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Understanding the Impact of Board Structure on Firm Performance: A Comprehensive Literature Review

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ABSTRACT

There have been numerous studies which examined the impact of board structure on firm performance. However, all these studies have failed to provide any form of consensus on how board structure or board composition impact firm performance. Hence, we are left asking the question: what is the effect of board structure on firm performance? The missing link therefore, is the absence of a comprehensive review of the literature which addresses the issue. The objective of this paper is to provide a thorough analysis of previous studies with the aim of providing some direction to and closure of the debate regarding the effect of board structure on firm performance. The results of the literature review showed that there are compelling arguments on both side to either support or refute the hypothesis that board structure impacts firm performance. Hence, this paper provides a new direction for researchers to take in an attempt to answer this decade-old question.

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1. Introduction

This comprehensive literature review is the result of what is an apparent inconclusive research finding relating to the effects of board structure of the performance of firms. Individual study has shown no significant effect of board structure -however defined- on firm performance, yet from time to time there comes a study that shows an effect on performance. As we enter into a new decade, this question that has been asked from previous decades is yet to be answered, hence, this paper is responding to this gap in the literature by bringing together leading studies on the issue and highlighting their findings. The result of which will point us to the direction researchers need to take in order to answer this question. The remaining sections of this paper will first examine the theoretical framework including agency theory and corporate governance issues, it then looks at empirical findings and end with discussion and conclusion.

The recent decades have been marked by significant changes in corporate governance systems worldwide. This has led to the ongoing debate as to the role of directors in the performance of firms. Boards of directors are charged with the responsibility of monitoring the performance and actions of

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senior management to ensure that they act in the best interest of the owners (Jensen and Meckling, 1976). Boards therefore have a critical role to play in addressing agency problems arising from the ubiquitous separation of firm ownership from control (Fama, 1980; Jensen, 1993; Shleifer and Vishny, 1997). The attention and interest devoted to corporate governance in recent years has grown exponentially due to major corporate collapses (e.g. Enron, WorldCom, HIH, Harris Scarfe, One. Tel) in the US and Australia (Jackling and Johl, 2009). Arising from the need for strong governance are the various standards and reforms developed such as the Sarbanes-Oxley Act in the USA, CLERP 9 in Australia, Combine Code in the UK, and the Organization for Economic Development (OECD) Code.

Interestingly, the impact of the liberalization and globalization of financial markets, corporate scandals and stronger demands for transparency and accountability have placed the duties and functions of boards of directors at the center of the corporate governance debate (Kiel and Nicholson, 2003; Ingley and Van Der Walt, 2005). While the society has called for an increased involvement of the board of directors, the question therefore becomes what the appropriate role of the directors should be (Pugliese, et al, 2009). Although researchers and practitioners have basically agreed on the importance of adequate board control and independence (Baysinger and Hoskisson, 1990; Jensen and Zajac, 2004), the issue of boards' involvement in their strategic role has been widely debated (Zahra and Pearce, 1989; Golden and Zajac, 2001; Daily, Dalton and Cannella, 2003).

Given the multifaceted task undertaken by boards, it seems plausible that they may impact firm performance, hence the question arises as to what types of board structures are optimal for the maximization of stockholders' wealth (O'Connell and Cramer, 2010). Therefore, it is not surprising that the questions about the impact of board characteristics on firm performance have been the subject of major studies across countries in recent years (Denis and McConnell, 2003). Discussion concerning the strategic involvement of boards has been energized by a combination of contextual factors, alternative theoretical perspectives and inconclusive empirical results (Pugliese et al, 2009). First, it was observed that in the 1970s, US boards of directors were passive in the wake of corporate failures and that a more strategic involvement was required to re-establish public confidence (Clendenin, 1972; Heller and Milton, 1972; Mace, 1976; Machin and Wilson, 1979; Vance, 1979). It is argued that more recent corporate governance reforms (Aguilera and Cuervo-Cazurra 2004; Enrione, Mazza and Zerboni, 2006; Sheridan, Jones and Marston, 2006) coupled with the increasing influence of institutional investors may have pushed board members closer to the strategic decision-making process (Judge and Zeithaml, 1992; Hoskisson, Hitt, Johnson and Grossman, 2002). Therefore, it is argued that these developments have stimulated boards of directors to challenge CEOs, and hence become more involved in strategy, an area that in the past was the exclusive domain of CEOs (Ruigrok, Peck and Keller, 2006; Monks and Minow, 2008). Second, although studies indicate that board members are becoming more aware of their strategy role (Demb and Neubauer, 1992; Heracleous, 2001; Huse, 2005), researchers have often indicated the disagreement in the empirical research on the relationship between boards and strategy (Johnson, Daily and Ellstrand, 1996; Deutsch, 2005).

The corporate governance literature outlines the important link between the board of directors and firm performance (Anderson and Reeb, 2004; Garcia-Ramos and Garcia-Olalla, 2011; Goel et al. 2012; Hermalin and Weisbach, 2003; Lane et al. 2006 and Voordeckers, 2006). However, this link has not been clearly established by research (Nicholson and Kiel, 2007), and the results have been mixed for non-listed family firms (Chrisman et al. 2010; Sciascia and Mazzola, 2008). Thus, it is for this reason there is much scholarly interest in focusing on research on the composition of boards and their roles (Voordeckers, Van Gils, and Van den Heuvel, 2007; Uhlaner, Wright, and Huse, 2007).

Several studies have examined the board of directors from different perspectives. Some analyzed the determinants of board composition (Bammens, Voordeckers, & Van Gils, 2008; Fiegener, Brown, Dreux, & Dennis, 2000; Gracia Olalla & Garcia Ramos, 2010; Giovannini, 2010; Jaskiewicz & Klein, 2007; Voordeckers, Van Gils, & Van den Heuvel, 2007). While Minichilli, Zattoni, and Zona (2009) examined issues surrounding the task performance in a sample of the 200 largest Italian industrial companies, other studies looked at the effect of board composition on firm performance; however, the evidence has not been conclusive (Arosa, Iturralde and Maseda, 2010). Some evidence suggests that outside directors can improve board effectiveness and firm performance. Studies such as (Anderson and Reeb, 2004; McKnight and Mira, 2003; Weisbach, 1988) found a positive and significant relationship between the proportion of outside directors and firm value. Interestingly, other studies (Agrawal & Knoeber, 1996;

Baysinger & Butler, 1985; Giovannini, 2010; Hermanlin & Weisbach, 1991) found a negative relationship between the performance of outside directors and firm performance, and investigations (Dalton, Daily, Ellstrand, & Johnson, 1998; De Andres, Azofra, & Lopez, 2005; Jackling & Johl, 2009) find no relationship between the two variables. Jackling and Johl, (2009) argue that these differences in findings are partly attributed to differences in the theoretical bases of investigation and the use of different measures of firm performance. Recent guidelines on corporate governance practices emphasize the important role of non-executive directors in mitigating agency conflicts. Both Hampel (1998) and Higgs (2003) recommend that independent non-executive directors should comprise at least 50% of UK boards. However, many corporate governance researchers have questioned the precise impact of board independence on firm performance (Dulewicz and Herbert, 2004).

One important issue within the academic community is the potential influence of board size on firm performance. Larger boards may result in a wider pool from which expertise can be drawn (Zahra and Pearce, 1989) and greater external linkages (Goodstein et al., 1994), however, larger bards may lead to lower group cohesion (Evans and Dion, 1991) and hence, greater levels of conflict (Goodstein et al., 1994). Studies have also suggested that effective corporate governance also assists in the attainment of high-level financial performance and market valuation (Klapper & Love, 2004; Rajagopalan & Zhang, 2008). La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) posit that emerging economies have traditionally been discounted in financial markets because of their weak governance structure. The size of the board may now need to be examined in more details.

2. A closer look at board-size and its impact on firm performance

There is no dearth of empirical literature on the relationship between board characteristics- such as size and composition – and firm performance. O'Connell and Cramer (2010) argue that while generalizations from such body of work are inevitable flawed, two distinct findings are apparent. O'Connell and Cramer (2010) claim that prior research provides mixed evidence with regard to the impact of board size on firm performance (e.g. Yermack, 1996; Dalton et al., 1999). Also, they argue that prior study has generally failed to establish a convincing link between the proportion of outside directors and firm performance (e.g. De Andres et at., 2005). Brennan (2006) further argues that the impact of corporate governance characteristics on firm performance is likely to vary across jurisdictions and hence, cross-country research may provide useful incremental insights.

Yermack (1996) studied the impact of board size on firm performance on a sample of large US industrial companies between 1984 and1991 and found an inverse relationship between firm value (measured by Tobin's Q) and the number of directors. Further, Yermack (1996) also shows that accounting measure, such as return on assets and return on sales are negatively related to board size. Yermack (1996) presents evidence that small boards of directors are more effective than larger boards as the benefits of increased size are normally displaced by the costs in terms of poorer communication and decision making associated with larger groups. Jensen (1993) argues that "as groups increase in size they become less effective because of the coordination and process problems overwhelm the advantages from having more people to draw on." Thus, when boards size increase beyond seven- or eight-persons Jensen (1993) claims they are less likely to function effectively and it becomes easier for the CEO to control. This view is not a settled one because there is contrary evidence that larger boards may reduce the domination of the CEO (Forbes and Milliken, 1999; Goodstein, Gautam and Boeker, 1994).

Resource dependency theory postulates that it is expected that boards of directors with high levels of links to the external environment would improve companies access to various resources thus improving corporate governance and firm performance (Jackling and Johl, 2009). An attempt was made to reconcile the differences in findings on "optimal" board size, hence Bennedsen, Kongsted, and Nielson (2008) acknowledged that the association between board size and performance may be linked to various firm characteristics such as age, industry affiliation, size as well as unobserved factors.

Kula (2005) argues that the size of boards affects the monitoring ability of boards. Larger boards are believed to be more capable of monitoring the actions of management, as it is more difficult for CEOs to dominate larger boards (Mak and Roush, 2000). However, there are accompanying disadvantages associated with large boards, such as the decreased ability to exercise control over management (Eisenberg et al., 1998), poorer communication and decision making (John and Senbet, 1998), poorer

processing of information (Hunther, 1997), longer time to make decisions (Dehaene et al., 2001; Vafeas,1999) and more attention to bureaucratic problems (Xie et al., 2003).

Fried et al. (1998) argue that from service and resource dependency perspectives, small board size along with outsider representation are conducive to an active board with high level of involvement in strategy formulation. Mak and Roush (2000) state their concern that larger boards are beneficial from resource dependency perspective, but dysfunctional from the decision-making perspective. Some studies found that large boards are inversely related to firm performance (Singh and Davisdson, 2003; Eisenberg et al., 1998; Hunther, 1997; and Hossain et al., 2001). However, other studies, such as Dehaene et al., (2001), Mak and Li (2001), found the total number of directors not to be significant to firm performance. The question now arises as to the role of independent directors on firm performance.

3. Independent directors and firm performance

Recent corporate failures have led to increased concerns regarding the effectiveness of board oversight function. Since the publication of the Cadbury report in 1992, governance reformers in the UK continue to emphasize the importance of independent directors who improve the monitoring function of boards (Hsu and Wu, 2014). The term "independent director" normally refers to non-executive directors (NEDs) who are free from any personal or economic association with the firm and its management.

The underlying theoretical support of board monitoring is grounded in agency theory (Jensen & Meckling, 1976). The general theme is that the main function of a board is to reduce agency costs arising from the separation of ownership from control and this is achieved by overseeing managerial decisions and activities (Hsu & Wu, 2014). Fama & Jensen (1983) argue that independent directors are divorce from economic interests or personal links with the firm and are therefore better able to perform the monitoring role because they are more likely to objectively evaluate and discipline senior management. Fama (1980) further argues that independent directors have an incentive to be effective monitors in order to maintain the value of their reputational capital in the external labour market. Shivdasni (1993) posits that high performing NEDs would gain opportunities to serve on other boards. Therefore, independent directors are better positioned to challenge management and request strategic changes when a firm experiences a continuous decline in performance (Daily & Dalton, 1994), such challenges, Weisbach (1988) argues, are valuable when a firm needs to change to maintain its survival.

Academic literature has become more interested in the board's role in setting strategy. Many scholars have argued that agency theory provides only a partial basis for developing propositions concerning the impact of board composition on corporate strategy and performance (Raheja, 2005; Adams & Ferreira, 2007; Harris & Raviv, 2008). From an operational perspective, the amount and quality of information available to independent directors materially affect their effectiveness (Hsu & Wu, 2014). The general view is that independent directors serve on a part-time basis and typically serve as directors on multiple boards (Patton & Blaker, 1987). Hence, they are less likely to allocate sufficient time to gain a complete understanding of each business, which may result in independent directors relying on their general knowledge rather than firm-specific knowledge in reviewing managerial performance and rewarding managers (Baysinger & Hoskisson, 1990). Hsu & Wu (2014) posit that such lack of firm-specific knowledge on the part of independent directors could provide the opportunity for managers to formulate myopic strategies for maximizing their personal wealth, which may ultimately affect firm performance.

The general view is that independent directors normally have limited contact with day-to-day executive affairs, thus making them more dependent on their interactions with top management to access firm-specific information for decision making (Fama & Jensen, 1983). Given that independent directors are generally strict monitors, top management is typically unwilling to share privileged information with them out of fear of their intense scrutiny (Adams & Ferreira, 2007).

The existing empirical evidence provides mixed results regarding the effectiveness of independent directors (Hsu & Wu, 2014). Some findings support the importance of independent directors in, for example, disciplining poorly performing CEOs (Finkelstein & D'Aveni, 1994), protecting shareholder wealth (Byrd & Hickman, 1992) and ensuring corporate reporting quality (Beasley, 1996; Chahine & Filatochev, 2011; Setia-Atmaja, Haman, & Tanewski, 2011). Still, most studies find only a small statistically insignificant connection between independent directors and firm performance (Agrawal &

Knoeber, 1996; Bhagat & Black, 2002; Vafeas & Theodorou, 1998). The verdict is unclear regarding the role of independent directors; so, does the effect of CEO duality overshadow or neutralize the role of the independent directors?

4. CEO duality and its impact on firm performance

Boards of directors are charged with ensuring that chief executive officers (CEOs) carry out their duties in a way that serves the best interests of shareholders. Thus, boards can be seen as monitoring devices that help align CEO and shareholder interests (Fama and Jensen, 1983). CEO duality occurs when the same person holds both the CEO and board chairperson in a corporation (Rechner and Dalton, 1991). CEO duality has opposing effects that boards must attempt to balance. On the one hand, duality can firmly entrench a CEO at the top of an organization, thus challenging a board's ability to effectively monitor and discipline (Mallette and Fowler, 1992). On the other hand, the consolidation of the two most senior management positions establishes a unity of command at the top of the firm, with unambiguous leadership clarifying decision-making authority and sending reassuring signals to shareholders (Finkelstein and D'Aveni, 1994).

Separation of ownership and management in modern corporations has led to different arguments regarding the relationship between the principal and agent. According to agency theory, the agent in this relationship will be a self-interest optimizer. In other words, executive managers will make decisions with the aim of optimizing their wealth and or minimizing their risks at the expense of the shareholders' value (Elsayed, 2007). Therefore, it has been argued that internal and external monitoring mechanisms need to be implemented to lessen the divergence in interest between shareholders and the management (Jensen amd Meckling, 1976).

However, other researchers argue against the hypothesis of agency theory and propose stewardship theory (Elsayed, 2007). For example, Donaldson and Davis (1991) claim that the executive manager under stewardship theory is far from being an opportunistic shirker, and essentially wants to do a good job, that is, he wants to be a good steward of the company's assets. The basic premise of stewardship theory is that the structure of the firm is the main determinant that can assist the executive manager to implement his or her plans effectively (Elsayed, 2007).

According to Johnson et al., (1996) the board of directors has three major responsibilities to accomplish: monitoring management actions, advising the CEO and getting external resources that are vital to build corporate capabilities. One fundamental question that has received growing attention in the literature is whether there is a relationship between board leadership structure and corporate performance. Or to put it another way, is it better to have one person to fulfil the CEO and at the same time to be the chairman of the board of directors, or is it preferred to give the job to two different persons? (Elsayed, 2007).

The board of directors is at the apex of the internal control system and has responsibility for the functioning of the firm (Jensen, 1993). However, when the board chairman is also the CEO, the board intensity to monitor and oversee management is reduced as a result of a lack of independence and a conflict of interest (Dobryznski, 1991; Millstein, 1992). The issue that arises when companies practice CEO duality is, "Who monitors management?" (Abdullah, 2004). Unlike in a two-tier system, the unitary system has the board at the highest internal control system, as argued by Jensen (1993). It has been argued that the firms' managers' influence in setting the board agenda and controlling information flow could impede the board's ability to perform its duties effectively (Solomon, 1993; Aram and Cowan, 1983). The firm's managers' ability to determine the board agenda and the flow of information is predicted to be much stronger when the board chairman is also CEO than when the firm adopts a non-dual structure (Abdullah, 2004). Dayton (1984) asserts that the board is the primary force pushing the company towards realizing the opportunities and meeting the obligations of the shareholders and other stakeholders. He argues that it is the CEO who allows the board to play the primary force.

In a similar vein, the dual leadership structure indicates the absence of separation of the decision management and decision control (Fama and Jensen, 1983). Rechner (1989) argued that the ideal corporate governance structure is one in which the board is composed of a majority of outside directors and a chairman who is an outside director. Hence, the weakest corporate governance is one where the board is dominated by inside directors and the CEO holds the chairmanship of the board. Where one person dominates a firm, the role of the independent director becomes hypothetical (Rechner, 1989;

Dayton, 1984). A structure of this type is likely to lead to the board being incapable of protecting the interests of the shareholders. The board with the high influence of the management will not be able to discipline the management appropriately as the management who controls the board will over-rule such initiatives (Adbullah, 2004). Miller and Friesen (1977) argue that the non-executive chairman promotes a higher level of corporate openness.

Different theoretical arguments have been used to either support or challenge CEO duality. Drawing on agency theory, the opponents (e.g. Levy, 1981; Dayton, 1984) suggest that CEO duality diminishes the monitoring role of the board of directors over the executive manager, and thus in term may have a negative effect on corporate governance. On the other hand, advocates of CEO duality (e.g. Anderson and Anthony, 1986; Donoaldson and Davis, 1991) assert that corporate performance is enhanced when executive manager has the full authority over his corporation by serving also as the chairman, as less conflict is likely to happen. Others such as Brickley et al., (1997) argue that there is no one optimal leadership structure as both duality and separation perspectives have related costs and benefits. Hence, duality will benefit some firms while separation will likely be advantageous for others.

The issue of separation of the top two posts has been addressed in the Cadbury Committee (1992), which recommended that the roles of board chairman and CEO be separated. The Malaysian Code of Corporate Governance (2001) also recommended a similar board structure. The reason for the need for separations is that when both, monitoring roles and implementing roles are vested in a single person, monitoring roles of the board will be severely impaired (Abdullah, 2004). The impairment of the board's independence could affect the board incentives to ensure that management pursues value increasing activities (Abdullah, 2004).

Though the literature seems to consistently argue that separate individuals for the post of CEO and chairman leads to better corporate governance systems, the real issue is whether this leads the board to be a better monitor, and thus, is capable of increasing the value of the firm. Proponents of CEO duality structure argue that combining these two roles provides a clear focus for objectives and operations (Stoeberl and Sherony, 1985). Separation of CEO and chairman posts has costs and benefits and it was shown that for larger firms, the costs are greater than the benefits (Brickley et al., 1997). Evidence from Abdullah (2002) in the Malaysian setting confirmed the costs and benefits contention. In their study, Berg and Smith (1978) found that there was no significant difference in various financial indicators between firms which experienced CEO duality and firms which did not. The substantial cost of separation could come from the incomplete transfer of company information and the confusion over who is in charge of running the company (Goodwin and Seow, 2000). It could be argued that when one person is in charge of both tasks, decisions are reached faster; also, when the board chairman and the CEO are the same persons, he or she is well aware of the decisions needed to improve the performance of the firm (Abdullah, 2004). In another study, Chaganti et al., (1985) also documented evidence similar to that found by Berg and Smith (1978) involving firms that experienced bankruptcy and survival. Rechner and Dalton (1991) also showed that firms with CEO duality consistently outperformed firms with a CEO non-duality structure. Therefore, in an attempt to put the issue to rest, Dalton and Dalton (2011) drawing on research of others argued that there is no evidence of substantive, systematic relationship between corporate financial performance and board leadership structure (Dalton et al., 2008; Dey et al., 2009; Faleye, 2007; Iyengar & Zampelli, 2009). The results of a few studies may now be instructive in our understanding of the issue.

5. A closer look at some empirical findings

Jackling and Johl (2009) examined board structure and firm performance from top Indian companies. Their study provided some support for aspects of agency theory as is showed that a greater proportion of outside directors on boards were associated with improved firm performance. They found that the notion of separating leadership in a manner consistent with agency theory was not supported. A case in point was the view that powerful CEOs (duality role, CEO being the promoter, and CEO being the only board manager) having a negative impact on performance was also not supported. Jackling and Johl (2009) also found some support for resource dependency theory, and their findings indicated that larger board size had a positive impact on firm performance, thus supporting the view that greater exposure to the external environment improves access to external resources and thus positively impact performance. Their study failed to support the resource dependency theory in terms of the association

between frequency of board meetings and performance. Similarly, their results showed that outside directors with multiple appointments appeared to have a negative effect on performance. Hence, they argued that "busyness" did not add value in terms of networks and enhancement of resource accessibility.

Mashayekhi and Bazar (2008) examined corporate governance and firm performance of firms listed on the Teran Stock Exchange, their results showed that the presence of outside/independent directors strengthened firm performance. However, they found no relationship between leadership structure and firm performance.

O'Connell and Cramer (2010) studied the association between firm performance and both board size and board composition for companies quoted on the Irish Stock Exchange. The evidence showed that board size exhibits a significant negative association with firm performance, also, the relationship between board size and firm performance is significantly less negative for smaller firms, finally, a positive and significant association between firm performance and the percentage of non-executive directors on the board was apparent.

Maseda, Iturralde and Arosa (2015) explored the impact of the presence of outside directors on firm performance in family small and medium-sized enterprises (SMEs) in 369 Spanish SMEs. Their findings showed an inverted U-shaped relationship between the proportion of outside directors of first- and second-generation family firms and firm performance. Their results also showed that a balanced presence of outside directors enhances the value creation process in firms.

Hsu and Wu (2014) examined the effect of board composition on the likelihood of corporate failure in UK. They examined both independent and non-independent (grey) non-executive directors. Their results showed that firms with a larger proportion of grey directors on their boards were less likely to fail. Also, the probability of corporate failure is lower both when firms have a higher proportion of grey directors relative to executive directors and when they have a higher proportion of grey directors relative to independent directors. However, their findings also showed a positive relationship between the likelihood of corporate failure and the proportion of independent directors on corporate boards. Finally, Hsu and Wu (2014) posit that corporate governance reform efforts may have overemphasized the monitoring function of independent directors and underestimated the benefits of NEDs' affiliations with the firm and its management.

6. Discussion and conclusion

There is obvious no end in sight to the debate of the effect of board structure on firm performance. The arguments may have come full-circle, the relevant question now becomes: does board structure have a material effect on firm performance? This literature review has presented the views and empirical findings of academics and seasoned researchers, yet there remains no general consensus on the question of whether board structure/composition positively or negatively affect firm performance. At this point, it would appear useless to continue the current trajectory of previous studies in different environment with the same independent variables. There is compelling evidence on both sides of the argument to either support or refute the hypothesis, hence, the time has now come for researchers to begin asking a different set of questions.

Could it be that firm performance is unrelated to board structure or board composition and has more to do with unique organizational and national culture and philosophy? Culture takes years to develop and is not changed by the appointment a few new directors nor a CEO. Culture normally is the offspring of one's unique custom and way of life, hence organizational actors normally display the custom that inform their consciousness. Directors should now be seen as cultural agents on the stage acting out a philosophy which is deeply embedded in their consciousness. It is this unique individual culturally informed consciousness that will dictate how these actors execute the corporate responsibilities. No amount of permutations regarding board composition and structure will answer the question of firm performance. Answering the question of the effect of board structure/composition on firm performance will only be achieved in a meaningful way when researchers understand what informs the consciousness of these organizational actors. It is this internalized consciousness coupled with the embedded unique organizational culture that researchers need to understand and explore because the social actors- the directors- are driven by a force greater than mathematical combination of board size and board composition.

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