The Impact of Corporate Governance Practices and Performance Measurement Systems on Firm Value in Emerging Markets

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Working title for the proposed PhD research:

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Abstract

The central theme that undergirds this proposed research stems from the theoretical framework of a management control systems (MCS) operating as a package. Two forms of control will be examined in combination: administrative (corporate governance practices) and cybernetic (innovative value-based performance measures); under the specific setting of listed companies from the emerging markets; namely Singapore, Malaysia, Indonesia, Philippines and Thailand. The purpose of this research is firstly, to investigate the influence of corporate governance mechanism on management's decision to undertake value-based performance measures. Secondly, it seeks to analyse this effect on firm value. In particular, this research will examine how firm value will be affected under two circumstances: when adhering to certain corporate governance practices and when innovative value-based performance measures are being implemented. This research aims to contribute towards building a more coherent theory of management control systems as a package and to gain new insights as to how corporate governance and management accounting practices unfold differently across different countries, especially in less developed economies.

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Chapter 1: Introduction

1.1 *Background and rationale of the research*

The last two decades have witnessed vast transformation in organizations worldwide, where intense competition and globalization of markets have forced organizations to re-define their strategies, structures and processes. This has led to increases in mergers and acquisition, and has encouraged organizations to secure competitive advantage through innovations in products, services, processes and information technologies.

The world of management accounting research has also changed as a consequence of the growth of international business, global competition, privatization, and deregulation. These changes have special implications especially for transitional economies such as Russia, China, Eastern Europe, Vietnam; and the newly industrialized or emerging economies such as India, Brazil, South Korea, Malaysia, Thailand, Philippines, Indonesia and Singapore[1]. These 'Less Developed Countries' (LDCs) are gaining increased attention from policy makers and academics across various disciplines because of their growing dependence on globalization and international trade reforms. Accounting change is an essential component of market-based development policies promoted by international agencies. Of equal importance is the provision of relevant, timely and accurate internal management accounting information. Management accounting assists executives in their efforts to improve the economic performance of the firm. However, it can be argued that the current continuous challenge is the alignment of 'local' business processes with 'global' corporate strategies. Frequent failures have cast doubt on whether Western management accounting practices can be effective especially without adjustment to local circumstances (O'Connor, Chow, & Wu, 2004). Thus there is a profound need to further the development of management accounting in these LDCs. Although work in this area is growing, it is still at its infancy. (Abdallah, 1992; Haldma & Lääts, 2002; Jusoh & Parnell, 2008; Williams & Seaman, 2002).

Many newly-industrialised or emerging economies such as Malaysia, Thailand and Korea have high technology-based manufacturing activities while in Singapore and Hong Kong, sophisticated financial and business services prevails. The traditional cost/management accounting systems which evolved since the 1950s was mainly based on concepts of standard costing, flexible budgeting, Cost-Volume-Profit analysis, variance analysis and responsibility accounting (Ittner & Larcker, 2001; Jaruga & Ho, 2002). However, these traditional management accounting practices has been criticized as

[1] Emerging economies are defined as "low-income, rapid-growth countries using economic liberalization as their primary engine of growth" (Hoskisson, Eden, Lau, & Wright, 2000), p.249. The International Finance Corporation (IFC 1999) identifies 51 rapid-growing developing countries as Asia, Latin America, Africa and the Middle-East as emerging economies. [See Hoskisson et al. (2000) for a list of emerging and transitional economies].

is required to bring the two together" (IFAC 2004, p.9). CIMA clearly distinguishes the external and internal aspects of corporate governance where the external dimensions focuses on the role of boards and the internal dimensions on the value drivers. The framework emphasizes the need to balance the conformance and performance aspects of the business in order to generate long term sustainable shareholder value. This is the initial motivation for this research proposal.

It is therefore inept to consider management control as being distinctly separate and independent from corporate governance concerns (Bhimani, 2009; Malmi & Brown, 2008). The control process is in itself defined by the intent to monitor the degree and alignment between organizational activities and desirable managerial outcomes. Bhimani (2009) argues that it is crucial and essential for firms to make the deployment of utilization of controls effective, transparent and visible. He concludes that this inevitably makes management accounting, risk management and corporate governance increasingly intertwined and interdependent.

Calls for research in corporate governance within the emerging markets transpired from the realization of researchers that there is no single agency model that adequately depicts corporate governance in all national contexts (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1997, 1998; Lubatkin, Lane, Collin, & Very, 2007; Young et al., 2008). In developed economies, because ownership and control are often separated and legal mechanisms protect owners' interests, the traditional principal-agent conflicts between owners (principal) and managers (agents) have received the majority of research in corporate governance (M. Jensen & Meckling, 1976; Young et al., 2008). However, in emerging economies, the institutional context makes the enforcement of agency contracts more costly and problematic (Wright, Filatotchev, Hoskisson, & Peng, 2005). This results in concentrated ownership, coupled with an absence of effective external governance mechanisms normally prevailing in emerging economies, giving rise to more frequent conflicts between controlling shareholders and minority shareholders (Dharwadkar, George, & Brandes, 2000; Morck, Wolfenzon, & Yeung, 2005). This has led to the development of a new perspective on corporate governance, which focuses on the conflicts between different sets of principals in the firm, known as the 'principal-principal' model of corporate governance, which centers on conflicts between the controlling and minority shareholders (Young et al., 2008). Comprehension of such relationships is needed to explore the wider impacts of extra-organisational factors on internal control and governance structures that are common in emerging economies.

The relationships between management accounting, corporate governance and risk management have been addressed only to a minimum extent in the prevalent academic literature (Bhimani, 2009). Thus, the *second* objective of this research is to investigate corporate governance practices within the emerging economies. In particular, how the unique corporate governance limiting a company's progress towards world-class manufacturing performance as the internal orientation of accounting information is too narrow for strategic decision making (Jaruga & Ho, 2002).

Most firms, except for large banks and large firms with foreign capital, in transitional and emerging economies are still rather conservative in using advanced, innovative and new 'value-based' management accounting methods such as activity-based costing, the balanced scorecard, strategic accounting and control systems, and economic value performance measures (Ittner & Larcker, 2001; Jaruga & Ho, 2002). Moreover, due to their unique environments, alternative approaches to Western management accounting methods are practiced in various emerging economies (Abdallah, 1992; O'Connor et al., 2004; Skousen & Yang, 1988). Therefore, firms in transitional and emerging economies have realized that they need effective management accounting techniques to provide management with relevant, timely and accurate information to improve their economic performance. However, there are currently scant findings published on the progress that firms in these economies have made toward this goal.

There have been several calls in the last few years for both theoretical and empirical contributions to the debate on how management accounting in transitional and emerging economies should develop in response to various globalization pressures and how management accounting can facilitate change (Hopper, Tsamenyi, Uddin, & Wickramasinghe, 2009). Despite this, the road to management accounting reform is rocky and long. Most transitional and emerging economies are still embarking on their management accounting reform process. Thus more studies on these economies can further uncover the effective diffusion of management accounting practices under different social and economic systems. The *first* objective of this research is to fulfill this need by investigating management accounting practices within the emerging markets.

Recently, there have also been numerous calls to examine corporate governance within the context of management accounting literature (Bhimani, 2009) and corporate governance within emerging markets (Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). Risk management and corporate governance issues are rising concerns as evidence by their significant influence on public policy debates regarding the control of organisations. The notion of risk and corporate governance has extensively influenced and defined many aspects of organisational and managerial endeavours, including management accounting and control practices (Bhimani, 2009; Seal, 2006).

The Chartered Institute of Management Accountants (CIMA) (2005) also recognises the frictions between governance and value creation; and between conformance and performance when they coined the term 'Enterprise Governance' to describe both corporate governance and business governance aspects of organizations. The Enterprise Governance framework note that "(T)here is a gulf between the corporate governance agenda and the 'business success' literature and a framework mechanisms in South East Asian countries influence managements' decision to implement innovative value-based performance measures, which in turn, affect the firms' performance.

1.2 Theoretical framework: Management Control Systems (MCS) as a package

The theoretical rationale for this research draws from the idea that management control systems operate as a package within organizations. The concept of organization having a control package is not new, having been introduced to the management accounting literature by early contingency theorists (Otley, 1980). Control refers to those practices intended to align individual's activities with organisational goals (Abernethy & Chua, 1996; Flamholtz, Das, & Tsui, 1985; Otley, 1980). A management control systems (MCS) package is generally conceptualized as a collection or set of control and control systems (Malmi & Brown, 2008). Although the concept of MCS operating as a package has existed for over 3 decades, explicit research and theorizing on this phenomenon is still scarce.

Malmi and Brown (2008) suggest a number of reasons as to why studying MCS as a package is important. First, the functioning of outcomes of any new management control system element in any given organization is likely to be related to the functioning of an existing management control package. Thus, MCS do not operate in isolation. Past researchers have warned that studying MSC in isolation will lead to inaccurate conclusions because outcomes are likely to be related to the extent a new system is coupled with existing systems (Chenhall, 2003; Dent, 1990; Fisher, 1998).

Second, prior research has substantially concentrated on studying recent developments in practice, including Activity Based Costing/Management, Balanced Scorecard, Value Based Measures/Management, and Target Costing – aiming to explain their emergence, adoption, functioning and outcomes. However, much of this extant research focuses on only one system at a time, thereby largely ignoring the wider control context or package of which they are a part. Such omissions can critically obscure the derived conclusions on the functioning and associated benefits of such innovations.

Third, limited understanding of the relative effectiveness of various forms of control still prevails. In particular, the question of how these various control (e.g. administrative, cybernetic, cultural) might complement or substitute each other in a range of circumstances or not, remains an area warranted for further investigation.

Fourth, there is a lack of understanding as to why and how various parts of a control package are used and emphasised in practice. The differences in emphasis in which they are contingent upon remain unanswered. Further research focusing on accounting based (cybernetic) controls as a part of organizational control package is required to assist in developing a more coherent theory of management control systems. Such a theory would not only facilitate in explaining the causes and effects of individual controls and controls as a package, but also how control systems relate to each other, to firm activities and contingent factors. This proposed research aims to address these gaps in existing research.

The motivation for this proposed research stems from the conceptual typology of an MCS package developed by Malmi & Brown (2008, pg.291)[2] as depicted in Figure 1:

Figure 1: Management Control Systems (MCS) Package

<table>
<tr><td colspan="7">Cultural Controls</td></tr>
<tr><td colspan="2">Clans</td><td colspan="3">Values</td><td colspan="2">Symbols</td></tr>
<tr><td colspan="2">Planning</td><td colspan="4">Cybernetic Controls</td><td rowspan="2">Reward and Compensation</td></tr>
<tr><td>Long range Planning</td><td>Action Planning</td><td>Budgets</td><td>Financial Measurement Systems</td><td>Non-Financial Measurement Systems</td><td>Hybrid Measurement Systems</td></tr>
<tr><td colspan="7">Administrative Controls</td></tr>
<tr><td colspan="3">Governance Structure</td><td colspan="2">Organisation Structure</td><td colspan="2">Policies and Procedures</td></tr>
</table>

Source: Malmi & Brown (2008, pg. 291)

There are five types of controls in Malmi & Brown's (2008) typology; cultural, planning, cybernetic, reward and compensation, and administrative controls. This proposed study seeks to investigate the linkage and relationship between two types of control in combination; cybernetic control and administrative control within the emerging markets, namely five rapidly growing South East Asian countries: Singapore, Malaysia, Indonesia, Philippines and Thailand. The elements of cybernetic controls that will be examined are the financial and hybrid measurement systems which constitute what is termed 'value-based management', a widely recognized innovation of the 90s within the management accounting literature (Ittner & Larcker, 2001). Examples of financial performance measures are return on investment and economic value added (EVA). Hybrid performance measurement systems contain both financial and non-financial measures such as the Balanced Scorecard.

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[2] The conceptual typology of an MCS package was developed by Malmi & Brown (2008) by analyzing and synthesizing nearly four decades of MCS research.

Under administrative controls, the element of governance structure will be examined. By combining the examination of both cybernetic and administrative control, this adheres to the suggestion of studying the phenomenon of MCS as a package in order to identify not only what is actually contained in a MCS package within the organization but also the potential linkages between systems which may reveal further missing and/or unnecessary elements. This will facilitate the building of a more coherent theory that will provide contribution to academics, practitioners and industry players globally.

Chapter 2: Statement of problem and research questions

The idea of MCS operating as a package within specific settings motivates the following research problem for this study:

What is the effect on the value of companies from emerging markets when certain corporate governance practices are in place and when innovative value-based performance measures (financial and hybrid) are implemented?

Consequently, this gives rise to the following research questions:

1) Does the corporate governance practices in countries from the emerging markets influence management to implement innovative value-based performance measures (financial and hybrid)?
2) How does this impact the value of companies from the emerging markets?

2.1 *Purpose of the research*

The purpose of this research is firstly, to investigate the influence of corporate governance mechanism on management's decision to undertake innovative value-based performance measures (financial and hybrid). Secondly, it seeks to analyse how the firm's value will be affected under two circumstances: when adhering to certain corporate governance practices and when innovative value-based performance measures (financial and hybrid) are being implemented.

2.2 *Scope of the research*

This research proposes to examine listed companies from 5 emerging markets: Singapore, Malaysia, Indonesia, Philippines and Thailand, over a span of 15 years, from 1995 to 2009, covering the period before and after the Asian financial crisis, and throughout the boom period to the recent global financial meltdown that intensified in 2008. This period is chosen because firstly, many of these countries from the emerging markets have gone through market liberalization after the Asian financial crisis. Secondly, this will provide greater understanding on the effects of government policy changes on firm performance and practices.

Chapter 3: Literature Review and hypotheses development

3.1 *Management Control Systems (MCS) as a package*

According to Malmi and Brown (2008), the first hurdle to undertake the study of MCS as a package is defining what is meant by MCS. Numerous definitions and descriptions of MCS exists within the literature, some are different while others overlap (Abernethy & Chua, 1996; Anthony, 1965; Chenhall, 2003; Fisher, 1998; Flamholtz et al., 1985; Langfield-Smith, 1997; Merchant & Van der Stede, 2007; Ouchi, 1979). The lack of clarity, wide variation and inconsistencies in how MCS have been conceptualized has created a number of problems in MCS research in relation to the interpretation of research results and the design of MCS (Malmi & Brown, 2008; Zimmerman, 2001).

Zimmerman (2001) suggests that the distinction between decision making and control must be made, when determining what should constitute as MCS. This means that any accounting systems designed to support only decision-making at any level of the company, while leaving the use of those systems unmonitored should not be termed MCSs, but instead management accounting systems (MAS). However, those systems, practices, measures, rules and values and other activities put in place in order to direct employee behaviour should be called management controls. Consequently, any system or practice such as balanced scorecard, governance structure or financial and non-financial performance measures can be categorized as a MCS (Malmi & Brown, 2008). Since there are usually a number of MCS in most organisations, the term 'package' is utilised[3]. As such, this proposed study conforms to the suggestion of Malmi & Brown (2008, p. 290) for the explicit definition of MCS, in which "management controls include all the devices and systems managers use to ensure that the behaviours and decisions of their employees are consistent with the organization's objectives and strategies but exclude pure decision-support system".

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[3] Merchant and Van der Stede (2007) suggests that the collection of control mechanisms should be called an MCS.

Past research on MCS has provided vast information about the operation of many of the elements within MCS individually. However, currently very little is known about how these elements are actually configured as a package across organizations, especially within South East Asian countries, although recent works by Sandelin (2008) and Kennedy and Widener (2008) have provided some insights on this phenomenon. Sandelin (2008) undertakes a case study to examine the operation of management control practices as a package in the context of a Finnish growth firm by focusing on cultural, personnel, action and results controls. He found that the form and functionality of an MCS package is influenced by internal consistency rather than contingent factors (Sandelin, 2008). Kennedy and Widener (2008) investigate the control framework that results from a lean manufacturing environment in Canada. They develop a theoretical framework that facilitates in understanding control choices, accounting practices, and organizational structure, associated with lean manufacturing (Kennedy & Widener, 2008).

On the basis of prior research, Malmi & Brown (2008) asserts that it remains unclear as to whether there are particular configurations that systematically exist in specific settings. In particular, do specific types of cybernetic controls generally exists with specific types of administrative or cultural controls? A recent study on radical innovation by Tellis, Prabhu & Chandy (2009) demonstrate that the strongest driver of radical innovation across nations is firm culture. They found that the firms' financial performances are reflected through the commercialization of these radical innovations. Therefore, as the environments within which organization exists are in a state of constant change, which of all the elements in the MCS package are the ones which have to fit the best, and which are less essential for maintaining control and gaining superior firm performance? By taking a broader approach to study MCS as a package in emerging markets, this proposed research attempts to provide some answers to the open questions above.

Currently, there is also little prior theory that enables researchers to establish the relationships between the elements in a control package (Chenhall, 2003; Malmi & Brown, 2008). How the elements within a MCS package relate to each other remains unanswered. This study aims to shed light on the obvious question of whether the effectiveness of each of the control system under examination is dependent on the existing configuration of the package. For example, misalignments between performance measures and the organizational structure or governance structure may result in ineffective control. By examining all or some of the elements in the package and the relationships between them, a better understanding of the effectiveness of individual elements will be achieved.

3.2 Value-based performance measures

According to Ittner & Larcker (2001), the value-based management (VBM) approach signifies the evolution of management accounting research and practice after more than 4 decades. The VBM approach emphasizes on value creation for the firm through the identification, measurement and management of drivers of customer value, organizational innovation and shareholder returns. This result in the establishment of a diverse set of 'new' and innovative management accounting techniques directed at promoting value creation, such as the development of balanced scorecards as indicators of economic success and economic value measures that are purported to better reflect shareholder returns.

Over the last decade, much has been written about value-based management. Most of the extant literature relates to VBM-metrics and its relationship with share price, a measure that contributes to the creation of shareholder value (Athanassakos, 2007; Biddle, Bowen, & Wallace, 1997; Stewart, 1991). Another substantial strand of research focuses on the implementation of VBM and its effects on company level (Lovata & Costigan, 2002; Ryan & Trahan, 1999, 2007; J.S. Wallace, 1997). A third strand of research highlights the assumed conflict between shareholder and stakeholder view of the firm (M. C. Jensen, 2002; J. S. Wallace, 2003). Lastly, the concept of how VBM is applied in practice has also begun to receive attention (Claes, 2006; Malmi & Ikäheimo, 2003).

From a management accounting perspective, the main issue is not whether the value-based performance measurements, such as economic value measures, are more highly correlated with stock returns than traditional accounting measures, but whether its usage towards internal decision-making, performance measurement and compensation purposes improves organizational performance (Ittner & Larcker, 1998). A further related issue is whether the performance implications of the value-based performance measures depend upon how the measures are used within the organization, for example in capital budgeting, goal setting, investor communication, business planning, compensation, and financial management purposes. Kim (2004) asserts that the consequences of ignoring value-based management in corporate strategies and governmental policies have resulted in hostile takeovers in the US in 1980s, financial crises in South East Asian countries in 1998, and the collapse of internet companies in 2000 (Kim, 2004). As such, this study aims to examine firm performance upon the adoption of value-based performance measures and explore how these measures are used within the firm. This will provide some directions as to the long-term benefits from the adoption of such innovative value-based performance measures.

3.3 Corporate governance within the emerging markets

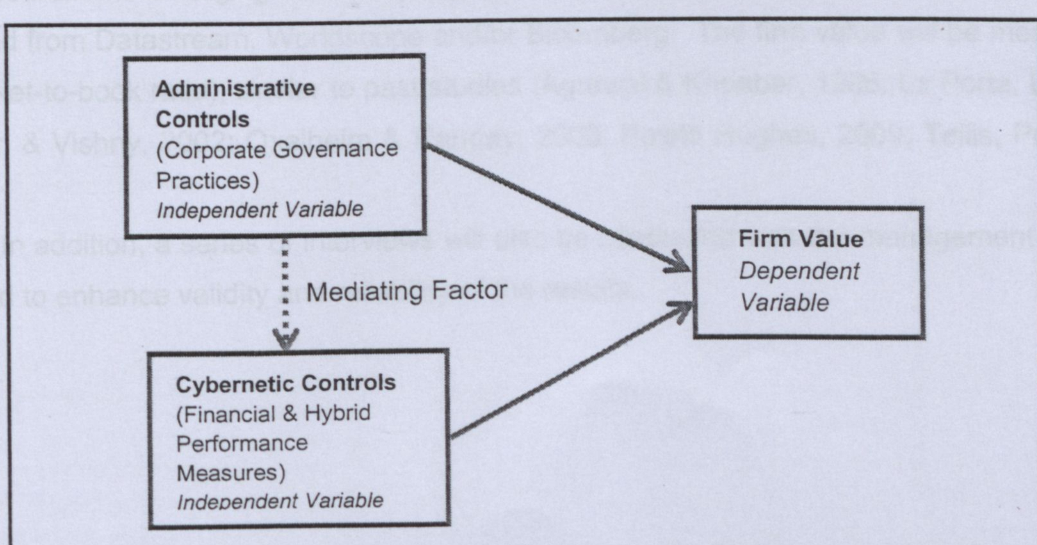
In addition to the problem of concentrated ownership and weak effective external governance mechanisms common in emerging economies, there is a growing expectation that corporate boards should be overseeing the quality of internal management and the strategic decisions and pursuits of their companies (Abdullah, 2004; Agrawal & Knoeber, 1996). How far the characteristics of corporate boards influence management control has not been subjected to extensive research, particularly the differentiating effects of foreign versus domestic board membership has received only scant attention so far (Choi & Hasan, 2005; Gulamhussen & Guerreiro, 2009; Oxelheim & Randøy, 2003).

Gulamhussen & Guerreiro (2009) studied the influence of foreign equity and board membership on corporate strategy and internal cost management of domestic banks in Portugal. Foreign equity and board membership affect managerial choices and hence, as corporate governance mechanisms, influence the strategic decisions, pursuits and cost control outcomes. They call for future extension of their study to test their main hypotheses in other markets that have undergone some liberalization especially in markets experiencing increasing globalization of foreign element of corporate governance. As such, this proposed study responds to this call by investigating 5 emerging markets from South East Asia: Singapore, Malaysia, Indonesia, Philippines and Thailand.

3.4 Proposed conceptual framework and hypotheses

Figure 2 illustrates the conceptual framework that guides this research. This framework is conceptualized based on Malmi & Brown's (2008) conceptual typology of an MCS package as shown in Figure 1.

Figure 2: Proposed conceptual framework



From the conceptual framework (see Figure 2) and the literature review, the following set of hypotheses are proposed:

H1: Higher foreign shareholders' equity increases the use of value-based performance measures.

H2: Higher composition of foreign outside board membership increases the use of value-based performance measures.

H3: Firms with low insider (management) ownership increases the use of value-based performance measures.

H4: Firms with higher institutional ownership increases the use of value-based performance measures.

H5: There is a positive relationship between the use of value-based performance measures and firm value.

H6: There is a positive relationship between foreign shareholders' equity and firm value.

H7: There is a positive relationship between the composition of foreign outside board membership and firm value.

H8: There is a negative relationship between insider (management) ownership and firm value.

H9: There is a positive relationship between institutional ownership and firm value.

Chapter 4: Methodology

To test the above hypotheses, a sample of firms listed on the stock exchanges of the 5 countries from the emerging markets (Singapore, Malaysia, Indonesia, Philippines and Thailand) will be collected from Datastream, Worldscope and/or Bloomberg. The firm value will be measured by Tobin's Q (market-to-book ratio), similar to past studies (Agrawal & Knoeber, 1996; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002; Oxelheim & Randøy, 2003; Poletti Hughes, 2009; Tellis, Prabhu, & Chandy, 2009).

In addition, a series of interviews will also be conducted with the management of the companies selected to enhance validity and reliability of the results.

Chapter 5: Conclusion – Implications and Significance of research

This proposed PhD research will provide key implications and significance to practitioners, academics and industry players in the business community through the understanding of corporate governance practices in emerging markets and its influence on organisations' internal decision-making and corporate strategy orientation. It will also shed light on how corporate governance mechanisms co-evolve with advanced and innovative management accounting techniques in emerging economies. Consequently, new insight will be gained on the progress of these emerging economies in light of global competition and advancement, relative to companies in developed markets, thereby contributing to the international business perspective.

Secondly, this research will uncover the characteristics of firms in emerging markets that are likely to adopt advanced performance measurement techniques. The role that foreign institutional investors play in emerging economies and their impact on firm performance will also be highlighted.

Finally, by taking a broader approach to study MCS as package, this will enable better theorizing of the actual impact of innovations such as the value-based performance measures, and as a result, facilitate in developing better designs of MCS packages to benefit organisations worldwide.

Chapter 6: Approximate timeline for the PhD research

Table 1 displays the time table for a rough time guideline from the start to completion of the 3-year PhD programme. This includes the time needed for preparation at the start of the programme, collection of data, analysis of results and writing the dissertation of approximately 100,000 words from the beginning to completion.

Table 1: Approximate guideline to complete the PhD dissertation:

Section/Chapter	Topic	Percentage (%)	Words	Months
	Preparation / Settling-in			2
1	Introduction	5%	5,000	3
2	Literature review	30%	30,000	6
3	Methodology • Data collection • Follow-up	20%	20,000	9
4	Data analysis	25%	25,000	7
	Attending Conferences • Preparation			1
5	Conclusions & Implications	20%	20,000	6
	Finishing touches			2
	Total	**100%**	**100,000**	**36**

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