

Review of the Relationship between Board Attributes and Firm Performance

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Abstract

Corporate governance over the years has become an issue of global concern due to the 2008 economic crisis and several financial scandals and corporate failures. This has drawn the attention of policy makers, researchers, investors and regulatory institutions. Moreover, the most significant mechanism of corporate governance is board of directors. Therefore, the purpose of this paper is to review previous studies that examine the relationship between board attributes and firm performance, and to identify possible literature gaps. For the purpose of this review, related materials were being gathered from Emerald management e-Journals and Research Gate database. The paper synthesizes empirical findings on the relationship between selected dimensions of board attributes and firm performance. The

paper identifies shortcoming of past studies and concluded by offering some avenues for future researches in this promising area of empirical research.

Keywords: Corporate governance, board attributes, firm performance, board size, board composition, board meeting

1. Introduction

Can board of directors attributes influence firm's financial performance? A justifiable response to this question is through scanning the results of previous empirical studies on the subject matter. However, corporate governance over the years has become an issue of global concern due to the 2008 economic crisis and several financial scandals and corporate failures (e.g., Enron, WorldCom, Lehman Brothers, Parmalat e.t.c) (Jones, Li & Cannella, Jr, 2015; Shahwan, 2014; Fallatah & Dickins, 2012; Benjamin, 2009; Dalton, Hitt, Certo & Dalton, 2007; Kyereboah-Coleman, 2007). Therefore, this has drawn the attention of policy makers, researchers, investors and regulatory institutions.

The attention increase in research on corporate governance was committed to members of corporate boards' influence on relevant organizational outcomes (Carpenter & Westphal, 2001). Members of board of directors in both public and private companies are vested with large number of responsibilities. These responsibilities include an ethical duty to represent the interests of funds providers (investors/shareholders) and to monitor the financial stability and performance of the organization (Ethics Resource Center, 2002).

In past decades, "boards' influence on firm performance has normally been analyzed using variables linked to their formal composition and structure, but such analyses have usually failed to identify any substantive relationship between these factors and firm performance" (Dalton & Dalton, 2011). Moreover, the relationship between boards of directors' attributes and firm performance is conundrum, as it remains unresolved in the academic literature (Rebeiz, 2015). Owing to this, empirical researches on the subject matter have been inconclusive and fragmented as accounted by *Ontological*, *Methodological* and *Behavioural complexities*.

Concisely, Rebeiz (2015) opined that '*Ontological complexities*' barricaded researchers' consensus on boards' attributes and firm performance due to the complexity of an organization's legal, economic and social systems which plays an inter-influence role between the organization and the external environment. To '*Methodological complexities*', positivists uses market or accounting indices in determining firm performance, where by both metrics suffer from measurement setbacks. The accounting metrics are based on historical values from financial statements, while market metrics are based on future expectations influenced by forces of demand and supply in the market. Whereas, '*Behavioural complexities*' is on the basis that directors' independence is being influenced by existing culture in the board room and information control by the Chief Executive Officer (CEO) which hinders independent judgement by board members (Rebeiz, 2005; Aram & Cowen 1983).

Previous studies on the relationship between boards' attributes and firm performance have measured performance as either using accounting based performance measures like return on assets (ROA), return on equity (ROE), net profit margin (NPM), dividend per share (DPS), and earnings per share (EPS) (e.g., Amba, 2013; Latif *et al.*, 2013; Marn & Romuald, 2012; Yasser, Entebang & Mansor, 2011; Vance, 1978). In addition, market-based measures like Tobin's Q (e.g., Kyereboah-Coleman, 2007; Nicholson & Kiel, 2003; Vafeas, 1999). While

board of directors attributes is measured using different constructs like; board composition, board characteristics, board process, and board structure that are based on agency theory model (Zahra & Pearce II, 1989).

Hence, this study aimed at reviewing the findings of previous studies that examined the relationship between corporate board of directors' attributes and firm performance, and to identify possible gaps in literature. The paper is divided into four sections. The first part is the introduction, which gives an in-look of the contents, then followed by materials/methods used. The third section provides the review of related literatures on some board attribute mechanisms and firm performance, while the last section is conclusion.

To achieve a comprehensive view of how boards' attributes relates to firms' financial performance, a broadly search was initiated within the academic literature in accounting and finance; and business management and strategy obtained from Emerald Management e-Journals and Research Gate database. However, the review was not base on time-period, but based on the keywords used for the title. In addition, not only those articles that involve empirical examination of how boards' attributes relates or impacts on financial performance in review of related literature is considered.

2. Board of Directors' Attributes

Corporate board of directors play numerous and integral roles in organizations. They are mainly saddle with the responsibility of (1) providing of oversight, advice, and counsel to Chief Executive Officers (CEOs), and (2) monitoring and if necessary disciplining CEOs (Finkelstein & Mooney, 2003). Based on agency theory, executives (agents) possess significant freedoms and powers to manage shareholders (principals') resources. It is believing that the executives have some objectives that may be conflicting with that of the owners (principals), hence, ignoring shareholders' wealth maximization objective (Masson, 1971). In this regard, it is being expected that board of directors are to perform painstaking function of monitoring and rewarding top executives to ensure the attainment of shareholders' wealth maximization (Zahra & Pearce II, 1989). Consequently, for board of directors to perform their functions effectively, some attributes must be in place.

However, boards of directors attributes are also referring to as board mechanisms. The classification of boards is under four different theoretical perspectives: (1) legalistic perspective, (2) Class Hegemony, (3) Resource dependence, and (4) Agency theory (Zahra & Pearce II, 1989). In this review, board attributes have been approached based on agency theory as explained earlier. Board attributes under the agency theory includes board composition, board characteristics, board process and board structure. The explanations to these are comprehensively in the subsequent paragraphs.

Board composition connotes the number and mixture of different director types, for instance, executive and non-executive directors, independent and non-independent directors. To Zahra and Pearce II (1989), board composition involves both the size (number of directors that serve on the board) and director types (widely recognized dichotomy between inside and outside directors). However, some stream of researchers (e.g., Tauringana, 2015; Marn &

Romuald, 2012; Barisua, Tobira & Lenee, 2012; Yasser, Entebang & Abu Mansur, 2011), refer to board composition as the number of non-executive directors on the board of a company. In essence, this review has treated board size and board composition as separate and independent attributes.

On the other hand, *Board Characteristics* denotes the distinguishing features of persons serving on a board. These features are directors' background (age, level of education and expertise) and personality (Hambrick, 1987, Mueller, 1981). *Board structure* as asserted by Zahra and Pearce II (1989) refers to the dimensions or specifications of the board's organization that include: (1) number and type of committees, (2) committee membership and leadership, and (3) flow of information among the committees. Whereas *Board process* involve the series of approaches taken by the board in making decisions. It includes dimensions like; frequency and number of meetings, formality of board proceedings, self-evaluation of board, CEO-board relation and level of agreement among directors on prevailing issues (Mueller, 1979).

Consequently, this review is not restricted to the constructs of board attributes in totality, but to selected dimensions of the attributes like board size, board composition and board meetings. The review of these dimensions is in relation to firm performance under independent headings.

3. Firm Performance

Corporate performance is an essential requirement for an organization's survival and growth (Kakanda, Bello, & Abba, 2016). Corporate performance relates to the process by which limited resources at organization's disposal are utilized effectively and efficiently in attaining the general objective of the enterprise for both present and future opportunities (Marn & Romuald, 2012; Yasser, Entebang & Abu Mansor, 2011). However, Berger & Patti (2002) are of the view that "A firm's financial performance, in the view of the shareholder is measured by how 'better off' the shareholder is at the end of a period, than he was at the beginning. Also, this can be determined using ratios derived from financial statements; mainly the balance sheet and income statement, or using data on stock market prices". Here, 'better off' means the increase in value of shareholders from the beginning to the end of a given accounting period (Kakanda, *et al.*, 2016).

Coherently, since agency theory argues that agency relationships should be the most stressing point when studying and analyzing corporate governance. Therefore, it is assuming that contribution of board of directors to organizational performance occurs by reducing agency cost arising from non-consensus of interest between the executives and the established organizational goals and procedures (Mizruchi, 1983). In essence, it is of the expectation that boards will enhance the financial performance of their organizations by maximizing shareholders' wealth.

3.1 Board size and Firm performance:

Board size is the magnitude of board of directors of a company. It is the total number of directors serving on the board of a company (Ogege & Boloupremo, 2014; Vafeas, 1999).

However, board size is view as the most crucial dimension of board attributes. This is because there are conflicting views in literature regarding board size. To the proponents of agency theory, it is assuming that a smaller board size is adequate and effective, because it has minimised monitoring duties, which encourage efficiency, coordination and communication. While an increase in board size causes delay in decision-making, coordination and communication; creates more conflict of interest (between executives and owners) and demoralized majority of members, hence affecting firm performance (Abdurrouf, 2011; Nanka-Bruce, 2011; Yermack, 1996; Jensen, 1993).

Conversely, it was also argued that as board size increases, the position of the directors are improved which gives them more right to exercise their power in governing the organization, as the CEO dominance on the board is reduced and become more difficult (Zahra & Pearce II, 1989). Therefore, this leads to a positive relation between board size and firm performance.

Moreover, Lipton and Lorsch (1992) reported that number of board members of a company should be between seven and eight. This assertion is also consistent with the opinion of Jensen (1993). In this effect, boards that have eight or less members stand a chance to maintain better focus, participation, good interaction and meaningful debate (Firsteberg & Malkiel, 1994). However, a required number of board members depend on industry-specific and size of firms; for instance, banking industry is found to have board size that is larger than that of manufacturing industry (Adams & Mehran, 2003).

Subsequently, some studies report that larger boards are assume to have directors with heterogeneous educational and industrial background and skill that will help to enhance actions of the firm, hence, improving performance (Pfeffer, 1987; Herman, 1981; Bacon, 1973). Gill and Obradovich (2012) whose study aimed at examining the impact of corporate governance and financial-leverage on the value of American firms, found that larger board size larger board size negatively affects the value of American firms. Other stream of studies that found negative relationship between board size and firm performance include Ali and Nasir (2014), Ibrahim and Abdul Samed (2011), Lin (2011), Juras and Hinson (2008), and Yawson (2006) among others.

On the other hand, Yasser *et al.* (2011) found a significant positive relationship between board size and performance measured by return on equity (ROE) and profit margin (PM). Concurrently, Al-Matari, Al-Swidi and Faudziah (2014) found board size to be positively but insignificantly related to financial performance (measured by ROA) of listed Muscat Security Market (MSM) in Oman. In the same vein, the finding of Marn and Romuald (2012) indicates that board size has significant effect on performance of listed Malaysian firm. Earnings per share (EPS) measure the performance here. Moreover, larger board size is being found to improve the monitoring role as well enhances economic performance (Maharaj, 2008; Joh, 2003). Based on the above review, the first hypothesis in this review is develope as:

H₁: Board size has positive relationship with firm performance

3.2 Board composition and Firm performance:

Board composition is the number of non-executive directors on board of a company. It is the ratio of non-executive directors to total directors (Barisua *et al.*, 2012; Marn & Romuald, 2012; Yasser *et al.*, 2011). It has been presumed that boards with significant outside directors will effectively perform their duty and have better decisions than board that is dominated by inside directors. Fama and Jensen (1983), Spencer (1983), and Jones and Goldberg (1982), argued that non-executive directors' representation on the board increases: board independence, directors' objectivity and enhances directors' expertise. On the contrary, other studies suggested that non-executive directors do not have the required time, knowledge, skill and expertise to carry out their work effectively (Geneen, 1984; Vance, 1983).

However, some group of empirical studies has found that increasing number of outside directors will influence performance. For instance, Barisua *et al.* (2012) has found that board of directors' composition is positive and significantly related to performance (EPS) of publicly traded Deposit Money Banks in Nigeria. Connelly and Limpaphayom (2004) found that board composition has positive relation with profitability of life insurance firms in Thailand (Connelly & Limpaphayom, 2004). Other studies that belong to this group are Abdurrouf (2011), Nanka-Bruce (2011), Saibaba and Ansari, (2011), Bhagat and Bolton (2009), Juras and Hinson (2008) among others.

In contrast, other studies found a negative relationship between board composition and firm performance. For example, Marn and Romuald (2012) found that board composition has no significant positive effect on the performance (EPS) of Malaysian listed firms. In addition, the study by Barisua *et al.* (2012) has found board composition to be negative and significantly related to performance (net profit margin) of Deposit Money Banks in Nigeria. The likes of these studies are Bhagat and Bolton (2008), Bozec (2005), Connelly and Limpaphayom (2004), Agrawal and Knoeber (1996), and Yermack (1996). Despite the conflicting findings on board composition and firm performance, yet this review hypothesized:

H₂: Board composition has positive relationship with firm performance

3.3 Board meeting and Firm performance:

Board meeting refers to the gathering of directors on the board to discuss issues regarding the company. It is measured as the number of meetings during a year by a company board of directors (Al-Matari *et al.*, 2014; Chechet, Yancy Jnr & Akanet, 2013; Vafeas, 1999). Board meetings play a significant role to the success of a company. In addition, board meetings serve as an important avenue for effective decision making of a company. Board of directors hold meetings on behalf of the company to discuss issues of the past, present and future that is related to the company, and resolutions passed during board meetings. Therefore, the more the number of board meetings, the better for a company, because the boards will have more and better chances of making various decisions (Khan & Javid, 2011; Pearce & Zahra, 1992).

However, Vafeas (1999) whose study aimed at examining the relationship between board meeting frequency and firm performance found that Boards that meet more frequently are

valued less by the market, a finding that seems to be determined by share price declines followed by higher meeting frequencies. Whereas Mangena and Pike (2005) found that, there is a significant positive relationship between the frequency of board meetings and performance of companies listed on the floor of Zimbabwe stock exchange. Again, there is a positive relationship between the disclosures of the frequency of board meetings and firm performance (Brown & Caylor, 2004). In this effect, attending board meetings by members ought to produce important resources to directors in enhancing the adequacy of the board (Said, Omar, & Abdullah, 2012).

Additionally, some empirical studies that found boards meeting to be positively related to performance are but not limited to Liang, Xu and Jiraporn (2013), Gavrea and Stegorean (2012), Kang and Kim (2011) and Khan and Javid (2011), Brown and Caylor (2004). Equally important, Jensen (1993) opines that: “daily tasks those continue most of the board’s meeting time and hence this limits the chances for external directors to conduct a meaningful oversight over management”. Jensen further stressed that board should not be over active as activity of board represents a reaction to adverse performance. In regards to this, some empirical studies that found a negative relationship between board meeting and performance are; Danoshana and Ravivathani (2014), Garcia-Sanchez (2010), and Kamardin (2009) among others. Therefore, this review hypothesized that:

H3: Board meeting has positive relationship with firm performance

4. Conclusion

The aim of this study was to review previous studies on board of directors’ attributes and firm performance and to identify possible literature gaps. The review is based on causal-effect relationship between board dimensions such as board size, board composition and board meeting and firm financial performance. Albeit, there are stream of studies on board attributes and firm performance, yet the results are still conflicting which make research in the area to be inconclusive. Nevertheless, this does not render the findings of previous studies invalid.

More importantly, the existing research studies have reflected limitations that accentuate the problem that is associated with the following:

(1) In scanning the direct relationship between dimensions of boards attribute and firm performance, the relationship might be influence indirectly by other factors like social, economic and political that might be the strength, weakness, opportunities, and threats (SWOT) posed by the market within which the business operates. The relationship can also be influence by the different roles played by boards to arrive at strategic outcomes which later influence performance (Zahra & Pearce II, 1989). This is an avenue for future researchers to use mediations or moderations in examining relationship between board attributes and firm performance.

(2) Methodological complexities and the use of historic data is another limitation in studies of board attribute and firm performance (Rebeiz, 2015). This problem can be lessening through integrating deductive analysis with interpretive reasoning. This will help future researchers to

have more result that is reliable since analyses from both secondary and primary data source will be complementing each other in result interpretations. Hence, improve research findings from data analyses with more accuracy and precision.

(3) The use of archival data from different sectors on a stock exchange can also affect the outcome of a study. Different sectors are characterized by different industry standard, different accounting policies, size and periods of operation. Future researchers can use companies with homogenous characteristics or make comparative analysis between firms from available sectors. In addition, conflicting results from studies in different countries might be due to economic and political differences among nations.

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