



Perspectives on board structure, composition, diversity and corporate performance

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ABSTRACT

The study examined previous studies on the relationship between board dynamics (structure, composition, diversity) and corporate performances, the results of the investigations revealed mixed findings on the relationship between board variables and corporate performance, some studies established evidence of significant positive relation while others discovered neutral and or negative relationship. Therefore the conflicting results discovered may be due to differences in corporate governance practice found in different countries.

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Introduction

Recent cases of large scale corporate scandals couple with high rate of liquidations around the world in renowned corporations such as Bristol-Myers Squibb, Cendant, Computer Associates (CA), Consec, Dynegy, Enron, Federal Home Loan Mortgage Corporation ("Freddie Mac"), HealthSouth, Peregrine Systems, Qwest, Rite Aid, Sunbeam, Tyco, Waste Management, WorldCom, and Xerox, ComROAD AG, Lernout & Hauspie Speech Products, Parmalat, and Royal Ahold, forced various governments, regulatory agencies and other international organisations like OECD to reform and overhauled the audit practices, corporate governance mechanisms and financial reporting system of public listed companies in order to restore the confidence of the investors. Mallin (2007) pointed out that in an efforts to sanitised and improved corporate governance mechanism in UK for example, government set up different committees at different periods to make recommendations about best corporate governance practice to be adopted, the committees include Cadbury (1992), Greenbury (1995), Hampel (1998) and Combined Code (2006). In a related development Agrawal and Chandha (2005) revealed that United States government in reaction to collapses of major corporations in 2002 implement an act known as Sarbanes- Oxley Act that aims to regulate public companies practices and protects the interest of investors. Likewise stock exchanges like NYSE and NASDAQ adopt new corporate governance policies with regards to public companies. Christensen *et al.* (2010) stated that in reaction to cases of corporate failures globally Australian stock exchange in (2003) and (2007) issued guideline on corporate governance known as principles of good corporate governance and best practice recommendations to regulate the affairs of public companies.

Theoretical perspectives of corporate governance

The relative importance of board of directors to organisational success and survival cannot be overemphasised, for example Kang *et al.* (2007) observes that board of directors is consider as one significant aspect of internal corporate

governance mechanism that are expected to guaranteed the alignment of diverse interests between the owners and management, and to ensure that discipline and effectiveness among board members is maintained.

In view of significant role play by board of directors in corporate existence Kiel and Nicholson (2003) and Lawal (2012) stated that several theoretical approaches emerged in order to explain the complex nature of corporate governance largely due to differences in perception of the concept by scholars in different academic disciplines such as finance, economics, management and sociology. As a result of these differences a number of theories emerged to explain how best "board" should be constituted to maximised organisational performance. The most widely used theories are: agency, stewardship, resources dependency and stakeholders' theory.

Agency theory

Agency theory was the predominant theory of corporate governance as observed by Nyberg *et al.* (2010) Daily *et al.* (2003) and Kiel and Nicholson (2003). They pointed out that the theory emerged as a result of separation of ownership and control in business between shareholders and directors. The main concern of the theory is to align the interest of the shareholders with that of the management. It was built on the assumption that there is mis-alignment of interest between shareholders (principals) and the directors (agents); the theory argued that directors interest will be align with that of owners through some sort of compensation, while interest of the owners is protected through effective monitoring and control mechanism. The theory recommends board with greater proportion of independent non-executive directors, duality in leadership and larger board size for effective performance.

Stewardship theory

Contrary to agency theory which described directors as self-centred and opportunistic, proponents of stewardship theory as pointed by Lawal (2011), Daily *et al.* (2003) and Kiel and Nicholson (2003) viewed directors as trustworthy individuals capable of managing the resources of the owners in the most

appropriate way. The directors consider serving the interest of the stockholders as serving their interest. The main role of the board under this theory is more of strategic policy formulation. Stewardship theory recommends board composition with higher proportion of independent directors while the position of chairman and that of CEO to be held by one person in order to maximise corporate performance.

Resource dependency theory

Hillman *et al.* (2000) and Hillman *et al.* (2009) described resources dependency theory as a theory that views organisations as an open system which relied on eventualities in the outside environment. The theory acknowledged the impact of external environmental issues on organisational performance therefore managers can act in a manner that will curtail the effects of environmental uncertainties. In relation to board of directors, proponents of resources dependency theory acknowledge the popularity of agency theory, but argued that it was more successful in understanding boards.

The theory is mainly concern with board size and composition which are consider as the basis for evaluating board performance in terms of providing essential resources required by the organisation. The theory concluded "that board size and composition are not random or independent factors, but are, rather, rational organizational responses to the conditions of the external environment". Finally the theory suggests that "resource-rich" directors should be the focus of board composition not just the number, but the type of directors on the board that matters.

Pfeffer and Salancik (1978) in Hillman *et al.* (2009) suggest that directors bring four benefits to organizations:

- (a) Information in the form of advice and counsel,
- (b) Access to channels of information between the firm and environmental contingencies,
- (c) Preferential access to resources, and
- (d) Legitimacy. Significant empirical evidence supports these proposed benefits, both generally and

Stakeholders' theory

Asher *et al.* (2005), Letza *et al.* (2004) and Lawal (2011) pointed out that contrary to agency theory that view organisations as a system of relationship between shareholders and management, stakeholders' theory view organisations as a system that accommodates not only the interest of the owners but also the interests of other groups within the environment which the organisation operates. The theory argued that since organisations cannot operate and exist in isolation without relating to its immediate environment then the interest of other stakeholders like employees, customers, suppliers and local community might be consider in the process of strategic decision making. Therefore the main argument of the theory as pointed Lawal (2011) is that organisations should not only maximised the returns of shareholders alone, but also the expectations of stakeholders should be consider. Finally the theory argued that for a firm to achieve effective performance in the market cordial relation must exist between the firm and the stakeholders and the firm board should be large and diversified enough to accommodate the interest of other stakeholders.

Literature Review on Board Dynamics and Corporate Performance

Findings from previous empirical research on the relationship between board dynamics (structure, composition and diversity) and corporate performance produced mixed results, some research established evidence of significant

positive relationship between board dynamics and corporate performance while others discovered a negative relation, therefore debate on this subject matter remained unresolved, furthermore some findings are inconsistency with the existing theories of corporate governance. Below are review of some findings from previous theoretical and empirical research on board dynamics and corporate performance.

Board Composition

Board composition is mainly concern with proportion or percentage of internal and external directors on the board. In this regard findings of previous theoretical and empirical literatures on the relationship between board composition and corporate performance were examined. For example Van-Ness *et al.* (2010) examined the relationship between board composition and corporate performance for a sample of two hundred (200) US firms selected from S&P 500 using accounting and market base measurement (revenue, return on assets, leverages, market to book value ratio and free cash flow to net income). The outcome of the study reveals that board composition defined as the (proportion of internal or external directors on board) is not related to performances. In a related development Vafeas (2000) investigates the relationship between board structure and corporate performance for a sample of three hundred and seven (307) US corporations using accounting measures. The study find out that board composition defined as (proportion of executive or non-executive directors on board) is not related to performances. However Jackling and Johl (2009) using accounting measures on a sample of one hundred and eighty (180) Indian large corporations finds a positive relationship between the proportion of external directors on board and corporate performance. Similarly Dehaene *et al.* (2001) and Victoria (2006) find a positive relationship between board structure and performance on 122 Belgium companies as well as eighty one (81) European companies drawn from nine EU members trading in US capital markets respectively. The worked Mak and Kusnadi (2005) find positive relation between the proportion independent non-executive directors and corporate performance on a sample of four hundred and sixty (460) listed companies from Singapore and Malaysia using Tobin's Q. Similarly Zubaidah *et al.* (2009) using value added efficiency of the firms' tangible and intellectual assets on seventy five companies from Malaysia find positive relationship between corporate performance and proportion of outside directors on board. But Kiel and Nicholson (2003) apply financial performances measures (Tobin's Q (financial market ratio that measure firm's value by dividing the total market value of a firm by its total assets) and return on assets) on a sample of three hundred and forty eight (348) firms listed on Australian stock market find a negative relationship between corporate performance and external directors. In the same vein Yermack (1996) investigates the relationship between companies' valuation and board size of 452 US Industrial companies using Tobin's Q on companies' financial data. The result of the study shows negative relationship between the proportion of external directors and firm performance.

Structure

Peng *et al.* (2007) and Elsayed (2007) described CEO duality as a situation where by the chief executive officer of a company will serve as chairman of the board of directors in same company. The literature reviews here examine the findings of previous studies on the relationship between CEO duality and corporate performance. Jackling and Johl (2009) and Zubaidah

et al. (2009) using a sample of companies from India and Malaysia respectively find out that board leadership style (duality or separation of CEO/Chairperson) is not related to corporate performance. However using return on equity and sales growths on a sample of 403 public companies in China during institutional transformation (period in which state owned enterprise formerly owned and control by government are transformed to public companies) Peng *et al.* (2007) find a positive and significant relationship between CEO duality and corporate performance. Van-Ness *et al.* (2010) find a positive relation between chief executive officer/chairman duality and corporate performance on sample of 200 US corporations. Similarly Dehaene *et al.* (2001) find a positive relation between CEO/Chairperson duality and corporate performance on sample of 122 public companies in Belgium using return on assets and return on equity. But contrary to some findings, using Tobin's Q on a sample of 452 US industrial corporations Yermack (1996) find negative relationship between CEO/Chairperson duality and corporate performance. Elsayed (2007) using Tobin's q and return on assets on a sample of 91 public companies listed in Egypt stock market finds no direct relationship between CEO duality and corporate performance. Christensen *et al.* (2010) examined the relationship between corporate governance and firm performance of 1039 Australian public companies as at 2004 using accounting ratios (return on asset and return on equity) and Tobin's Q (financial market ratio that measure firm's value by dividing the total market value of a firm by its total assets).

The study yield mixed results for example positive relation was established between CEO/Chairperson duality and corporate performance when Tobin's Q was used, while negative relation was recorded when accounting measures were used.

Board Diversity

Board diversity as defined by Kang *et al.* (2007) has to do with variation and multiplicity in composition of board of directors, the variation may either be instantly noticeable attributes such as age, gender, nationality and ethnic background of the directors, or less detectable such as education, functional and occupational background, industry experience and organizational membership. The literatures review below examines the findings of previous investigations on the relationship between board diversity and corporate performance. Maran (2008) investigates the relationship between board diversity defined as the (proportion Malaysians and Non-Malaysians on board) and firm performance using return on asset on sample of 100 Malaysian public corporations. The study finds positive relation between board diversity and organisational performance. Erhardt *et al.* (2003) examined the relationship between board diversity defined as the (proportion of women and minorities on board) and corporate performance of a sample of 127 US corporations using return on asset and return on investment. The study finds positive relation between board diversity and performance Van-Ness *et al.* (2010) find positive relation between board diversity and firm performance in a sample of 200 US corporations.

In another development Cater *et al.* (2003) examined the relationship between board diversity and firm's performance of six hundred and thirty eight 638 fortunes firms in US using Tobin's Q (financial market ratio that measure firm's value by dividing the total market value of a firm by its total assets). The outcome of the investigation reveals a positive relationship between board diversity (proportion of women and minorities on

board) and firms' performance. But using market to book value on a sample of 459 public companies from Scandinavia (Denmark 154, Norway 144 and Sweden 161) Randoy *et al.* (2006) find neither positive nor negative relation between board diversity (gender, age and nationality) corporate performance. Francoeu *et al.* (2008) examined the relationship between board diversity (proportion of women in top management and on board of directors) of a sample of 230 public companies in Canada using (Fama and French 1992; 1993) valuation model. The study shows that the proportion of women on board or top management does not bring additional value to the companies. Rose (2007) study the relationship between board diversity and corporate performance using Tobin's Q of public companies listed on Copenhagen stock market excluding financial institutions from 1998-2001. The study finds no evidence between board diversity (proportion of women, percentage foreigners on board and educational background of board members) and firms' performance.

Conclusion

The outcomes of the literatures review so far on board dynamics (structure, composition and diversity) and firm's performances reveal mixed findings, this indicates that none of the existing theories on corporate governance (agency, stewardships, resources dependency and stakeholders) has so far explained the complexities involve in board dynamics. For example some findings support and confirmed the recommendations of a given theory with regards to either board composition diversity or CEO duality while other findings contradict the theory.

It should be noted that the term performance mean different thing to different organisations, it can be long term, short term, financial or non-financial, however most of the researchers viewed it from financial point of view ignoring the non-financial aspect of performance, furthermore the effects of changes in government policies as well as the impact of changes in economic situations on corporate performance was not fully considered in most instances by the researchers. Therefore the suggestions and or recommendations provided by some of the existing theories of corporate governance are not only inadequate but also weak, because none of the theories provide a clear definition of "performance" and no performance evaluation method or methods was suggested, that is why numerous performance measures were used by different researchers which yielded conflicting results, therefore to resolve some issues in board dynamics and corporate performance such as conflicting results there is need for clear definition of performance as well as proper methodologies for measuring of performance .

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