Impact of Board Structure on Performance of Listed Financing Sector in Sri Lanka

S. Balagobei and S. Anandasayanan
Department of Financial Management, University of Jaffna, Sri Lanka
saseelas@yahoo.com

Abstract: Over recent years, corporate governance has become a major and highly contentious issue in all advanced economies, as well as in developing countries. Board size and composition constitute two of the most prevalent corporate governance factors, attracting wide theoretical attention. This paper examines the relationship between two of the most pertinent corporate governance factors–that is, the size of the Board of Directors and the proportion of non-executive directors– and firm performance on a sample of 19 listed companies from financial sector over the period 2008-2010. Our results reveal that board size and board composition significantly impact on ROE and Tobin's Q of the firms in financial sector. Further there is a negative relationship between the board size and firm performance but the positive relationship between board composition and the firm performance.

Keywords: Board composition, Corporate governance, Firm performance.

I. INTRODUCTION

In today's global business environment characterized by an increased competition the effectiveness of corporate governance in protecting shareholders' interests has become more vital than ever. Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. The term corporate governance basically represents a set of mechanisms by which small investors protect themselves against expropriation by both managers and controlling shareholders [16]. A vast amount of corporate governance literature exists on the effectiveness of boards of directors.

The relationship between board size, board composition and valuation and performance has been a continuing area of interest in the literature. Board size and composition constitute two of the most prevalent corporate governance factors, attracting wide theoretical attention. Indeed, researchers have emphasized the influence the size and the composition of the Board of Directors may have in corporate affairs. These corporate governance factors may affect the Board of Directors' ability to be an effective monitor of senior management and influence the impact of insiders on corporate performance by acting as either a complement of or substitute for ownership structure [17]. Performance, which shows if the resources of the firm are used efficiently to fulfill the goals of the firm [3], is crucial in evaluating the overall success of the firm [15].

Many researches have been conducted on board size and board composition related to firm performance. Most of the articles are concerned with the Western countries. But no studies are in listed financing sector in Sri Lanka. Therefore this study is undertaken to examine the effect of board size and board composition on firm performance of listed financing sector in Sri Lanka. The main objective of this study is to examine the effect of board Size and composition on performance of listed financing sector in Sri Lanka for the period from 2008 to 2010.

II. OBJECTIVES

This study has the following objectives:

- To investigate the impact of board Size on performance of listed financing sector in Sri Lanka.
- To examine the impact of board composition on performance of listed financing sector in Sri Lanka.

III. LITERATURE REVIEW

There are numerous studies on the board size and board composition and its impact on firm performance. It is widely believed that companies with small Board of Directors are more effective and profitable since they have a better monitoring role [6, 11, 13, 14]. Indeed, Jensen [10] concludes that the effectiveness of a Board may decline as Board size increases above a moderate number. Yermack [19] examines the relationship between firm performance and Board size on a sample of large U.S. corporations and finds a significant negative relationship. The result is robust to numerous controls for firm size, industry membership, inside stock ownership, growth opportunities and alternative corporate governance structures.

Moreover, many studies have examined the effect Board composition may have on firm performance, obtaining mixed conclusions. Fama [4] and Fama and Jensen [5] argue that non-executive directors add value to firms by providing expert knowledge and monitoring services. Outside directors are supposed to be guardians of the shareholders' interests through monitoring, or, in some cases, substitutes for other types of monitoring mechanisms. Empirical results support the argument that outside directors are more effective monitors and a critical disciplining device for managers [2, 8, 17]. Fama and Jensen [5] argue that outside directors have an incentive to act as monitors of management because they want to protect their reputation as effective and independent decision-makers.

IV. CONCEPTUAL FRAMEWORK

Based on the literature survey the following conceptualization is developed to show the relationship between board structure and performance of listed companies in Sri Lanka.
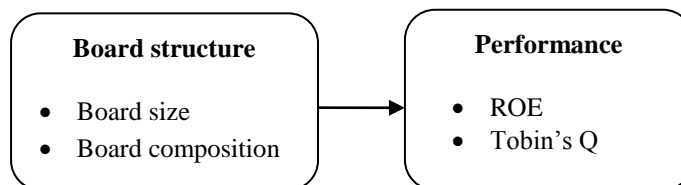

Board structure
- Board size
- Board composition

Performance
- ROE
- Tobin's Q

Figure 1: Relationship between board structure and performance

This model shows the relationship between independent variable (board structure) and dependent variable (performance).

V. SAMPLE DESIGN AND VARIABLES

The sample for this paper is drawn from 19 listed companies from the financial sector in the Colombo Stock Exchange (CSE) .The study was mainly done by using secondary data. For the purpose of this study data were collected for the period between 2008 and 2010. The study has four independent variables that are assumed to determine the financial performance. The first independent variable is board size at the board of directors. Board composition, size (logarithmic value of total assets) and leverage ratio are the other three independent variables of the study. Leverage ratio is calculated at the total debt divided by book value of the total liabilities. In this study the performance of the company is measured by Return on Equity (ROE) and Tobin's Q ratio. Return on Equity is measured by Profit after interest and taxation divided by number of ordinary share issued. Tobin's Q, the ratio of market value of the firm's equity and debt to the current replacement cost of assets.

VI. HYPOTHESES OF THE STUDY

In order to assess the influences of board size and board composition on firm performance, researchers set out two testable hypotheses as follows:

H_1 : Board size significantly impact on firm performance.

H_2 : Board composition significantly impact on firm performance.

VII. RESULTS AND DISCUSSION

Descriptive Statistics: Table 1 presents descriptive statistics on the Board structure and the performance measures for the sample of listed financing companies over the period 2008-2010.

Table 1: Descriptive Statistics

Variables	Minimum	Maximum	Mean	Std.dev
Board size	5.00	13.00	8.7018	1.99
Board composition	3.00	10.00	6.9123	1.97
ROE	-3.62	2.75	0.0109	0.799
Tobin's Q	0.01	7.53	0.6853	1.1180
Log total assets	9.02	11.57	10.165	0.79787
Leverage	1.02	4.07	0.4743	0.82688

The above table shows the number of directors in the board (BS) have a wide range from 5 to 13. The mean of the size of the board (BS) is 8.70 with a standard deviation of 2. Minimum board composition rate is 3 and the maximum is 10 with a standard deviation 6.9123. Mean value of the board composition is 6.9123. The minimum and the maximum range of the ROE are respectively -3.62 and 2.75. Tobin's Q has a range from 0.01 to 7.53. The mean of the Tobin's Q is 0.6853.

Correlation Analysis: Table 2 presents the Pearson correlation coefficients between dependent variables and independent variables separately. There is a negative significant relationship between board size and ROE at 0.01 levels. There is negative relationship between board size and Tobin's Q but not significant. Board composition has positive relationship with ROE and significant at 1% level.

	Board size	Board composition	Log to total assets	Leverage	ROE	Tobin's Q
Board size	1	0.593** 0.000	0.007 0.956	0.047 0.723	-0.470** 0.000	-0.044 0.739
Board composition		1	-0.174 0.185	-0.076 0.562	0.447** 0.000	0.077 0.556
Log to total assets			1	0.254 0.050	-0.221 0.089	-0.281* 0.030
Leverage				1	-0.105 0.424	-0.124 0.344
ROE					1	-0.043 0.742
Tobin's Q						1

**Correlation is significant at the 0.01 level (two-tailed); *Correlation is significant at the 0.05 level (two-tailed)

Regression Analysis: Multiple regression was carried out, in order to assess how well the company performance (ROE and TOBIN'S Q) can be explained by knowing the value of independent variables.

Table 3: Regression of Model 1

Model 1	Beta	Standard Error	Significant
Constant	158.309	37.321	0.114
Board size	-0.005	0.02	0.040
Board composition	3.604	1.440	0.015
Log Total assets	-14.281	9.804	0.151
Financial leverage ratio	-4.962	9.315	0.596

R^2=0.305; Dependent Variable: ROE

Table 3 shows the results of the multiple regression (Model-1). According to this result the coefficient of board size is -0.005. This is significant at 5% level. The beta value of the board composition is 3.604. This is also significant at 5% level. These results are supported for the acceptance of H1 and H2. The Co-efficient of Determination R^2 = 0.305 or .31 approx. This statistics gives the ratio of explained variation to total variation converting the 0.31 to a percentage, it is concluded that approximately 31% of the variability of dependent variable is accounted for by the independent variables in this model.

Table 4: Regression of the Model 2

Model 2	Beta	Standard Error	Significant
Constant	4.424	1.895	0.023
Board size	-0.216	0.123	0.085
Board composition	0.278	0.120	0.024
Log Total assets	-0.446	0.214	0.041
Financial leverage ratio	-0.162	0.180	0.373

R^2 = 0.164; Dependent Variable: Tobin's Q

According to this results the beta value of the board size is -0.216, *p* value is 0.085 and the beta value of board composition is 0.278 and *p* value is 0.024. The data demonstrate strong support for the

hypothesis that there is significant relationship between board size and firm performance and Board composition significantly impact on firm performance. This statistics gives the ratio of explained variation to total variation converting the 0.16 to a percentage, it is concluded that approximately 16% of the variability of dependent variable is accounted for by the independent variables in this model.

VIII. Conclusion

All two of the proposed model of the study show significant results. That is board size and board composition significantly impact on ROE and Tobin's Q of the firms in financial sector. The results of this study supported with the prior studies [17, 19]. The study does not consider all the elements of corporate governance, which impact the performance of the company. In using the findings of this research these conceptual limits are needed to be considered.

References

[1]. Coles, J. L., Daniel, N. D. and Naveen, L., "Boards: Does one size fit all?", Journal of Financial Economics, 87, pp. 329-356, 2008.
[2]. Coughlan, A. and Schmidt, R. "Executive Compensation, Managerial Turnover and Firm Performance: An Empirical Investigation", Journal of Accounting and Economics, 7, pp. 43-66, 1985.
[3]. Daft, R.L. "Management", 4th ed., Florida, the Dryden Press, 1997.
[4]. Fama, E., "Agency Problems and the Theory of the Firm", Journal of Political Economy, pp. 288-307, 1980.
[5]. Fama, E. and Jensen, M. "Separation of Ownership and Control", Journal of Law and Economics. 26, pp. 301-326, 1983.
[6]. Gladstein, D., "Group in Context: A Model of Task Group Effectiveness", Administrative Science Quarterly, 29, pp. 499-451, 1984.
[7]. Guest, P.M., "The Impact of Board Size on Firm Performance: Evidence from the UK", the European Journal of Finance 15(4), pp. 385-404, 2009.
[8]. Hermalin, B.E. and M.S., Weisbach, "The Determinants of Board Composition", Rand Journal of Economics, 19(4), pp.589-606, 1988.
[9]. Holthausen, R. and Larcker, D., "Boards of Directors, Ownership Structure and CEO Compensation, Organizational Structure and Financial Performance." Unpublished Paper, Wharton School, University of Pennsylvania Philadelphia, P.A., 1993.
[10]. Jensen M. "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems", Journal of Finance. 48, pp. 831-880, 1993.
[11]. Jensen, M., and Meckling W., "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." Journal of Financial Economics. 3, pp. 305-360, 1976.
[12]. Johnson, M., Daily, C. and Ellstrand, A., "Boards of Directors: A Review and Research Agenda." Journal of Management. 22, pp. 409-438, 1996.
[13]. Lipton, M., and Lorsch, J. W. A., "Modest Proposal for Improved Corporate Governance", Business Lawyer, 1(1), pp. 59–77, 1992.
[14]. Olson, M., "The Rise and Decline of Nations. Economic Growth, Stagflation, and Social Rigidities", Yale University Press, New Haven, CT. 1982.
[15]. Parker, C. "Performance Measurement", Work Study, 49(2), pp. 63-66, 2000.
[16]. Shleifer, A., and Vishny, R.W., "A Survey of Corporate Governance", Working Paper, NBER, 1996.
[17]. Singh, M., and Davidson, W. N., "Agency Cost, Ownership Structure and Corporate Governance Mechanisms." Journal of Banking and Finance, 27, pp. 793-816, 2003.
[18]. Weisbach, M. "Outside Directors and CEO Turnover." Journal of Financial Economics, 20, pp. 431-460, 1988.
[19]. Yermack, H., "Higher Market Valuation of Companies with a Small Board of Directors." Journal of Financial Economics. 40, pp. 185-211, 1996.