study by Cheung et al. (2006) finds an inverse relationship, whereas the study by Gallery et al. (2008) does not find any relationship between the two.

Many countries now require audit committees to be composed of members with specific attributes in public listed companies. For example, SOX 2002 requires that each member of the committee be independent and the committee have a member who is a financial expert. After SOX 2002 the audit committee’s responsibilities were increased to embrace looking after the overall financial function of the company (Gorman 2009). In Australia, ASX corporate governance reform requires each listed company to establish an audit committee that consists only of non-executive directors, and has at least three members with a majority of independent directors. It requires that the committee is chaired by an independent director who is not the chair of the board. Reform in the UK has mandated that listed companies establish an audit committee of at least three (in the case of smaller companies two) independent non-executive directors.

The reform of 2006 in Bangladesh stipulates that the board of directors should form an audit committee of three board members including an independent director and the chair of the committee must have knowledge or expertise in accounting or finance. It further stipulates that the committee should assist the board of directors in ensuring that the financial statements reflect a true and fair view of the state of affairs of the company and that the business has a good internal monitoring system. Though past research on the relationship between the audit
committee and DRPTs is inconclusive in Western countries, there is no literature on audit committees as a safeguard to protect minority shareholders from DRPTs in a developing country like Bangladesh.

**(v) Separation of CEO and Chair of the Board**

There is divided opinion about the separation of the CEO and chair of the board. Those who are against the separate role argue that the dual responsibility by a single individual is beneficial for a company as it establishes a strong and an unambiguous leadership in a company (Finkelstein and D'Aveni 1994). On the other hand, scholars who support the separation of the CEO and chair of the board argues that boards of directors are less effective when the chief executive is also the chair of the board because of the absence of decision management and decision control (Jensen 1993). To maintain a balance of power in a company, the chief executive officer (CEO) and chair of the board should be held by two individual persons and companies should clearly define the role and responsibilities of board and CEO.

Although scholars are divided in their opinion on the separation of CEO and chair of the board, many corporate governance guidelines require corporations to have two separate individuals to hold these positions. For example, the corporate governance guidelines code of 2010 in the UK requires the chairman and chief executive position should be held by two separate individuals and the division of responsibilities between them should be clearly established, set out in writing and agreed by the board. The ASX guidelines also require the same.

Researchers have extensively studied the effect of CEO and Chair duality on firm performance (Rechner and Dalton 1991, Daily and Dalton 1992, Gompers et al. 2003). However, there is an absence of studies on the effect of duality and DRPT, with two notable
exceptions: Cheung et al. (2006) in Hong Kong and Gallery et al. (2008) in Australia. However, neither of these studies finds any relationship between these two.

In Bangladesh a separate CEO is required in the reform. In the pre-reform period, many companies did not have separation of CEO and Chair. Moreover, CEOs in many companies were family members of the sponsor director (Farooque et al. 2007) which may be changed after the reform. However, there is no study on the current status of the separate CEO and chair, nor is there any study on the effect of separation of the CEO and Chair position on DRPTs in Bangladeshi companies.

(vi) Independent External Auditor

External auditors can act as a safeguard for minority shareholders, in the sense of giving an audit opinion on the true and fair view of the financial statements prepared by management. However, apart from providing this statutory audit service, auditors can provide non-audit services to clients. This develops economic dependence of the external auditor on the client. Auditor’s independence is pivotal in giving their opinion about the true and fair view of a client’s financial statements. Auditor’s independence may be compromised because of economic dependence on their client (Mautz and Sharaf 1961, Frankel et al. 2002a, Gul et al. 2007). Many countries now restrict non-audit services by external auditors. For example, SOX brought several reforms to the auditing profession. Section 201 of SOX prohibits providing several non-audit services to client: bookkeeping and accounting service, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing services, management functions and human resources, broker or dealer, investment adviser, investment service, legal and expert services unrelated to the audit. Under section 203 SOX also requires lead partner rotation every five years to prevent economic dependence on the client and a one year cooling off period for audit team.
members to be hired in a financial reporting role of a company. Unlike SOX, CLERP 9 in Australia does not ban non-audit service to audit clients but restricts it to a maximum of ten hours. When an auditor provides non-audit services, CLEPR 9 requires directors to explain that the auditor’s independence is not impaired and to disclose the amount of fees paid for non-audit services.

Some past findings support the idea of association of non-audit services and audit quality (Ashbaugh et al. 2003, Antle et al. 2003, Frankel et al. 2002b). However, some scholars disagree with this view (Arrunada 1999, Wallman 1996). Wallman (1996), for example, argues that non audit service does not compromise audit quality, rather it helps auditors’ work. Whether it helps or not, many empirical studies fail to establish the inverse association between non-audit services and audit quality (Kinney et al. 2004, Bloomfield and Shackman 2008).

Though the association between auditors’ non-audit service and audit quality has been studied widely, there is no study that investigates the effect of non-audit service on DRPTs. A few researchers have studied the effect of Big5/Big4 of audit firms on DRPTs (Cheung et al. 2009a, Gao and Kling 2008). Larger firms have less incentive to compromise their integrity and are more concerned about their reputation than smaller firms (DeAngelo 1981). Therefore, they are expected to be a better safeguard for DRPTs in an organization. However, the results of these studies are inconsistent. The study by Gao et al. (2008) finds an inverse relationship between the two, whereas Cheung et al. (2009) finds no relationship.

In Bangladesh in the pre-reform period, the independence requirement for the external auditors was mainly determined by Section 212 of the Company Act of Bangladesh 1994 which stipulates that an employee of the company, a person who is indebted or guarantor of
another person’s loan to the company for an amount exceeding one thousand taka (about A$15), a director of the company, a partner of a firm which is the managing agent of the company and share holder of exceeding five percent in nominal value of the subscribed capital of the company cannot act as an external auditor of a company. The independence required in the Company Acts is lenient and does not restrict any non-audit service by the external auditors of companies. Moreover, there is no separate body for monitoring the external auditors in Bangladesh, like Public Company Audit Oversight Board (PCAOB) in the USA. The profession is still self-regulated by a professional body of auditors, the Institute of Chartered Accountants of Bangladesh. The SEC and Register of Joint Stock Companies of Bangladesh, two government bodies whose primary role is monitoring securities market and registration of companies, have legal provision to monitor accounting firms. However, both organizations rarely monitor accounting firms and lack competent staff for the work (Kabir et al. 2011). In order to improve the independence and quality of audit services by the external auditors, the 2006 reform imposes some restrictions on performing non-audit services.

The provision regarding non-audit service in the Bangladeshi 2006 reform is similar to SOX. It restricts six types of non-audit services: appraisal and valuation, financial information system design and implementation, book keeping service, broker-dealer service, actuarial service, and internal audit service. However, there is no literature on auditors as safeguards of DRPTs in Bangladeshi companies.

(vii) Direct participation of minority shareholders

Scholars are divided in their opinion on shareholders’ participation in corporate governance – one group is in favour and the other is in opposition to shareholders’ participation (Bebchuk 2006). Those in favour argue that direct participation will protect minority shareholders rights
in the organization. The opposition argues that this will cause dispute and disruption in management. This debate has culminated in regulators and policy makers in many countries now supporting some degree of minority shareholder participation in decisions that directly affect their rights. As mentioned in the earlier section, many countries now require shareholders’ approval of RPTs while others have the requirement of pre-review of RPTs by an external independent party. For example, Israel, New Zealand, Norway, Slovenia, Dominican Republic, Macedonia, Ruwanda, Sierra Leone, Tunisia Chile, Swaziland, Sweden Albania, Azerbaijan, Tajikistan and Ukraine require approval from shareholders for some types of related party transactions. Some countries require both approval of related party transactions by shareholders and prior review of related party transactions by external party, such as Egypt, Tajikistan, Tunisia and Sweden (Tareq et al. 2011). In the USA, SOX 2002 bans loans to executives and stringent disclosures for purchase of securities by any directors or a shareholder holding more than ten percent of shares. The ASX guideline in Australia does not have any clause on RPTs for Australian companies. However, section 208 of the Company Law 2001 requires Australian companies to obtain shareholders’ approval for most RPTs. Contravention of that section can be liable to a related person penalty of up to $200000, disqualification for directorship or imprisonment up to five years. Apart from this, the recent ASIC Regulatory Guide 76 requires Australian listed companies to take independent valuation from experts in certain cases, for example, in the case of complex RPTs, RPTs deemed significant from the point of view of the entity, non interested directors do not have expertise on RPTs valuation and so on (ASIC 2011).

Apart from the above, many countries have allowed participation of minority shareholders in some areas of governance which can curb the dominance of controlling shareholders and have the potential to reduce DRPTs. In Australia, for example, CLERP 9 gives shareholders the right to participate in the voting of the adoption of the remuneration report by directors and to
ask questions about the remuneration report. It further requires minority shareholders be allowed to submit questions to the auditor about their audit and be given an opportunity to ask questions in an AGM. The UK corporate governance code of 2010 also allows minority shareholder participation in a company. The UK reform mandates the chair of a board to discuss governance and strategy with shareholders and ensure that the views of shareholders are communicated to the board as a whole. Moreover, the chair is to arrange for the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend. This reform requires a company to propose a separate resolution on each substantially separate issue and allow the shareholders to apply their voting right in the AGM.

In contrast, many companies in Bangladesh do not hold an AGM regularly, let alone allowing minority shareholders’ participation in companies’ decisions (Uddin and Choudhury 2008). The company law of 1994 provides some basic participation of minority shareholders, e.g. participation in AGM and voting on certain agenda items in the AGM, such as appointment of directors and auditors. However, as mentioned by Uddin and Chowdhury (2008), minority shareholders rarely get the chance to apply their voting in AGMs as many of these meetings last for five minutes and everything is decided by the powerful sponsor directors. The existing corporate law allows very limited participation of minority shareholders in a company and the reform 2006 is silent on this. Table 2.4 presents a summary of the salient research on corporate governance safeguards for DRPTs to date.
## Table 2.4: Summary of Corporate Governance Safeguards for DRPTs Research

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Country</th>
<th>Findings on DRPTs and Safeguards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chung et al. (2006)</td>
<td>Hong Kong</td>
<td>The researchers find that DRPT are inversely related to audit committee independence but find no relationship with independent director and CEO-Chair duality.</td>
</tr>
<tr>
<td>Gallery et al. (2008)</td>
<td>Australia</td>
<td>The researchers find inverse relationship of DRPTs with the number of independent directors in board, but fail to find any relationship with audit committee and duality of the chair of the board and CEO.</td>
</tr>
<tr>
<td>Cheung et al. (2009a)</td>
<td>Hong Kong</td>
<td>The result shows that state ownership of companies are positively and independent directors are inversely related to DRPTs. However, the study does not find any relationship with big4 auditor firm with DRPTs.</td>
</tr>
<tr>
<td>Kohlbeck and Meyhew (2005)</td>
<td>USA</td>
<td>The researchers find an inverse relationship between CEO and directors’ cash compensation and DRPTs and a positive relationship between CEO’s stock options and DRPTs.</td>
</tr>
<tr>
<td>Dahya et al.(2008)</td>
<td>22 countries</td>
<td>The study finds that independent directors are inversely related to DRPTs.</td>
</tr>
</tbody>
</table>
2.3.5 Legal System and Minority Shareholders Protection from DRPTs

Researchers have argued and empirically shown that the law can protect minority shareholders from discriminatory behaviour of controlling shareholders or other powerful individual of an organization (LaPorta et al. 1998, 2000, Johnson et al. 2000, LaPorta et al. 2008, LaPorta et al. 1997). These researchers use legal system of a country as a proxy for the level of legal protections for minority shareholders. Legal systems of countries around the world can be classified into two main families: English common law and civil law. The latter is subdivided into three categories: French civil law, German civil law and Scandinavian civil law. The spread of legal systems across the world was influenced by one or a combination of several factors: (1) the colonization of England and France spread English common law and French civil law to the colonies; (2) imitation and adaptation—for example, Japanese adaptation of the German legal system; and (3) regional influence—for example, Scandinavian countries have a similar legal system. A common law system is present in England, the United States of America, Australia, New Zealand and many former colonial countries of England. The French civil law system is present in France, Spain, Mexico, Argentina, Peru, Brazil and many formal colonial countries of France. Germany, Japan, Switzerland, South Korea and Taiwan have the German civil law system; and Scandinavian civil law is seen in Scandinavian countries. The English common law system and effective law enforcement have been found to have better quality minority shareholder protection than countries with civil law systems.

There are two basic reasons for the superiority of the English common law system. First, English common law system affords a greater level of protection for minority shareholders than other systems (LaPorta et al. 1998, LaPorta et al. 2000). This is so because of the nature of the system (Johnson et al. 2000), which allows more freedom than in civil law countries.
(LaPorta et al. 2004). In common law countries, the judiciary has the power to make decisions based on broad principles of law. However, in civil law countries, the legal system is based on comprehensive legal codes and judges are not permitted to go beyond those codes in making judgements. Therefore, it is more difficult to use legal loopholes in common law countries than in civil law countries to disadvantage minority shareholders.

Although many countries allow minority shareholders to sue directors (who are in many cases controlling shareholders) for oppressive behaviour, these cases are treated differently in civil and common law countries. The courts in civil law countries will consider such actions legal if the act done by directors conforms to the legal code—the focus is not on fairness or minority shareholders natural rights. In contrast, the main emphasis of a common law court is equitable treatment of minority shareholders going beyond the code (Johnson et al. 2000).

The second advantage to minority investors in a common law country is better protection for them in legal statutes. There are three main minority investors’ rights in legal statute: the right to corporate information, the right related to related party transactions, and the right to sue directors and make them liable for their activities. However, there is great variation among countries as far as minority investor protection is concerned. An example of one such variation is the derivative action procedure. In many countries, shareholders can sue directors or management by themselves. However, a derivative suit gives shareholders the right to sue directors and managers on behalf of the company concerned. Many countries have reformed the related party transaction approval procedure. Some countries now require shareholders’ approval of RPTs while others have the requirement of pre-review of RPTs by an external independent party. Securing information about their investment is a right of shareholders. Greater disclosure gives more information to stakeholders. Over the past years many countries have increased the disclosure requirement in general and particularly disclosure of related
party transactions. Moreover some countries allow access to company books by minority shareholders. Researchers have found significant differences in the legal statutes between common and civil law countries. For example, reviewing 72 countries’ laws for a related party transaction, Djankov et al.(2008) shows that common law countries legal statutes provide better protection to minority shareholders. He gives the illustration that common law countries mandate higher disclosure requirements (common law countries on average have 0.78 disclosure on related party transaction compared to 0.42 disclosure of French civil law countries on a scale of 0-1 where 1 means full disclosure). The findings by Djankov et al (2008) also show that common law countries have higher standards on other aspects of a related party transaction as far as minority investor protection is concerned (e.g. access to evidence by minority investor, ease of holding liable those parties involved in wrongdoing in a related party transaction and so on).

However, research suggests that legal origin is not a destiny; quality legal reform, reform sensitive to legal tradition and enforcement of those reforms are means of minority investors protection improvement (LaPorta et al. 2008). This echoes the finding of Tareq et al. (2011). They reveal that from 2006 to 2010, on average, countries across the world have improved minority shareholder protection but that the improvement is not homogenous across countries and there is no relationship of legal systems with the pace of reform for minority shareholders protection. Therefore, legal origin is not a destiny of country – proper reform of legislation can improve the protection for minority shareholders in a country with any legal origin.

Bangladesh inherited a common law system from British canonicalization; but it has inefficient government monitoring and enforcement agencies which hinders enforcement of the law. Having good quality law and a sound legal system is not enough; legal enforcement is also important. Empirical studies suggest that apart English common law legal system higher level of law enforcement is necessary for minority shareholder protection (LaPorta et
al. 1998, LaPorta et al. 2000). The enforcement of law for protecting minority shareholders from controlling shareholders is detailed in the next section of this chapter.

2.3.6 Legal Enforcement and DRPTs

Researchers argue that the ‘quality of safeguard’ and ‘enforcement of safeguard’ are the most important things in protecting minority shareholders from the oppressions and prejudicial behaviors of controlling shareholders (e.g. LaPorta et al. 1998, 2000, Johnson et al. 2000, LaPorta et al. 2008, LaPorta et al. 1997). It is deemed that proper quality of safeguards ensures proper protection of minority shareholders. However, having safeguards is not enough – genuine enforcement is necessary for minority shareholders protection.

The study by Dyck and Zingales (2004) and Enriques and Volpin (2007) show that proper law enforcement curbs the private benefit of controlling shareholders. Sweden is example of this. As stated in the earlier section, pyramids, cross holding and dual-class shares are the mechanisms for achieving higher control with less cash flow right in a corporation, and this is the prime motivator for DRPTs. Most Swedish firms have these ownership structures which apparently make Swedish minority shareholders prone to expropriation by controlling shareholders. However, the strict enforcement of safeguards does not allow minority shareholders’ oppression in Sweden (Holmen and Knopf 2004).

Low enforcement of safeguards allows and expands controlling shareholders discriminatory behaviour. As the controlling shareholders can expropriate resources from a company they agree to pay more for control rights in countries where safeguards are not well enforced (Nenova 2003, Dyck and Zingales 2004, Nenova 2005). Italy, for example, does not strictly enforce safeguards for protecting minority shareholders; therefore the minority shareholders
are more prone to controlling shareholders oppression of their rights compared to many similar European countries (Zingales 1995).

Quality of the safeguard is pivotal in protection minority shareholders from DRPTs. To be of high quality, among other things, the law of a country should protect all kind of (or at least most) DRPTs. As legislators are human beings with bounded rationality, it is not always possible for them to foresee all kinds of DRPTs that would be used by controlling shareholders. Therefore, regular updates of the RPT regulations would be required to ensure proper protection of minority shareholders. Table 2.5 presents a summary of the salient research on law and minority shareholders protection to date.
<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Country</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nenova (2003)</td>
<td>18 countries</td>
<td>This paper invests the price of controlling share and legal enforcement. Using sample from 661 dual-class share firms in 18 countries, the researcher reports that legal enforcement and investor protection are significantly related to the variation of premium price for controlling share. The researcher argues that controlling shareholders agree to pay more for control right in countries where minority shareholders are not well protected as they can tunnel out resources there more.</td>
</tr>
<tr>
<td>Holmen and Knopf (2004)</td>
<td>Sweden</td>
<td>This paper investigates minority shareholders expropriation and private benefit of controlling shareholders in Swedish companies. The researchers find little evidence of minority shareholders expropriation in Swedish firms. The researchers argue that though the pyramidal and dual class share structure in make Swedish minority shareholders apparently prone to controlling shareholders oppression, strict enforcement of law prevent such minority shareholders oppression in Sweden.</td>
</tr>
<tr>
<td>Author(s)</td>
<td>Country</td>
<td>Findings</td>
</tr>
<tr>
<td>---------------------------</td>
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<td>------------------------------------------------------------------------------------------------------------------------------------------</td>
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<tr>
<td>Dyck and Zingales (2004)</td>
<td>Multiple countries</td>
<td>This paper investigates private benefit of controlling shareholders. Using data from 39 countries, the researchers report private benefit of control exits in the sample countries and suggest legal enforcement as a major way of curving private benefit of controlling shareholders.</td>
</tr>
<tr>
<td>Nenova (2005)</td>
<td>Brazil</td>
<td>This paper investigates how legal reform of minority shareholders right affects the premium price for controlling shareholding of a company. Using stock market and other corporate archival data, the researchers finds that during weak protection regime of minority shareholders, the controlling shareholding premium is significantly higher than that of strict protection regime. The author argues that the higher control value is due to the higher possibility of expropriation of minority shareholders in a weak minority shareholders protection regime.</td>
</tr>
<tr>
<td>Enriques and Volpin (2007)</td>
<td>France, Germany and Italy</td>
<td>This paper studies the corporate governance reform in France, Germany and Italy between 1991 and 2005. Using several examples and analysing some recent reforms in these countries, the researchers argue strict legal enforcement as a safeguard for protecting minority shareholders.</td>
</tr>
</tbody>
</table>
2.4 Measurement of DRPTs

The current literature does not provide complete or commonly agreed measures for the amount or extent of DRPTs. This section details the current DRPT measures and outlines their limitations.

2.4.1 Current DRPTs Measures

Several empirical researchers use total dollar amount of related party transactions as a measure of DRPTs (Gordon et al. 2004, Kohlbeck and Mayhew 2005, Kohlbeck and Mayhew 2010). Though RPTs are used by controlling shareholders for their self-interest, clearly not all RPTs are undertaken for expropriation purposes. The bulk of RPTs are likely to be for genuine business purposes (Gordon et al. 2004). Therefore, considering all RPTs as DRPTs would cause high measurement error.

Instead of using all related party transactions as a proxy for DRPTs, different researchers have used selected related party transactions as a measure for DRPTs. For example, Chhaochharia and Grinstein (2007) use four types of transactions: sales of asset or goods, purchase of asset or goods, services provided and loans to managers or member of board of directors. In comparison, Berkman et al. (2009) use total loan guarantee to related parties as a measures for DRPTS. A further variation on the selection of particular RPTs as proxy measures of DRPTs is Gao and Kling’s (2008) measure of DRPTS as the difference between accounts receivables and payables to related parties divided by total assets, or Jiang’s (2010) use ‘other receivables’ scaled by total asset as a measure of DRPT.

Another approach to the measurement of DRPTs is the classification of total RPTs into tunnelling and propping transactions. These researchers view tunnelling as DRPTs and therefore detrimental to the shareholders’ value. One other hand, they consider propping as
favourable transactions for minority shareholders. To measure tunnelling and propping they use total dollar value of some selective transactions (Cheung et al. 2006, Gao and Kling 2008, Cheung et al. 2009a). Cheung et al. (2006, 2009a) consider asset acquisition, asset sales, equity sales, sale or purchase of goods, cash payment to related party, cash receipt from a related party and transactions with non-listed subsidiary as propping transactions.

Apart from company-level measures of DRPTs, some researchers have developed a country-level index-based measure of DRPTs. These are composite indexes that comprise of various safeguards applying in countries. Djankov et al.’s (2008) Anti-self Dealing Index, for example, includes the following items in the index: shareholders’ approval for RPTs, disclosure of RPTs, independent review before an RPT, disclosure of RPTs in periodic filings, punitive measures for prejudicial RPTs are legal protection for prejudicial RPTs at country level. The index assigns specific points for these protections from DRPTs in a country.

Table 2.4 provides a listing with definitions of the various DRPT measures used to date.
<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Country of Study</th>
<th>DRPT Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chhaochharia and Grinstein (2007)</td>
<td>USA</td>
<td>Uses total dollar amount of four types of transactions for measuring DRPT: sales of asset or goods, purchase of asset or goods, service provided and loan to managers or member of board of directors.</td>
</tr>
<tr>
<td>Cheung et al. (2006)</td>
<td>Hong Kong</td>
<td>Use total dollar amount of asset acquisition, asset sales, equity sales, sale or purchase of goods, and cash payment to related party as a measure of DRPTs.</td>
</tr>
<tr>
<td>Cheung et al. (2009a)</td>
<td>China</td>
<td>Use total dollar amount of asset acquisition, asset sales, equity sales, sale or purchase of goods, and cash payment to related party as a measure of DRPTs.</td>
</tr>
<tr>
<td>Gao and Kling (2008)</td>
<td>China</td>
<td>The researchers use following formula to measure DRPTs:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(Accounts Receivable – Accounts Payable)/Total Asset</td>
</tr>
<tr>
<td>Antonios et al. (2011)</td>
<td>Greece</td>
<td>Uses sale of assets and sale of goods to related parties as a measure of DRPTs.</td>
</tr>
<tr>
<td>Ge et al. (2010)</td>
<td>China</td>
<td>Uses sale of assets and sale of goods to related parties as a measure of DRPTs.</td>
</tr>
<tr>
<td>Author(s)</td>
<td>Country of Study</td>
<td>DRPT Measurement</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>------------------</td>
<td>----------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Gallery et al. (2008)</td>
<td>Australia</td>
<td>Uses total dollar amount paid to staff and suppliers and related party loan as a measure of DRPTs.</td>
</tr>
<tr>
<td>Gordon et al. (2004)</td>
<td>USA</td>
<td>Uses number of RPTs in a company as proxy for DRPTs</td>
</tr>
<tr>
<td>Kohlbeck and Mayhew (2005, 2010)</td>
<td>USA</td>
<td>Uses total dollar amount of RPTs as a measurement for DRPTs</td>
</tr>
<tr>
<td>Dahya et al. (2008)</td>
<td>22 countries</td>
<td>Use total RPTs as a measurement for DRPTs</td>
</tr>
<tr>
<td>Jiang et al. (2010)</td>
<td>China</td>
<td>Uses other receivables scaled by total asset as a measure of DRPT</td>
</tr>
</tbody>
</table>
2.4.2 Limitation of the current DRPTs measurements

Although prior studies that develop DRPT measures have contributed a lot to help understand the concept and development of a body of evidence in the field of agency theory’s principal-principal problem, these measures have several limitations. The total related party-based measurement is fraught with high measurement error as many RPTs in an organization are for strategic or legitimate business purposes — such as buying from a company’s own subsidiary for supply chain reliability and safety reasons, for gaining tax benefits and so on. Therefore, total RPTs might wrongly measure expropriation of minority shareholders rights if RPTs in a company are mainly for legitimate business purposes.

The ‘selected RPT items’ approach produces measures that suffer from the limitation of not having a way of confirming which selected related party transactions are actually DRPTs and which are actually legitimate business transactions. For example, the Gao and Kling’s (2008) measure uses the difference between account receivable and account payable arising from RPTs divided by total asset to measure minority share appropriation. However, assets can be appropriated not only by credit transactions but also by cash transactions. Moreover, appropriation can be done by selling assets and/or goods at a price lower than ‘fair value’ to a private organization of dominant shareholders, as well as buying asset and/or goods at a price higher than ‘fair value’. Moreover, all credit sales or purchases to related parties are not for private benefit of controlling shareholders, as mentioned earlier, they may be done for strategic reasons. The measurements used by Jiang (2010) and Chhaochharia and Grinstein (2007) have similar limitations.

Cheung et al.’s (2006, 2009a) measurement may be appropriate to a specific context e.g. in Hong Kong or in China where there are lot of state owned or controlled entities. But, the generalization of the measurement to other countries could cause high measurement error as
different transaction could be favoured for tunnelling and propping purposes by different controlling shareholder (e.g., government versus family controlling shareholders) in different countries. Moreover, the classification is based on the view that propping is beneficial for minority shareholders. However, the benefit from propping transactions is complex to judge because of the clandestine nature of the propping transaction (Friedman et al. 2003, Dow and McGuire 2009). Furthermore, propping may be motivated by the controlling shareholder’s intention to return the company to better financial health in order to engage in future expropriations (Bertrand et al. 2002).

It is also noted that although the Anti-self Dealing index of Djankov et al.’s Anti-self Dealing Index is a comprehensive index to measure DRPTs, it is designed to measure DRPTs at a country level. Therefore, that index is not suitable for measuring DRPTs at company level.
2.5 Conclusion

It can be concluded from this chapter that excessive power (control), low cash flow right and either greed for private benefit or a belief that the level of control permits ‘rent’ extraction to compensate for low cash flow right, are ingredients for controlling shareholders’ practices which erode minority shareholders right through DRPTs. Directors are mandated to run the corporation for the benefit of the all shareholders. However, directors, who are in many cases in developing countries are controlling shareholders or representative of them, fail to do so. Excessive power with low cash flow right enables controlling shareholders to arrange discriminatory transactions with related parties for private benefit. Over the years corporate governance reform has tried to protect minority shareholders from the greed and power of controlling shareholders by requiring safeguards in corporations for minority shareholders protection. The literature generally shows that minority shareholders often do not get the protection of these corporate governance safeguards as they are not properly enforced.

The current measures of DRPTs measure mainly gross RPTs or some selected items of RPTs which are prone to high measurement errors. There is paucity of effort in the development of a more precise measure for DRPTs at the firm level. Though the Anti-self Dealing Index by Dajankov et al. (2008) is comprehensive and relatively accurate, it is not applicable at the company level. Therefore, the current literature needs an improved measure for company-level DRPTs.
CHAPTER 3
THEORETICAL FRAMEWORK, RESEARCH QUESTIONS AND MODEL SPECIFICATION

This chapter proposes a theoretical framework for the thesis. It describes about the theory and its suitability for the current research. It further analyses the effectiveness of the reform 2006 using the proposed theoretical framework. This chapter also identifies the research questions of the study and develops the model to answer those questions.

3.1 Theoretical Framework for the Research

‘New Institutional Sociology’ and ‘Agency theory’ are probably the most widely used theories in corporate governance reform research. New institutional sociology is a popular choice among researchers who study adoption of corporate governance reform in a country.\(^4\) Examples of the use of this theory for studying a country’s corporate governance reform are Sanders and Tuschke (2007), Khadaroo and Shaikh (2007), Siddiqui (2010), Chizema and Kim (2010), and Chizema (2010). However, new institutional sociology does not consider the effectiveness and efficiency perspective which is the focus of traditional institutional theory.

\(^4\) New institutional sociology was developed by Meyer and Rowan (1977), who argued that institutional rules function as myths which an organization incorporates, gaining legitimacy, resources, stability and enhanced survival prospects. In a seminal work they claim that institutionalization is a process that makes organizations similar. They argued that the institutionalization process is of three types: coercive isomorphism, normative isomorphism, and mimetic isomorphism. Coercive isomorphism occurs through political or state pressure, normative isomorphism is influenced by professional bodies, and mimetic isomorphism occurs when organizations imitate other successful organizations. Meyer, J. W. & Rowan, B. 1977. ‘Institutionalized Organizations: Formal Structure as Myth and Ceremony.’ American Journal of Sociology, 83:2, 340-63.
Powell and DiMaggio (1991) view new institutional sociology as being a rejection of rational-actor models. Scholars of new institutional sociology believe that maintaining legitimacy is more important than efficiency and effectiveness for organizational survival. A legitimacy perspective is suitable to use for explaining the extent of disclosure (or lack of disclosure) by the controlling shareholder about DRPTs, since it relates to external impressions management. It is not suitable for explaining the extent to which corporate governance reforms have effectively mitigated (or failed to mitigate) the practice of DRPTs pursued by a controlling shareholder. This requires a theory of rational economic behaviour based on self-interest.

Agency theory is used by researchers to study effectiveness and efficiency of the governance reforms. For example, Hutchinson et al. (2008) uses agency theory to evaluating CLERP 9 and ASX Corporate Governance Reform in Australia. Although it is influential and used in many areas in corporate governance research, agency theory has been criticised by researchers for its limitations in several areas detailed in the next part of this chapter.

For evaluating the effectiveness of the Bangladeshi corporate governance reforms to protect minority shareholders from DRPTs, this study draws on the theoretical perspective offered by ‘new institutional economics’. New institutional economics extends neo-classical economics by introducing transaction costs, social relationships and organization structures. Nobel laureates Ronald Coase, Douglass North and Oliver E. Williamson have established these elements as important factors in modern economic analysis.

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5 The theory of institutional economics is divided into two schools: old institutional economics and new institutional economics. Old institutional economics (OIE) ideas were strong between 1920s to 1940s. OIE criticised the mainstream new classical economics for too much emphasis on markets and the assumption of completely rational individuals, as well as for ignoring psychological issues in decision making, property rights, and social norms in economic policy analysis and market failure. However, after the Second World War, mainstream new classical economics was much influenced by Keynes and the idea of OIE started to lose it dominance. For detail see Rutherford, M. 2001. ‘Institutional Economics: Then and Now.’ Journal of Economic Perspectives, 15:3(Summer), 173-94.
This study will use Williamson’s ‘Market and Hierarchy Model’ (see later) for analysing the effectiveness of the Bangladeshi corporate governance reforms to protect minority shareholders from DRPTs. To Williamson, governance means infusing order to mitigate conflict of interest for mutual gain (Williamson 1975, 2008). The model facilitates the comparison of different forms of governance. It is relevant as it gives a legitimate theoretical framework for analysis of organizational relationships, taking into consideration different forms of governance, transaction costs and the behaviours of organizational actors.

Williamson’s model has some similarities with agency theory (Jensen and Meckling 1976) but is based on more realistic assumptions and stronger philosophical standing. The similarity of agency theory with that of Williamson’s model is that both take a contractual perspective and consider cost-benefit, self-interest and information asymmetry between contracting parties. On the other hand, the difference between the two is that agency theory sees effective governance from the narrow perspective of the principal’s interest, a view which has been criticized by scholars (Perrow 1986, Wright et al. 2001). Williamson’s model, on the other hand, sees governance from a neutral perspective. Furthermore, it is based on a more realistic assumption than that underpinning agency theory. Agency theory considers a contract as a full contract where conditions are set in advance, while Williamson’s market and hierarchy model assumes that governance is a complex contract and, like all complex contracts, it is incomplete because of the bounded rationality of human beings.

Assumptions underpinning Williamson’s model are:

2. Opportunistic behaviour of contracting parties.
3. Markets may not work properly (market failure).

---

6 The agency theory states that a principle assigns some responsibility to an agent to act on behalf of him and to serve the best interest of the principle through a contract; the principle uses incentive mechanisms to align the agents objectives to that of the principle and to curb the opportunistic behaviour of agent resulting from information asymmetries between the two parties.
$k > 0$

$h = 0$

$h > 0$

$k = 0$

Contact with no safeguard (possibility of opportunistic behaviour, information disparity and so on)

Bangladesh was close to node B before reform as $h \approx 0$

Bangladesh is close to C after reform as $h > 0$

Contract with safeguard (possibility of opportunistic behaviour, information disparity depends on $h$)

Here, $k$ is the level of opportunistic behaviour, information asymmetry and so on

$h$ is the level of safeguard for contract

The relationship between $k$ and $h$ is as follows:

$$k = f(h) \mid E(h) - h = 0$$

$E(h) = \text{expected } h$

$h = \text{actual } h$

Figure 3.1: Depiction of Williamson’s *Market and Hierarchy* Model applied to the Change in Bangladeshi Corporate Governance
Williamson’s market and hierarchy model suggests three basic kinds of governance systems: Governance by market, hierarch or governance by owner(s) and hybrid governance. Node A of the diagram is an ideal world with no market failure, information to all the parties, no opportunistic behaviour by any party, and zero transactions cost for governance \((k = 0)\). This is the form of governance in a fully functional market. However, in this real world node A is rare for many transactions. Node D of the diagram is a governance system by all owners of an organization. This type of governance ensures information to all owners, no opportunistic behaviour by any owners, and zero transactions cost \((k = 0)\). However, in reality governance by all the owners of a company may not be feasible, efficient and effective.\(^7\) In between these two types of governance systems there may be two basic hybrid forms of governance. Node B is a governance system with a contract with some parties (managers and board of directors) to run their business on behalf of all the owners.\(^8\) However, because of the bounded rationality of the contracting parties all situations may not be included in the contract. This can cause dispute between the contracting parties. Moreover, opportunistic behaviour of any of the contracting parties may hinder the proper enforcement of the contract. One solution to this problem is to provide safeguard for enforcement \((h)\). Node C is a governance system with safeguard for enforcing the contract, and therefore at node C is where \(h > 0\). Though node C gives protection from an unfavoured situation to the contracting parties, it costs money.

\(^7\) According to the model the suitability of governance depends on three attributes of the transaction to be governed: frequency, uncertainty and asset specificity. If a transaction is frequent, certain and has least asset specificity then market is the most efficient method of governance. One the other hand, if a transaction is infrequent, uncertain in it outcomes and asset specific then governance by owners is most efficient and effective. This thesis analyses the governance of a corporation which is frequent but its outcome is moderately uncertain and moderately asset specific. Therefore, according to the ‘Market and Hierarchy Model’ hybrid governance is the most efficient and effective method.

\(^8\) In Bangladeshi corporate context managers are the extension of the controlling owner in the board or some individuals very loyal to them. Therefore, this analysis ignores managers from the analysis.
<table>
<thead>
<tr>
<th>Law</th>
<th>Minority shareholders’ protection from DRPT</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Banking Company Act 2001</td>
<td>Section 27(1) and 28 provide some protection to minority shareholders from DRPTs by restricting loans without any collateral security to any directors, director’s family members or any organization where the directors or directors’ family members are involved as director, shareholders or owner. Banks must not wave loans of these parties if they fail to repay their loans.</td>
</tr>
<tr>
<td>Bangladesh Bank (BRPD Circular No 7, 1999)</td>
<td>Any loan facility or guarantee or security provided to a director of a bank or to his relatives must be approved by the board of the bank and has to be disclosed in the balance sheet. However, the loan cannot exceed 50% of the paid-up value of the shares of the director.</td>
</tr>
<tr>
<td>The Company Act 1994</td>
<td>According to section 103 of the Company Act 1994 a company must not make any loan or give any guarantee or provide any security in connection with a loan made by a third party to any director of the lending company or any firm in which any director of the lending company is a partner or any private company of which any director of the lending company is a director. However, this section will not apply to a loan or giving of any guarantee or providing any security by a lending company if such company is a banking company or a private company not being a subsidiary of a public company and the loan is sanctioned by the Board of Directors. However, the total amount of the loan cannot exceed 50% of the paid up value of the shares held by the director in his own name.</td>
</tr>
</tbody>
</table>
Before the 2006 reform the level of safeguard for the minority shareholders in Bangladesh was very low i.e. \( h \approx 0 \). As shown in Table 3.1, apart from the reform there is minimum protection for minority shareholders. The relevant clauses contained in Company Law 1994, Bank Company Act 1991 and the BRPD circular by the central bank have been quite limited. Therefore, before the reform Bangladesh’s corporate governance was near to node B in Figure 3. After the reforms, the safeguards \( (h) \) are much higher than they were before the reforms — thus Bangladesh’s corporate governance is close to node C. However, \( h \) gives rise to higher costs to companies: independent directors’ fees, expenditure for the audit committee, additional reporting costs for corporate governance disclosure, and so on. Such costs are passed on to minority shareholders by lesser dividend and lesser corporate value. If the safeguards \( (h) \) do not protect the minority shareholders from opportunistic behaviour \( (k) \) of controlling shareholders as manifest in DRPT, then the additional costs incurred may put minority shareholders in a worse situation than in the pre-reform period. Therefore, after the 2006 reforms, which position is preferable for the minority shareholders? The following three alternatives situations in terms of the nodes in Figure 3 can be identified:

- Node B and node C are equally preferred because the 2006 reforms are unenforceable in practice, and hence have no impact.
- Node B is preferable to node C because the compliance costs to the company (which affect minority shareholders) outweigh the expected benefits from a reduction in DRPTs.
- Node C is preferable to node B because the reforms are effective in generating benefits of improved minority shareholder protection that outweigh the company’s compliance costs.
3.2 Development of the Research Questions

Several research questions are formulated for this study concerning the effects of corporate governance features introduced by the 2006 reform and the extent of DRPTs practiced in Bangladesh. First, the 2006 reforms stipulate that at least ten percent of the directors on the board should be independent. There was neither such legal requirement nor indeed any culture (except some few exceptions) of appointing independent directors in the pre-reform period. If directors are truly independent and act in the best interests of all shareholders, then it is logical to assume that there will be an improvement in the situation of minority shareholders in the corporation. This is unlikely to be the case if the appointment of so-called independent directors is not genuine. Colleagues or friends of controlling members are found in prior research to be ineffective in curtailing the private benefits to controlling shareholders (Monks and Minow 2003, Dahya et al. 2008). The reform stipulates selection of the independent director(s) by the existing board whose dominance and private benefit may be curtailed by the inclusion of genuine independent directors. Therefore the following research question will be investigated along with the sub questions:

*RQ1:*

*Have DRPTs significantly decreased following the requirement of appointing independent director(s) in the reform?*

Sub questions:

(i) *If the answer is no, what factors have influenced the ineffectiveness of independent directors in Bangladeshi companies?*

(ii) *Has the effect of independent director on DRPTs in the period been similar for all companies?*
Second, the 2006 reforms stipulate that the board of directors should form an audit committee of three members including an independent member, and the chair of the committee should have professional qualification or knowledge, understanding and experience in accounting or finance. The audit committee’s main responsibility is to ensure that the financial statements present a true and fair view of the company. It has a duty to report any fraud and irregularities in the company. If the audit committee fulfills an important aspect of its monitoring role of reporting fraud and misappropriation of assets, then it is expected that this will improve minority shareholders’ protection. While it has been argued that having an effective audit committee can significantly reduce DRPTs, this will depend on the effective functioning of the audit committee. As already mentioned, independence and accounting education and experience of committee members are necessary for effective function of the audit committee. The reform requires only one independent member and is very lenient on the accounting competence requirement of the chair of the audit committee. Audit committee members may be selected from board members who are under the influence of the dominant shareholders or may not have proper education or experience in this position. Circumstances such as these cast doubt on the ability of the audit committee to function properly in fulfilling its monitoring and oversight roles. Therefore the following research questions will be investigated with the sub questions:

RQ2:

*Have DRPTs decreased following the requirement to have an audit committee under the reform?*

Sub questions:

(i) *If the answer is no, what factors have influenced the ineffectiveness of audit committee?*
(ii) Has the effect on DRPTs in the period been similar across companies?

Third, as mentioned earlier, separation of the company’s operations management and policy-decisions is pivotal for balance of power and accountability in organizations. It prevents abuse of power and brings accountability of powerful people in organizations. The 2006 reform mandates that the chairperson of the board and CEO of a company should be two different persons. This is important when implementing other aspects of the 2006 reform, involving the requirement that prohibits external auditors from performing several non-audit services for their client, and that requires directors certification on the soundness of the internal control system, the appropriateness of accounting policies and accounting estimates, the application of the International Accounting Standards in the preparation of financial statements, and the fairness in presentation of the financial statements by management. If the chairperson of the board and the CEO posts are held by two different persons, it can be expected that there would be some improvement in the uncontested power of the dominant shareholder group in Bangladeshi companies. The certification by directors means that they are responsible for proper disclosure and fairness of transactions in their companies. Banning non-audit services decrease the economic dependency of the auditor upon the client and therefore increase integrity and quality of audit (Ferguson et al. 2004, Frankel et al. 2002b). In Bangladesh in the pre-reform period, however, CEOs in many companies were family members of the sponsor director (Farooque et al. 2007), had low demand for good quality audit (Kabir et al. 2011), and controlling directors would follow law as a matter of formality (Uddin and Coudhury 2008). If that situation still prevails then the ban on non-audit services, separate CEO and certification about the financial statements by directors may have little effect on DRPTs. Therefore the following research question will be investigated along with the sub questions:
RQ3:

Have DRPTs decreased following the requirement of separation of the duality of the CEO-Chair, restriction on not audit services, and increased directors' liability under the reform?

Sub questions:

(i) If the answer is no, what factors have influenced the lack of effect on DRPTs of CEO-Chair separation, restriction of not audit services and the increase in directors’ liability under the reform?

(ii) Has the effect on DRPTs in the period been similar for all companies?

3.3 Model Specification

As discussed, the appointment of independent directors, the formation of audit committees, and the duality of the CEO and chair of the board are main reform initiatives intended to bring about an improvement in the protection of minority shareholder rights. To investigate the effect of these reforms on minority rights from DRPTs perspective, the researcher has developed the following regression model. Past studies (Cheung et al. 2006, Cheung et al. 2009a, Peng et al. 2010, Dahya et al. 2008, Gao and Kling 2008) advocate including some control variables for more complete model specification. As indicated in the next chapter, the model automatically controls unobserved time invariant variables because of the statistical method used:\(^9\)

\[
DRPT_{it} = \beta_0 + \beta_1 \text{In} \_ \text{Dir}_{it} + \beta_2 \text{Audit} \_ \text{Com}_{it} + \beta_3 \text{Separate} \_ \text{CEO}_{it} + \\
\beta_4 \text{Big4} \_ \text{Auditor}_{it} + \beta_5 \text{Firm} \_ \text{Size}_{it} + \beta_6 \text{CG} \_ \text{Reform}_{it} + \\
\beta_7 Z_{t-1} \_ \text{Category}_{it} + \beta_8 \text{Board} \_ \text{Size}_{it} + \beta_9 \text{Group}_{it} + e_{it} \quad \ldots \ldots \ldots (3.1)
\]

\(^9\) This includes all unobserved variables which does not change over time, for example, corporate culture (assuming this does not change over the study time frame), corporate reputation and so on.
Where,

\( DRPT_{it} \) = the discriminatory related party transactions in company \( i \) in year \( t \)

\( In\_Dir_{it} \) = the number of independent directors in company \( i \) in year \( t \)

\( Audit\_Com_{it} \) = a dummy variable with value 1 if there is an audit committee in company \( i \) in year \( t \) and 0 otherwise

\( Separate\_CEO_{it} \) = a dummy variable with value 1 if board chair and CEO are filled by two different persons in company \( i \) in year \( t \) and 0 otherwise

\( Big4\_Auditor_{it} \) = a dummy variable with value 1 if company \( i \) in year \( t \) is audited by a big 4 audit firm and 0 otherwise

\( Firm\_Size_{it} \) = natural log of asset in company \( i \) in year \( t \)

\( CG\_ Reform_{it} \) = a dummy variable with value 1 if year \( t \) is before reform and 0 otherwise\(^{10}\).

\( Z_{i,t-1} \) Category\(_{it} \) = a dummy variable with value 1 if company \( i \) in year \( t-1 \) is in Z category and 0 otherwise

\( Board\_Size_{it} \) = Total members in the board of directors in company \( i \) in year \( t \)

\( Group_{it} \) = a dummy variable with value 1 if company \( i \) belongs to any industrial group and 0 otherwise

All \( \beta \)'s are different parameters to be estimated and \( \varepsilon_{it} \) is the error term in the regression model

The reform requires all companies to have an audit committee to assist the board of directors. However, the banking companies in Bangladesh have to comply with the central banks regulation apart from SEC regulations. As already mentioned in the earlier chapter, the central bank of Bangladesh issued an order in 2003 to form an audit committee in every commercial bank on its schedule. Therefore, equation 1 does not evaluate the effect of the audit committee stipulated by the 2006 reform as many banking companies in Bangladesh may already have an audit committee before the reform. One major difference between the

\(^{10}\) Reform 2006 mandates a company to certify the soundness of internal control system and fair presentation of financial statements by the board and restricts providing some non audit services by the auditors. To evaluate these reform a single variable ‘CG_ Reform’ is included in the model.
central bank’s regulation and the 2006 reform is the independence of the committee members. The 2006 reform requires at least one of the members to be independent. However, the central bank order 2003 does not contain any such requirement. To evaluate the effect of the independent member on the audit committee, the researcher has developed the following regression model.

\[
DRPT_{it} = \beta_0 + \beta_1 \text{In}_\text{Dir}_{it} + \beta_2 \text{Independent Audit Com}_{it} + \beta_3 \text{Separate CEO}_{it} + \\
\beta_4 \text{Big4 Auditor}_{it} + \beta_5 \text{Firm Size}_{it} + \beta_6 \text{CG Reform}_{t-1} + \beta_7 \text{Z}_{t-1} \text{Category}_{it} +    \\
\beta_8 \text{Board Size}_{it} + \beta_9 \text{Group}_{it} + \epsilon_{it} \tag{3.2}
\]

Where,
\[
DRPT_{it} = \text{the discriminatory related party transactions in company } i \text{ in year } t \\
\text{In}_\text{Dir}_{it} = \text{the number of independent directors in company } i \text{ in year } t \\
\text{Independent Audit Com}_{it} = \text{a dummy variable with value 1 if the audit committee is consist of at least one independent member in company } i \text{ in year } t \text{ and 0 otherwise} \\
\text{Separate CEO}_{it} = \text{a dummy variable with value 1 if board chair and CEO are filled by two different persons in company } i \text{ in year } t \text{ and 0 otherwise} \\
\text{Big4 Auditor}_{it} = \text{a dummy variable with value 1 if company } i \text{ in year } t \text{ is audited by a big 4 audit firm and 0 otherwise} \\
\text{Firm Size}_{it} = \text{natural log of asset in company } i \text{ in year } t \\
\text{CG Reform}_{t} = \text{a dummy variable with value 1 if the year } t \text{ is before reform and 0 otherwise}.
\]
\[
\text{Z}_{t-1} \text{ Category}_{it} = \text{a dummy variable with value 1 if company } i \text{ in year } t-1 \text{ is in Z category and 0 otherwise} \\
\text{Board Size}_{it} = \text{total members in the board of directors in company } i \text{ in year } t \\
\text{Group}_{it} = \text{a dummy variable with value 1 if company } i \text{ belongs to any industrial group and 0 otherwise} \\
\text{All } \beta's \text{ are different parameters to be estimated and } \epsilon_{it} \text{ is the error term}
\]

The 2006 reform in Bangladesh mandates that the CEO and Chair of the board should be two separate individuals. However, many companies may have already been run by a
separate CEO before the reform. Moreover, according to section 2 (e) of BRPD circular no. 15 of 2002 of the central bank, the CEO of a bank can not be a director or shareholder of a bank (Bangladesh Bank 2002b). Therefore, all banking companies may have had a separate CEO before the reform. To investigate the effect of having a separate CEO following the reform the researcher includes the interaction term *Separate CEO* *CG_ Reform* in the following equation:

\[ DRPT_{it} = \beta_0 + \beta_1 In\_Dir_{it} + \beta_2 Audit\_Com_{it} + \beta_3 Separate\_CEO_{it} + \beta_4 Big4\_Auditor_{it} + \beta_5 Firm\_Size_{it} + \beta_6 CG\_Re form_{it} + \beta_7 Z_{t-1,\text{Category}}_{it} + \beta_8 Board\_Size_{it} + \beta_9 Group_{it} + \beta_{10} Separate\_CEO\_CG\_Re form_{it} + \varepsilon_{it} \]

\[ \ldots \ldots \ldots \ (3.3) \]

Where,

- \( DRPT_{it} \) = the discriminatory related party transactions in company \( i \) in year \( t \)
- \( In\_Dir_{it} \) = the number of independent directors in company \( i \) in year \( t \)
- \( Audit\_Com_{it} \) = a dummy variable with value 1 if there is an audit committee in company \( i \) in year \( t \) and 0 otherwise
- \( Separate\_CEO_{it} \) = a dummy variable with value 1 if board chair and CEO are filled by two different persons in company \( i \) in year \( t \) and 0 otherwise
- \( Big4\_Auditor_{it} \) = a dummy variable with value 1 if company \( i \) in year \( t \) is audited by a big 4 audit firm and 0 otherwise
- \( Firm\_Size_{it} \) = natural log of asset in company \( i \) in year \( t \)
- \( CG\_Re form_{it} \) = a dummy variable with value 1 if the year \( t \) is before reform and 0 otherwise
- \( Z_{t-1,\text{Category}}_{it} \) = a dummy variable with value 1 if company \( i \) in year \( t-1 \) is in \( Z \) category
- \( Board\_Size_{it} \) = Total members in the board of directors in company \( i \) in year \( t \)
- \( Group_{it} \) = a dummy variable with value 1 if company \( i \) belongs to any industrial group and 0 otherwise
- \( Separate\_CEO\_CG\_Re form_{it} \) = an interaction term between *Separate CEO* and *CG_Reform*
- All \( \beta \)s are different parameters to be estimated and \( \varepsilon_{it} \) is the error term
All estimated $\beta$s represent a measure of the mean effect of each safeguard on DRPTs for all companies. Therefore, the above three equations evaluate the effectiveness of the corporate governance safeguards on DRPTs for the sample of companies and predict their effect for all listed companies. However, the regression result will not provide any information about how effective the safeguard is at individual company level. To investigate the effectiveness of the safeguards in individual companies the researcher resorts to the following three GCM models. The results from these GCM models also provide information on the gradual improvement (deterioration) of effect of the safeguard on DRPTs over time.

$$DRPT_{it} = (\alpha + \beta_1 + \beta_2 + \beta_3)In_{Dir_{it}} + (\beta_2 + \beta_3)Audit_{Com_{it}} + (\beta_3 + \beta_4)Separate_{CEO_{it}} + \beta_4Big4_{Auditor_{it}} + \beta_5Firm_{Size_{it}} + \beta_6CG\_Reform_{it} + \beta_7Z_{t-1\_Category_{it}} + \beta_8Board_{Size_{it}} + \beta_9Time_{it} + \beta_{10}Time_{it} * In_{Dir_{it}} + \beta_{11}Time_{it} * Audit_{Com_{it}} + \beta_{12}Time_{it} * In_{Audit\_Com_{it}} + \epsilon_{it}$$

$$\ldots \ldots \quad (3.4)$$

Where,

$DRPT_{it}$ = the discriminatory related party transactions in company $i$ in year $t$

$In_{Dir_{it}}$ = the number of independent directors in company $i$ in year $t$

$Audit_{Com_{it}}$ = a dummy variable with value 1 if there is an audit committee in company $i$ in year $t$ and 0 otherwise

$Separate_{CEO_{it}}$ = a dummy variable with value 1 if board chair and CEO are filled by two different persons in company $i$ in year $t$ and 0 otherwise

$Big4_{Auditor_{it}}$ = a dummy variable with value 1 if company $i$ in year $t$ is audited by a big 4 audit firm and 0 otherwise

$Firm_{Size_{it}}$ = natural log of asset in company $i$ in year $t$

$CG\_\_Reform$ = a dummy variable with value 1 if the year is before reform and 0 otherwise

$Z_{t-1\_Category_{it}}$ = a dummy variable with value 1 if company $i$ in year $t-1$ is in $Z$ category and 0 otherwise

$Board_{Size_{it}}$ = Total members in the board of directors in company $i$ in year $t$

$Time_{it}$ = is a variable with value 0 for the first year, 1 for second year and so on

$Time_{it} * In_{Dir_{it}}$ = an interaction term between $Time_{it}$ and $In_{Dir_{it}}$
\[ \text{Time}_t \times \text{Audit\_Com}_t = \text{an interaction term between Time}_t \text{ and Audit\_Com}_t \]

\[ \text{Time}_t \times \text{In\_Audit\_Com}_t = \text{an interaction term between Time}_t \text{ and In\_Audit\_Com}_t \]

All \( \beta \)'s are the different fixed parameters to be estimated – this measures the overall effect of each independent variable on DRPTs; \( \beta \)'s are the random coefficient of each independent variable which measures the variation in the effect of each of the independent variables on DRPTs. This indicates effectiveness of the safeguards in individual companies; the interaction terms of the independent variables with \( \text{Time} \) measures how the independent variables affect DRPTs over time, and \( \varepsilon_t \) is the error term.
CHAPTER 4

METHODOLOGY

The research approach in this study will involve the use of mixed methods. Quantitative analysis based on panel data regression models using secondary data is adopted to address all three main research questions proposed in chapter 3. Each main research questions is worded in terms of quantifiable relationships that can be observed for the sample when analysed as a whole. Additionally, the quantitative empirical approach is applied to address the sub-question associated with each main research question. These sub-questions relate to the effect of safeguards on DRPTs at an individual company. For their quantitative analysis at this level, the growth curve modelling (GCM) technique is used because it can make an analysis about relationships in the model at the firm-by-firm level. For a deeper understanding of practices and other phenomena at the firm level, however, qualitative methods of analysis are required. Hence, to address the research sub-questions regarding probable ineffectiveness of the safeguards of the reform, insights can be gained from individual actors in the corporate governance processes at the firm level. This will entail semi-structured interviews with a selection of directors (including Audit Committee members) of listed companies.

The first part of this chapter describes and justifies the sample selection and nature of data to be collected for quantitative analysis. It also sets out the quantitative methods of analysis based on regression and GCM techniques. The second part of this chapter details approach
to qualitative data collection and analysis. It explains the sampling method, interview process and analysis of interview transcripts. The last section of the chapter provides the definitions and measures for the variables used in the quantitative models that will test the three main research questions.

4.1 Quantitative Methods

4.1.1 Sample Selection and Sources of Quantitative Data

There are 240 listed companies on Dhaka Stock Exchange (SEC 2010). Among all the listed companies 89 are financial organizations. A random sample of fifty companies is chosen from these listed companies and data from years 2002 to 2009 (inclusive) of these sampled companies are collected from published annual reports and other corporate documents for the modelling. This period is chosen because this period gives symmetry around the corporate governance reform year of 2006 i.e. 4 years either side. Also 2002~09 had steady economic growth of approximately 6% per annum GDP growth on average. Data were hand collected from published annual reports which were obtained from DSE library and some downloaded from company websites. Considering the time and resources required for hand collection of eight years’ data from library and web search, the researcher considers that fifty companies, randomly selected, are sufficient to be representative of the whole population of 240 listed companies in Bangladesh. Moreover, using multiple years of data controls for unobserved time invariant variables (e.g corporate culture, reputation and so on) embddied in the dataset. This is not possible using a larger sample for single year dataset (Wooldridge 2003). Many companies in the sample do not disclose RPT transactions in the sample years; others reports RPTs in all or some of the years. Since the study is a panel data study, the researcher includes companies which report related party transactions at least for five years of the sample period. Based on this criterion, the final sample consists of 182
firm-year data of twenty five companies. It is uncommon to have takeovers and winding up in listed companies in Bangladesh. So companies were not affected by restructuring or discontinuation over the eight year period.

4.1.2 Methods of Quantitative Data Analysis

4.1.2.1 Fixed versus Random Effects Estimation Method

The time-series and cross-sectional nature of the data for the study requires that it be analysed using the panel data method. There are two alternative panel data methods utilised in this study: Fixed Effect estimation method (FE); and the Random Effect estimation method (RE).

The FE method can be used when unobserved effects are correlated with explanatory variables of the model, while the RE method is suitable when these are not correlated. Thus, the nature of the data dictates which method can be applied. Arbitrary assumptions about the correlation among unobserved heterogeneous effects and explanatory variables may lead to inconsistent estimation of parameters (Green, 2000). Hausman (1978) suggests a test for detecting this correlation. The test is based on the idea that if there is no correlation between the error term and explanatory variables then the parameter estimation method of FE and RE are both consistent, but FE is inefficient. However, if there is correlation then the FE is consistent but the RE estimation is not (Greene 2000). Therefore, the test is based on the difference between the estimates of the two methods. The test of the correlation between unobserved and explanatory variables, which can determine whether to use the FE or RE panel data method, is specified as follows:
\[ W \sim \chi^2[k - 1] = (\hat{\beta}^{FE} - \hat{\beta}^{RE})^2 [\text{var}(\hat{\beta}^{FE}) - \text{var}(\hat{\beta}^{RE})]^{-1} \]  

(4.1)

Where, \( W \) is the Housman test statistic distributed as chi-squared \( (\chi^2) \) with \((k-1)\) degree of freedom; \( k \) is number of parameters to be estimated.

In respect of the FE estimation method, it is described by Wooldridge (2003) through a set of equations. He starts with the following model which contains \( K \) explanatory variables and has \( a_i \) as the individual heterogeneous factor:

\[ y_{it} = \beta_1 x_{it1} + \beta_2 x_{it2} + \ldots + \beta_k x_{itk} + a_i + u_{it}, t = 1,2,\ldots, T \]  

(4.2)

If equation 4.2 is summed over \( T \) and then divided by \( T \), then it gives:

\[ \bar{y}_i = \beta_1 \bar{x}_{i1} + \beta_2 \bar{x}_{i2} + \ldots + \beta_k \bar{x}_{ik} + a_i + u_i \]  

(4.3)

Where \( \bar{y}_i = \sum_{t=1}^{T} y_{it} / T \) and so on.

Next equation (4.2) is deducted from equation (4.3) to give:

\[ y_{it} - \bar{y}_i = \beta_1 (x_{it1} - \bar{x}_{i1}) + \beta_2 (x_{it2} - \bar{x}_{i2}) + \ldots + \beta_k (x_{itk} - \bar{x}_{ik}) + u_{it} - u_i, t = 1,2,\ldots, T \]

\[ \Rightarrow \tilde{y}_{it} = \beta_1 \tilde{x}_{it1} + \beta_2 \tilde{x}_{it2} + \ldots + \beta_k \tilde{x}_{itk} + \tilde{u}_{it}, t = 1,2,\ldots, T \]  

(4.4)

Where, the double dotted values in equation (4.4) are time-demeaned data.

If pooled OLS is used to estimate the parameters of equation (4.4), then the idiosyncratic error \( u_{it} \) should be uncorrelated with all the explanatory variables across all time periods.
The other way to do FE Estimation is to use one dummy variable for each \( i \) (in this study \( i = 1, 2 \ldots .50 \)) then to run OLS. This way of using the fixed effect method is known as the Least Square Dummy Variable method (LSDV). Using LSDV produces the same parameter estimation as with the above time-demeaned fixed effect system. However, the LSDV can be problematic as it uses too many dummy variables. For \( n \) number of companies \((n-1)\) dummy variables have to be used. Therefore, LSDV estimates \([n-1]+k+1\) or \((n+k)\) numbers of parameters (in this study \(25+k\)).

Turning to the RE estimation method, Wooldridge (2003) also describes this method through a set of equations. He again starts by assuming a model with \( K \) explanatory variables and \( a_t \) as the individual heterogeneous factor. If \( a_t \) is not correlated with the \( x_{itj} \), then the RE method is more efficient than FE method.

\[
y_{it} = \beta_1 x_{it1} + \beta_2 x_{it2} + \ldots + \beta_k x_{itk} + a_t + u_{it}, t = 1,2,\ldots,T
\]  

(4.5)

As \( a_t \) is not visible, it is within the error term \( u_{it} \). And it makes the error term \( \nu_{it} = a_t + u_{it} \).

Therefore,

\[
y_{it} = \beta_1 x_{it1} + \beta_2 x_{it2} + \ldots + \beta_k x_{itk} + \nu_{it}, t = 1,2,\ldots,T
\]  

(4.6)

Consequently, the error term will be serially correlated as it has time invariant \( a_t \) in it:

\[
Corr(\nu_{it},\nu_{is}) = \frac{\sigma_a^2}{(\sigma_a^2 + \sigma_u^2)}, t \neq s
\]
Using pooled OLS to estimate the RE model will cause bias in the estimated parameter.

Generalized Least Square (GLS) is robust to serially correlated error terms (Wooldridge 2003). The GLS is done in the following way:

Suppose, \( \lambda = 1 - \frac{\sigma_u^2}{(\sigma_a^2 + \sigma_u^2)} \), where the value of \( \lambda \) is between zero and 1.

Now, equation 4.6 is summed over \( T \) and divide by \( T \) to give:

\[
\bar{y}_i = \beta_1 \bar{x}_{i1} + \beta_2 \bar{x}_{i2} + \ldots + \beta_k \bar{x}_{ik} + \bar{v}_i
\]

(4.7)

Next equation (4.7) is multiplied by \( \lambda \) and subtracted from equation (4.6) to give:

\[
y_{it} - \lambda \bar{y}_i = \beta_0 (1 - \lambda)x_{it1} + \beta_1 (x_{it1} - \lambda \bar{x}_{i1}) + \ldots + \beta_k (x_{itk} - \lambda \bar{x}_{ik}) + (\hat{v}_{it} - \lambda \bar{v}_i)
\]

(4.8)

This quasi-demeaned equation is free from serial correlation. If the parameter of the equation (4.8) is estimated by OLS this will be a Generalized Least Square Estimation. Hence,

\[
\hat{\lambda} \text{ Can be estimated by } \hat{\lambda} = 1 - \left[ I(1 + T(\hat{\sigma}_a^2 / \hat{\sigma}_u^2)) \right]
\]

Where, \( \hat{\sigma}_a^2 = \frac{NT(T-1)}{2} - \sum_{i=1}^{N} \left( \sum_{s=1}^{T} \sum_{s=r+1}^{T} \hat{v}_{is} \hat{v}_{is} \right) \) and \( \hat{v}_{it}, \hat{v}_{is} \) are the residual and \( \hat{\sigma}_u^2 \) is the square of the standard error from estimating from equation (4.8) by pooled OLS. Therefore,

\[
\hat{\sigma}_a^2 = \hat{\sigma}_v^2 - \hat{\sigma}_u^2.
\]

**4.1.2.2 Growth Curve Modelling**

In GCM, time is included as an independent variable to trace change in the dependent variable over time. GCM has the capacity to model the fixed and random part of the intercept and the independent variables. Equation 4.9 shows an example of a growth curve model:
\[ y_{it} = (\alpha + \alpha_i) + (\beta_i + \beta_1)time_i + (\beta_i + \beta_2)x_{it1} + \ldots + (\beta_i + \beta_k)x_{itk} + u_{it} \quad (4.9) \]

In the above model \( \alpha \) is the fixed intercept and \( \alpha_i \) is the random part of the intercept; \( \beta \) s with suffix roman numbers are fixed parameters to be estimated and all \( \beta_i \) s are the random part of each parameter.

GCM provides more information than traditional regression analysis where only the fixed part of the parameter is estimated. For example, \( \alpha \) indicates the mean of the model and \( \alpha_i \) indicates the variation among each company.

Parameters estimated by the FE or the RE model estimate one intercept for the whole model and one slope of each explanatory variable. However, the intercept and slope parameters do not show how the intercept and slope might vary among individual observations of the data set. In the current study, the FE or RE can be used to investigate the research questions related to the effect of the 2006 reforms on DRPTs. However, the FE or RE models cannot be used to analyse the following research questions: Is the improvement (deterioration) in DRPTs following the 2006 reform the same for all companies?

In the FE and RE methods, improvements/deteriorations in DRPTs for all companies are averaged. Therefore, improvement/deterioration about individual companies cannot be known. The Growth Curve Model (GCM) overcomes this drawback and therefore can be used to investigate the above research question.
GCM has been used in medicine for analysis of stroke patient recovery trajectory (Pan et al. 2008). It has also been used in sociology and psychology for studying growth in the delinquent behaviour of adults (Muthén and Muthén 2000) and adolescents (Schaeffer et al. 2006); and in organizational studies of increasing job satisfaction of employees over a period of time (Bliese and Ployhart 2002). However, in the area of accounting and corporate governance literature, the researcher is not aware of the use of GCM to date. The parameters of the GCM are estimated using the maximum likelihood estimation method.

4.2 Qualitative Methods

Qualitative methods are used to investigate the research question related to inefficiencies (if any) of the safeguards in the reform 2006 in preventing DRPTs. In-depth face-to-face interviews are appropriate to use, considering the nature of the research questions. Consideration was also given to the use of focus groups, but the busyness of company directors coupled with the sensitivity of the topic made this a non-viable option.

The individual interviewees consisted of board members, audit committee members, and independent directors. The interviews were semi-structured in nature. Separate sets of questions were prepared for each category of participant. If a board member served on both the audit committee and the board, s/he was asked questions from both sets. Questions, including tentative follow-up questions, were prepared in advance, and adjustments were done as the situation arose during the interview.

Interviews were digitally recorded with the permission of the interviewee. The recordings were then transcribed and analysed to get insights about the discrepancies of actual practice with the reform requirement. A limitation of the interview method of data collection is that participants might not disclose all relevant information.
A detailed interview protocol was prepared to ensure that appropriate processes were followed regarding digital recording, written consent, and assurance of confidentiality. This ensured consistency among interviews. Ethical approval from the university ethics committee of the researcher was obtained before any interviews were conducted.

### 4.2.1 Interview Procedure

The interviews were conducted over a ten-week period from August 2011 to October 2011. To assist the participants in deciding whether or not to participate in the research, they were cordially invited to read the interview questions. If the participant agreed to participate in this research project, s/he was invited to attend an interview session with the researcher. The interview took between 45 minutes and 1.5 hours, and participants were asked questions about their experiences and knowledge of corporate governance practices in companies in which they hold directorships or serve in an audit committee.

Before the interview, participants were briefed. The researcher explained that he had sought to guard against any risk or perceived risk associated with participation in the interview. Also the interview data and subsequent publications would ensure participants would remain anonymous. Furthermore, participants had the right to withdraw partially or completely at any time or to refuse to answer any individual or further questions. The interviews were conducted at a time and location convenient to the participant. One prospective participant gave the researcher appointments for several times but missed all the appointments. Therefore, the researcher had to abandon this one planned participant.
4.2.2 Sampling Method

Non-random sampling is deemed appropriate when the sample selected by a random process is not feasible due to access difficulties (Davidson 2006). The non-random sampling method is common in qualitative research (Merriam 2009). Personal contact was used to select two initial participants and they were requested to refer further participants to the researcher. Thus a snowballing of participants occurred. The researcher personally knows several senior members of the business community who serve on boards and audit committees of listed companies. These directors were approached to take part in an interview. If they express their initial interest, they were sent the interview questions and a detailed statement about the project to assist them in making their decision about taking part in the interview. In this way the researcher interviewed the first two participants. The researcher then requested these two participants to suggest names of other potential participants and they contracted into the project in the same way as the first two. In this way, another fourteen participants were obtained for the interview. Demographic background on participants is given in chapter 6.

4.2.3 Sample Size

In qualitative research, the concept of saturation is a general guideline used for sample size determination. Although helpful, the concept of saturation point is vague. Some literature suggests that 5 to 8 participants suffice when the sample is homogeneous and up to 12 to 20 participants for a non-homogenous sample (Crabtree and Miller 1999: 42). Assuming homogeneity of the sample of the study, 8 directors, 8 independent directors and 8 audit committee members were interviewed. Participants are board members and audit committee members of 12 listed companies of Bangladesh. These companies belong to the banking, insurance, power, pharmaceuticals and textile industries.
4.3 Measurement of Variables

*Independent Director:* Under requirements of the 2006 corporate governance reform statute an independent director is defined as “a director who does not hold any share in the company or who holds less than one percent (1%) shares of the total paid-up shares of the company, who is not connected with the company's promoters or directors or those shareholders who hold one percent (1%) or more of the total paid-up shares of the company on the basis of family relationship; who does not have any other relationship, whether pecuniary or otherwise, with the company or its subsidiary/associated companies; who is not a member, director or officer of any stock exchange, and who is not a shareholder, director or officer of any member of a stock exchange or an intermediary of the capital market” (SEC 2006: 2). The number of directors who match these criteria, based on self-reported independent directors as disclosed in the company annual report, is used to measure the variable.

*Audit Committee and Independent Audit Committee:* The study uses two variables related to audit committee. In the first model, ‘Audit Committee’ is used as an independent variable. The variable is coded 1 if a company has an audit committee in a particular year and 0 otherwise. ‘Independent Audit Committee’ is used as an independent variable in the second model. Audit committee literature suggests competence, independence diligence and authority are four key attributes of audit committees (Lary and Taylor 2012). The objective of this study is to analyze the effectiveness of reform 2006 in minimizing DRPTs. If data were available, the researcher could have included audit committee chair’s financial expertise in the study. Unfortunately, companies are not required to, and most companies do not, provide any information on the qualification and experience of audit committee members in annual reports. All companies, however, have to disclose compliance of the
independence of the audit committee members. Therefore, using the annual reports and the corporate governance compliance statement it is possible to identify the number of independent members on the audit committee. Independence is measured using the number of independent members in the audit committee of company in a particular year.

**Big4 Audit Firm:** In Bangladesh, Hoda Vasi Chowdhury, A Qasem and Co. and SF Ahmed are representative firms of Deloitte Touche Tohmatsu, Price Waterhouse Coopers and Ernst and Young, respectively; Rhaman Rahman Huq is a member of KPMG International. Following Kabir et al. (2011) the researcher considers firms audited by any of these representative or member firms as Big 4 Audit Firms.

**Separate CEO:** The researcher categorizes an observation as ‘Separate CEO’ when two separate individuals perform the responsibility of the CEO and Chair of the board. The variable is coded 1 if board chair and CEO are filled by two different persons and 0 otherwise. This information is gleaned from the names of the CEO and Chair given in annual reports.

**Board Size:** The total number of board members, including the independent directors, is used to measure this variable. This information is given in annual reports.

**DRPTs:** This study develops new a measure for DRPTs. The next chapter details the measurement.
CHAPTER 5

A NEW MEASUREMENT FOR DRPTS

5.1 Introduction

This chapter is related to the achievement of the first objective of this thesis – to develop a measure for DRPTs. As mentioned in the earlier chapter, there is no accurate measure of DRPT in literature as yet. The available measures in the literature are: total RPTs, selected items of RPTs at company level and the Anti-self Dealing Index at country level. The available current measures at company level are prone to high measurement error as these measures may contain genuine business purpose transactions. Though the country level measure, Anti-self Dealing Index is a sophisticated and comprehensive measure for DRPT, thus far there is no systematic effort to develop a measure for DRPTs at a company level.

This chapter develops a new measure for DRPTs at the company level. Computer simulation techniques and real data are used to test the statistical power of the new measure. The new measurement is also tested using sensitivity on share prices and compared with the existing total RPTs measure. The simulation tests and the market sensitivity test show evidence on the superiority of the new measurement over the existing total RPT-based proxy measure for DRPTs.
The next part of this chapter describes the proposed new measure. After that the research method for testing the measure is stated. Then the simulation and real data test results for the measure are reported. The final section concludes the chapter.

5.2 The new DRPT measurement model

Bebchuk et al. (2000), Dahya et al. (2008) and Jiang et al. (2010) argue that low cash flow rights in a company creates incentives for controlling shareholders to tunnel out corporate resources to entities where they have more cash flow rights and the power to do that tunnelling. To illustrate how conditions of low cash flow rights and high voting power can produce tunnelling, consider the following scenario:

Controlling shareholder, S, has $CF_1\%$ cash flow right and $VC_1\%$ voting control in firm $F_1$. Simultaneously, S has $CF_2$ cash flow right and $VC_2$ control in firm $F_2$.

$S$ will benefit from any favourable transaction between $F_1$ and $F_2$ if $CF_1 < CF_2$. Therefore, $S$ will be motivated to be involved in a transaction that favours firm $F_2$ and the lower the percentage of $CF_1$ the higher the possibility that $RPTs$ of $F_1$ are motivated by asset appropriation. Another, important factor that is required for giving $F_2$ a favourable deal is the control by $S$ of $F_1$. $S$ can control $F_1$ if it exceeds a certain threshold. Theoretically the threshold is more than 50%, however practically much less than that as mentioned in the earlier section. However, in general $S$ makes a transaction more favourable to $F_2$ as $VC_1$ increases. Therefore, $VC_1$ has a direct and $CF_1$ has an inverse relationship with minority asset appropriation.
It is assumed in the model in Figure 5.1 that companies will become involved in related party transactions for two main reasons: a genuine business purpose and a private benefit for controlling shareholders. Based on earlier literature, the researcher further conjectures that cash flow right and power of the controlling shareholders are the two motivating factors for tunnelling out resources from a company. If the controlling shareholder has less cash flow rights in the firm then his motivation to tunnel out is higher than if he has high cash flow rights. However, low cash flow right alone is not enough for tunnelling out resources from the company. The controlling shareholders must also have enough power to give a favourable deal to a related party where they have private benefit. Therefore, control and low cash flow right simultaneously influence DRPTs. The researcher uses the following regression to separate these DRPTs from genuine related party transactions:

\[ RPT_{it} = \alpha + \beta_1 Con_{it} + \beta_2 CF_{it} + \beta_3 CF_{it} \times Con_{it} + \beta_4 Size_{it} + \varepsilon_{it} \]  

(5.1)

Where

- \( RPT_{it} \) is the total related party transactions of company \( i \) in year \( t \)
- \( Size_{it} \) is the size of company \( i \) in year \( t \)
Con is the level of voting control of majority shareholders in company $i$ in year $t$

$CF_{it}$ is the percentage cash flow right of the controlling shareholders in company $i$ in year $t$

$CF_{it} \ast Con_{it}$ is the interaction term between control and cash flow right of controlling shareholders

$\varepsilon_{it}$ is the error term

From empirical results from data run with equation 5.1, $\hat{\alpha}$ would represent average RPTs after controlling for size of the company; $\hat{\beta}_1 Con_{it} + \hat{\beta}_2 CF_{it} + \hat{\beta}_3 CF_{it} \ast Con_{it}$ would represent the new measure for DRPTs; and $\hat{\varepsilon}_{it}$ is the measurement error.

The researcher models related party transactions as: $RPT \approx (\text{Cash Flow Right, Control, Size, } \alpha, \beta s)$. The level of cash flow right and control of the controlling shareholders are the primarily factors that are expected to influence them to tunnel out resources from the company for their private benefit. The coefficients, $\beta s$, of these variables and the interaction of these variable combined provide a measure of the estimated amount of DRPTs in a company. In reality, the coefficients $\beta s$ can only be estimated (i.e the $\hat{\beta} s$) using a sample of companies. Therefore, $\hat{\beta}_1 Con_{it} + \hat{\beta}_2 CF_{it} + \hat{\beta}_3 CF_{it} \ast Con_{it}$, the new measurement, separates out those related party transactions influenced by the levels of cash flow right and power of the controlling shareholders, from the total related party transactions.
5.3 Method of Empirically Testing the DRPT Measurement Model

5.3.1 Data Selection

Bangladeshi companies listed on the Dhaka Stock Exchange are used for testing the new measure for DRPTs. Bangladeshi companies are suitable for the tests at least for two reasons. Past studies have shown that minority shareholders are oppressed more in countries where there is concentrated power in a group of shareholders (LaPorta et al. 1999) and in countries that lack good quality legislation to protect minority shareholders and lax enforcement of law (La Porta et al. 1997, LaPorta et al. 1998, LaPorta et al. 2000). Most companies in Bangladesh are family firms (Siddiqui 2010) and dominant shareholders of founder families resist minority shareholders involvement in companies (Uddin and Choudhury 2008, Reaz and Arun 2006). Moreover, the top management of companies of Bangladesh are mostly from controlling families or persons loyal to them (Farooque et al. 2007). Apart from the reform package of 2006, there is minimum protection for minority shareholders, with some clauses contained in company law and the banking company act of the country. The Securities and Exchange Commission (SEC) in Bangladesh is the government body to monitor listed companies. However, the SEC lacks expert personnel (World Bank 2003) and its work is mainly concentrated on formulating stock trading rules (Kabir et al. 2011). All these factors make minority shareholders prone to expropriation of their share of resources by controlling shareholders.

Second, the research design used in this study requires a priori indication of DRPTs in companies. Each year the SEC categorizes listed companies into four categories: companies paying at least 10% dividend and holding annual general meeting (AGM) are labelled A, companies paying less than 10% dividend and holding AGM are labelled B, companies
neither paying any dividend nor holding an AGM in a particular year are labelled Z, and new companies are labelled G (SEC 2005). In Bangladesh many companies do not hold an AGM to avoid the anger of minority shareholders on mismanagement and other corporate governance weaknesses. This avoidance of facing minority shareholders indicates a high possibility of asset expropriation in the Z category companies. This \textit{a priori} indication of DRPTs as reflected in the Z category companies is used in the research design.

5.3.2 Design of Performance Tests for the New and Existing DRPT Measurements

Using equation (5.1), the researcher first partitions the total amount of related party transactions into genuine business transactions and DRPTs. The nature of the data in the study suggests that it needs to be analysed using the panel data method. The Hausman test suggests that the Fixed Effect method is suitable for the data.

\[ \hat{\beta}_1 \text{Con}_u + \hat{\beta}_2 CF_u + \hat{\beta}_3 CF_u \times \text{Con}_u \]

from equation 5.1 is the total amount of transactions for private benefit of controlling shareholders in a particular year and therefore is the new measure of DRPTs. To examine how the new measure performs, the researcher tested the Type 1 and Type 2 error rates of the measure. After that the error rates are compared with an existing measure of DRPTs.\textsuperscript{11}

A Type 1 error occurs when a researcher fails to reject the null hypothesis when that is actually false. One the other hand, a Type 2 error occurs when the researcher rejects the null hypothesis when it is actually not false. Type 1 error is analogous to a false fire alarm when

\textsuperscript{11} The new measure is compared with total related party transaction measurement. The selected related party transaction measure requires detail disclosure of related party transactions in financial statement which our sample companies lack.
there is no fire or wrongly detecting a disease when someone does not have that disease; type two error is analogous to failure to ring the fire alarm when there is a actual fire or not detecting someone’s disease by a pathological test when s/he is actually suffering form that disease. These two errors are the essence of statistical hypothesis testing. These error rates are measured in percentage form; (100% - Type 2 Error rate) is called power of a test. In this study, Type 1 occurs if the new measure falsely detects DRPTs when there is no such transaction; and a Type 2 error occurs when the measure cannot detect DRPTs when there is a related party transaction for private benefit of the controlling shareholders.

The following regression model is used to detect the Type 1 and Type 2 errors of the models.

\[ DRPTs = \alpha + \beta \text{PART} + \varepsilon \]  \hspace{1cm} (5.2)

Where PART is a dummy variable that partitions the sample into two parts and the value of the partition point is specified \textit{a priori}. The sign and significance level of $\beta$ indicate whether the researcher rejects or does not reject the null hypothesis. A similar research design has been used in the accounting literature for developing and testing earning management proxy measurements (McNichols and Wilson 1988, Dechow et al. 1995, Kothari et al. 2005).

The researcher first calculates the Type 1 and Type 2 error rates of the new measurement and then compares these with the error rate of the existing total RPT measurement. Algorithms for the tests are as follows:

**Type 1 Error Test**

(i) Five percent of the sample companies are selected at random without replacement.
(ii) A dummy variable named PART is created.

(iii) Companies selected at step (1) are coded as 1 and the rest of the sample companies are coded 0 for the PART dummy variable.

(iv) Dummy variable PART is regressed on the new measure of DRPTs i.e

\[ \hat{\beta}_1 \text{Con}_u + \hat{\beta}_2 \text{CF}_u + \hat{\beta}_3 \text{CF}_u * \text{Con}_u . \]

(v) The above steps are done 1000 times and records are maintained on how many times the null hypothesis of no DRPTs is rejected at ten, five and one percent significance levels using a one tailed test.\(^{12}\)

**Type 2 Error Test (Power of the Measure)**

(i) Eighty percent of the sample firms are selected at random without replacement.

(ii) A dummy variable named PART is created.

(iii) PART is coded 1 if a company is in Z category in the next accounting year.

(iv) PART is regressed on the new measure of DRPTs i.e

\[ \beta_1 \text{Con}_u + \beta_2 \text{CF}_u + \beta_3 \text{CF}_u * \text{Con}_u \]

(v) The above steps are done 1000 times and records are maintained on how many times the null hypothesis of no DRPTs can not be rejected at ten, five and one percent significance levels using a one tailed test.

---

\(^{12}\) For doing all the steps automatically, the researcher coded the algorithms in STATA statistical software.
In the above Type 1 error test algorithm, five percent randomly selected companies are coded as companies involving DRPTs for the partitioning variable. Therefore, the researcher expectation is that the measure fails to reject the null hypothesis of no DRPT. One the other hand, in the Type 2 error test algorithm, $Z_{t-1}$ category companies are taken as the partitioning variable. A company may not pay a dividend for various reasons, e.g. the company incurred a loss in a particular year or the company wanted to retain profit for investing a project instead of paying out dividend to the shareholders. However, when a company does not hold an AGM it indicates that the board (who are mostly the controlling shareholders or representative of them) wants to avoid the anger of minority shareholders for malpractice in the organization including DRPTs. Therefore, the researcher conjectures that $Z_{t-1}$ category companies are prone to asset expropriation through RPTs by the controlling shareholders in Bangladeshi companies and expects $Z_{t-1}$ category companies to be positively related to DRPTs.

5.3.3 Measurement of Variables in the New DPRT Model

Variables contained in the new DRPT measurement model specified above, are described and justified as follows:

*RPTs (Total Related Party Transactions)*

Following several earlier studies, this thesis uses the total related party transactions (RPT) figure reported in companies’ annual reports. International Accounting Standard 24 defines related party transaction as a transfer of resources, services or obligations between related parties, regardless of whether a price is charged. The related parties include shareholders,
member of board of directors, management, parent or subsidiary company and associated person or organizations of these parties.

*CF (Controlling Shareholders’ Cash Flow Right)*

Cash flow right refers to the percentage a shareholder gets of dividend and residuals of a company after paying liabilities in the case of liquidation. Bertrand et al. (2002) suggests two alternative ways of measuring controlling shareholders’ cash flow right: directors ownership in the company and minority shareholders ownership in a company. The first one is a directly measure cash flow right, whereas the second one measures cash flow right of controlling shareholders in an inverse scale. Following the first approach of Bertrand et al. (2002), the researcher uses founder shareholders’ ownership in a company as their cash flow right.

*Con (Level of Control by Controlling Shareholders)*

50%+ shares are required for full control of a company. However, as mentioned earlier, a 20% (or even 10%) owner of a company can control it using dual class, pyramidal or cross holding of shares in the corporate group. In empirical research, 20% ownership is used as a cut-off point for control of a company (LaPorta et al. 1999, Alves 2010). Preference shares in the capital of a company create dual class shares. Cross holding and pyramidal shares are seen in corporate groups. The researcher codes *Con (Level of Control by Controlling Shareholders)* as 1 if the founder shareholders’ of a company own more than fifty percent of shares (more than twenty percent of shares in the case of a company belongs to a group or companies with preference shares in its capital) and 0 otherwise.

*Size*
This variable is measured as total assets of a company in millions taka (Bangladeshi currency).

\(Z_{t-1} \text{Firm}\)

This is the partitioning variable of equation 5.2. The SEC labels companies neither paying any dividend nor holding AGM in the immediate past year as Z companies. When a firm is labelled as Z in a particular year by SEC, the preceding year is coded as 1 and 0 otherwise.

**5.4 Results of the Model’s Performance Tests**

**5.4.1 Descriptive Statistics**

Table 5.1 presents an industry classification of the sample companies: financial, food, information technology, textile, pharmaceutical and chemical, fuel and power, cement and engineering. Table 5.2 presents the summary statistics of the variables in the new DRPT measurement model. The mean of the related party transactions is shown in natural logarithmic form. Table 5.2 suggests that only part of the total RPTs are tunnelled out from the company for private benefit of the controlling shareholders and other related party transactions are for genuine business purposes. Total RPTs and DRPTs are visualized in Figure 5.2 which shows total RPTs and DRPTs over the sample period of 2002 to 2009.
Table 5.1: Sample companies by industry classifications

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of firms</th>
<th>Number of firm years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial company</td>
<td>13</td>
<td>94</td>
</tr>
<tr>
<td>Food</td>
<td>3</td>
<td>23</td>
</tr>
<tr>
<td>Information Technology</td>
<td>2</td>
<td>14</td>
</tr>
<tr>
<td>Textile</td>
<td>2</td>
<td>16</td>
</tr>
<tr>
<td>Pharmaceuticals and Chemicals</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>Fuel and Power</td>
<td>2</td>
<td>8</td>
</tr>
<tr>
<td>Cement</td>
<td>1</td>
<td>12</td>
</tr>
<tr>
<td>Engineering</td>
<td>1</td>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>25</strong></td>
<td><strong>182</strong></td>
</tr>
</tbody>
</table>
### Table 5.2: Summary statistics of the variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>S.D</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Related Party Transactions</td>
<td>637.62</td>
<td>1187.26</td>
<td>.03</td>
<td>8627.71</td>
</tr>
<tr>
<td>Discriminatory Related Party Transactions</td>
<td>66.75</td>
<td>76.66</td>
<td>1.00</td>
<td>332.38</td>
</tr>
<tr>
<td>Cash Flow Right of Controlling Shareholders</td>
<td>42.0</td>
<td>20.02</td>
<td>.10</td>
<td>90</td>
</tr>
<tr>
<td>Total Asset</td>
<td>22.62</td>
<td>2.38</td>
<td>15.40</td>
<td>26.68</td>
</tr>
<tr>
<td>Z_{t-1} Category</td>
<td>.07</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: $n = 182$, Total Related Party Transactions, Discriminatory Related Party Transactions and Total Asset figures are in log of million Taka (Bangladeshi currency). Cash flow right of controlling shareholders are in percentage form. $Z_{t-1}$ Category is a dummy variable. Out of 182 firm years there are 75 firm years in $Z_{t-1}$ Category in our sample.
Figure 5.2: Total RPT and DRPT over the sample period 2002 to 2009
5.4.2 Type 1 and Type 2 (Power) Error Rates of the Measures

Table 5.3 presents Type 1 and Type 2 test results of the new measurement model. It shows the percentage of times the new measurement model fails to reject the null hypothesis at ten, five percent and one percent significance level. It also shows the comparison of the test results with the existing related party based measurement. Type 1 error rate of both the models are pretty low at all the significance levels. However, Type 1 error rate of the new model is lesser at all significance levels.

Table 5.3 also presents the Type 2 error (power) of the two measurements. The new measurement performs well at 10% level of significance. The test fails to reject DRPTs by controlling shareholders about 95% times in the 1000 runs of the equation 5.2. However, the existing total RPT based measurement rejects DRPTs by controlling shareholder only about 40% times in the 1000 runs of the equation. Therefore, the power of the new model outweighs the existing total RPT based measurement i.e 95% vs. 60%. The Type 2 error rate of the new measurement is not very satisfactory at 5% and 1% significance levels. However, the error rates at these levels are still lower than the total RPT based measurement.

About half (52%) of the sample firms are from financial companies. Therefore, the researcher tests the new measure of DRPT for both the financial companies and non financial companies. Table 5.4 presents the Type 1 error rate, Type 2 error rate and power of the new measurement; it also compares the result with that of the total RPT based measure. It shows that Type 1 error rates of the models are low for both measures but DRPTs is still lower than that of the total RPTs in all significance levels. However, the Type 2 error rate in this case of the sample are high. Error rates are sensitive to sample size. When the sample is split into financial and non-financial companies then the sample size becomes almost half of the original sample. The lower power of the measurements will be due to the smaller sample size. However, the new
measurement still performs better at all significance levels than those the existing total RPT based measurement.
<table>
<thead>
<tr>
<th>Type 1 Error Rate</th>
<th>Significance Level</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10%</td>
</tr>
<tr>
<td>New Measurement</td>
<td>7%</td>
</tr>
<tr>
<td>Total RPT measurement</td>
<td>9%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Type 2 Error Rate (Power)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>New Measurement</td>
</tr>
<tr>
<td>Total RPT measurement</td>
</tr>
</tbody>
</table>

Note: The result is based on 1000 regressions runs of each measurement at 10%, 5% and 1% level of significance (one tail test). Figures in the parenthesis show the power of each measurement at respective significance level.
Table 5.4: Type 1 and Type 2 error result of the new and total RPT based measurement for financial companies and non-financial companies

<table>
<thead>
<tr>
<th></th>
<th>Financial Companies</th>
<th>Non-Financial Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Significance Level</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Type 1 Error Rate</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Measurement</td>
<td>8%</td>
<td>5%</td>
</tr>
<tr>
<td>Total RPT measurement</td>
<td>11%</td>
<td>7%</td>
</tr>
<tr>
<td><strong>Type 2 Error Rate (Power)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Measurement</td>
<td>3% (97%)</td>
<td>40% (60%)</td>
</tr>
<tr>
<td>Total RPT measurement</td>
<td>65% (35%)</td>
<td>90% (10%)</td>
</tr>
</tbody>
</table>

Note: The result is based on 1000 regressions of each measurement at 10%, 5% and 1% level of significance (one tail test). Figures in the parenthesis show the power of each measurement at respective significance level.
5.4.3 Further Evidence: DRPTs sensitivity on firms’ market value

Past studies suggest that curbing DRPTs in a company effects firm value positively (Atanasov et al. 2010, Black and Khanna 2007) as investors positively react to curbing DRPTs in their investment decisions. For example, the study by Atanasov et al. (2010) finds that the 2002 reform in Bulgaria made a significant contribution to reducing DRPTs which were reflected positively in the increase of firm value after the reform. The finding of the study by Black and Khanna (2007) that evaluates reform 2000 in India is consistent with Atanasov et al (2010); the share price of the Indian listed companies increase by 4% after one day of the announcement of the reform. Likewise, Black and Khanna (2007) contend that investors perceived the potential of the reform to reduce DRPTs and other malpractice in Indian corporations as this was manifested in the share prices at the time.

This section provides further evidence on the acceptability of the new measure of DRPTs by showing the sensitivity of firm’s market value to the measure. To test the sensitivity of market value to the measure, the researcher plotted the share price of each firm against the DRPTs using the new measurement model, $\beta_1 Con_{\mu} + \beta_2 CF_{\mu} + \beta_3 CF_{\mu} \ast Con_{\mu}$ and total RPTs over the sample period. Figure 5.3 plots share price and the new DRPTs measure. It shows that the share price line and DRPTs line diverge in many sample companies which indicates an inverse relationship between the two. However, this sensitivity is not quite clear in Figure 5.4 which plots share price and total RPTs of the sample companies. This suggests higher sensitivity of market value of a company on the new measure over total RPTs as a measure of DRPTs.

To get a clearer picture of market sensitivity of the new DRPT measures, the researcher uses six Olson models (Ohlson 1995); the first three models contains the new measurement and the last three models include total RPTs. There is a significant negative effect of DRPTs on share
price of firms in all of the first three models. This result is consistent with the fact that the new measure reflects discriminatory behaviour of controlling shareholders to minority shareholders which reduces firm value. The later three models show no effect of total RPTs on share price. This insignificant result may be due to high measurement errors in the existing total RPT based measure; therefore, the effect is attenuated by the high genuine RPTs in the total RPTs.

Figure 5.3: The new measure of DRPTs and share price: company-by-company plots
Figure 5.4: Total RPTs and share price: company-by-company plots
Table 5.5: Sensitivity of DRPT on share price: panel data regression results

<table>
<thead>
<tr>
<th></th>
<th>Sensitivity of DRPT on share price</th>
<th>Sensitivity of Total RPT on share price</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Model 1</td>
<td>Model 2</td>
</tr>
<tr>
<td>Constant</td>
<td>296.73</td>
<td>-512.51</td>
</tr>
<tr>
<td></td>
<td>(90.47)</td>
<td>(449.47)</td>
</tr>
<tr>
<td>NAV</td>
<td>.74***</td>
<td>.75***</td>
</tr>
<tr>
<td></td>
<td>(.12)</td>
<td>(.12)</td>
</tr>
<tr>
<td>EPS</td>
<td>.31</td>
<td>.09</td>
</tr>
<tr>
<td></td>
<td>(.52)</td>
<td>(.60)</td>
</tr>
<tr>
<td>DRPT</td>
<td>-50.25**</td>
<td>-44.01*</td>
</tr>
<tr>
<td></td>
<td>(23.05)</td>
<td>(23.38)</td>
</tr>
<tr>
<td>Total RPT</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volatility</td>
<td>1.01***</td>
<td>.98***</td>
</tr>
<tr>
<td></td>
<td>(.06)</td>
<td>(.06)</td>
</tr>
<tr>
<td>Total Asset</td>
<td>-</td>
<td>35.55</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(19.49)</td>
</tr>
<tr>
<td>Bank</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$R^2$</td>
<td>.84</td>
<td>.84</td>
</tr>
<tr>
<td>$n$</td>
<td>182</td>
<td>182</td>
</tr>
</tbody>
</table>

Note: * p < .1, ** p < .05, *** p < .01
5.5 Conclusion

In this chapter the researcher has developed and tested a new measurement for DRPTs. The new measure has also been compared with an existing proxy measure of DRPTs. The current research literature’s use of the total RPT measure and selected RPT measures as proxies for DRPTs is theoretically weak, and prone to be high in measurement error. The new DRPT measurement developed in this chapter is founded on improved theoretical underpinning. The high measurement error in the previous proxy measures arises because these proxies contain both legitimate RPTs and discriminatory (i.e., asset expropriations) RPTs. Current literature suggests low cash flow right and high voting control of controlling shareholders are the prime motivators for DRPTs. The proposed new measure uses these two variables in separating out asset expropriation transactions from genuine related party transactions.

Several test results show satisfactory results in favour of the new measure. Test results show that error rates and power of the new measure are satisfactory and comparatively better than that of the existing total RPT based measure. Though Type 1 error rates of total RPTs are low, Type 2 error rates of the measure are very high. However, the new measure has low error rates in both cases. Furthermore, the new measure is sensitive to share price of a firm, which confirms acceptability of the new measure as a measure of discriminatory transactions of controlling shareholders. However, the total RPT based measure does not impact on firms’ share price.

The empirical evidence in this chapter highlights the drawback of prior DRPT measures and the superiority of the new measure. This new measure separates out asset expropriating transactions from genuine RPTs and thus provides a better measure for empirical researchers in accounting. It is also a measure that can better estimate the actual extent of DRPTs at the
company level and hence, can provide policy-makers and minority shareholder with improved information to assist in protection from DRPTs.
CHAPTER 6

FINDINGS: EVALUATION OF THE 2006 REFORM
FROM THE DRPTS PERSPECTIVE

6.1 Introduction

This chapter presents the results related to the second research objective of this thesis – to evaluate the effectiveness of the corporate governance reforms of 2006 in Bangladesh (referred to as reform 2006) for protecting minority shareholders from DRPTs. In chapter 3 the researcher developed several research questions to address this objective. Also chapter 3 developed several models to answer those research questions. These models are tested using quantitative research methods. However, as explained in Chapter 4, qualitative methods are also used. The researcher conducted several semi-structured interviews to get insights about the research questions. The researcher has then tested the quantitative models using secondary data collected from corporations in Bangladesh and has analysed transcription of the interviews. This chapter presents both the quantitative analysis of secondary data to test the models and qualitative analysis from the text of the interviews. Hence, there are two main sections in this chapter – the quantitative section details the analysis and results of the models and the qualitative section presents the finding of the interviews.
6.2 Quantitative Analysis and Results

In this sub-section, the descriptive statistics are presented followed by the multivariate analysis of the quantitative models from chapter 3.

6.2.1 Descriptive Statistics

Table 6.1 presents descriptive statistics on the 182 firm-year observations of this study. The table separates firms into financial and non-financial sectors. There are 94 (51%) firm-year observations from financial companies and the rest 88 (49%) are from non-financial companies. The mean RPT of sampled companies for all the observations is 637.62 million taka (A$ 8.98 million). The non-financial firms’ average total RPTs are higher than that of the financial firms, 805.70 million (A$ 11.35 million) vs. 480.28 million (A$ 6.76 million). This is probably because of the legal restriction of board approval for related party loans from financial companies. As previously mentioned, total DRPT is only a part of total RPTs as the later contains both genuine business transactions and DRPTs. Like the total RPT, DRPTs in financial companies are also lower than that of financial companies – mean DRPT of financial companies is 54.40 million taka (A$ 0.77 million) and 84.07 million taka (A$ 1.18 million) in non-financial companies. This is probably because of higher regulation in financial companies.

On average sampled companies have 10 members on their board. Financial companies have a comparatively larger board size (12 members on average) compared to the non-financial companies (7 members on average). Most sample companies changed board size over the sample period 2002 to 2009 (see Figure 6.1).

The board of the sampled companies had 0 to 3 independent directors during the sample period. Financial companies in the sample have a higher number of independent directors ranging from 0 to 3 compared to non-financial companies (0 to 2). This is because the reform
recommends at least 10 percent of the board to be independent members. As the sample’s financial companies have a higher number of board members, they have higher independent directors. The number of independent directors changed over the sample period because of the reform 2006 (see Figure 6.2). Bangladesh did not have a culture of appointing independent director on company boards before the reform. There was no independent director in any of the sample companies except two before the reform (sample number 7 and 8). Further inspection of the data reveals that these two non-financial companies are local subsidiaries of two foreign companies, who voluntarily appointed independent directors to their board just a few years before the reform.
Table 6.1: Descriptive Statistics of the sampled firms

<table>
<thead>
<tr>
<th>Variable</th>
<th>$n$</th>
<th>Mean</th>
<th>S. D</th>
<th>Min.</th>
<th>Max.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total RPT</td>
<td>182</td>
<td>637.62</td>
<td>1187.26</td>
<td>.03</td>
<td>8627.71</td>
</tr>
<tr>
<td>DRPT</td>
<td>182</td>
<td>66.75</td>
<td>76.66</td>
<td>1</td>
<td>332.38</td>
</tr>
<tr>
<td>Total Asset</td>
<td>182</td>
<td>28531.89</td>
<td>43960.28</td>
<td>4.88</td>
<td>278302.80</td>
</tr>
<tr>
<td>Independent Directors</td>
<td>182</td>
<td>.41</td>
<td>.58</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>182</td>
<td>.35</td>
<td>.48</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Board Size</td>
<td>182</td>
<td>10.02</td>
<td>3.92</td>
<td>3</td>
<td>23</td>
</tr>
<tr>
<td><strong>Financial Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total RPT</td>
<td>94</td>
<td>480.28</td>
<td>746.84</td>
<td>10.68</td>
<td>3371.39</td>
</tr>
<tr>
<td>DRPT</td>
<td>94</td>
<td>54.40</td>
<td>51.42</td>
<td>1</td>
<td>247.72</td>
</tr>
<tr>
<td>Total Asset</td>
<td>94</td>
<td>51781.92</td>
<td>51059.07</td>
<td>3737.5</td>
<td>278302.80</td>
</tr>
<tr>
<td>Number of Independent Directors</td>
<td>94</td>
<td>.29</td>
<td>.52</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>94</td>
<td>.27</td>
<td>.44</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Board Size</td>
<td>94</td>
<td>12.34</td>
<td>3.67</td>
<td>6</td>
<td>23</td>
</tr>
<tr>
<td><strong>Non-financial Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total RPT</td>
<td>88</td>
<td>805.70</td>
<td>1510.31</td>
<td>.03</td>
<td>8627.72</td>
</tr>
<tr>
<td>DRPT</td>
<td>88</td>
<td>84.07</td>
<td>94.56</td>
<td>1</td>
<td>332.39</td>
</tr>
<tr>
<td>Total Asset</td>
<td>88</td>
<td>3696.63</td>
<td>5073.46</td>
<td>4.88</td>
<td>19891.93</td>
</tr>
<tr>
<td>Independent Directors</td>
<td>88</td>
<td>.53</td>
<td>.62</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>88</td>
<td>.42</td>
<td>.49</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Board Size</td>
<td>88</td>
<td>7.54</td>
<td>2.36</td>
<td>3</td>
<td>11</td>
</tr>
</tbody>
</table>

Note: Total RPT, DRPTs and Total Asset figures are in million Taka (Bangladeshi currency). Independent directors, independent audit committee members and board size are in number of individuals.
Figure 6.1 Board sizes of the sample companies

Figure 6.2: Number of independent director in the sample companies
Both financial and non-financial companies in the sample have a maximum one independent member on their audit committee during the whole sample period. Many companies in the sample had audit committees before the reform. This is because the sample contains financial companies which were required to have an audit committee before the reform according to the central bank regulation. All companies however formed an audit committee after the reform except one non-financial company which is yet to form any audit committee even after three year of the reform.

Many of the sampled companies included an independent member on their audit committee after the reform 2006, though some are yet to follow this reform provision. Seven companies (28%) of all the sampled firms do not have an independent member on their audit committee. Among the non-compliance firms, four are financial companies and the remaining three are non-financial companies. Therefore, the non-compliance among financial companies (30%) is slightly higher than that of non-financial companies (25%). There are independent members on the audit committee of two companies before the reform. As mentioned above, these two non-financial companies are local subsidiaries of two foreign companies, who voluntarily appointed independent members to their audit committee before the reform.

Reform 2006 stipulates that the office of CEO and Chair of the board should not be held by a single individual. That is, duality of role of the CEO and Chair was strongly discouraged under reform 2006. Many of the sampled companies had a separate CEO in the company before the reform. All the financial companies have a separate CEO on their board for the

---

13 This finding is consistent with the recent SEC report on compliance corporate governance which shows that 74.34% listed companies fully and 20.39% partly complied the reform directive and the rest 5.27% did not submit report to SEC SEC 2011. ‘Securities and Exchange Comission of Bangladesh Annual Report 2010-11.’ This suggests the random sample is representative of the population i.e all listed companies in Bangladesh.
whole sample period. The reason for this is that the financial companies are required to have a separate CEO according to central bank’s regulation (Bangladesh Bank 2002b). However, non-financial companies which did not have a separate CEO before the reform (41%) are reluctant to comply with this reform. Only one company in the sample appointed a CEO after the reform.

6.2.2 Correlation Analysis

Table 6.2 gives the bi-variate correlations between the dependent variable (DRPT) and the set of independent and control variables specified in the primary model in this study, model 3.1 in Table 3. It reveals that only three of the independent variables are significantly correlated with DRPT. First, independent directors is weakly significantly correlated with DRPT ($r = -0.12, p<.1$). This is a preliminary indication that when the number of independent directors on the board is higher, then the incidence of DRPTs will be lower. Second, there is a strong correlation between the engagement of a Big4 Auditor and the extent of DRPTs ($r = -0.47, p<.001$). This indicates a lower incidence of DRPTs in a company when that is audited by any of a Big4 audit firm. Third, there is a strong correlation between companies within an industrial group and extent of DRPTs. This is also a primary indication that companies in groups engage in DRPTs more than non-group companies.
Table 6.2: Correlation Matrix of Variables of the Study

<table>
<thead>
<tr>
<th>Variable</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. DRPTs</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Independent Directors</td>
<td>-.12*</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Audit Committee</td>
<td>-.20</td>
<td>.34***</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Independent Audit Committee</td>
<td>-.05</td>
<td>.89***</td>
<td>.44***</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Big4 Auditor</td>
<td>-.47***</td>
<td>.09</td>
<td>.19***</td>
<td>.03</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Board Size</td>
<td>-.04</td>
<td>-.01</td>
<td>.35***</td>
<td>-.01</td>
<td>.10</td>
<td>1.00</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>7. Z_{t-1} Category</td>
<td>.10</td>
<td>-.12*</td>
<td>-.03</td>
<td>-.10</td>
<td>-.16**</td>
<td>.18***</td>
<td>1.00</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>8. Company Size</td>
<td>-.80</td>
<td>.07</td>
<td>.51***</td>
<td>.10</td>
<td>.25***</td>
<td>.65***</td>
<td>-.12*</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Group</td>
<td>.31***</td>
<td>.11</td>
<td>-.20***</td>
<td>.14**</td>
<td>-.21***</td>
<td>-.36***</td>
<td>-.01</td>
<td>-.36***</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>10. Financial companies</td>
<td>-.08</td>
<td>-.20***</td>
<td>.39***</td>
<td>-.15**</td>
<td>.21***</td>
<td>.61***</td>
<td>-.01</td>
<td>.75***</td>
<td>-.61***</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Note: * p < .1, ** p < .05, *** p < .01
6.2.3 Panel Data Regression Analysis

To answer the research questions in chapter 3, the researcher has run four regression models developed and discussed in chapters 3 and 4. These regression models have been developed to analyse the effects of different safeguards introduced in the reform (e.g. independent directors, audit committee, separate CEO and so on) on DRPTs. The results are presented in Table 6.3.

For the four models, the results in Table 6.3 first show that there is no effect of independent directors on DRPTs. That is, having an independent director in the board does not affect DRPTs in Bangladeshi companies. This result is similar to the finding of Chung et al. (2006) but different from studies by Gallery et al. (2008) Gao and Kling (2008), Dahya et al. (2008), and Cheung (2009a) who find a significant inverse relationship of independent directors with DRPTs.

Second, the audit committee also shows no significant effect on DRPT in Table 6.3. Therefore, having an audit committee does not affect the amount of DRPT in Bangladeshi companies during the sample period. This result is different from the result of Cheung et al.(2006) who finds significant inverse relationship of audit committee and DRPT; however the result is similar to the finding of Gallery et al. (2008) who fails to find any relationship of the two variables.
<table>
<thead>
<tr>
<th>Table 6.3: Regression Results for effects of Reform 2006 factors on the level of DRPTs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>-----------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Constant</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Independent director</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Audit Committee</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Separate CEO</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Firm Size</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Big4 Audit Firm</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Z-1 Category</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Board Size</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Reform</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Group</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Independent Audit Committee</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Separate CEO * Reform</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Financial Companies</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>$R^2$</td>
</tr>
<tr>
<td>$N$</td>
</tr>
</tbody>
</table>

*Note:* *p* < .1, **p* < .05, ***p* < .01
Third, the regression result in Table 6.3 shows that big four audit firms are significantly inversely related to DRPT. This is consistent with the finding of Gao et al. (2008) but differs with Cheung et al. (2009) that fails to find any relationship between the two. Therefore, the result suggests that companies audited by big four audit firms have less DRPTs in Bangladeshi listed companies.

Fourth, firms with a Z categorization in the previous year have significantly higher DRPTs than that of non Z categorized firms. Moreover, like the study by Bertrand et al. (2002), this study also finds significantly higher DRPTs in companies in the industrial group than companies not in that group.

Regression Model 1 includes the existence of an audit committee to test its effect on DRPTs. However, the goal of the research is to evaluate the 2006 reform. As mentioned earlier, many companies had an audit committee before the 2006 reform. However, the reform initiated the recommendation to have only independent members in the audit committee. Model 2 tests the effect on DRPTs of having independent members on the audit committee. The result, however, finds no effect of independent audit committee members on DRPTs.

Many companies had a separate CEO and Chair before the reforms. None of the regression models find any effect of having a separate CEO on DRPTs which is consistent with the earlier DRPT research (Cheung et al. 2006, Gallery et al. 2008). Only one sample firm in the study appointed a separate CEO after the reform. Model 3
includes an interaction term between ‘Separate CEO’ and ‘Reform’ in order to study such change. The result shows that the company which made such a change does not have any effect on its DRPTs. This non-significant effect may be due to the small number of sample companies that appointed a separate CEO or may be due to real ineffectiveness of having a separate CEO.

About half of the sample companies of this study are financial companies. To test whether financial companies are different from non-financial firms, model 4 controls financial companies as a dummy variable. However, the result shows that there is no effect of being a financial company on DRPTs. The effect of other variables does not change much in the model.

As mentioned in the descriptive statistic sections, two of the sample companies are a local subsidiary of a foreign company. They had independent directors and independent audit committee members before the reform. The researcher excluded these two companies from the sample firms and re-ran all the models. However, the results of the models remain almost the same.

To check for any multicollinearity among the independent variables of the study, the Variance Inflation Factors (VIF) of each independent variable is calculated. Though there is no precise cut-off point for indication of multicollinearity, a VIF greater than 10 is often used as a rule of thumb for the presence of multicollinearity among independent variables of a regression model. The highest VIF of the models’ independent variables is
4.16 indicating that the independent variables in the study are free from any multicollinearity problem.

6.2.4 Growth Curve Modelling (GCM) Result

To investigate the research questions related to companies’ individual performance, the study uses the GCM technique. As mentioned earlier, GCM provides analysis which can supplement the regression results.

All three GCM models in the study find the following coefficients to be significant:

\[ \sigma(\beta_{\text{Independent}\_\text{Director}}), \sigma(\beta_{\text{Independent}\_\text{Audit}\_\text{Committee}}), \text{ and } \sigma(\beta_{\text{Separate}\_\text{CEO}}). \]

This suggests the existence of high dispersion in the corporate governance safeguards on DRPTs in the sample companies. This significant dispersion in the above effects suggests that the non-significant effect of these independent variables on DRPTs found in the regression models may be due to the cancelling out of larger effects with smaller effects among sample companies. The results in Table 6.4 of GCM Model 1 show that the interaction effect between time and independent directors is significant. This indicates that independent directors are becoming more effective over the 2002-09 period of study at preventing DRPTs in Bangladeshi listed companies. This is probably because the independent directors are in the process of learning their job as independent directors. However, the interactions between time and audit committee in Model 2 and between time and independent audit committee members in Model 3 are insignificant. This suggests no improvement of these safeguards over the sample period.
Table 6.4: GCM Results for effects of Reform 2006 factors on level of DRPTs

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
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<tr>
<td>Constant</td>
<td>6.66***</td>
<td>6.75***</td>
<td>6.76***</td>
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<tr>
<td></td>
<td>(2.35)</td>
<td>(2.36)</td>
<td>(2.37)</td>
</tr>
<tr>
<td>Independent director</td>
<td>.20</td>
<td>.17</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(.58)</td>
<td>(.57)</td>
<td>-</td>
</tr>
<tr>
<td>Audit Committee</td>
<td>.15</td>
<td>.22</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(.29)</td>
<td>(.33)</td>
<td>-</td>
</tr>
<tr>
<td>Separate CEO</td>
<td>-.10</td>
<td>-.27</td>
<td>-.04</td>
</tr>
<tr>
<td></td>
<td>(.56)</td>
<td>(.60)</td>
<td>(.57)</td>
</tr>
<tr>
<td>Firm Size</td>
<td>-.16</td>
<td>-.16</td>
<td>-.17</td>
</tr>
<tr>
<td></td>
<td>(.11)</td>
<td>(.11)</td>
<td>(.11)</td>
</tr>
<tr>
<td>Big 4 Audit Firm</td>
<td>-.57***</td>
<td>-.57***</td>
<td>-.43***</td>
</tr>
<tr>
<td></td>
<td>(.22)</td>
<td>(.22)</td>
<td>(.23)</td>
</tr>
<tr>
<td>Z_1 Category</td>
<td>.16</td>
<td>.13</td>
<td>.17</td>
</tr>
<tr>
<td></td>
<td>(.26)</td>
<td>(.26)</td>
<td>(.26)</td>
</tr>
<tr>
<td>Board Size</td>
<td>.05</td>
<td>.05</td>
<td>.06*</td>
</tr>
<tr>
<td></td>
<td>(.03)</td>
<td>(.03)</td>
<td>(.03)</td>
</tr>
<tr>
<td>Time</td>
<td>.09</td>
<td>-.01</td>
<td>.10</td>
</tr>
<tr>
<td></td>
<td>(.07)</td>
<td>(.14)</td>
<td>(.08)</td>
</tr>
<tr>
<td>Reform</td>
<td>.03</td>
<td>.04</td>
<td>-.05</td>
</tr>
<tr>
<td></td>
<td>(.25)</td>
<td>(.24)</td>
<td>(.23)</td>
</tr>
<tr>
<td>Time * Independent Director</td>
<td>-.14*</td>
<td>-.12</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(.08)</td>
<td>(.09)</td>
<td></td>
</tr>
<tr>
<td>Time*Audit Committee</td>
<td>-</td>
<td>-.07</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(.10)</td>
<td></td>
</tr>
<tr>
<td>Time* Independent Audit Committee</td>
<td>-</td>
<td>-</td>
<td>-.11</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(.10)</td>
</tr>
</tbody>
</table>

Random Coefficient

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>σ (Constant)</td>
<td>.78**</td>
<td>.80**</td>
<td>.84**</td>
</tr>
<tr>
<td></td>
<td>(.47)</td>
<td>(.49)</td>
<td>(.47)</td>
</tr>
<tr>
<td>σ (β_{Time})</td>
<td>.25***</td>
<td>.25***</td>
<td>.27***</td>
</tr>
<tr>
<td></td>
<td>(.06)</td>
<td>(.06)</td>
<td>(.06)</td>
</tr>
<tr>
<td>σ (β_{Independent_Director})</td>
<td>1.39***</td>
<td>1.39***</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(.33)</td>
<td>(.33)</td>
<td>-</td>
</tr>
<tr>
<td>σ (β_{Audit_Committee})</td>
<td>.42</td>
<td>.42</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(.38)</td>
<td>(.38)</td>
<td>-</td>
</tr>
<tr>
<td>σ (β_{Separate_CEO})</td>
<td>1.03***</td>
<td>1.01***</td>
<td>1.06***</td>
</tr>
<tr>
<td></td>
<td>(.46)</td>
<td>(.49)</td>
<td>(.48)</td>
</tr>
<tr>
<td>σ (β_{Independent_Audit_Committee})</td>
<td>-</td>
<td>-</td>
<td>1.73***</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(.39)</td>
</tr>
</tbody>
</table>

Note: * p < .1, ** p < .05, *** p < .01
6.3 Qualitative Research Finding

As explained in the methods chapter, several interviews were conducted to get a deeper understanding about the research question concerning what attitudinal and behavioural influences underlie the ineffectiveness of the safeguards against DRPTs set out in the 2006 reform. Because of the nature of this research question, semi-structured interviews are used. This section presents the findings of the interviews and suggests probable reasons for the ineffectiveness of the safeguards in the reform.

6.3.1 Demographic Information on the Interview Participants

Tables 6.5 to 6.8 present the demographic background of the interviewees. The average age of the interviewees is 56.38 years. The mean age of the independent and non-independent directors is 57.12 years and 55.63 years respectively. Note that the non-independent directors are made up of the founder and executive directors. All the non-independent directors are businessmen except two – one is the CFO of a power/energy company, the other is the CEO of a financial institution. The professional backgrounds of the independent directors are from diverse areas: academic, public accounting practice, corporate accountants and ex-bureaucrats. Half of the independent directors (50%) interviewed are academicians working in different public and private universities; two are (25%) retired bureaucrats with active involvement with social and voluntary organizations and two are a business executive and a partner of a chartered accountancy firm.

The interviewees who are members of audit committees are also from diverse professional backgrounds. Among the eight participants, three are academician, one is a
public accountant, two are business executives and the other two are retired bureaucrats. Like their profession, academic backgrounds of the audit committee members are also diversified: one from engineering, four from accounting and finance, and two are from liberal arts background.

### Table 6.5: Professional Background of Participants

<table>
<thead>
<tr>
<th>Profession</th>
<th>Total Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businessman</td>
<td>6</td>
</tr>
<tr>
<td>Academician</td>
<td>4</td>
</tr>
<tr>
<td>Public Accounting Practice</td>
<td>1</td>
</tr>
<tr>
<td>Business Executive</td>
<td>3</td>
</tr>
<tr>
<td>Retired Bureaucrat</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>16</strong></td>
</tr>
</tbody>
</table>

### Table 6.6: Professional Background of Non-Independent Directors

<table>
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<tr>
<th>Profession</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Businessman</td>
<td>6</td>
</tr>
<tr>
<td>Academicians</td>
<td>0</td>
</tr>
<tr>
<td>Public Accounting Practice</td>
<td>0</td>
</tr>
<tr>
<td>Business Executives</td>
<td>2</td>
</tr>
<tr>
<td>Retired Bureaucrats</td>
<td>0</td>
</tr>
<tr>
<td>Others</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>8</strong></td>
</tr>
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</table>
Table 6.7: Professional Background of Independent Directors

<table>
<thead>
<tr>
<th>Profession</th>
<th>Total Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businessman</td>
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</tr>
<tr>
<td>Academicians</td>
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</tr>
<tr>
<td>Public Accounting Practice</td>
<td>1</td>
</tr>
<tr>
<td>Business Executive</td>
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</tr>
<tr>
<td>Retired Bureaucrat</td>
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</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>8</strong></td>
</tr>
</tbody>
</table>

Table 6.8: Educational Background of Independent Directors

<table>
<thead>
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<th>Profession</th>
<th>Total Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engineering</td>
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</tr>
<tr>
<td>Liberal Arts and Social Science</td>
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<tr>
<td>Not-disclosed</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>8</strong></td>
</tr>
</tbody>
</table>

6.3.2 Independence of Independent Directors in Bangladesh

According to the reform guidelines exiting directors select the independent director to their board. Most corporations in Bangladesh are run by powerful founder family members who make all major decisions and follow state laws as a matter of formality (Uddin and Choudhury 2008). The appointment of genuinely-independent directors could curtail the the founder family’s dominance and private benefit; therefore the existing controlling shareholders are likely to choose someone who is tame and under their
influence. The interviews with non-independent directors reveal that the exiting directors select independent director(s) who do(es) not cause any trouble in the board. One independent director admits:

The independent director is just a compliance requirement. The selection of independent directors depends on the CEO and the Chair of the Board. Either the chair of the board or the CEO finds someone who would not cause any problem in the board. Other directors normally accept the candidate selected by the CEO or Chair as they are getting assurance from them that the independent director(s) would not cause any problem in their affairs.

One sponsor director frankly states in the same way:

Independent directors are selected by the exiting directors based on the criterion that these directors would not disturb them in their affairs and would listen to them. I have seen this in many companies where I sit as a director.

The corporate governance reform 2006 restricts any relationship either pecuniary or otherwise with a company for an independent director. However, it does not say anything about the relationship with influential individuals in the company. The interview reveals that many of the independent directors are linked with the influential person in the board.

One independent director notes:

I had a link with the board. Therefore, they took me in when they required complying with the SEC corporate governance guidelines. Normally the board nominates such a person who complies with the guidelines, just for the sake of complying with the rule.

Effectiveness of the safeguard through the mechanism of ‘tamed’ independent director is highly unlikely. Independent directors who sit on the ex-colleague’s or friend’s company’s board are likely to be biased towards the interests of that person in doing their
job. The collegial and inter-personal culture within the board prevents independent directors speaking out for minority shareholders (Monks and Minow 2003). The interviews reveal that many independent directors fail to take due care of their duties when they should report concerns to the board or the SEC. One independent member of an audit committee of a financial organization states:

If the CEO spends Tk. 500,000 for any purpose and there is the Chair’s consent for that, then even though it may be for an abnormal purpose, we do not do anything as it is consented by the chair. The practice is not always what is written in the rule.

The inference from these interviews about the independence of directors appointed to Boards of Bangladeshi corporations under the SEC’s criteria is consistent with the claim by Dahya et al. (2008) that controlling shareholders do not choose true independent directors as that would cause a loss of private benefit to the controlling shareholders.

6.3.3 Audit Committee Competence
As already mentioned in the literature review chapter, accounting knowledge and experience are pivotal attributes of a competent audit committee (Bedard et al. 2004, Lary and Taylor 2012). Many audit committee members in Bangladesh lack either or both of these vital attributes for their job. The corporate governance guidelines stipulate that the chairperson of the audit committee should have professional qualifications or knowledge, and understanding and experience in accounting or finance. Requiring only the chairperson, not other audit committee members, to have accounting or finance expertise seems a very lenient requirement for assuring the formation of a competent audit committee. The interviews with the audit committee members reveals that lack of
knowledgeable and experienced members make some committees like a one man show and other members of the committee as spectators. One audit committee member with accounting background notes:

The other two audit committee members completely depend on me. They ask my opinion in most cases. If all of them had accounting and finance background we could have performed much better.

Some of the committee members interviewed held incompatible education background e.g sociology, water resource engineering and so on (See Table 6.9). Some of these participant mentioned that they have fellow audit committee members even with degree in medicine. These interviews revealed that inappropriately qualified members struggle in doing their job on the audit committee. An independent audit committee member with a sociology education background notes:

At the beginning I was very uncomfortable with my role on the audit committee. I start leaning. I collected the government guidelines and books about audit committee. My son has an MBA in Finance. He helped me a lot to learn the basic things in finance and accounting. I used to take some books in the audit committee meeting and used those during meetings. I think a Chartered Accountant would perform better in this position.

Hence, the lenient requirement for expertise on the audit committee in Bangladesh tends to make this committee just a formality of compliance rather than fulfilling an effective role of vetting the financial statements and monitoring the internal and external audit functions of the company. In this sense, the audit committee seems to achieve little more for minority shareholders and wider stakeholders than increasing the burden of compliance cost.
Table 6.9: Audit Committee Competence

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<td>Retired Bureaucrats</td>
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<tr>
<td><strong>Total</strong></td>
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</tbody>
</table>

6.3.4 DRPTs Approval in Bangladeshi Companies

Though banking companies in Bangladesh requires board approval for related party loans, there is no regulatory requirement in non-financial companies for approval of RPTs by the board, or even a requirement for discussion of RPTs by the board. The interview process reveals that there is no voluntary discussion of RPTs in board meetings nor do the board members feel the necessity for that. One board member comments:
We do not discuss related party transactions in board meeting. There is disclosure for that in the annual report and these are audited by external auditor. Therefore, I think we should not do that.

In relation to financial companies, the interviews reveal that these companies do discuss RPTs in the board meetings. As already mentioned financial companies require board approval for a loan to a related party. An interview reveals that, although RPTs are discussed in the board of financial companies, the terms and conditions of these loans are questionable and more favourable than that of arms-length transactions. Non-interested board members do not oppose these approvals because they may desire similar treatment in their case at some stage in the future. One independent board member of a bank frankly states:

We discuss related party transaction in board meetings. However, if any director has any interest in any of these transactions, normally other non-interested director do not want to discuss that issue much to avoid any conflict with that director. They do that because in future they may require similar favourable treatment from the board.

This revelation is consistent with Siddiqui and Podder (2002) and Ahmed (2012b), who find a high percentage of bad loans in Bangladeshi commercial banks which are in many cases caused by disbursement to directors, directors’ relatives or related organizations without considering the creditworthiness of these borrowers. This finding is also consistent with Silanes et al. (2003) who show that the borrowing terms offered to related parties of Mexican banks are much more favourable than those available to unrelated ones and often related parties are less credit worthy.
6.3.5 The Stance of the Board’s Chair

Delegation of responsibilities to professional managers by the owners is the normal mode of operation as corporations become larger. However, the deeply-held attitude of founder shareholders in Bangladesh corporations is to resist this need to delegate responsibilities to professional managers. Many founder shareholders hold the position of chair of the board and take the stance that the listed company is their family business. They view the CEO and top executives as their loyal and obedient employees. One founder director of a bank states:

Appointment and remuneration of the CEO is mainly decided by the chair of the board. Therefore, CEOs generally try to keep the chair happy and do not do anything that may cause any conflict with the chair. In black and white they are supposed to work independently but the reality is different. The chair of the board is a major shareholder of the company and he treats the CEO as an employee of his business. And I think it should be like this.

The reform stipulates that CEO and Chair of the board should be held by two different persons and the board should clearly define respective roles and responsibilities of the chair and the CEO. The central bank requires that the CEO of a financial company must look after the operation of a business. The interviews reveal that a CEO can hardly take any decision without the consent of the dominant founder shareholders who dominates the board as a chair. One founder director of a company comments:

Normally the Chair holds most power in a typical Bangladeshi company. The CEO maintains a good relationship with the board and tries to avoid any conflict to secure his job.

Another independent director of a financial company states:
The Chair is the all in all in the organization. The CEO prepares proposals for loans and other things for his approval. The chair discusses these at the board and makes decisions. Therefore, it seems to me that the post of CEO is meaningless as every decision is made by the Chair and the board.

This finding is similar to Reaz and Arun (2006) who maintain that the founder shareholders of private commercial banks in Bangladesh virtually control everything from appointment/firing of CEO, to loan approval, to purchase decisions, to salary determination. Founder directors of Bangladeshi listed corporations consider their business as their sole proprietorship type organization. This mentality prevents accepting modern corporate practice of delegating operations of the business to professional manager. One director comments:

Most of the businessmen (in Bangladesh) are a first or second generation businessman. They lack vision and long term aspect of business and therefore do not want bringing contemporary corporate culture into their organizations. They even never realize these things.

This comment is consistent with Uddin and Choudhury (2008) who opine that the Bangladeshi corporate sector is at its infancy and therefore lacks the corporate culture of delegation of duties to professional managers.

6.3.6 Disparity in Governance among Companies
The SEC in Bangladesh is the monitoring authority for compliance to the reform 2006. The SEC requires that compliance status to specific requirements in the guidelines must be included in the annual report. According to the SEC, as of 30 June 2011 74.34% of listed companies fully complied and 20.39% partly complied to the directive to report
their compliance status. However, 5.27% of listed companies did not submit an annual report to SEC (SEC 2011). Kabir et al. (2011) argue that these compliance levels reported by the SEC are unlikely to be a reflection of actual compliance levels because the SEC lack monitoring capacity and manpower to investigate the self-reported compliance status by companies on various items.

Even if compliance with the letter of the SEC’s requirements is achieved, the findings in this study concerning the dominance of the founder family, the lack of independence of directors, and the lack of expertise amongst audit committee members suggests that the SEC’s corporate governance requirements are relatively ineffective in protecting the interests of minority shareholders in many Bangladeshi listed companies. These results are consistent with Wetphal and Zajac (1994), Carpenter and Feroz (2001), Fiss and Zajc (2004) and Tilcsik (2010) who shows that a powerful individual or group in an organization may comply with rules on paper but in reality do not do so.

However, the interviews reveal some exceptions to this. One independent director of a bank comments on the appointment of independent directors:

In a typical Bangladeshi company the board selects someone as independent director who would not cause any problem in the affairs of the board. However, there are some exceptions. Some good governed companies have specific by-laws regarding the qualification of the independent directors. For example, I know some companies who have by-laws that the chairman of the Department of Finance of the University of Dhaka or the President of the Institute of Chartered Accountant of Bangladesh would be their independent director. These companies appoint genuine independent directors and are generally very well governed.
Another director comments about balance of power between the board and the management of Bangladeshi companies:

I have bad experience as a director. I felt like … I was not enjoying my job because the board was dominating the management for every operation of the business. So I gave up and resigned. However, there are some companies which are running smoothly following good governance principles.

These comments are consistent with the GCM results which show significant disparity of the safeguard effects on DRPTs among the sample companies. The inference is that some companies are well governed and are following the reform guidelines genuinely, whereas most companies are following the reform guidelines symbolically.

6.3.7 Improvement in the effectiveness of safeguards

Mukherjee-Reed (2002) and Uddin and Choudhury (2008) contend that western style governance is not suitable for developing countries. Their contention is disputed in this study. The interviews point to the problem lying with the proper implementation of these safeguards – not the safeguard per se. The problem for implementation in Bangladesh is found in this study to be due in large part to lack of experience of the independent directors in similar positions. All the eight independent directors interviewed did not have any experience in a similar position as independent director. Since 2006, independent directors have become a new governance mechanism which is a concept that did not exist in previous corporate culture in Bangladesh.

Though the results from the quantitative analysis revealed ineffective corporate governance mechanisms for reducing DRPTs in many Bangladeshi companies, there was
also evidence that the situation would improve gradually. This prospect of gradual improvement is supported by the discourse from the interviews. Several of the interview participants stated that their main motivation to become an independent director was to learn from their new position and build their reputation in fulfilling such a role. One independent director notes:

It was a new opportunity for me. It’s a public listed leasing company. I wanted to know how the board works in a listed company and how different decisions are made there. Moreover, sitting in the board improves reputation.

Another independent director comments:

Money was not at all the motivating factor as the money we make as an independent director is not that high. There are about 52 commercial banks in Bangladesh. I wanted to learn how the banks works. Moreover, it is a symbol of a social prestige to sit in the board of a listed company.

This finding is consistent with the GCM results in the earlier section which shows that independent directors are becoming increasingly effective over the years after the reform. The researcher argues that over time independent directors would learn from their directorial role and would become effective in protecting minority shareholders to maintain their reputation among investors as an independent director. This is consistent with the Fama and Jensen (1983) hypothesis – outside directors form a market of independent directors that will monitor the quality of work of independent directors. Non performing independent directors will be eliminated from the market and will not be appointed as directors in any company. It is believed that the market for independent directors will develop over time in Bangladesh as the current inexperienced independent
directors become experienced over time and learn how to be effective in maintaining their reputation in an emerging market for outside directors.
CHAPTER 7

CONCLUSION

7.1 Overview and Summary of Findings

This thesis evaluates the effectiveness of reform 2006 in curbing DRPTs. Unlike some past studies which opine that western style governance is not suitable for developing countries (Mukherjee-Reed 2002, Uddin and Choudhury 2008, Siddiqui 2010), the researcher maintains the current Western-adapted reform is appropriate in Bangladesh but highlights some drawbacks in its implementations. The deficiencies in implementation are found to be mainly due to a lack of experience of the independent directors in similar positions, strong and ubiquitous influence of founder family members in the corporations, lack of competency of the audit committee and the infancy of corporate culture in Bangladesh. These influences cause a decoupling of regulation and practice in respect of corporate governance safeguards against DRPTs. Control over the opportunistic behaviour of controlling shareholders in Bangladeshi corporations remains relatively weak in practice.

One major reform in 2006 is the inclusion of independent directors on the board. Unlike past studies in China (Gao and Kling), Australia (Gallary et al 2008) and Hong Kong (Cheung et al 2009) the results of this thesis show no significant effect of independent directors on DRPTs. The interviews conducted for this thesis reveal flaws in the selection of independent directors and inexperience of independent directors in their role.
However, the interviews reveal that independent directors are motivated to learn the job and are concerned about their social reputation which indicates potential to improvement in their performance over the coming years. Growth curve modelling results shows that independent directors are becoming significantly effective in reducing DRPTs over time. This indicates the independent directors in Bangladesh are currently in learning phase and have potential to become effective in protecting minority shareholders in the future.

The interview process reveals that most of the independent audit committee members are either retired bureaucrats or academics. Many of them openly acknowledge their deficiencies in accounting knowledge and experience. The results of the quantitative analysis show no improvement of audit committee effectiveness over the post-reforms period of years investigated. This is probably because audit committee members with shallow or no accounting knowledge may not decipher complex transactions with related-parties by controlling shareholders and their loyal professional managers. Therefore, it is not surprising that the effectiveness of the audit committee is not improving over time. The responsibility of the audit committee is to monitor the integrity of the financial affairs of a company. Former bureaucrats or academics lacking accounting education and experience may not be capable of detecting and addressing complex discriminatory transactions by controlling shareholders against other shareholders in collaboration with their managers.

It has been highlighted in an earlier chapter that a collegial environment prevents independent directors speaking out to protect minority shareholders’ interests. The interview results reveal that many independent directors do not speak out to protect
minority shareholders’ interests mainly because of their friendly relationship with the chair or controlling shareholders group who recruited him/her to the board.

The results of the qualitative and quantitative sections show that a lack of accounting education and experience hinders the audit committee’s activities. At present the guidelines requires one independent member on the committee. However, it does not require any accounting education or experience of the members. Accounting expertise is a pre-requisite for effective performance of an audit committee member in this era of complex business transactions in corporations (Agrawal and Chandra 2005).

7.2 Contribution to the Literature

There are two principal contributions of this thesis. The first contribution of this thesis is the development of a measure for DRPTs. Current literature does not provide a precise measure for DRPTs at company level. Total RPTs or some selected items of total RPTs are used as measures of DRPTs by researchers. However, all RPTs are not for asset appropriation by powerful shareholders; many RPTs are for genuine business purposes. Therefore, these current measures contain high measurement errors. High power and low cash flow right of controlling shareholders motivate them to appropriate minority assets through DRPTs (Bebchuk et al. 2000, Dahya et al. 2008, Jiang et al. 2010). Using cash flow rights and voting power of controlling shareholders, this study segregates DRPTs from total RPTs. This study provides the first effort to separate out DRPTs from total RPTs in the literature. The new measurement is low in measurement error. Computer simulation and real data tests find the new measure as more precise than the existing total
RPT measure. In quantitative research, accurate measurement of variables is pivotal. Error in measurement of a variable may lead to biased and inconsistent estimation of a coefficient in regression analysis (Wooldridge 2003). As mentioned in the earlier chapter, empirical studies have to date found inconsistent relationships between/among DRPTs and other variables which may be largely due to high measurement errors of current DRPT measures. The new DRPT measure may resolve some of these inconsistent findings in this area of literature.

The second contribution of this thesis is that, using the new measure, this thesis evaluates the effectiveness of reform 2006 in restricting DRPTs in Bangladeshi corporations. As mentioned in the first chapter of this thesis, past studies have investigated a range of effects of corporate governance reforms mainly in developed countries. These include the costs and benefits of Sarbanes-Oxley Act 2002 to US companies (Zhang 2007, Doyle et al. 2007, Iliev 2010, Ashbaugh-Skaife et al. 2009, Ashbaugh-Skaife et al. 2008), effectiveness of governance reform in preventing RPTs in developed countries mainly the USA (Chhaochharia and Grinstein 2007) and Australia (Gallery et al. 2008) and so on. Therefore, this area of literature on most developing countries is largely undeveloped. This thesis contributes to the existing literature by investigating the effectiveness of the reforms in a developing country from the specific perspective of DRPTs.
7.3 Implications of the Findings

As mentioned in Chapter 1, reform 2006 in Bangladesh imposes additional costs on corporations, which would be passed on to shareholders. If the reforms do not yield appropriate benefits to all shareholders, the net cost involved means that the minority shareholders, at least, would be in a worse situation than in the pre-reform period, knowing that the controlling shareholders have the power to minimize net costs to them. The strengthening of reform initiatives by tightening the prescription in the requirements and enhancing the enforcement resources of the regulator might make it more effective to protect minority shareholders from DRPTs. SOX, for example, was amended several times to make it more effective as well as compliance friendly by corporations. Though SOX provides protection to minority shareholders, some requirements of the law are costly to comply with, which triggered amendment of a few sections of the original law. Section 404 of SOX mandates a public corporation’s assessment and report on the effectiveness of internal control by managers and certification of the management’s assessment by an independent auditor. In the first few years after the enactment of the act, compliance with these requirements of the law became notoriously costly for companies and subsequently the section was amended in 2007 to reduce the cost burden for companies (Iliev 2010).

However, amendment of the reform needs to be well-informed and evidence-based. The result of this thesis suggests appointment of independent directors by the existing non-independent directors as one of the main reasons for ineffectiveness of the reform. It is revealed in the interviews that independent directors who sit on a company board with their ex-colleague or friend fail to take due care of their duties when they should report a
concern to the board or the SEC of Bangladesh. This suggests a need for strengthening of the guidelines regarding independence of the independent directors and their appointment. SEC could consider establishing a pool of suitable independent directors from which listed companies must draw, or alternatively, the SEC could introduce a certification process for independent directors who are appointed by companies.

The results of the thesis, in general, show that the current ineffectiveness of the corporate governance safeguard for protection of minority shareholders from DRPTs is mainly due to ineffective implementation of the safeguards. The ineffective implementation is due in large part to a lack of qualification, experience and training of the independent directors and audit committee members. Therefore the result of the thesis suggests amendment of the guidelines regarding mandatory proper education and experience requirements of independent directors and audit committee members. It is hoped that this study will inform policy-making decisions in relation to future corporate governance reforms in Bangladesh and other developing countries as well as alerting policy-makers to the amendment of the reforms.

Empirical studies have to date found inconsistent relationships between/among DRPTs and other variables which may be due to the use of an imprecise measure for DRPTs in prior studies. As mentioned in this thesis, currently many researchers use total dollar amount of RPTs as a proxy for DRPTs (Gordon et al. 2004, Kohlbeck and Mayhew 2005, Kohlbeck and Mayhew 2010) and other researchers use selected RPTs or some derivatives of related party transactions as a measure of DRPT (Cheung et al. 2009a, Cheung et al. 2006). All these measures, however, are based on weak theoretical
underpinnings and, because of their poor construct validity, are prone to high measurement error. This research will contribute in filling the vacuum for a more precise DRPTs measurement. As a result, it is anticipated that the future adoption (and possible further refinement) of the measure developed in this thesis will be able to resolve these anomalous prior findings related to relationships between/among DRPTs and its related variables.

7.4 Limitations

There are limitations relating to the use of the interview method, sources of secondary data and analytical techniques used in this thesis. First, interviews were used as part of the research methods. A limitation of interviews is that participants might not reveal certain relevant information, especially if they perceive the research questions as sensitive. While the interview approached used in this study has only been face-to-face with individuals, a focus group approach could have provided a more comprehensive understanding of the position taken by members of an organisation or profession. However, the busyness of directors and audit committee members coupled with the sensitivity of the topic made focus groups a non-feasible option.

Second, one of the main contributions claimed for this thesis is the development of a new measure for DRPTs. Computer simulation tests find the new measure more precise than other existing measures of DRPTs. However, this study uses data collected from companies in one country. The measure may not give the same precision if it is validated using data collected from companies in different countries.
Third, the quantitative analysis in this thesis is based on secondary data collected from annual reports and other documents published by Dhaka stock exchange. Though the annual reports are audited and the documents published by the stock exchange are perceived as a credible source, the data published in these reports and documents may contain financial statement misstatements and compliance reporting omissions. Also hand collection of this secondary data by the researcher, while done with much care, may be prone to data extraction and collation error.

Finally, the data analysis technique of growth curve modelling is part of the analytical methods used in this thesis. GCM can be modelled in two ways: Random Coefficient Modelling (RCM) and Structural Equation Modelling (SEM). Although random coefficient modelling techniques and structure equation modelling produce similar results (Bliese and Ployhart 2002), the latter has the advantage of considering measurement errors in variables and using multiple indicators for measuring a latent variable. However, RCM is used in this thesis as SEM technique requires very large number of samples size which made it a non-viable options for this thesis.
7.5 Future Research Direction

In terms of directions for extending this study regarding discrimination actions by controlling shareholders, past studies suggest that initial public offerings (IPOs) are a major way of appropriating minority shareholders’ assets in a company. A recent investigation by the Ministry of Finance of Bangladesh reveals that there had been significant transfers of wealth from minority shareholders to controlling shareholders by private placement in IPOs during 2010-2011. This is an area for future investigations.

In respect of further research on the effectiveness of corporate governance reforms, the 2006 Reform in Bangladesh does not require shareholders’ approval or external independent review of RPTs. Some countries have such protection against DRPTs. It is costly to arrange meetings for RPTs approval. Does the cost outweigh its benefits? A future investigation might suggest the need for this type of safeguard in Bangladesh.

Finally, the development and testing of the new DRPT measure in this study would need to be replicated in other countries or corporate governance jurisdictions in order to substantiate its suitability for more general application.
APPENDIX

QUESTION SCHEDULE FOR THE INTERVIEW

A. Questions to be asked of all participants

- Please tell me a little about your career and experience in business generally.
- Are you a director and/or audit committee member in any other company(ies)?
  If yes, in which company(ies) and for how long?
- What is the nature of the working relationship between the CEO and the Chair of the Board?
- How has the size of the Board changed as a result of the reforms? Do you consider the current size of the Board to be appropriate to the task? Why or why not?
- How has the composition of the Board changed as a consequence of the reforms? Is the composition appropriate?
- What factors does the Board consider in appointing a new member? Have these factors changed as a result of the reforms?

Corporate governance guidelines notification of the SEC

- How familiar are you with these guidelines?
- To what extent have the guidelines been adopted by this company?
- Do you think these guidelines are beneficial to this company?
  a. If yes, in what ways has your company benefitted from the guidelines?
  b. If no, do you consider the guidelines unnecessary?
- What problems, if any, has the company encountered in applying the guidelines?

- Do you think the guidelines have been beneficial to other companies of which you are a director? Why or why not?

B. Questions to be asked only to independent directors and audit committee members

- When and how were you recruited as an independent director by this company? Who introduced you to the company?

- What factors motivated you to serve on the Board?

- Do you communicate with Board members other than at Board meetings? If yes, how and why?

- What do you see as your role as an independent director? What obstacles, if any, do you face in fulfilling that role?

- At Board meetings, to what extent do inside directors consider the opinions of independent directors?

- Do the Articles of Association of your company require Board approval of related party transactions?

- Does the Board discuss related party transactions at its meetings?

- In your opinion, what is the role of the audit committee in this company?

- What is your specific task as a committee member? What obstacles, if any, do you face in fulfilling that role?

- What motivates you to work as an audit committee member?
- How does your background (education and experience) help you in your role on the audit committee?

- Do you think the backgrounds of members of the audit committee in this company are appropriate to the task?

- How effective is the audit committee? How could it do its job better?

- If you are a member of an audit committee in another company or companies, to what extent do you believe those committees add value?
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<tr>
<th>No.</th>
<th>Age</th>
<th>Education</th>
<th>Profession</th>
</tr>
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</table>
| 1   | 55  | B.Com (Hons.)
M.Com(Accounting)
FCA                                      | Public Accounting Practice |
| 2   | 35  | B.Com                                        | Accountant                  |
| 3   | 72  | BA (Honours) from Dhaka University
MA (UK)                                  | Retired bureaucrat          |
| 4   | 45  | BCom (Hons)
MCom, University of Dhaka
MBA (Canada)                              | University professor        |
| 5   | 60  | BA (Honours)
MA Sociology, University of Dhaka
Masters in Sociology, (Russia)           | University professor        |
| 6   | 70  | -                                            | Retired bureaucrat          |
| 7   | 60  | Chartered Accountant                         | Accountancy education       |
| 8   | 60  | BSc, MSc and PhD in Civil Engineering       | University professor        |
### Profile of Non-independent Directors

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<td>CFO of a group of companies</td>
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<tr>
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<td>businessman</td>
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<td>businessman</td>
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<td>45</td>
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<td>CEO of a bank</td>
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<td>50</td>
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## Profile of Audit Committee Members

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<th>Age</th>
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</table>
| 1   | 55  | B.Com (Hons.)  
M.Com(Accounting)  
FCA | Public accounting practice |
| 2   | 35  | B.Com | Accountant |
| 3   | 72  | BA (Honours) from Dhaka University  
MA (UK) | Retired bureaucrat |
| 4   | 60  | BA (Honours)  
MA Sociology, University of Dhaka  
Masters in Sociology, (Russia) | University professor |
| 5   | 70  | - | Retired bureaucrat |
| 6   | 60  | Chartered accountant | Accountancy education |
| 7.  | 60  | BSc, MSc and PhD in Civil Engineering | University professor |
| 8   | 65  | B.Com  
Charted accountant | CFO of a group of companies |
I. RELATED PARTY TRANSACTIONS IN THE COMPANY LAW 1994

Company Law 1994 of Bangladesh provides limited protection to minority shareholders from some related party transactions. According to section 103 of the Company Act 1994 (1) no company, shall make any loan or give any guarantee or provide any security in connection with a loan made by a third party to--

(a) any director of the lending company

(b) any firm in which any director of the lending company is a partner;

(c) any private company of which any director of the lending company is a director or member; or

(d) any public company, the managing agent manager or director where of is accustomed to act in accordance with the directions or instruction of any director of the lending company:

Provided that nothing in this section shall apply to the making of a loan or giving of any guarantee or providing any security by a lending company, if--

(i) such company is a banking company or a private company not being a subsidiary of a public company, or if such company as a holding company makes the loan or gives the guarantee or provide the security to its subsidiary; and

(ii) the loan is sanctioned by the Board of Directors of any company and approved by the general meeting and, in the balance sheet, there is a specific mention of the loan,
guarantee or security, as the case may be. Provided further that, in no case the total amount of the loan shall exceed 50% of the paid up value of the shares held by such director in his own name.

(2) In the event of any contravention of sub-section (1) every person who is a party to such contravention including in particular any person to whom a loan is made or on whose behalf a guarantee is given to or security provided shall be punishable with the fine which extend to five thousand taka or simple imprisonment for six months in lieu of fine and shall be liable jointly and severally to the lending company for the repayment of such loan or for making good any sum which the lending company may be called up to pay under the guarantee given or security provided by the lending company.

(3) This section shall apply to any transaction represented by a book debt which was from its inception in the nature of a loan or an advance.
II. RELATED PARTY TRANSACTIONS LAWS IN THE BANK COMPANY ACT 1991 (AMENDED IN 2003)

Section 27 and 28 of the Bank Company Act 1991 provide some protection to minority shareholders from DRPTs by restricting loans without any collateral security to any directors, director’s family members or any organization where the directors or directors’ family members are involved as director, shareholders or owner. Banks must not wave loans of these parties if they fail to repay their loans. Section 27 stipulates that (1) no banking company-

a) shall make any loans or advances on the security of its own shares;

b) shall, without security, make any loan or advance to any of the following persons or institutions, or make any loan or advance in cases where those persons or institutions are guarantors-

i) any of its directors;

ii) any member of the family of any of its directors;

iii) any commercial institution or private company in which the banking company itself, or any of its directors or any member of the family of any of its directors is involved as director, owner or shareholder;

iv) any public limited company which is in some way or other controled by the company itself, or any of its directors or any member of the family of any of its directors, or the
shares of which are held by any of the said persons to such an extent as to give it control of no less than twenty per cent of the voting rights.

(2) No banking company shall give to any of the following persons or institutions any loan or advance without the approval of the majority of the directors, excluding the director concerned.-

a) any of its directors; or

b) any person, commercial institution or company in which any of the directors of the said banking company is interested as partner, director or guarantor.

Explanation.- For the purpose of this subsection "director" shall include the director's wife, husband, father, mother, son and daughter.

(3) No banking company shall, without the previous permission in writing of the Bangladesh Bank, give to any person or institution, directly or indirectly, any benefit the aggregate value of which exceeds-

a) 15 per cent of the total capital of the said banking company; or

b) 25 per cent of the total capital of the said banking company where the security of the said benefits has been provided by such financial securities as might be easily put on the market for sale.
Explanation.- (1) "Benefit" shall mean any loan, advance or any other loan benefit, or financial guaranties or any such obligation as any banking company has taken on in behalf of any person or institution; and

(2) "Total capital" shall mean paid-up capital and reserve fund including those various kinds of security which are in accordance with the provisions of the Bangladesh Bank under section (13), certificates of indebtedness, deposits, obligations etc.

(4) Every banking company shall, before the close of the month to which the report relates, submit to the Bangladesh Bank a report in the prescribed form and manner, and in the said report the following particulars shall be mentioned-

a) all loans and advances granted by it to companies, private as well as public, in which the banking company or any of its directors is interested as director; and

b) all loans and advances granted by it to public companies in which the banking company or any of its directors is interested as managing agent or guarantor.

(5) If on examination of any report submitted under subsection (4) it appears to the Bangladesh Bank that any loans or advances referred to in that subsection have been granted to the detriment of the interests of the depositors of the banking company, the Bangladesh Bank may, by order in writing, prohibit the banking company from granting any such further loans or advances or impose restrictions on the granting of such loans or advances, and may direct the banking company to secure the repayment of loans or advances granted in this way within such time as may be specified in the order.
Section 28 restricts the respite of loans. It states that (1) No banking company shall, without the previous approval of the Bangladesh Bank, grant respite of loans taken from it by any of the following persons or institutions,-

a) any of its directors, and his family members;

b) a commercial institution or company in which any director of the banking company is interested as landowner, co-director, managing agent; and

c) any such person in which any director of the banking company is interested as partner or landowner.

(2) Any respite of loans in disregard of the provisions of subsection (1) shall be illegal, and whoever is responsible for such a respite shall be punishable with imprisonment for no more than three years or a fine of no more than thirty thousand Takas or both.
III.  BRPD CIRCULAR NO. 7 DATED AUGUST 5, 1999
RESTRICTION ON LENDING TO DIRECTORS OF PRIVATE BANKS

The following instructions on the above issued with the authority vested under Section 45 of Bank Companies Act, 1991:

1. Any loan facility or guarantee or security provided to a Director of a bank or to his relatives must be sanctioned by the Board of Directors of the bank and has to be specifically mentioned in the Balance sheet of the bank. However the total amount of the loan facilities extendable to a Director or to his relatives should not exceed 50% of the paid-up value of the shares of that bank held in Director's own name.

2. If the total amount of loan facilities already extended to a Director or to his relatives exceeds 50% of the paid-up value of the shares of the bank held in Director's own name, the amount in excess should be repaid within the time approved by Bangladesh Bank. Under no circumstances, renewal or extension of time of the loan facilities in excess of that 50% can be made.

3. No such loan wherein the borrower is exempted fully or partially from bearing the loss including Mudaraba or Musharaka systems of loan can be extended to any Director or any relatives of him.

4. Subject to compliance of the conditions mentioned in paragraph No.1 above, loan facilities in excess of Tk.10 lacs for funded loan and Tk.50 lacs (funded and non-funded) in favor of any Director or his relatives or proprietorship or partnership firms and private
or public limited companies wherein those persons have interests, can be extended subject to obtaining no-objection from Bangladesh Bank.

5. If any Director of a bank without being apparently involved in any industrial /commercial organization, conducts or directs accounts thereof or otherwise has control thereupon or extends collateral security or guarantee against any loans thereof, he will be treated to have interest in that organization/loan account.

6. Bank loan of any public limited company will be treated as liability of a Director of the bank in proportion of the amount (percentage) of shares of that company held by him.

7. If any Director extends guarantee against any loan for any specific amount, his liability will remain limited up to that specific amount.

8. In case of extending loan facilities in favor of the organization wherein the Director has interest, all kinds of legal formalities have to be properly executed as per norms.

9. Respective rules and regulations of Bank Companies Act, 1991 regarding loan facilities in general and other instructions of Bangladesh Bank should be followed as usual.

10. For the purpose of extending loan facilities, the explanation as given under Sub-section 27(2) of Bank Companies Act, 1991 will be applicable to define the term
`Director', i.e., it will include his/her spouse, father, mother, son, daughter, brother, sister and all his dependants.

11. If any loans availed in the names of the Directors or organizations wherein they have interests, turn to defaulted ones, legal action has to be initiated instantly and inter alia the Directors have to be served with the notice under Section 17 of Bank Companies Act, 1991.

12. The quarterly statement of liabilities of the Directors and Ex-Directors of the bank as defined in the latest amendment of Bank Companies Act, 1991, will have to be submitted to Bangladesh Bank in the format as enclosed with the BRPD Circular Letter No. 8 dated 19 June, 1997.

13. Any change/cancellation/return of security, collateral security, guarantee etc, provided against the loan of any Director or Ex-Director of a bank will require prior permission from Bangladesh Bank.

14. Any change of the conditions of any loans of any Director or Ex-Director of a bank will require prior permission from Bangladesh Bank. Copies of sanction-letters of all loans of the Director or Ex-Director have to be submitted to Bangladesh Bank. Copies of the sanction-letters of existing loans have to be submitted within September 30, 1999 to Banking Regulation and policy Department. In future, copies of the sanction-letters will have to be submitted to the said Department within 1(one) week from the date of sanction
of the loan with the no-objection from Bangladesh Bank but before the disbursement of the loan.

15. The above rule will also be applicable in case of those loans extended in favor of any organizations wherein any Director/ex-Director of the bank has interest or he/she was once proprietor, partner, director or guarantor thereof; i.e., any change of the security, collateral security, guarantee provided against the loans of those organizations or of the conditions of sanction will require prior permission from Bangladesh Bank. Copies of sanction-letters of such loan-accounts will have to be submitted to Banking Regulation and policy Department within October 15, 1999.

16. No remission facilities (including A/C blocking) to any loan accounts wherein bank's Director or Ex-Director has interest can be allowed without prior permission from Bangladesh Bank. However, in case of the Ex-Directors who are at present not holding any share of the bank including the Govt.-nominated Directors, the issue of waiver of interest on loans availed before they were Directors of the bank or after they ceased to be the Directors, with the permission of the Board of Directors of the bank will not require prior permission from Bangladesh Bank.

17. If re-scheduling is required in case of loans extended before the issuance of BRPD Circular No. 07 dated 5.8.99 in favor of Director or any organization wherein he has interest, time of repayment in case of term loan can be extended for maximum 03(three) years and in case of working capital latest up to 31st December, 2001. The proposal of rescheduling has to be approved by the Board of Directors of the bank and will come into
effect after obtaining no-objection from Bangladesh Bank. If the history of past repayment of loan accounts of the Director or wherein they have interests, is good and at the same time repayment is not being possible for reasons beyond control and temporary inconvenience, only those accounts will be considered for rescheduling as per above procedure.
1.00 Board of Directors:

1.1. Board’s Size

The number of the board members of the company should not be less than 5 (five) and more than 20 (twenty): Provided, however, that in the case of banks and non-bank financial institutions, insurance companies and statutory bodies for which separate primary regulators like Bangladesh Bank, Department of Insurance etc. exist, the Board of those companies should be constituted as may be prescribed by such primary regulators in so far as those prescriptions are not inconsistent with the aforesaid condition.

1.2. Independent Directors

All companies should encourage effective representation of independent directors on their Board of Directors so that the Board, as a group, includes core competencies considered relevant in the context of each company. For this purpose, the companies should comply with the following:– (i) At least one tenth (1/10) of the total number of the company’s board of directors, subject to a minimum of one, should be independent directors.

For the purpose of this clause “independent director” means a director who does not hold any share in the company or who holds less than one percent (1%) shares of the total paid-up shares of the company, who is not connected with the company’s promoters or
directors or shareholder who holds one percent (1%) or more than one percent (1%) shares of the total paid-up shares of the company on the basis of family relationship; who does not have any other relationship, whether pecuniary or otherwise, with the company or its subsidiary/associated companies, who is not a member, director or officer of any stock exchange, and who is not a shareholder, director or officer of any member of stock exchange or an intermediary of the capital market.

(ii) The independent director(s) should be appointed by the elected directors.

1.3. Chairman of the Board and Chief Executive

The positions of the Chairman of the Board and the Chief Executive Officer of the companies should preferably be filled by different individuals. The Chairman of the company should be elected from among the directors of the company. The Board of Directors should clearly define respective roles and responsibilities of the Chairman and the Chief Executive Officer.

1.4 The Directors’ Report to Shareholders

The directors of the companies should include following additional statements in the Directors’ Report prepared under section 184 of the Companies Act, 1994:-

(a) The financial statements prepared by the management of the issuer company present fairly its state of affairs, the result of its operations, cash flows and changes in equity.

(b) Proper books of account of the issuer company have been maintained.
(c) Appropriate accounting policies have been consistently applied in preparation of the financial statements and that the accounting estimates are based on reasonable and prudent judgment.

(d) International Accounting Standards, as applicable in Bangladesh, have been followed in preparation of the financial statements and any departure therefrom has been adequately disclosed.

(e) The system of internal control is sound in design and has been effectively implemented and monitored.

(f) There are no significant doubts upon the issuer company’s ability to continue as a going concern. If the issuer company is not considered to be a going concern, the fact along with reasons thereof should be disclosed.

(g) Significant deviations from last year in operating results of the issuer company should be highlighted and reasons thereof should be explained.

(h) Key operating and financial data of at least preceding three years should be summarised.

(i) If the issuer company has not declared dividend (cash or stock) for the year, the reasons thereof should be given.
(j) The number of Board meetings held during the year and attendance by each director should be disclosed.

(k) The pattern of shareholding should be reported to disclose the aggregate number of shares (along with name wise details where stated below) held by:

(i) Parent/Subsidiary/Associated companies and other related parties (name wise details);

(ii) Directors, Chief Executive Officer, Company Secretary, Chief Financial Officer, Head of Internal Audit and their spouses and minor children (name wise details);

(iii) Executives; and

(iv) Shareholders holding ten percent (10%) or more voting interest in the company (name wise details).

Explanation: For the purpose of this clause, the expression “executive” means top five salaried employees of the company, other than the Directors, Chief Executive Officer, Company Secretary, Chief Financial Officer and Head of Internal Audit.

2.00 Chief Financial Officer (CFO), Head of Internal Audit And Company Secretary:

2.1. Appointment
The company should appoint a Chief Financial Officer (CFO), a Head of Internal Audit and a Company Secretary. The Board of Directors should clearly define respective roles, responsibilities and duties of the CFO, the Head of Internal Audit and the Company Secretary.

2.2. Requirement to Attend Board Meetings

The CFO and the Company Secretary of the companies should attend meetings of the Board of Directors, provided that the CFO and/or the Company Secretary should not attend such part of a meeting of the Board of Directors which involves consideration of an agenda item relating to the CFO and/or the Company Secretary.

3.00 Audit Committee:

The company should have an Audit Committee as a sub-committee of the Board of Directors. The Audit Committee should assist the Board of Directors in ensuring that the financial statements reflect true and fair view of the state of affairs of the company and in ensuring a good monitoring system within the business. The Audit Committee shall be responsible to the Board of Directors. The duties of the Audit Committee should be clearly set forth in writing.

3.1. Constitution of Audit Committee

(i) The Audit Committee should be composed of at least 3 (three) members.

(ii) The Board of Directors should appoint members of the Audit Committee who should be directors of the company and should include at least one independent
director.

(iii) When the term of service of the Committee members expires or there is any circumstance causing any Committee member to be unable to hold office until expiration of the term of service, thus making the number of the Committee members to be lower than the prescribed number of 3 (three) persons, the Board of Directors should appoint the new Committee member(s) to fill up the vacancy(ies) immediately or not later than 1 (one) month from the date of vacancy(ies) in the Committee to ensure continuity of the performance of work of the Audit Committee.

3.2. Chairman of the Audit Committee

(i) The Board of Directors should select 1 (one) member of the Audit Committee to be Chairman of the Audit Committee.

(ii) The Chairman of the audit committee should have a professional qualification or knowledge, understanding and experience in accounting or finance.

3.3. Reporting of the Audit Committee

3.3.1. Reporting to the Board of Directors

(i) The Audit Committee should report on its activities to the Board of Directors.

(ii) The Audit Committee should immediately report to the Board of Directors on the following findings, if any:-
(a) Report on conflicts of interests;

(b) Suspected or presumed fraud or irregularity or material defect in the internal control system;

(c) Suspected infringement of laws, including securities related laws, rules and regulations; and

(d) Any other matter which should be disclosed to the Board of Directors immediately.

3.3.2. Reporting to the Authorities

If the Audit Committee has reported to the Board of Directors about anything which has material impact on the financial condition and results of operation and has discussed with the Board of Directors and the management that any rectification is necessary and if the Audit Committee finds that such rectification has been unreasonably ignored, the Audit Committee should report such finding to the Commission, upon reporting of such matters to the Board of Directors for three times or completion of a period of 9 (nine) months from the date of first reporting to the Board of Directors, whichever is earlier.

3.4. Reporting to the Shareholders and General Investors

Report on activities carried out by the Audit Committee, including any report made to the Board of Directors under condition 3.3.1 (ii) above during the year, should be signed by
the Chairman of the Audit Committee and disclosed in the annual report of the issuer company.

4.00. External/Statutory Auditors

The issuer company should not engage its external/statutory auditors to perform the following services of the company; namely:-

(i) Appraisal or valuation services or fairness opinions;

(ii) Financial information systems design and implementation;

(iii) Book-keeping or other services related to the accounting records or financial statements;

(iv) Broker-dealer services;

(v) Actuarial services;

(vi) Internal audit services; and

(vii) Any other service that the Audit Committee determines.

5.00 Reporting the Compliance in the Director’s Report

The directors of the company shall state, in accordance with the annexure attached, in the directors’ report whether the company has complied with these conditions.
CORPORATE GOVERNANCE GUIDELINES FOR BANKS

Bangladesh bank, the central bank of Bangladesh, issue guidelines and rules for monitoring banks and financial institutions. It has issued several circulars relating to corporate governance guidelines in banks in Bangladesh.

Corporate Governance in Bank Management
(BRPD Circular No. 16 dated 24 July 2003)

BRPD Circular No. 16 dated 24 July 2003 of Bangladesh Bank stipulates the responsibilities and authorities among the board of directors, the chairman, Chief Executive Officer (CEO) of and adviser to the private bank in respect of its overall financial, operational and administrative policymaking and executive affairs including overall business activities, internal control, human resources management and development thereof, income and expenditure etc., along with lending and risk management issues, is outlined as follows:-

01. Responsibilities and authorities of the board of directors:

(a) Work-planning and strategic management:

(i) The board shall determine the objectives and goals and to this end shall chalk out strategies and work-plans on annual basis. It shall specially engage itself in the affairs of making strategies consistent with the determined objectives and goals and in the issues relating to structural change and reorganization for enhancement of institutional efficiency and other relevant policy matters. It shall analyse /monitor at quarterly rests the development of implementation of the work-plans.
(ii) The board shall have its analytical review incorporated in the Annual Report as regard the success/failure in achieving the business and other targets as set out in its annual work-plan and shall apprise the shareholders of its opinions/recommendations on future plans and strategies. It shall set the Key Performance Indicators (KPIs) for the CEO and other senior executives and have it evaluated at times.

(b) Lending and risk management:

(i) The policies, strategies, procedures etc. in respect of appraisal of loan/investment proposal, sanction, disbursement, recovery, rescheduling and write-off thereof shall be made with the board's approval under the purview of the existing laws, rules and regulations. The board shall specifically distribute the power of sanction of loan/investment and such distribution should desirably be made among the CEO and his subordinate executives as much as possible. No director, however, shall interfere, directly or indirectly, into the process of loan approval.

(ii) The board shall frame policies for risk management and get them complied with and shall monitor at quarterly rests the compliance thereof.

(c) Internal control management:

The board shall be vigilant on the internal control system of the bank in order to attain and maintain satisfactory qualitative standard of its loan/investment portfolio. It shall review at quarterly rests the reports submitted by its audit committee regarding compliance of recommendations made in internal and external audit reports and the Bangladesh Bank inspection reports.
(d) **Human resources management and development:**

1. Policies relating to recruitment, promotion, transfer, disciplinary and punitive measures, human resources development etc. and service rules shall be framed and approved by the board. The chairman or the directors shall in no way involve themselves or interfere into or influence over any administrative affairs including recruitment, promotion, transfer and disciplinary measures as executed under the set service rules. No member of the board of directors shall be included in the selection committees for recruitment and promotion to different levels. Recruitment and promotion to the immediate two tiers below the CEO shall, however, rest upon the board. Such recruitment and promotion shall have to be carried out complying with the service rules i.e., policies for recruitment and promotion.

2. The board shall focus its special attention to the development of skills of bank's staff in different fields of its business activities including prudent appraisal of loan/investment proposals, and to the adoption of modern electronic and information technologies and the introduction of effective Management Information System (MIS). The board shall get these programs incorporated in its annual work plan.

(e) **Financial management:**

(i) The annual budget and the statutory financial statements shall finally be prepared with the approval of the board. It shall at quarterly rests review/monitor the positions in respect of bank's income, expenditure, liquidity, non-performing asset, capital base and adequacy, maintenance of loan loss provision and steps taken for recovery of defaulted loans including legal measures.
(ii) The board shall frame the policies and procedures for bank's purchase and procurement activities and shall accordingly approve the distribution of power for making such expenditures. The maximum possible delegation of such power shall rest on the CEO and his subordinates. The decision on matters relating to infrastructure development and purchase of land, building, vehicles etc. for the purpose of bank's business shall, however, be adopted with the approval of the board.

(f) Formation of supporting committees:

For decision on urgent matters an executive committee, whatever name called, may be formed with the directors. There shall be no committee or sub-committee of the board other than the executive committee and the audit committee. No alternate director shall be included in these committees.

(g) Appointment of CEO:

The board shall appoint a competent CEO for the bank with the approval of the Bangladesh Bank.

02. Responsibilities of the chairman of the board of directors:

(a) As the chairman of the board of directors (or chairman of any committee formed by the board or any director) does not personally possess the jurisdiction to apply policymaking or executive authority, he shall not participate in or interfere into the administrative or operational and routine affairs of the bank.
(b) The chairman may conduct on-site inspection of any bank-branch or financing activities under the purview of the oversight responsibilities of the board. He may call for any information relating to bank’s operation or ask for investigation into any such affairs; he may submit such information or investigation report to the meeting of the board or the executive committee and if deemed necessary, with the approval of the board, he shall effect necessary action thereon in accordance with the set rules through the CEO. However, any complaint against the CEO shall have to be apprised to Bangladesh Bank through the board along with the statement of the CEO.

(c) The chairman may be offered an office-room, a personal secretary/assistant, a telephone at the office and a vehicle in the business-interest of the bank subject to the approval of the board.

03. Responsibilities of the adviser:

The adviser, whatever name called, shall advise the board of directors or the CEO on such issues only for which he is engaged in terms of the conditions of his appointment. He shall neither have access to the process of decision-making nor shall have the scope of effecting executive authority in any matters of the bank including financial, administrative or operational affairs.

04. Responsibilities and authorities of the CEO:

The CEO of the bank, whatever name called, shall discharge the responsibilities and effect the authorities as follows:
(a) In terms of the financial, business and administrative authorities vested upon him by the board, the CEO shall discharge his own responsibilities. He shall remain accountable for achievement of financial and other business targets by means of business plan, efficient implementation thereof and prudent administrative and financial management.

(b) The CEO shall ensure compliance of the Bank Companies Act, 1991 and/or other relevant laws and regulations in discharge of routine functions of the bank.

(c) The CEO shall report to Bangladesh Bank of issues violative of the Bank Companies Act, 1991 or of other laws/regulations and, if required, may apprise the board post facto.

(d) The recruitment and promotion of all staff of the bank except those in the two tiers below him shall rest on the CEO. He shall act in such cases in accordance with the approved service rules on the basis of the human resources policy and sanctioned strength of employees as approved by the board. The board or the chairman of any committee of the board or any director shall not get involved or interfere into such affairs. The authority relating to transfer of and disciplinary measures against the staff, except those at one tier below the CEO, shall rest on him, which he shall apply in accordance with the approved service rules. Besides, under the purview of the human resources policy as approved by the board, he shall nominate officers for training etc.
Audit Committee of the Board of a bank can play an effective role in providing a bridge between the board and management, shareholders, depositors and stake-holders and help in ensuring efficient, safe and sound banking practices. Role of the audit committee is also important in evolving an effective procedure for financial reporting disclosure, developing a suitable internal control system and maintaining liaison with internal and external auditors to minimize various business risks. Moreover, new business opportunities and increased competition due to globalization of markets, increased use of electronics and information technology, increased complexity of transactions, accounting standards and regulatory requirements are contributing to essentiality and expansion of the role of audit committee. Under the above circumstances, as part of the best practices, banks are advised to constitute Board's Audit Committee and the following regulations are being issued by Bangladesh Bank for compliance by the banks:-

**Overall Purpose/Objectives**

The audit committee will assist the board in fulfilling its oversight responsibilities including implementation of the objectives, strategies and overall business plans set by the board for effective functioning of the bank. The committee will review the financial reporting process, the system of internal control and management of financial risks, the audit process, and the bank's process for monitoring compliance with laws and regulations and its own code of business conduct.
Roles and Responsibilities of the Audit Committee

The audit committee will:

Internal Control

(1) Evaluate whether management is setting the appropriate compliance culture by communicating the importance of internal control and the management of risk and ensuring that all employees have understanding of their roles and responsibilities;

(2) Review the arrangements made by the management for building a suitable Management Information System (MIS) including computerization system and its applications;

(3) Consider whether internal control strategies recommended by internal and external auditors have been implemented by the management;

(4) Review the existing risk management procedures for ensuring an effective internal check and control system;

(5) Review the corrective measures taken by the management as regards the reports relating to fraud-forgery, deficiencies in internal control or other similar issues detected by internal and external auditors and inspectors of the regulatory authority and inform the board on a regular basis.

Financial Reporting

(1) Review the annual financial statements and determine whether they are complete and consistent with the accounting standards set by the regulatory authority;
(2) Meet with management and the external auditors to review the financial statements before their finalization.

**Internal Audit**

(1) Review the activities and organizational structure of the internal audit function and ensure that no unjustified restrictions or limitations are made;

(2) Review the efficiency and effectiveness of internal audit function;

(3) Review that findings and recommendations made by the internal auditors for removing the irregularities detected and also running the affairs of the bank are duly considered by the management.

**External Audit**

(1) Review the auditing performance of the external auditors and their audit reports;

(2) Review that findings and recommendations made by the external auditors for removing the irregularities detected and also running the affairs of the bank are duly considered by the management;

(3) Make recommendations to the board regarding the appointment of the external auditors. Compliance with existing laws and Regulations;
Review whether the laws and regulations framed by the regulatory authorities (central bank and other bodies) and internal regulations approved by the board have been complied with.

**Other Responsibilities**

(1) Place compliance report before the board on quarterly basis regarding regularization of the errors & omissions, fraud and forgeries and other irregularities as detected by the internal and external auditors and inspectors of regulatory authorities;

(2) Perform other oversight functions as requested by the board and evaluate the committee's own performance on a regular basis.

**Organization**

(1) The audit committee will comprise of 03 (three) members;

(2) Members of the committee will be nominated by the board of directors from the directors;

(3) Members may be appointed for a 03 (three)-year term of office;

(4) Company secretary of the bank will be the secretary of the audit committee.

**Qualifications of the Member**

(1) Integrity, dedication, and opportunity to spare time for the committee will have to be considered while giving nomination a director to the committee;

(2) Each member should be capable of making valuable and effective contributions in the functioning of the committee;
(3) To perform his or her role effectively each committee member should have adequate understanding of the detailed responsibilities of the committee membership as well as the bank’s business, operations and its risks.

Meetings

(1) The audit committee should hold at least 3/4 meetings in a year and it can seat any time as it may deem fit;

(2) The committee may invite such other persons (e.g. the CEO, head of internal audit) to its meetings, as it deems necessary;

(3) The internal and external auditors of the bank should be invited to make presentations to the audit committee as appropriate;

(4) To maximize effectiveness, detailed memorandum to be discussed in the meeting should be distributed to committee members well in advance of the meeting to allow proper consideration of enclosed papers;

(5) The proceedings of all meetings will be minuted.
Responsibilities of running the affairs of a bank-company, like other companies, are entrusted to its board of directors. The responsibilities of the board of directors of a bank company are more important than those of other companies; because in case of a bank-company it is essential to earn and maintain confidence of the depositors as its business is mainly run with the depositors' money. The board of directors shall also have to strive to protect interests of its depositors as well as of the shareholders. It is imperative to constitute the board of directors with competent and professionally skilled persons and limit the number of directors with a view to formulating policy-guidelines and supervising business activities of the bank efficiently as well as ensuring good and corporate governance in the bank management. Bangladesh Bank deems it necessary to issue directives for compliance of the bank company regarding constitution of the board of directors and fit and proper test for appointment of directors in the interest of depositors and for securing proper management of the bank-companies. Therefore, in exercise of the powers conferred by section 45(1) of the Bank Companies Act, 1991, the following restrictions have been imposed regarding constitution of the board of directors and fit and proper test criteria for consideration and compliance of the appointing authority (viz.- general meeting, board of directors etc.) of the private banks regarding appointment or reappointment and filling up of casual vacancy of the offices of bank directors:
1. Constitution of the Board of Directors:-

a) The board of directors of the bank-companies shall be constituted of maximum 13 (thirteen) directors. However, the directors of the banks, where the number of directors is more than this number, shall be allowed to complete their present tenure of office.

b) This restriction shall apply to appointment/reappointment of the directors against retirement or filling casual vacancy subject to section 15 Ka Ka of the Bank Companies Act, 1991. Not more than one member of a family will become director of a bank. For this purpose family members shall include spouse, parents, children, brothers and sisters of the director and other persons dependent on him/her.

2. Fit and Proper Test:-

a) The concerned person must have management/business or professional experience for at least 10 (ten) years;

b) (S)he has not been convicted in any criminal offence or involved in any fraud/forgery, financial crime or other illegal activities;

c) (S)he has not been subject to any adverse findings in any legal proceedings,

d) (S)he has not been convicted in regard to contravention of rules, regulations or disciplines of the regulatory authorities relating to financial sector;

e) (S)he has not been involved with a company/firm whose registration/license has been revoked or cancelled or which has gone into liquidation;

f) Loans taken by him/her or allied concern from any bank or financial institution have not become defaulted;

g) (S)he has not been adjudicated a bankrupt by a court;
h) (S)he must be loyal to the decisions of the board of directors. However, in case of note of dissent, (s)he may record it in the minutes of the board meeting and/or bring it to the notice of Bangladesh Bank considering its merit.

3. A person, proposed as a candidate for the office of director, shall furnish along with the consent letter for the purpose of section 93 of the Companies Act, 1994 a declaration as per the attached format that (s)he is not disqualified to become a bank director in accordance with the above mentioned fit and proper test.

4. The declaration shall have to be signed by the concerned person (candidate) and if elected it shall have to be forwarded to Bangladesh Bank by the Chairman of the board of directors.

5. The above-mentioned restrictions for qualifications of bank directors shall be in addition to any related laws/regulations for the time being in force.
RULES AND REGULATIONS FOR APPOINTMENT OF CEO AND ADVISER
BRPD CIRCULAR NO. 15 DATED SEPTEMBER 03, 2002

Sub-section (4) of Section 15 of Bank Companies Act, 1991 empowers Bangladesh Bank to issue regulations requiring bank companies to obtain prior approval of Bangladesh Bank in respect of appointment as well as dismissal, release or removal of Chief Executive and Adviser in bank companies. In bank management, the issue of good governance is very important. In order to strengthen the financial base of the bank and obtain confidence of the depositors, appointing honest, efficient, experienced and suitable Chief Executive is one of the responsibilities of the Board of Directors. In order to ensure good governance the following rules are issued for compliance of the banks replacing the previous instructions in this respect:

1. Moral Integrity:
In case of appointment to the post of Chief Executive /Adviser, satisfaction in respect of the concerned person should be ensured to the effects that:

a) (s)he has not been convicted by any Criminal Court of Law;
b) (s)he has not violated any rules, regulations or procedures /norms set by any Controlling Authority;
c) (s)he was not associated with any such company /organization, registration or licence of which has been cancelled or which has gone into liquidation;
d) (s)he has not been disqualified to be the Chairman or Director or Chief Executive of any Company

2. Experience and Suitability:

a) For appointment as Chief Executive, the concerned person will have experience for at least 15 (fifteen) years as an active officer in bank or financial institution and at least for 02 (two) years in the post immediate to the post of the Chief Executive of a bank. The tenure of the Chief Executive shall be for at least 03 (three) years, which is renewable. For appointment as Adviser,
15 (fifteen) years' job experience in bank or financial institution or administrative experience will be regarded as eligibility. But, the tenure of the Adviser shall not exceed 01 (one) year.
b) Higher academic education in the field of Economics, Banking and Finance or Business Administration will be regarded as additional qualification for the concerned person.
c) In respect of service, the concerned person should have high record of performance.
d) Satisfaction should be ensured that the concerned person was not dismissed from his service when he was Chairman/Director/Official of any company;
e) No Director of the Bank or financial institution or person who has business interest in that bank will be considered eligible for appointment to the post of Chief Executive/ Adviser.

3. Transparency and Financial Integrity:
Before appointment as chief Executive/Adviser, satisfaction should be ensured to the effects that:
a) The concerned person was not involved in any illegal activity while performing duties in his own or banking profession;
b) (s)he has not suspended payment or has not compounded with his creditors;
c) (s)he has never been adjudicated an insolvent .

4. Before appointment as Chief Executive or Adviser, prior permission in writing from Bangladesh Bank as per provision of Sub-section (4) of Section 15 of Bank Companies Act, 1991 should be obtained. In order to have such permission, full bio-data and terms and conditions of appointment (mentioning direct and indirect payable salary and allowances and facilities) should be submitted to Bangladesh Bank. The banks are required to follow the guidelines stated below while determining the salary and allowances of the Chief Executive and submitting such proposal to Bangladesh Bank: -

(1) In fixing the salary and allowances of the Chief Executive of a bank, financial condition, area of operation, business-volume and earning capacity of the bank, qualifications, age and
experience of the person concerned and the remuneration paid to the persons occupying same position in the peer banks shall have to be taken into consideration.

(2) Total salary shall be comprised of direct salary covering 'Basic Pay' and 'House Rent' and allowances as 'Others'. The allowances (e.g., provident fund, utility bill, leave-fare assistance etc.) in 'Others' head should be specified in amount/ceiling. Besides, other facilities (e.g., car, fuel, driver etc.), as far as possible, shall have to be monetized and thus determining monthly total salary, it shall have to be mentioned in the proposal to be submitted to Bangladesh Bank. In the proposal, Basic Pay, House Rent, Festival Allowance, other allowances and other facilities shall have to be specified in amount in Taka.

(3) Terms of salary-allowances and other facilities as specified in the terms and conditions of appointment cannot be changed during the tenure. In case of renewal, proposal may be made for re-fixation of the salary considering the job performance of the incumbent Chief Executive.

(4) The Chief Executive so appointed shall not get any other direct or indirect facilities (e.g., dividend, commission, bonus, club expense etc.) other than the salary-allowances and other facilities as enumerated in item no. (2).

(5) The bank shall not pay any income tax for the Chief Executive, i.e., the Chief Executive so appointed shall have to pay it.

5. No person crossing the age of 65 years shall hold the post of Chief Executive of a bank.
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