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IMPACT OF BOARD STRUCTURE ON CORPORATE FINANCIAL PERFORMANCE

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ABSTRACT

Board structure represents one of the core issues in corporate governance. This study investigates the impact of board structure on corporate financial performance in Nigeria. It examines the composition of boards of directors in firms and analyzes whether board structure has an impact on financial performance. Four board characteristics which include: board composition, board size, board ownership and CEO duality (representing the independent variables), were correlated with the financial performance of the selected firms. Regression was used to estimate the relationship between corporate performance and the independent variables. The result indicates that there is strong positive association between board size, outside directors sitting on the board and corporate financial performance. Negative association was observed between directors' stockholding and corporate financial performance. Furthermore, the study reveals a negative association between ROE and CEO duality, while a strong positive association is observed between ROCE and CEO duality. The results imply that large board size performs effectively. There is also evidence that higher proportion of outside directors on the board have a positive impact on financial performance. However, the effect of directors' shareholding on performance (measured by ROE) is negative while the relationship between ROCE and directors' shareholding is strongly positive and significant.

KEYWORDS

Board Structure, Financial Performance, Corporate Governance.

INTRODUCTION

In all business organizations, the board of directors is charged with oversight of management on behalf of shareholders. Agency theorists argue that in order to protect the interests of shareholders, the board of directors must assume an effective oversight function (Uadiale, 2010). It is assumed that board performance of its monitoring duties is influenced by the effectiveness of the board, which in turn is influenced by factors such as board composition and quality, size of board, duality of chief executive officer, board diversity, information asymmetries and board culture (Brennan, 2006).

REVIEW OF LITERATURE

Raheja (2005) theoretically models the determinants of board structure, specifically the roles of insiders and outsiders directors. He argues that insiders are an important source of firm-specific information for the board, but may have distorted objectives due to private benefits and lack of independence from the CEO. Compared to insiders, outsiders are more independent, providing better monitoring, but are less informed about the firm's constraints and opportunities.

CORPORATE GOVERNANCE MECHANISMS

There are many variables that may constitute yardsticks by which corporate governance can be measured in an organization. Some of these mechanisms include board size, board composition, CEO-Chairman duality and board ownership; these are briefly discussed below. Board size is considered to be a crucial characteristic of the board structure, and empirical studies in this respect show mixed results. Large boards could provide the diversity that would help companies to secure critical resources and reduce environmental uncertainties (Pearce and Zahra, 1992; Goodstein *et al.*, 1994). But, as Yermack (1996) said, coordination, communication and decision-making problems increasingly impede firm performance when the number of directors increases. Thus, as an extra member is included in the board, a potential trade-off exists between diversity and coordination. Limiting board size to a particular level is generally believed to improve the performance of a firm because the benefits by larger boards of increased monitoring are out weighed by the poorer communication and decision making of larger groups. Too big a board is likely to be less effective in substantive discussion of major issues among directors in their supervision of management.

Lipton and Lorsch (1992) argue that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to coordinate and for it to process and tackle strategic problems of the organisation. Yermack (1996), using data from Finland find negative correlation between board size and profitability. Eisenberg *et al.*, (1998) also reports that small size boards are positively related to high firm performance. Mak and Yuanto (2003) using sample of firms in Malaysia and Singapore, find that firm valuation is highest when board has 5 directors, a number considered relatively small in those markets. In a Nigerian study, Sanda *et al.*, (2003) report that firm performance is positively correlated with small, as opposed to large boards.

Board composition refers to the number of independent non-executive directors on the board relative to the total number of directors. An independent non-executive director is defined as an independent director who has no affiliation with the firm except for their directorship (Clifford and Evans, 1997). There is an apparent presumption that boards with significant outside directors will make different and perhaps better decisions than boards dominated by insiders. Fama and Jensen (1983) suggest that non-executive directors can play an important role in the effective resolution of agency problems and their presence on the board can lead to more effective decision-making. Enhanced director independence, according to Young (2003) is intuitively appealing because a director with ties to a firm or its CEO would find it more difficult to turn down an excessive pay packet, challenge the rationale behind a proposed merger or bring to bear the skepticism necessary for effective monitoring. The proponents of agency theory say that corporate governance should lead to higher stock prices or better long-term performance, because managers are better supervised and agency costs are decreased.

Empirical studies of the effect of board membership and structure on firm value or performance generally show results either mixed or opposite to what would be expected from the agency cost argument. Some studies find better performances for firms with boards of directors dominated by outsiders (see John and Senbet 1998), while Weir and Laing (2001) find no such relationship in terms of accounting profit or firm value. Also, Forsberg (1989) find no relationship between the proportion of outside directors and various performance measures.

In the same vein, Bhagat and Black (2002) find no correlation between the degree of board independence and four measures of firm performance, controlling for a variety of other governance variables, including ownership characteristics, firm and board size and industry. They find that poorly performing firms were more likely to increase the independence of their board. Klein (1998) finds that firm performance is insignificantly related to a higher proportion of outsiders on the board. Thus, the relationship between the proportion of outside directors and firm performance is mixed.

Under CEO-chairman duality, the CEO of a company plays the dual role of chairman of the board of directors. There are two schools of thought on CEO-chairman duality. Several researchers argue that CEO-chairman duality is detrimental to companies as the same person will be marking his "own examination scripts". Separation of duties will lead to: (i) avoidance of CEO entrenchment; (ii) increase of board monitoring effectiveness; (iii) availability of board chairman to advise the CEO, and (iv) establishment of independence between board of directors and corporate management (Rechner and Dalton, 1991).

On the other hand, other researchers believe that since the CEO and chairman is the same person, the company will: (i) achieve strong, unambiguous leadership; (ii) achieve internal efficiencies through unity of command; (iii) eliminate potential for conflict between CEO and board chair, and (iv) avoid confusion of having

two public spokespersons addressing firm stakeholders (Davis, *et al.*, 1997). Consistent with these arguments, Cannella and Lubatkin (1993) report a positive link between a dual leadership structure and financial performance, Dedman and Lin (2002) find no evidence of significant abnormal returns upon the announcement of splitting roles in the post-Cadbury period. A closer look at the empirical evidence reveals that the relationship between CEO-chairman duality and company performance is mixed and inconclusive.

Board Ownership is also an important characteristic of board structure. To the extent that executive board members own part of the firm, they develop shareholder-like interests and are less likely to engage in behaviour that is detrimental to shareholders. Therefore, managerial ownership is inversely related to agency conflicts between managers and shareholders. In contrast to this notion, Demsetz and Lehn (1985) find no link between ownership structure and firm performance, and assert that there is little support for the divergence of interests between managers and shareholders. In empirical contrast to the Demsetz and Lehn (1985) findings, and in line with the beneficial effects of ownership, Morck, *et al.*, (1988) find that firm performance first rises as ownership increases up to 5%, then falls as ownership increases up to 25% and then rises slightly at higher ownership levels. They support the theory that managers tend to allocate the firm's resources in their own best interests, which may conflict with those of shareholders. McConnell and Servaes (1990) provide further evidence on the relationship between the distribution of equity ownership and firm value and find a significant curvilinear relation between *Q* and the fraction of shares owned by corporate insiders. Specifically they find that *Q* first increases, then decreases as share ownership is concentrated in the hands of managers and board members.

A possible explanation for the nonlinearity in the ownership–performance relationship is that managers become entrenched when possessing a very high percentage of ownership. Alternative governance mechanisms, such as the corporate control market, become less effective when managers become entrenched. Research on the importance of ownership concentration in the UK has been sparse. Leech and Leahy (1991) find that profitability differences between ownership-controlled (closely-held) firms compared to management-controlled (diffusely-held) firms are only marginal. Such differences are unlikely to be economically meaningful.

IMPORTANCE OF THE STUDY

This study focuses on the impact of board structure on corporate financial performance in Nigeria. This is crucial especially with the recent reports of corporate failure in many economies. The series of corporate distresses have been blamed on the inefficiency on the part of board of directors in carrying out their oversight functions in the various companies. Thus it becomes important to carry out this study which investigates the impact of board structure on corporate financial performance.

STATEMENT OF THE PROBLEM

Boards of directors have been largely criticized for the decline in shareholders' wealth and corporate failure in recent times. They have been in the spotlight for the fraud cases that had resulted in the failure of major corporations, such as Enron and WorldCom. In Nigeria, a series of widely-publicized cases of accounting improprieties have been recorded in organizations such as Oceanic Bank, Intercontinental Bank, Finbank and Bank PHB. Some of the reasons stated for these corporate failures are the lack of vigilant oversight functions by the board of directors, the board relinquishing control to corporate managers who pursue their own self-interests and the board being remiss in its accountability to stakeholders etc. As a result, various corporate governance reforms have specifically emphasized on appropriate changes to be made to the board of directors in terms of its composition, structure and ownership configuration (Abidin, *et al.*, 2009).

OBJECTIVES OF THE STUDY

The objective of this study is to determine the relationship between Board structure and financial performance of the selected firms. The study specifically identified the following objectives:

- i. to determine the extent to which board size affects corporate financial performance,
- ii. to examine the relationship between board composition and corporate financial performance,
- iii. to evaluate the impact of directors' stockholding on corporate financial performance, and
- iv. to investigate the relationship between CEO duality and corporate financial performance in Nigeria.

RESEARCH QUESTIONS

The study attempts to find answers to the following specific questions:

- i. To what extent does board size affect corporate financial performance?
- ii. Does board of directors' composition have any relationship with corporate financial performance?
- iii. What impact does directors' stockholding have on corporate financial performance?
- iv. Is there any relationship between CEO duality and corporate financial performance in Nigeria?

RESEARCH HYPOTHESES

The following hypotheses were formulated to guide the researcher in finding answers to the research questions:

- H_{O1} : There is no significant relationship between CEO duality and corporate performance.
 H_{O2} : There is no significant relationship between proportion of outside directors sitting on the board and corporate financial performance.
 H_{O3} : There is no significant relationship between board size and corporate financial performance.
 H_{O4} : There is no association between directors' stockholding and corporate financial performance.

RESEARCH METHODOLOGY

This study uses a survey research design. Since this study is on board structure of quoted companies in Nigeria, population of the study is made up of companies listed on the floor of the Nigerian Stock Exchange (NSE). However, firms belonging to the financial services industry and regulated utility companies are excluded from the population. This is due to the special regulatory environment in which they operate. Simple random sampling technique is used in selecting the sample used for this study. A total sample of five (5) firms was selected for the study. Information relating to firm performance (ROE and ROCE) and board characteristics (board size, board composition, board ownership and CEO duality) were collected from the sampled company's annual reports for the year ended 2009. Dependent variable of the study is corporate financial performance which is represented by ROE (measured as the proportion of Profit after tax to issued share capital) and ROCE (measured as the proportion of profit after tax to issued share capital plus reserves). The independent variables are board size, board composition, board ownership and CEO duality.

RESULTS

For the purpose of empirical analysis, this study uses descriptive statistics, Pearson correlation analysis and linear multiple regression as the underlying statistical tests. The regression analysis is performed on the dependent variable, CORPERF, to test the relationship between the independent variables (board structure characteristics). The regression model utilized to test the relationship between the board characteristics and corporate performance is as follows:

$$\text{CORPERF} = \beta_0 + \beta_1\text{BSIZE} + \beta_2\text{BCOMP} + \beta_3\text{BOSHIP} + \beta_4\text{CEO} + e$$

Where: β_0 = Intercept coefficient. β_1 = Coefficient for each of the independent variables. BSIZE = Number of directors on the board. BCOMP = Proportion of outside directors sitting on the board. BOSHIP = Proportion of total equity owned by executive and non-executive directors respectively. CEO = Value zero (0) if the same person occupies the position of the chairman and the chief executive and one (1) for otherwise. Analyses were carried out with the aid of the Statistical Package for Social Sciences, (SPSS Version 15.0).

TABLE 1: SHOWING THE DESCRIPTIVE STATISTICS OF ALL THE VARIABLES USED IN THE STUDY

	N	Minimum	Maximum	Mean	Std. Deviation
ROE	5	-.88	8.50	2.0138	3.6521
ROCE	5	-2.11	1.77	.1114	.5827
BDSIZE	5	5	15	7.33	2.203
BCOMP	5	.00	.89	.5131	.2644
BOSHIP	5	.00	1.00	.3700	.3623
CEODUALITY	5	0	1	.78	.315
Valid N	5				

Source: Audited financial statement of the selected firms.

The mean ROE of the sampled firms is N2 and the mean ROCE is N0.11. The results indicate that for every N100 invested on equity there is a return of N2. In the same vein, return on every

N100 of capital employed is N0.11. The average board size of the 5 firms used in this study is 7, while the proportion of the outside directors sitting on the board is 51%. The result also indicates that the proportion of total equity owned by executive and non-executive directors is 37%. The result above also reveals that 78% of the sampled firms have separate persons occupying the posts of the chief executive and the board chair, while 22% of the sampled firms have the same person occupying the two positions.

A Pearson correlation analysis is performed on the variables to check for the degree of multi-collinearity among the variables.

TABLE 2: CORRELATION ANALYSIS USING ROE AS PERFORMANCE VARIABLE

		ROE	BDSIZE	BCOMP	BOSHIP	CEODUALITY
ROE	Pearson Correlation	1	.452(**)	.068	-.158	-.152
	Sig. (2-tailed)		.009	.675	.365	.412
	N		5	5	5	5
BDSIZE	Pearson Correlation		1	-.054	.106	.263
	Sig. (2-tailed)			.621	.510	.113
	N			5	5	5
BCOMP	Pearson Correlation			1	-.650(**)	.026
	Sig. (2-tailed)				.001	.733
	N				5	5
BOSHIP	Pearson Correlation				1	-.232
	Sig. (2-tailed)					.140
	N					5
CEODUALITY	Pearson Correlation					1
	Sig. (2-tailed)					
	N					

** Correlation is significant at the 0.01 level (2-tailed).

ROE is positively correlated with board size and is significant at (0.009). Similar results appear for board composition though not significant (0.621). However, ROE has a negative relationship with board ownership and CEO duality but not significant. The results also show that a negative and significant (0.001) relationship exists between board composition and board ownership.

TABLE 3: CORRELATION ANALYSIS USING ROCE AS PERFORMANCE VARIABLE

		ROCE	BDSIZE	BCOMP	BOSHIP	CEODUALITY
ROCE	Pearson Correlation	1	.267	.019	-.027	.514(**)
	Sig. (2-tailed)		.126	.901	.751	.003
	N		5	5	5	5
BDSIZE	Pearson Correlation		1	-.064	.109	.274
	Sig. (2-tailed)			.605	.543	.117
	N			5	5	5
BCOMP	Pearson Correlation			1	-.571(**)	.033
	Sig. (2-tailed)				.001	.748
	N				5	5
BOSHIP	Pearson Correlation				1	-.229
	Sig. (2-tailed)					.137
	N					5
CEODUALITY	Pearson Correlation					1
	Sig. (2-tailed)					
	N					

** Correlation is significant at the 0.01 level (2-tailed).

Table 3 indicates that ROCE is positively correlated with three of the board structure variables (board size, board composition and CEO duality), though significant with only CEO duality (0.003). A negative correlation is observed between ROCE and board ownership though not significant (0.751). Board ownership also has a negative and significant (0.001) relationship with board composition. A negative correlation is also observed between board ownership and CEO duality, but not significant.

TABLE 4a: MODEL SUMMARY

R	R square	Adjusted R Square	Std Error of the Estimate	Durbin-Watson
.656	.430	.337	3.2454	2.562

Dependent Variable: ROE

TABLE 4b: ANOVA

	Sum of Square	Df	Mean Square	F	Sig.
Regression	121.321	2	60.6605	3.087	.004*
Residual	132.297	2	66.1485		
Total	253.618	4			

Dependent Variable: ROE; *Significant at 0.01 level

TABLE 5: MODEL SUMMARY

R	R square	Adjusted R Square	Std Error of the Estimate	Durbin-Watson
.541	.293	.206	0.5141	1.8247

Dependent Variable: ROCE

TABLE 5b: ANOVA

	Sum of Square	df	Mean Square	F	Sig.
Regression	3.035	2	9.211225	2.271	.053**
Residual	4.372	2	19.114384		
Total	7.407	4			

Dependent Variable: ROCE; **Significant at 0.05 level

Tables 4 and 5 present the model summary. The R^2 value, which indicates the explanatory power of the independent variables, is 0.430 and 0.293 respectively. This means that 43.0% of the variation in ROE is explained by the variation in the independent variables, while 29.3% of the variation in ROCE is explained by the variation in the independent variables. This result connotes that there is a significant relationship between corporate financial performance and board structure in Nigerian listed firms. From the output of the analysis in Tables 4b and 5b, the analysis of variance (ANOVA) returns significant p-values of 0.004 and 0.053 for ROE and ROCE respectively. This shows that the explanatory variables are linearly related to CORPERF and the model seems to have some validity.

TABLE 6: CO-EFFICIENT ESTIMATES

	Unstandardized Co-efficients		Standardized Co-efficients		Sig.
	B	Std Error	Beta	t	
(Constant)	-.520	2.521		-.121	.861
BDSIZE	.721	.121	.521	3.812	.000*
BCOMP	-.172	1.421	-.161	-.051	.943
BOSHIP	-3.121	1.602	-.251	-1.423	.060**
CEODUALITY	-3.326	1.072	-.421	-1.852	.002*

Dependent Variable: ROE; *Significant at 0.01 level; ** Significant at 0.10 level

Table 6 shows the results of the coefficient estimates with ROE as dependent variable. Board size and CEO duality are significant at p-value < 0.05. This indicates a positive relationship between them and ROE. Board Ownership is significant at p-value < 0.10. Board composition is not significant at either level.

TABLE 7: CO-EFFICIENT ESTIMATES

	Unstandardized Co-efficients		Standardized Co-efficients		Sig.
	B	Std. Error	Beta	t	
(Constant)	-1.092	.532		-2.012	.039
BDSIZE	.031	.036	.121	.491	.482
BCOMP	.216	.419	.113	.397	.515
BOSHIP	.261	.322	.173	.771	.398
CEODUALITY	.772	.316	.539	2.181	.009*

Dependent Variable: ROCE; *Significant at 0.05 level

Table 7 shows the results of the coefficient estimates with ROCE as dependent variable. Three of the board structure variables (board size, board composition and board ownership) are not significant at p-value < 0.05. Only CEO duality is significant at p-value < 0.05. This means that there is a relationship between CEO duality and ROCE.

DISCUSSIONS

The results of the analysis revealed that there is strong positive association between board size, outside directors sitting on the board and corporate financial performance. This result aligns with the result of Raheja (2005) who hypothesized a positive effect on financial performance. This is because outside-directors are more independent and providing better monitoring. However, the result contradicts that of Weir and Lang (2001). Furthermore, this study revealed that there is negative association was observed between directors' stockholding and corporate financial performance; this result is contrary to that of Morck, et al., (1988) who reported positive association. This study also revealed that there is a negative association between ROE and CEO duality. This result is in line with the argument of Rechner and Dalton (1991) who argue that CEO-chairman duality is detrimental to companies as the same person will be marking his "own examination scripts". Finally the study revealed that there is a strong positive association between ROCE and CEO duality. This result aligns with the result of Cannella and Lubatkin (1993) who reported a positive link between a dual leadership structure and financial performance.

FINDINGS

This study investigated the impact of board structure on corporate financial performance in Nigeria. The results of the study revealed the following: (i) That there is strong positive association between board size, outside directors sitting on the board and corporate financial performance. (ii) That there is negative association was observed between directors' stockholding and corporate financial performance. (iii) That there is a negative association between ROE and CEO duality. (iv) That there is a strong positive association is observed between ROCE and CEO duality.

RECOMMENDATIONS

Therefore, this study recommends that large board size should be encouraged. The composition of outside directors as members of the board should be sustained and improved upon. Furthermore, this study may be improved upon by including more variables that may affect corporate financial performance.

CONCLUSION

The objective of this study was to empirically examine the impact of board structure on corporate financial performance in Nigerian quoted firms. In achieving this aim, the study obtained data on variables which were believed to have relationship with corporate financial performance and board structure. These variables included ROE, ROCE, BSIZE, BCOMP, BOSHIP, CEO-DUALITY. On the basis of these variables, hypotheses were postulated. Results from the study indicate that there is strong positive association between board size and corporate financial performance. The study also reveals a positive association between outside directors sitting on the board and corporate financial performance. A negative association was observed between

directors' stockholding and corporate financial performance. In addition the study reveals a negative association between ROE and CEO duality, while a strong positive association is observed between ROCE and CEO duality. The results imply that large board size performs effectively. There is also evidence that a higher proportion of outside directors on the board have a positive impact on firm financial performance. However, the effect of directors' shareholding on firm performance (measured by ROE) is negative while the relationship between ROCE and directors' shareholding is strongly positive and significant (0.003).

SCOPE FOR FURTHER RESEARCH

This study concentrated only on board composition and its impact on financial performance of non-financial sector firms which are listed in the Nigerian Stock Exchange. Firms belonging to financial sector were excluded due to the special regulatory environment in which they operate. Thus, it becomes necessary for future researchers to focus their studies on firms operating in the financial sector of the Nigerian economy. Furthermore, future studies could seek to investigate the effect of board gender diversity on corporate financial performance.

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