GOVERNANCE OF TUNNELLING IN DEVELOPING COUNTRIES: EVIDENCE FROM BANGLADESH

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Governance of Tunnelling in Developing Countries: Evidence from Bangladesh

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Abstract

Tunnelling (also known as self-dealing transactions) are non-arm's length transactions with related parties of controlling shareholders for their private benefit and at the cost of other shareholders. Tunnelling is a governance issue between controlling shareholders and minority shareholders in both developed and developing countries. However, most studies on tunnelling are in developed countries with the few exceptions of studies on China, India and Mexico. Using Oliver Williamson's *Market and Hierarchy* model this paper analyses the suitability of the governance requirements on tunnelling in Bangladesh and reports on interviews with non-independent directors, independent directors, and audit committee members. The study thus identifies the limitations and factors that affect the implementation and effectiveness of the current governance requirements to constrain tunnelling in companies in Bangladesh.

JEL code: J3; K2; M4.

Keywords: tunnelling; Bangladesh; market and hierarchy model.

1. Introduction

This paper uses Oliver Williamson's *Market and Hierarchy* model to analyse the form of governance on tunnelling appropriate for developing countries, specifically Bangladesh, and reports on interviews with company directors to assess the implementation and effectiveness of governance on tunnelling in Bangladesh.

Tunnelling (also known as self-dealing transactions) has drawn considerable attention in recent years. Tunnelling is non-arm's length transactions with related parties of controlling shareholders 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). These transactions not only erode firm value (Peng et al. 2010, Atanasov et al. 2010, Jiang et al. 2010) but may also lead to bankruptcy. Many of the notorious corporate collapses are associated with these transactions (Ge et al. 2010, Gallery et al. 2008). Many studies on tunnelling have been done on developed countries (for example, Gallery et al. 2008, Kohlbeck and Mayhew 2010, Kohlbeck and Mayhew 2005, Gordon et al. 2004). In contrast, with a few notable exceptions (e.g. 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)), there has been limited research on tunnelling in developing countries.

As with many developing countries Bangladesh has a history of extreme oppression of minority shareholders by controlling shareholders (Uddin and Choudhury 2008, Siddiqui 2010). The only protection against tunnelling in companies is some limited legislative protection and the corporate governance guidelines. The law provides some protection to minority shareholders from tunnelling by restricting loans without any collateral security to directors or their related

parties and requires board approval of these loans; and banks must not waive loans made to these parties if they fail to repay the loans. In addition to these provisions, the current corporate governance guidelines provide some protection from tunnelling by requiring a listed company to appoint independent directors to its board and to form an audit committee with one independent member.

While it can be argued that the corporate governance guidelines in Bangladesh have similarities with the corresponding guidelines in many developed countries, several researchers have questioned their effectiveness and suitability in protecting minority shareholders in an economically less developed country like Bangladesh. Uddin and Choudhury (2008) evaluated the corporate governance guidelines in Bangladesh, drawing on the perceptions and opinions of stakeholders. Based on Weber's (Weber 1978) notion of 'traditionalism' and 'rationality/formal structure', they suggest that the corporate governance guidelines are not adequate for a developing country like Bangladesh. A more recent study by Siddiqui (2010) also focused on general suitability of the corporate governance guidelines in Bangladesh. His view coincides with that of Uddin and Choudhury (2008). Using new institutional sociology, he argues that coercive and mimetic pressures have influenced corporate governance reform, but it does not address the need of investors in corporates in Bangladesh. Though the studies by Siddiqui (2010) and Uddin and Choudhury (2008) have evaluated the overall suitability of the corporate governance guidelines, neither they nor any other researchers have investigated the effectiveness of the guidelines in providing protection from tunnelling. As far as the authors are aware this is the first study on tunnelling in Bangladeshi. Governance imposes an additional cost on companies. If the governance mechanisms aimed at protecting minority investors fail to stop tunnelling by controlling shareholders, then the cost involved means that minority investor are in a worse situation than without the protection. Given the significance to minority shareholders of curbing tunnelling in Bangladesh, it is important to investigate the effectiveness

of current governance in curbing tunnelling by companies in Bangladesh and consider how the governance could be improved.

This paper contributes to the existing literature by identifying the suitability of the current governance for tunnelling in Bangladesh and involves analysis of the current governance of tunnelling using Oliver Williamson's *Market and Hierarchy* model, identifying the limitation of governance of tunnelling in Bangladesh, and presenting evidence on obstacles in implementing the current governance in Bangladeshi companies.

2. Literature Review

2.1 Different Types of Tunnelling for Private Benefit

There is a range of different types of transactions used by controlling shareholders for tunnelling. For example, selling an asset at a lower price or acquiring an asset at a higher price from related parties of controlling shareholders benefits the related parties of the controlling shareholders at the cost of minority shareholders. Past studies reveal the existence of this discriminatory practice in many countries. The study by Cheung et al. (2009b) finds that the management of listed companies in Hong Kong sell assets to related parties at lower prices than in similar arm's length transaction. And when these companies buy assets from related parties they pay more than market prices. A similar scenario is described by Ge et al. (2010) in China that shows Chinese listed firms sells assets to related parties on unfavourable terms. Companies buy/sell not only assets but also goods on favourable terms to related parties. The empirical research shows that companies give favourable terms to related parties in selling and purchase of goods for the benefit of controlling shareholders and at the cost of minority shareholders (Cheung et al. 2009a, Cheung et al. 2006).

Related party lending is another common method of channelling private benefits to controlling shareholders in many developed and developing countries. The study by Silanes et al. (2003) shows that Mexican banks make loans to related parties at interest rates on average about four percent lower than market rates and are less demanding of credit worthiness than in loans to arm's length parties. Similarly, Jiang et al. (2010) report evidence of non-arm's length deals in related party loans in China. The study finds that related parties loans significantly reduce market value which indicates that these loan are on terms that are favourable to the related parties. Similar results are reported in Kahle and Shastri (2004) for the USA and Gallery et al (2008) for Australia.

Controlling shareholders may resort to private placement of equities for private benefit. The controlling shareholders may sell shares to a related party at a lower price than ruling in the market for listed companies or the net asset value of the company (for non-listed companies). This not only changes the ownership structure but also tunnels out resources at the expense of the minority shareholders. The few studies in this area are by Wu (2004) and Hertzel and Smith (1993) which reveal that powerful controlling shareholders and managers resort to private placement to related parties at a discount for their private benefit. Table 1 presents the salient research on different types of tunnelling.

2.2 Governance Mechanism of Tunnelling

Governance safeguards are intended to protect minority shareholders from tunnelling and other oppressive and prejudicial behaviour by controlling shareholders. The major corporate governance safeguards against tunnelling are: market mechanisms, direct participation of minority shareholders, legal restrictions on related party transactions and appointing independent directors and independent audit committee members.

Table 1: Summary of Salient Research on Different Types of Tunnelling

Author(s)	*Tunnelling Type*	*Country*	*Findings*
Silanes (2003)	Related party loan	Mexico	From analysis of a sample of 1500 loans of 17 Mexican banks, the researchers find that loans to related parties are on average at about four percent less than other loans and the banks are less demanding on credit worthiness.
Gordon et al.(2004)	Related party sale and purchase of merchandise, sale and purchase of services and sale and purchase of assets, related party loans and investment in related parties.	USA	Using 878 transactions from112 publicly traded companies the study demonstrates the nature and types of tunnelling in the US. The result shows that the most common tunnelling transactions is with non-executive directors followed by the chair of the board. Major types of tunnelling transactions are sale and purchase of merchandise, sale and purchase of services sale and purchase of assets, related party loans, and investment in related parties.
Kahle and Shastri (2004)	Related party loan	USA	The result shows that loans made to executives are at interest rates below the market rates. This suggests tunnelling via related party loans.
Gallery et al. (2008)	Related party payments and loans.	Australia	Using companies listed on the ASX the researchers conclude that controlling shareholders tunnel out resources from the company through related party payments and loans.
Chueng et al. (2009b)	Asset acquisition, asset sales, equity sales, sale or purchase of goods, and cash payment to related party	Hong Kong	Comparing 254 related party and arm length transactions the researchers show that companies in Hong Kong sell assets to related parties at much lower prices than in similar arm's length transaction. Furthermore, when these companies buy assets from related parties they pay more than market price.
Ge et al. (2010)	Related party sale of goods and assets	China	Using data on the top 100 listed companies the researchers show that Chinese firms tunnel out minority shareholders assets through sale of goods and assets to related parties.
Jiang et al. (2010)	Related party loans	China	Using data on 1377 companies from 1996 to 2004 the researchers find that Chinese firms' loans to related parties significantly affect the market value of those companies.

(i) Market Mechanism and Tunnelling

Market mechanisms can protect minority shareholders from controlling shareholders discriminatory behaviour, including tunnelling. Market mechanisms, such as a hostile takeover can remove inefficient and corrupt management from corporations. Furthermore, the market can signal inefficiency and discriminatory behaviour of controlling shareholders by affecting the share price negatively. Distorted market mechanisms allow tunnelling out of resources by taking excessive compensation (Borokhovich et al. 1997) and cause inefficiencies in management of a company (Garvey and Gordon 1999).

For proper functioning of the market, information asymmetry among corporate stakeholders should be minimal and thus true and fair information is pivotal. Stakeholders who use information for decision making may be misled by fraudulent information that can distort the market. Operation of the market is an efficient way of safeguarding minority shareholders as this safeguard is free for companies. However, in many countries (especially in developing countries) the market fails either completely or partially and therefore seldom provides full protection to minority shareholders from the discriminatory behaviour of controlling shareholders.

(ii)Law and Legal Enforcement

The law and legal enforcement is another safeguard against tunnelling. A high level of legal protection for minority shareholders and active enforcement may limit the private of the tunnelling behaviour of controlling shareholders (Dyck and Zingales 2004). Many developed countries now completely ban some related party transactions. For example,

the Sarbanes Oxley 2002 Act (SOX 2002) bans loans to executives in the USA. Most developed countries also ensure proper enforcement of laws that complement other safeguards against tunnelling. For example, many Swedish companies have pyramidal, cross holding and dual-class share capital structures which makes Swedish minority shareholders prone to expropriation by controlling shareholders. Nevertheless, strict enforcement of the law does not severely limits oppression of minority shareholders by controlling shareholders (Holmen and Knopf 2004). However, many developing countries have a weak legal system and/or slack enforcement and thus have inadequate legal protection for minority shareholders against tunnelling.

As observed above, Bangladesh has a history of extreme minority shareholders oppression by controlling shareholders (Uddin and Choudhury 2008). The Banking Company Act and the Bangladesh Bank Circular (see Table 2) offer some form of protection. However, influential founder families in Bangladesh comply with the law only as a formality. The Security and Exchange Commission (SEC) and the Bangladesh Bank are the two monitoring agencies in Bangladesh. But both of these organizations are less than effective because of lack of expertise (Kabir et al. 2011) and the political influence of the founder family members (Ahmed 2012).

Table 2: Minority shareholder protection from tunnelling in Bangladeshi law

Law	*Tunnelling Protection*
The Banking Company Act 2001	Section 27(1) and 28 provide some protection to minority shareholders against tunnelling 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 made to these parties if they fail to repay the loans.
Bangladesh Bank (BRPD Circular No 7, 1999)	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 this has to be disclosed in the balance sheet. Furthermore, the loan may not exceed 50% of the paid-up value of the shares of the director.

(iii) Minority Shareholders Participation and Tunnelling

Though some scholars oppose minority shareholders participation in a company on the grounds that this will cause dispute and disruption to management (Bebchuk 2006), regulators and policy makers in many developed countries have now increased shareholders participation in corporate governance which has the potential to curb the dominance of controlling shareholders and to protect against tunnelling. In Australia, for example, the Audit Reform and Corporate Disclosure Act 2004 (also known as CLERP 9) gives shareholders the right to participate in the voting on adoption of the remuneration report and to ask questions on the report. It further requires minority shareholders to be allowed to submit questions to the auditor about the audit and to be given an opportunity to ask questions at the AGM. The UK corporate governance code 2010 also provides for minority shareholder participation in a company. The code requires the board chair to discuss governance and strategy with shareholders, to ensure that the views of shareholders are communicated to the board as a whole, and to arrange for the audit, remuneration and nomination committees to be available to answer questions at the AGM. The code requires

a company to propose a separate resolution on each substantially distinct issue and allow the shareholders to apply their voting right at the AGM.

In addition to the USA, Australia and the UK, other countries have also reformed the requirements on corporate governance in the last decade to increase the participation of minority shareholders. Tareq et al (2011) summarise the recent reforms to increase minority shareholders participation in different countries of the world (Table-3). They report that many countries have reformed the approval procedures for related party transactions; some countries now require shareholders' approval of related party transactions while others have a requirement for pre-review of related party transactions by an external independent party.

Table 3: Reform for Minority Shareholders Participation (2005-2010)

2005-06
China, Hong Kong and Tunisia – amended the law to require companies to open the books for shareholders inspection.
Israel and New Zealand – require approval by shareholders for related party transactions.
2006-07
Norway and Slovenia – require approval by shareholders for related party transactions.
2007-08
Albania, Azerbaijan and Tajikistan – require approval of related party transactions by shareholders. Egypt introduced a requirement for prior review of related party transaction by an external party.
2008-2009
Colombia, Dominican Republic, Macedonia, Rwanda and Tajikistan – made it easier to sue directors.
Dominican Republic and Rwanda - allow shareholders access to the company books.
2009-10
Chile, Swaziland and Sweden – require approval of related party transaction by shareholders.
Sweden –requires prior review of related party transaction by external parties.
Georgia, Swaziland and Tajikistan – made it easier to access corporate information.

Source: Tareq et al. (2011)

In contrast, the opportunity for participation of minority shareholders in Bangladesh companies is very poor. Bangladesh companies do not hold an AGM regularly, let alone permit minority shareholders participation in companies (Uddin and Choudhury 2008). The company law of 1994 provides some basic forms of participation by minority shareholders,

for example, participation in the AGM and voting on certain agenda items at the AGM: appointment of directors, auditors, and so on. However, as mentioned in Uddin and Chowdhury (2008) minority shareholders rarely get the chance to apply their voting rights at an AGM as many of these meeting last for just five minutes and all substantive issues are decided by the powerful sponsor directors. The existing corporate law allows very limited participation of minority shareholders in a company and the current corporate governance guidelines are silent on this.

(iii) Independent Directors and Tunnelling

A requirement for some independent directors, which can perhaps be traced back to the US Investment Company Act 1940, has been a major issue for many corporate governance advocates (Farrar 2001). Independent directors neither hold executive positions nor have any pecuniary relationship with the company. Therefore, they should work as a watchdog on discriminatory behaviour including tunnelling by controlling non-independent directors. Most past studies document that independent directors significantly reduce tunnelling. For example, Gallery et al. (2008), Gao et al. (2008), Dahya et al. (2008), Cheung et al. (2009a) find an inverse relationship between the incidence of tunnelling and the number of independent directors on the board. However, Chung et al. (2006) do not find that independent directors are effective in reducing tunnelling.

Many countries now require some independent directors on a company's board. In US public companies independent directors must form a majority of the board. Similarly in Australia. The current corporate governance guidelines in Bangladesh mandate appointment of at least ten per cent or at least one independent director on the board. This number does not conform with the corporate governance guidelines on independent directors that apply in most other

countries and there is no evidence to suggest that the requirement has been effective in curbing tunnelling in Bangladeshi companies.

(iv) Audit Committee and Tunnelling

Audit committees were first introduced in the USA in 1978 as a 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 reporting of a company. For the director members of the audit committee, independence and competence, among other attributes, are essential for the proper functioning of the 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).. Though researchers have studied the effect of audit committees on financial statement quality and on financial integrity, there are few studies on the relationship between tunnelling and audit committees. .

Many countries now require that audit committees for public listed companies have specific attributes. For example, SOX 2002 requires that each member of the committee be independent and that the committee have a member who is a financial expert. After SOX 2002 the audit committee's responsibility was increased to monitor the overall financial function of the company (Gorman 2009). In Australia, the ASX corporate governance guidelines require listed companies to establish an audit committee with a majority independent directors and that the committee is chaired by an independent director who is not the board chair. The UK corporate governance guidelines mandate listed companies to establish an audit committee of at least three (in the case of smaller companies two) independent directors.

The corporate governance guidelines in Bangladesh stipulate 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. The guidelines require 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. There is no research evidence on audit committees as a safeguard to protect minority shareholders from tunnelling in Bangladeshi companies.

3. Theorizing Governance of Tunnelling

3.1 Market and Hierarchy view of governance of tunnelling

This paper uses Williamson's *Market and Hierarchy* model (Williamson 2002, Williamson 2005, Williamson 1975) to analyse the effectiveness of the corporate governance reforms to protect minority shareholders in developing countries. 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 for tunnelling and the behaviour of organization actors.

Williamson's model has some similarities to agency theory (Jensen and Meckling 1976) but is based on more realistic assumptions and has stronger philosophical standing.[1] The similarities with agency theory are that both take a contractual perspective and consider cost-benefit, self-interest and information asymmetry between contracting parties. However, the

[1] Agency theory states that a principal assigns some responsibility to an agent to act on behalf of him and to serve the best interest of the principal through a contract; the principle uses incentive mechanisms to align the agent's objectives to that of the principal and to curb the opportunistic behaviour of agent facilitated by the information asymmetries between the two parties.

difference between the two is that: agency theory sees effective governance from the narrow perspective of the principal's interest, a view which has received some criticism (Perrow 1986, Wright et al. 2001). Williamson's model, on the other hand, sees governance from a neutral perspective and is based on a more realistic assumption than that underpinning agency theory. The latter considers a contract as a full contract where conditions are set in advance, while the former 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 the model are:

1. Bounded rationality of human beings.
2. Opportunistic behaviour of contracting parties.
3. Markets may not work properly (market failure).

Williamson's *Market and Hierarchy* model suggests three basic kinds of governance system. Firstly, governance by the market: in its purest form this eliminates opportunistic behaviour by any parties and is therefore an efficient governance mechanism. However, this form of governance requires some attributes of the market, such as, full information for all the parties in the market, full transparency, and so on. In most countries, markets do not fully have these attributes. However, market mechanism do operate with effect. For example, in developed countries a hostile takeover can remove inefficient and corrupt management from companies. Furthermore, inefficiencies and discriminatory behaviour by controlling shareholders may negatively affect the share price. Empirical research shows that market mechanisms facilitate good governance practices in organizations in respect of issues such as fair compensation for managers (Borokhovich et al. 1997) and in achieving efficiencies in the management of a company (Garvey and Gordon 1999).

Secondly, governance by all the parties in a transaction: if transactions are governed by all the interested parties there will be no information asymmetry among the parties. But full participation may not be possible or feasible because of limitations on the availability of all the parties in many situations, such as, in daily corporate governance where there are many owners of the company. The third form of governance suggested by Williamson is a hybrid form of governance which relies on functioning of the market for some circumstances and participation by all interested parties for others.

Williamson suggests that the suitability of governance for a transaction depends on three attributes of the transaction: *frequency, complexity* and *asset specificity*. If a transaction is frequent, simple and has least asset specificity then the market is the most efficient method of governance. On the other hand, if a transaction is infrequent, complex and asset specific then governance by owners is the most efficient and effective. This paper analyses the governance of tunnelling in public companies in Bangladesh. As mentioned above, related party transactions are the main medium of tunnelling by controlling shareholders. Related party transactions are normally infrequent in most organizations, but can range from being simple to very complex and from high to low in asset specificity. Therefore, the *Market and Hierarchy Model* would suggest that hybrid governance is the most efficient and effective method for corporate governance in relation to tunnelling in Bangladesh.

3.2 Weaknesses in the Governance of Tunnelling in Bangladesh

The above theoretical analysis shows that hybrid form of governance is most appropriate form for governance of tunnelling transactions. As mentioned above hybrid governance

system is joint governance by market and as well as all the owners or their representatives. Though the current governance for tunnelling in Bangladesh has similarity with the hybrid governance system, it has several weaknesses.

As mentioned above, market mechanisms can protect minority shareholders from controlling shareholders discriminatory behaviour. However, as in many developing countries, the market is not fully functional in Bangladesh. This gap in market mechanisms for tunnelling can perhaps be filled-up by higher participation of minority shareholders in related party transactions. However, the current guidelines and laws do not require direct participation by minority shareholders in related party transaction by Bangladeshi companies. Therefore, the governance of tunnelling is therefore largely dependent on independent directors and audit committee members, but their performance is questionable.

If directors are truly independent and act in the best interests of all shareholders, then it is logical to expect that there would be decreasing frequency of tunnelling transactions. However, this is unlikely to be the case if the appointment of so-called independent directors is not genuine. The current governance guideline 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. However, controlling shareholders are unlikely to choose genuine independent directors as that would reduce their private benefits (Dahya et al. 2008).

The guidelines also 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 works properly by reporting fraud and misappropriation of assets then it is expected that this would improve the protection for minority shareholders. However, the corporate governance guidelines require only one independent members and is vague on the competence of the chair of the audit committee in respect of accounting and finance. Audit committee members may be selected from board members who are subject to the influence of the dominant shareholders or may not have adequate education or experience for a position on the committee. Circumstances such as these cast doubt on the ability of the audit committee to function properly. These weaknesses in the current governance arrangements make minority shareholders vulnerable to tunnelling transactions.

4.0 Empirical Investigation

In-depth face-to-face interviews were conducted to empirically investigate the effectiveness of the current governance of tunnelling in Bangladesh and to gain insights on factors that may lead to ineffectiveness. Focus group discussion was considered as an alternative to interviews but the busyness of directors coupled with the sensitivity of the topic make this a non-viable option.

Interviews were semi-structured in nature. Interviewees were board members, audit committee members, and independent directors. Separate sets of questions were prepared

for each category of participant. If a board member serves on both the audit committee and the board, the member was asked questions from both sets. Therefore, questions including tentative follow up questions were prepared in advance, and adjustments were made as required during the interview. Interviews were digitally recorded with the permission of the interviewee. The recordings were then transcribed and analysed to enable comparison of actual practice with forma requirements. An obvious 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 as regards digital recording, written consent, and assurance of confidentiality. This ensures consistency across interviews. Ethical approval from the university ethics committee of the interviewer was obtained before the series of interviews commenced.

4.1 Interview Procedure

The interviews were conducted over a ten-week period from August 2011 to October 2011. If a potential participant agreed to participate in this research project, s/he was invited to attend an interview session with the researcher. The interview took approximately 45 minutes to 1 hour and participants were asked questions about their experience and knowledge of corporate governance practices on related party transactions in companies in which they hold directorships or serve on an audit committee. To assist the participant in deciding whether or not to participate in the research, they are were invited to read the interview questions.

Participants were briefed ahead of the interview that there was no risk associated with participation in the interview. Participation were also briefed that the research results for

individuals would be completely confidential. Furthermore, participants were informed that they could withdraw partially or completely at any time or to refuse to answer any particular question. The interviews were conducted at a time and location convenient to each participant.[2]

4.2 Sampling Method

Non random sampling is appropriate when a sample selected by a random process is difficult to access (Davidson 2006) and non-random sampling is common in qualitative research (Merriam 2009). Personal contact was used to select two initial participants and they were requested to refer further participants; thus a snowballing of participants occurred. The interviewer 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 the interview. Two of them expressed their initial interest and they were sent the interview questions to fully inform them of the nature of the interviews. In this way the researcher interviewed first two participants. The researcher then requested these two participants to suggest names of other potential participants and these were contacted by the same method as the first two. In this way fourteen other participants were selected for interview.

4.3 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 not precise. Some of the

[2] One prospective participant gave the researcher appointments for several times but missed all the appointments. Therefore, the researcher stoped contacting him any further.

literature suggests that 5 to 8 participants suffice when the sample is homogeneous and 2 to 20 participants for a non-homogenous sample (Crabtree and Miller 1999: 42). Assuming homogeneity of the sample of the study, 8 independent directors, and 8 other directors were interviewed, a total of 16 participants. Eight of the directors were also members of audit committees. The participants were board members of 12 listed companies of Bangladesh. These companies belong to the banking, insurance, power, pharmaceuticals, and textile industries.

5. Findings

5.1 Demographic Information of the Interview Participants

The average age of the interview participants was 56.4 years. The mean age of the independent directors were 57.1 years and the sponsor and executive directors was 55.6 years. The professional backgrounds of the independent directors covered a diverse range: academic, public accounting practice, corporate accountants, and ex-bureaucrats. All the non-independent directors were businessmen except two – one is the CFO of a power company the other one is the CEO of a financial institution. Four of the independent directors interviewed were academics working in different public and private universities two were retired bureaucrats with active involvement with social and voluntary organizations, one was a business executive, and one was a partner in a chartered accountancy firm.

The interviewees who were members of audit committees are also from diverse professional background. Among the eight participants, three were academics, one a public accountant, two were business executives, and the other two are retired bureaucrats. The academic

background of the audit committee members was also diverse: one from engineering, five from accounting and finance, and two from a liberal arts background.

5.2 Related Party Transactions Approval Procedure in Bangladeshi Companies

Though financial institutions in Bangladesh require board approval for related party loans, there is no legal requirement in non-financial institution for discussion of related party transactions, let alone approval by the board. The interview process revealed that there was no voluntary discussion of related party transactions by the boards and the board members did not feel that there was a need for that. One board member commented as follows:

> We do not discuss related party transactions at board meeting. There is disclosure of that in the annual report and these are audited by the external auditor. Therefore, I do not think it is necessary.

However, governance of tunnelling only using accounting disclosure is inadequate even in developed countries with stronger capital markets than in a developing country like Bangladesh. The information made available in annual reports to shareholders on related party transactions is simply not sufficient to make an informed judgement on whether the transactions were in the company's best interest or not (OECD 2012: p. 71) .

The interviews revealed that in the case of financial institutions related party transaction were discussed at board meetings. As already mentioned, financial institutions require board approval for a loan to a related party. However, he interview responses showed that although related party transactions were discussed at board meetings of these companies, the terms and conditions of the loans made were more favourable than that would have applied with

arm's length parties. It appears that non interested board members do not oppose the approvals because of a desire for similar treatment for themselves. One independent board member of a bank frankly admitted that:

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

This is consistent with Siddiqui and Podder (2002) and Ahmed (2012), which found that a high percentage of the bad loans by Bangladeshi commercial banks were to directors, directors' relatives or related organizations and little consideration has been given to the creditworthiness of these borrowers. This finding is also consistent with the findings of researchers in other developing countries. For example, Silanes et al (2003) finds that the terms for related party loans by banks in Mexico are much more favourable than for loans to unrelated entities and often the related parties are less credit worthy.

5.3 Independence of Directors and Audit Committee Members

According to the corporate governance guidelines existing directors select the independent directors for their board. Most companies 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 would curtail their dominance and potential for private benefits; therefore the existing controlling shareholders would choose someone who is willing to bend to their control. The interviews reveal that the existing directors select independent director(s) who aree compliant with the wishes of the controlling shareholders. One independent director frankly admitted that:

> The independent director is just a compliance requirement. The selection of independent directors depends on the CEO and the Chair of the Board. 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 Chair or CEO as they feel assured that the independent director(s) would not cause any problem in their affairs.

One founder director made a similarly frank admission:

> Iindependent directors are selected by the existing directors based on the criteria that these directors would not disturb them in their affairs and would listen to them. I have seen this in many of the companies where I sit as a director.

The corporate governance guidelines restrict any relationship either pecuniary or otherwise that an independent director can have with the company. 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 were required to comply with the SEC corporate governance guidelines. Normally the board nominate such person who complies with the guidelines, just for the sake of complying with the rules.

In such circumstances the requirement for independent directors is highly unlikely to be effective. Independent directors who sit with ex-colleagues or friends on a company board are likely to be biased in doing their job. The collegial and friendly culture in the board will prevent independent directors from speaking out in favour of the interests of minority shareholders (Monks and Minow 2003). The interviews reveal that many independent directors fail in their duty of care when they should raise matters at board meetings or,

ultimately, report to the SEC. One independent member of the audit committee of a financial institution noted:

> If the CEO spends 500,000 taka[3] for any purpose and there is 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. Practice is not always what is written in the rule.

The findings from the interviews are consistent with Dahya et al. (2008) who maintain that controlling shareholders would not choose true independent directors as that would cause the loss of private benefit of the controlling shareholders.

5.4 Audit Committee Members' Competence and Tunnelling

As already mentioned in the earlier section, accounting knowledge and experience are pivotal attributes of a competent audit committee (Bedard et al. 2004, Lary and Taylor 2012). However, in Bangladesh many audit committee members 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 qualification or knowledge, understanding and experience in accounting or finance. Obviously this is a less than demanding requirement for an audit committee. The interviews with the independent audit committee members reveals that lack of knowledgeable and experienced members made some committees operate as a one man show and other members of the committee as spectators. One audit committee member with accounting background noted:

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

[3] Taka is the currency of Bangladesh.

The permissive requirements on the audit committee often makes this committee little more than a compliance formality and yet increases compliance costs for the company. Some of the committee members had education background that was totally inappropriate for an audit committee, for example, sociology, and water resource engineering (See Table 4). Some of the participants mentioned that they had fellow audit committee members with degree in medicine. The interviews thus revealed that the members struggled to do their job in the committee. An independent audit committee member with education background in sociology noted:

> At the beginning, I was very uncomfortable with my role in the audit committee. I started my learning by studying the government guidelines and books about audit committees. 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. However, I think a Chartered Accountant would have performed better in this position.

Table 4: Audit committee competence

	Total Number
Professional Background	
Businessman	0
Academics	3
Public Accounting Practice	1
Business Executive	2
Retired Bureaucrats	2
Total	8
Educational Background	
Engineering	1
Accounting and Finance	4
Arts and Social Science	2
Not-disclosed	1
Total	8

6. Conclusion

This paper reports on the governance of tunnelling in Bangladesh. The theoretical analysis of the effectiveness of current governance of tunnelling transactions in Bangladeshi companies is based on the *Market and Hierarchy* model of Oliver Williamson.. The theoretical analysis suggests that a hybrid form of governance as the most suitable for tunnelling as governance by the market or by all the shareholders are non-viable due to the low frequency of related party transactions, that they can range from being simple to very complex, and from high to low in asset specificity. According to the model, Hybrid governance is governance by market force and participation by all owners. The analysis shows that the current governance for tunnelling is not fully hybrid in nature. Governance by the market is very limited in a developing country like Bangladesh due to the less than well-functioning capital market. This ineffectiveness of the market can be perhaps be substituted by direct participation of minority shareholders in the approval of related party transactions. While this is already in practice in many countries the current law and corporate governance guidelines do not require such approval in Bangladesh. The current governance of tunnelling is heavily dependent on independent directors and independent audit committee members. However, the interview process reveals the limited effectiveness of these governance mechanisms in Bangladesh.

The interviews reveal that many independent directors do not speak out to protect minority shareholders interests mainly because of the friendly relationship with the controlling shareholder group who recruited them to the board.

The interviews also reveal that most of the independent audit committee members are not appropriately qualified in accounting and finance knowledge and experience. Such audit committee members are unlikely to be sufficiently competent to decipher complex manipulation by controlling shareholders and their loyal professional managers. The responsibility of the audit committee is to monitor the integrity of the financial affairs of a company. Poorly qualified committee members may not be capable of protecting minorities from complex fraudulent transactions by controlling shareholders set up in collaboration with unscrupulous professional managers.

Governance guidelines impose additional costs on corporations which are ultimately passed on to shareholders. If these guidelines do not yield appropriate benefits to them, the net cost involved means that the shareholders are in a worse situation than without the governance guidelines. This paper indicates that amendments to ensure direct participation of minority shareholders in decisions on related party transactions might make the current governance more effective in protecting minority shareholders against tunnelling.

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