BOARD STRUCTURE, COMPOSITION AND FIRM PERFORMANCE: A THEORETICAL AND EMPIRICAL REVIEW

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Abstract- Corporate governance literature is very wide and involves several empirical studies conducted on the relationship between board structure, composition and firm performance. The separation of ownership and control in organizations were aimed at reducing the losses suffered by the investors in the event of financial scandals. This paper reviewed the theoretical and empirical literatures on the relationship between board composition and its impact on firm performance. The findings from the studies provides different results; while some are of the view that board structure is related to firm performance, many empirical studies indicates no relationship. However, others found a U shape relationship between firm performance and board structure. Therefore, this study argued that board structure is not much significant to determine the financial performance of a firm.

Keywords- board structure, composition, firm, financial performance

I. INTRODUCTION

THERE have been many reforms, legislations and court cases recorded during the last century all in the struggle to safeguard shareholders' rights and properties, and moreover, to encourage the theory of corporate governance (Grant 2003). But in spite of all these legislations and effort to prevent the shareholders, the world economy suffered some depressions rising from the stock market crisis, the collapse of giant companies and the financial crisis of 1997 and 2008.

TMoreover, there have been a number of scandals involving executives of different organizations. The collapse of Enron in 2001 led to the emergence of another legislation passed by the congress in 2002; the Sarbanes Oxley Act 2002 which demands more oversight, enforcement of punishment on immoral behavior, and addressing the issue of conflict of interest, the Act aims to prevent management and accounting scandals (Zhang 2002). However, despite these legislations, there are a number of scandals that happened after the enactment of the laws. For example, WorldCom, Satyam 2007 and RSB 2009 scandals. It therefore became imperative to introduce policies aimed at mitigating the losses suffered by the investors in the event of such scandals. Corporate governance therefore provides such solutions among which are protection of minority shareholders and creditors from the majority shareholders (L. Porta et al 2000).

Corporate governance aims to reduce these scandals and propose a better way of managing resources in the organizations. The separation of ownership and control as provided by the agency theory and entrusting the managers as provided by the stewardship theory provides efficient means of corporate performance. Similarly, a number of reforms were suggested on how best a board should be structured and equally the composition to avoid manipulation by one person or group of persons so that decisions can be taken in the best interest of the organization.

The study intends to review theoretical and empirical literatures on the relationship between board structure and composition and firm financial performance. In line with these, the paper will examine the motives behind corporate governance and the essence of the separation of ownership and control in organizations, specifically, the two most important theories of corporate governance; agency theory and stewardship theory. Moreover, empirical studies conducted on how boards should be structured for example; the proportion of non-executive directors, the CEO/Chairman duality and board diversity shall be reviewed.

II. CORPORATE GOVERNANCE AND BOARD STRUCTURE

Huse (2007) sees 'corporate governance as the interaction between various internal and external actors and the board members in directing a firm for value creation'. A business exists to maximize the value of shareholders. The above definition shows that there is a relationship between the shareholders and those managing their resources in a firm. Moreover, the performance of a firm seems to be a yardstick of determining how effectively managers have managed the resources entrusted to their care.

In another definition, Daily et al (2003) defined corporate governance as 'the determination of the board uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations'. Corporate governance is therefore concerned on how boards of directors will strive to safeguard the shareholders wealth and other creditors from self-centered

managers through observing the activities of the managers (Van Eeset al 2009).

Many boards of directors have been associated with the business failures and loss of shareholders' investments and creditor moneys (Abidinet al 2009).

There are a number of arguments on what the best structure for an organization is and whether these structures impact on the firms' performance. Some boards comprise more inside directors, some have a large proportion of non-executive directors while some have CEO/Chairperson positions occupied by one person. Lincket al (2008) observed that the cost of managing boards and the expected benefits determines to some extent how a firm can structure its board.

Roberts et al (2005) reports that there have been much emphasis on the structure and composition of the boards, most especially the number of non-executive directors and their freedom in the boards as yardstick for determining how effective the board is. However, Finkelstein and Mooney (2003) found that 'independence' and performance of a firm are unconnected to each other.

Nevertheless, boards exist primarily to offer 'advise', 'monitor' and 'discipline' the 'CEO's'. However, there are still debates going on what should constitute the optimum board structure, and whether large firms should have large or smaller boards, and the reverse for smaller firms. Similarly, the number of inside executives and outside executives on boards and their independence is also questionable. Moreover, are the non-executive directors really independent? If they are, in what way?

III. THEORETICAL LITERATURE

Following the concept of separation of ownership and control in large organizations, the problem of how such organizations will be governed arose, and this has attracted the attention of a number of academic scholars. Fama and Jensen (1983) argued that the 'separation of decisions and risk bearing functions' varies from one organization to another. Agency theory was therefore introduced to provide guidance on how large organizations should be managed by the boards of directors. Decision making is the central point of agency theory where the responsibility of taking decisions in the corporations is delegated to the directors by the shareholders. This responsibility therefore goes beyond only taking decisions, but monitoring how the decisions taken are implemented in the organizations.

The emergence of agency theory was as a result of the work of Jensen and Meckling (1976). They tried to explain the contract relationship between entities in an economy, especially the principal agent relationship. Clarke (2005) believes the theory emerged to resolve this conflict. Basically, the theory emerged to provide further insights on the issue of separation and control in an organization. It is clear that shareholders provide finances in an organization and expect to earn dividend and equally add value to their wealth. Therefore, managers were contracted to manage these finances on certain costs so that at the end of the day, shareholders expectations will be fulfilled.

Jensen and Meckling (1976) defined 'agency relationship as a contract under which one or more persons (the principal(s)) engage another person (agent) to perform some service on their behalf which involves delegating some decision making authority to the agent'. Clarke (2005) further clarifies that 'the principals' represent shareholders and their expectation was that the organization should be managed solely on their own interest. While the agents referred to the managers.

There have been many expectations from boards of directors based on the assumption that they will live up to their task in enforcing their own side of the contract. Roberts et al (2005) points out that those boards are expected to be independent in discharging their duties. Similarly, the executives charged with the responsibility of controlling the organization are also expected to exercise a high degree of 'trust' in managing all the affairs of the organization. However, Clarke (2005) observed that since individuals want to always maximize their utility, there is the fear that 'the principal agent relationship will be problematic'. This lead to the emergence of another theory; 'stewardship theory'.

Originally from psychology and sociology, stewardship theory believes that individuals place the interest of the organization before theirs and in the event of misalignment of these interests, much emphasis is placed by the stewards on negotiation than putting blame on one another (Davis et al 1997).

Similarly, according to Ramdani and witteloostuijin (2010) stewardship theory assumes that board of directors should consist of more inside directors because they are more conversant about the firm than the outsiders and therefore, can make better decisions in the interest of the firm.

Hence, stewardship theory is centred on the belief that managers are honest and trustworthy individuals and therefore can act in a professional way in managing the resources entrusted to their care efficiently and effectively (Nicholson and Kiel 2007).

IV. EMPIRICAL LITERATURE

PROPORTION OF NON EXECUTIVE DIRECTORS (NED's)

There are arguments on the link between the performance of a firm and the constitution of the board. A number of researches indicate a significant relationship between firm performance and the composition of non-executive directors (NED's) on

the board (Mura 2007). Even though, Young (2000) argued that differences in the composition of the boards coupled with lack of specified number of directors to constitute a board hinders the generalization of the actual impact of diverse kinds of board structures. Nevertheless, a number of studies discovered that there is no any relationship between board composition and firm performance (Dalton et al 1998 and Bhagat and Black 2002). Others Andres and Vallelado (2008) provide a U shaped relationship between firm performance and the composition of the boards.

There is an increasing need for representation of independent executives in the boards in order to provide good governance practice. Basically, non-executive directors are appointed into the boards as observers and to regulate the activities of the executive directors so that decisions can be taken in the best interest of all stakeholders (Deakinset al 2000). Beside this, it is expected that NED's on the boards will enhance the overall development of the company. Helland and Sykuta (2005) observed that boards composed of larger number of NED's tend to be more observant, and this enhances the performance of the organization.

Empirical researches on the link between firm performance and the composition of the board of directors is hindered by many a problem among which is the origin of the issue. Recent researches shows that increase in shareholders' value is sometimes attributed to the composition of the boards. Even though, Fields and Keys (2003) discovered that the problem between the board structure and firm performance is yet to be resolved. Nevertheless, Mura (2007) examined the relationship between the number of NED's on the board of directors and firm performance. The study was conducted on a total number of 1100 UK listed non-financial firms between the years 1991-2001. The findings revealed that board of directors with larger number of NED's seem to impact positively on the performance of a firm. This finding seem to agree with that of Deakinset al (2000) who discovered that larger number of external directors leads to increasing the value of the firm.

V. CEO/CHAIRPERSON DUALITY

One of the key important issues in corporate governance is the separation of duties of two most important persons in organizations (CEO and Chairperson). The separation of the two roles indicates that two people will serve as the CEO and the Chairman. Whereas if they are not separated, it means one person will hold the same positions and by implication, will be in charge of monitoring the activities and evaluating the performance of other executives including him. This brought about the issue of duality in organizations. It is however argued that this might give rise to conflict of interest and may weaken the independence of the observer group in the organization (Abidinet al 2009).

Dalton et al (1998) conducted a meta-analysis on a sample of 69 that consists of 12,915 companies. They study the relationship between board composition, board structure and financial performance; their findings indicate no any relationship between these variables. Again, results from the moderator analysis carried out on the impact of company size, nature of the financial performance indicators and different board compositions shows only a little relationship between board structure and firm financial performance.

Ramdani and Witteloostuijin (2010) studied the impact of CEO duality, independence of the boards and firm performance. The study was conducted on a sample of companies listed in the stock exchange market of four East Asian countries; Indonesia, Malaysia, Korea and Thailand using quartile regression analysis. Their finding shows that while CEO/Chairperson duality is effective in some organizations, it was found to be ineffective in others. But their overall result shows a positive relationship between CEO duality and firm performance. This seems to agree with the findings from a research conducted by Peng et al (2010) on 300 state owned enterprises (SOE's) and privately owned enterprises (POS's) in China. The results show that while CEO/Chairperson duality is positive in POS's, it was however found to be negative in SOE's. Another research preceding this by Abidinet al (2009) based on 75 companies randomly selected in Malaysia, shows a positive relationship between CEO/Chairperson duality.

On the contrary, it was found that other researches conducted showed a negative relationship. One of such studies include Lyengar and Zampelli (2009), the study was conducted on 1880 sample of firms selected from different industries in the United States for the periods 1995-2003. The sample selection was based on firms which during the period under consideration were managed by CEO/Chairperson duality structure. The result from the findings show that CEO duality is negatively related to firm performance from whatever angles theorganization views that. This view is supported by (Judge et al 2003 and Mustinaet al 2010) according to them, CEO duality is negatively related to firm financial performance.

VI. BOARDS DIVERSITY ON FIRM PERFORMANCE

There is a growing vast majority of literatures on the effect of board diversity and firm performance. There have been mixed results on the effect of gender on firm performance based on previous researches conducted. (Elhardtet al 2003 and Francoeuret al 2008) for example found a positive result between board diversity and firm performance. Rose (2007)

however found negative result between gender diversity and firm performance. Another study by Miller and del Carmen Triana (2009) found that board diversity and firm performance depends on 'firm reputation and innovation'.

Board diversity can be defined in terms of 'observable diversity and less observable diversity'. While the former is concerned with board diversity in terms of race or ethnic background, nationality, gender and age, the latter involves diversity in terms of educational, functional and occupational backgrounds, industry experience and organizational membership (Kang et al 2007). The structure of the board of directors is of paramount importance within the context of corporate governance. However, Rose (2007) argued that the structure of a board in terms of 'gender or ethnic background, education and the proportion of foreigners' has nothing to do with the performance of a firm.

Empirical studies on boards of directors' diversity reported different results. Erhardtet al (2003) studied the relationship between diverse boards of directors and firm performance using regression analysis. Their study examined the data on return on assets and investments of 127 large United States companies for 1993 and 1998 financial years, and the percentage of women and minorities on boards of those companies. Their findings reveal that board diversity is positively related to the key performance indicators and as such, it is relevant to the financial performance of the firm. However, Brammeret al (2007) discovered that there is a 'limited' statement of gender and ethnicity in the UK boards of directors, and where such exists, it is influenced by the 'external environment'. Therefore, they argued that board diversity is not related to firm performance. However, Carter et al (2010) discovered that the relationship between board diversity and firm performance is 'endogenous'. Therefore, their findings reveal that board diversity is neither positively nor negatively related to firm performance, the effect depends on diverse conditions and time.

VII. SUMMARY OF BOARD CHARACTERISTICS THAT MAY IMPROVE FIRM'S PERFORMANCE

The following are recommended as characteristics of boards that may enhance firm performance:

1. Emphasis should be placed on key actors (CEO and Chairman) as the major players in determining firm performance. And also establish good link with external organization and the firm.
2. Since there is no optimal board structure, it is suggested that the structure should depend on certain attributes of the firm.
3. The resources owned by the firm and the network of the board of directors should help improve the firm performance.

CONCLUSION AND RECOMMENDATIONS

Academic literatures proposed that composition of boards' structure is related to firm financial performance. This study focused on the relationship between the proportion of NED's, CEO/Chairperson duality, and board diversity on firm performance. Theoretical literatures provided by corporate governance provide two important alternatives; the agency theory is based on the notion that separation of ownership and control determines the effectiveness of a board of directors. Similarly, the stewardship theory proffers that firms with combined ownership structure tend to operate more successfully through better co-ordination and thus deal with more strategic issues effectively.

Based on the empirical works reviewed, the findings from the study discovered that authors present different findings; while some are of the view that board structure is related to firm performance (Erhardt 2003); many empirical studies indicate no relationship between board structure and firm performance (Dalton et al 1998; Bhagat and Black 2002; Finkelstein and Mooney 2003; Rose 2007). However, others Andres and Villelado (2008) discovered a U shape relationship between the firm performance and board structure.

This study therefore argued that board structure is not much significant to determine firm financial performance; moreover, what should constitute an optimal board structure? Because the literatures fail to show what should be the optimal structure of a firm. The study therefore seems to agree with the findings of (Dalton et al 1998; Fields and Keys 2003; Daily et al 2003) where they discovered that the relationship between board structure and firm performance is yet to be resolved.

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