Management Accounting Research 20 (2009) 6–17

Contents lists available at ScienceDirect

Management Accounting Research

journal homepage: www.elsevier.com/locate/mar

The influence of foreign equity and board membership on corporate strategy and internal cost management in Portuguese banks☆

Mohamed Azzim Gulamhussen[a,*], Luís Guerreiro[b]

[a] ISCTE Business School, Av Forças Armadas Cacifo 101-B, 1649-026 Lisbon, Portugal
[b] Banco de Portugal, Lisbon, Portugal

ARTICLE INFO

JEL classification:
F36
G30

Keywords:
Foreign equity and boards
Corporate governance
Bank cost management

ABSTRACT

This study examines the influence of foreign equity and board membership on corporate strategy and the management of internal costs of banks headquartered in Portugal using proprietary data maintained by the Central Bank. The findings reveal that foreign equity reduces both total and operating costs, and foreign board membership reduces domestic banks' dependence on revenues from traditional areas of business and enhances the potential for generating revenues from non-traditional areas of business. These results are controlled for a variety of standard accounting ratios used in the literature. We argue that foreign equity and board membership forces banks to redirect corporate strategy and to reduce internal costs.

1. Introduction

Enterprise governance is an emerging concern. The Chartered Institute of Management Accountants (CIMA) (2005) in the UK uses this term to describe both corporate governance and business governance aspects of organisations.[1] CIMA clearly distinguishes the external and internal aspects of corporate governance where the external dimension focuses on the role of boards and the internal dimension on the value drivers. Horngren et al. (2005) contend that the effectiveness of corporate governance affected by boards is increasingly judged based on how far they are concerned with overseeing the strategic management of firms and, indirectly, on their influence on the management of internal costs of firms. The paper aims to make an empirical assessment of this general proposition. It does so by focusing on the influence of foreign equity holders and board members on the oversight they achieve in the strategic and the cost management dimensions of the functioning of banks.

At a national level, corporate governance is defined as the legal, institutional, and cultural mechanisms adopted by equity owners to exercise control over corporate insid-

☆ We gratefully acknowledge financial support from Fundação para a Ciência e Tecnologia (PTDC/GES/72859/2006). The views expressed in this paper are those of the authors and do not necessarily represent those of the institutions to which the authors are affiliated.

* Corresponding author. Tel.: +351 217903954; fax: +351 217964710.
E-mail address: magn@iscte.pt (M.A. Gulamhussen).

[1] The CIMA Strategic Scorecard is a tool that is being developed by the CIMA. It emerged from an earlier project led by the International Federation of Accountants (IFAC, 2004) to develop the framework of enterprise governance. This framework emphasises the need to balance the conformance and performance aspects of the business in order to generate long-term sustainable shareholder value. The scorecard should provide the means for the board of directors of companies of all sizes to obtain assurance that the strategic process is operating effectively in order to generate long-term sustainable value. The objectives of the scorecard are to: assist the board, particularly the independent non-executive directors, in the oversight of a company's strategic process; assist the board in dealing with strategic choice and transformational change; give assurance to the board in relation to the company's strategic position and progress; track actions in, and outputs from, the strategic process; and assist the board in identifying key points at which it needs to take decisions. The scorecard is primarily an internal tool that aims to help boards improve their effectiveness. However, the process of preparing the scorecard and the resulting outputs can help boards to fulfil their external reporting responsibilities.

1044-5005/$ – see front matter
doi:10.1016/j.mar.2008.10.006

ers and management (La Porta et al., 1999). Corporate governance patterns differ markedly across countries in several respects such as the importance of large stockholders, the legal protection of shareholders, the extent to which relevant laws are enforced, the treatment of stakeholders such as labour and the community, the reliance on debt finance, the structure of the board of directors, the way in which executives are compensated, accounting practice, and the frequency and treatment of mergers and takeovers (Shleifer and Vishny, 1997). The best practices of corporate governance tend to be associated with the Anglo-American, German and Japanese systems (Oxelheim and Randøy, 2003). These are considered to be reliable proxies for "good" governance systems mainly because of their stricter information requirements (OECD, 2004).

At the firm level, corporate governance can be defined as a set of relationships between a firm's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set and the means used to determine how to attain those objectives and monitor performance. "Good" corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system within an individual company and across an economy as a whole provides a degree of confidence that is necessary for the proper functioning of a market economy resulting in lower internal costs.[2] Corporate governance is now increasingly regarded as engaging boards' oversight of firms' strategic management and cost management effectiveness (O'Connell, 2004).

A "good" corporate governance system can reduce information asymmetries and ease monitoring (Edwards and Nibler, 2000). The removal of barriers to cross-border investment nowadays gives firms the alternative of breaking away from domestic governance systems in order to reap rewards associated with the adoption of a more demanding system that comes in the form of improved performance. The potential gain from complying with a "good" system needs to be appraised after allowing for the substantial costs incurred by the compliance itself. These costs arise from such factors as more extensive accounting and reporting, the need for a broader and more qualified investor-relations staff, and more top management time allocated to investors (Stulz, 1999).

Although much of this also applies to banks, it is true that the banking firm differs significantly from corporations in other economic sectors. There is a clear conflict inside banks (between the interests of the shareholders and of the depositors), since managers are usually willing to take high-risk projects that increase share value at the expense of the value of the deposits. To avoid crises of confidence and bank runs, small deposits are insured and banks are regulated (John et al., 2000). Therefore, special attention should be given to governance issues in the context of banks.

Banks can adopt a "good" governance system through foreign equity and foreign board membership. Foreign equity, through foreign exchange listing, is the most widely recognised way of breaking out of a segmented home market. A foreign exchange listing signals a firm's commitment to the higher reporting standards prevailing in the market in which it lists and this can boost foreign investors' recognition of the firm and increase the ability to attract new investors. On the other hand, globalisation of equity creates an opportunity for foreign shareholders to acquire large stakes in foreign firms. However, foreign investors must be confident that the capital they provide will be properly monitored. While the cost of getting involved can be prohibitive for small equity holders, larger shareholders can afford active monitoring (Shleifer and Vishny, 1997). Since board representatives for large foreign shareholders are more likely to use their influence and perform arm's-length monitoring, their entry as owners should help domestic banks move into newer lines of business and lower internal costs. The banking literature recognises the importance of foreign equity and several empirical studies confirm the positive influence of foreign ownership on domestic bank performance (Levine, 2003).

Alternatively, banks can "import" a more demanding corporate governance system by simply having one or more representatives of that system as board members thereby signalling greater commitment to corporate monitoring and transparency, which is expected to be valued by investors. The presence of at least one foreign member representing a more demanding system will probably result in more active boards that are more independent of management. To date, only one study (Choi and Hasan, 2005) analyses the influence of the presence of foreign directors on the performance of domestic banks in Korea. The study confirms the hypothesis that presence of foreign directors improves stock market returns of banks that allow foreign equity holdings. However, this result is based on a very small sample (77 observations) and the association is confirmed on the basis of only one dummy variable; there is therefore ample scope to build on this initial contribution.

The empirical analysis in this study is based on banks headquartered in Portugal. The advantage of breaking away from a segmented or partly segmented capital market is likely to be greatest for firms based in small capital markets, as is the case of Portugal, due to limited availability of a domestic shareholder base and lower availability of a pool of experts to perform the oversight function (Stulz, 1999). Consequently, we expect both foreign equity and board membership to influence corporate strategy and internal costs management of domestic banks.

The paper is organised as follows. In Section 2 we outline some fundamentals relating to the corporate governance and the banking sector in Portugal. In Section 3 we present the main hypotheses tested in this paper. In Section 4 we describe the data and methodology and in Section 5 we present the empirical findings. Finally, in Section 6 we summarise the main findings and suggest some avenues for future research.

[2] Corporate governance impacts economic performance because it provides mechanisms that affect the returns on investment by suppliers of external finance to firms. Firms typically have more productive uses for these resources than the actual suppliers of external finance. But asymmetries of information inhibit such opportunities (Tirole, 2001).