Board structure and firm performance: A study of listed Commercial banks in Sri Lanka

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Abstract

Corporate governance is the system of internal controls and procedures by which individual companies are managed. It is generally accepted that boards of directors play a fundamental role in corporate governance. The study investigates the impact of board structure (an important internal corporate governance mechanism) on firm performance of listed commercial banks in Sri Lanka. The results were based on the analysis of data from 2010 to 2014 with 10 listed commercial banks in Sri Lanka. Board size, gender, duality, education, board age and Independent were the board structure variables, and ROA and ROE were the measurement device of firm Performance. This study finds that board characteristics such as board size, board independence, gender and educational qualifications of directors are not significantly related to firm performance. On the other hand, CEO duality is negatively correlated to firm performance, suggesting that, under the condition that CEOs serve as executives, the board would likely fail to be an objective supervisor, which negatively affects performance of the commercial banks.

Key words: Corporate governance, Board Structure, Firm performance

1. Introduction

Corporate governance is considered to have significant implications for the growth prospects of an economy. Good corporate governance practices are regarded as important in reducing risk for investors, attracting investment capital and improving the performance of companies.It is generally accepted that board of directors play a fundamental role in corporate governance and the structure of the board matters (Jensen, 1993; Bertner and Kaplan, 1997). However, there is no consensus as to what the optimal board structure is (Dalton et al. 1998).

The importance of board composition is typically studied from the perspective of corporate governance, which is the integrated set of internal and external controls that harmonizes manager (agent)-shareholder (principal) conflicts of interest resulting from the separation of ownership and control (Williamson, 1984). Without governance controls, managers are more likely to deviate from the interest of shareholders. The board, however, with its legal authority to hire, fire, and compensate top management teams, can set the premises of managerial decision making, monitor managerial behavior, and safeguard invested capital (Fama and Jensen, 1983).

A key element in the corporate governance mechanism is the board of directors. For instance, Jensen (1993) proposes to re-focus on boards as the first line of monitoring.Scholars approaching the board composition issue from an agency theory perspective typically advocate for outsider-dominance, that is, outsiders should be in the majority on corporate boards (Bacon and Brown, 1973; Firstenberg and Malkiel, 1980; Securities and Exchange Commission, 1980).

The Basel Committee on banking supervision made up of supervisory authority which was established by the Central Bank governors of the group of ten countries in 1975, usually meet at the Bank forInternational Settlement (BIS) endorsed the concept of corporate governance to safe guard depositors' funds. To this effect, the Basel Committee on banking supervision published evidence in 1999 to assist banking supervisors in promoting the adoption of sound corporate governance practices. In February 2006, the Basel Committee on banking supervision issue a revised version of the 1999 paper titled enhancing corporate governance for banking organizations which details some considerations for corporate governance related activities of the banking organization that are conducted through structure that lack transparency or in jurisdiction that pose impediments to information flows.

Most studies of board effectiveness exclude financial firms from their samples. As a result, we know very little about the effectiveness of banking firm governance. This last issue is particularly important since many governance reform proposals are motivated by studies of non-financial organizations.Banks clearly appear to have different governance structures than non-financial firms. The question is whether these governance structures are ineffective, as the Walker Review seems to suggest. The purpose of this paper is to try to provide an answer to this question by examining the relationship between board structure and bank performance. We focus on 10listed commercial banks under CSE in Sri Lanka.

2. Review of the literature

Many empirical studies have attempted to investigate the impact of board structure on firm performance. However, , the empirical findings on this link have been mixed and inconclusive. Much of the resulting policy prescriptions enshrined in codes of 'good' corporate governance rely on universal notions of 'best practice, which often need to be adapted to the local contexts of firms or 'translated' across diverse national institutional settings.

Karan and Furtado(1992) find that boards of failed and non-failed firms show significant differences in aperiod as long as five years before bankruptcy. Useem (1993) reports thatfor corporations with outsider-dominated and strong independent boards, when firms'strategy has failed, it is the CEOs who are replaced, as compared to firms with aninsider-dominated board, it is the middle managers get fired, leaving the CEO andfirm strategy unchanged. Rosenstein and Waytt (1990) find that the addition of anoutside director results in positive abnormal returns.

Ellingson (1996) finds that theassociation between CEO compensation and firm performance is stronger when theboard is composed of a majority of outside directors. In going-private transactions,where top managers may have an incentive to reduce the premium paid to outsideshareholders, Lee et al. (1992) find that boards dominated by outside directors areassociated with higher returns than those dominated by insiders. Baysinger and Butler(1985) find that changes in board composition over a ten-year period appear to have arelationship with accounting performance. Board composition has also beenfound to influence the evaluation of takeover proposals for

both the bidding and targetfirms (Brickley and James 1987; Byrd and Hickman 1992; Shivdasani 1993).

Still other studies find no relationship between board composition and firm performance (MacAvoy et al. 1983). Ina recent meta-analytic review board structure/ leadership structure and firm financial performance, Dalton et al. (1998) conclude that there is "little evidence of systematic relationships between governance structure and financial performance".

These conflicting and inconclusive empirical findings can be attributed to several factors. One is the complexity of the board structure and firm performance relationship itself. This is especially true in large firms, which are the focus of most board composition studies. The complexity of large firm may constrain the ability ofthe board to initiate changes and affect the direction of the firm (Dalton and Kesner, 1983). Bourgeois (1987) concludes that managers in large complex organizations are limited in their capacity as influences of events rather than controllers of certain outcome.

The opinions described in the Walker Review suggest that there should be a negative relationship between bank board size and performance due to the costs of decision making in large groups. The evidence for non-financial firms is consistent with the idea that, on average, the costs of large boards outweigh their benefits. For example, Yermack (1996) finds that on average, firm performance is lower for non-financial firms with larger boards ina sample from 1984-1991. Coles, Daniel and Naveen (2008) find similar results in a sample of non-financial firms from 1992-2001. However, recent literature examining determinants of board size and composition suggests that larger and more complex firms will require more advice from their boards and thus havelarger boards (e.g. Boone, Fields, Karpoff and Raheja, 2007; Coles, Daniel and Naveen, 2008; Lehn, Patro and Zhao, 2008 and Linck, Netter and Yang, 2008).

One of the most analysed variables in the study of corporate governance is the size of the board. Yet, it is not clear about direction of the effect of the size of the board on firm performance (Barroso Castro et al., 2010; Bennedsen, Kongste, & Nielsen, 2008). Velnampy (2013)finds that determinants of corporate governance are not correlated to the performance measures of the organization with the samples of 28 manufacturing companies over the periods of 2007 2011 in Sri Lanka.

Baysinger and Butler (1985) find that companies perform better if boards include more outsiders. Similarly, Rosenstein and Wyatt (1990) found that a clearly identifiable announcement of the appointment of an outside director led to an increase in shareholder wealth. Jensen (1993) argues that the preference for smaller board size stems from technological and organizational change which ultimately leads to cost cutting and downsizing. Hermalin and Weisbach (2003) argue the possibility that larger boards can be less effective than small boards. When boards consist of too many members agency problems may increase, as some directors may tag along as free-riders. Lipton and Lorch (1992) recommend limiting the number of directors on a board to seven or eight, as numbers beyond that it would be difficult for the CEO to manage.

An effective board should comprise of majority of non-executive directors (Dalton et al. 1998). However, executive director's responsibility is the day-to-day operation of the business such as finance and marketing, etc. They bring specialized expertise and a wealth of knowledge to the company (Weir & Laing, David 2001). As they are subordinates of the CEO, they are not in a position to monitor or discipline the CEO (Daily & Dalton 1993). Therefore it is important to have a mechanism to monitor the actions of the CEO and executive directors (Weir & Laing, David

2001).Firms with a higher proportion of outside directors are likely to replace the CEO after a period of poor performance of the company (Weisbach 1988).

3. Statement of problem

From a financial industry perspective, corporate governance involves the manner in which the business affairs of individual institutions are governed by their Boards and management. It also includes the effective management of compliance with applicable laws, regulations, and guidelines. The focus on corporate governance is particularly acute in financial services and most of all in the banking sector.

Governance in banks is a considerably more complex issue than in other sectors. Banks will attempt to comply with the same codes of board governance as other companies but in additional factors like risk management, capital adequacy and funding, internal control, and compliance all have an impact on their matrix of governance. Governance is also a curiously two-sided issue for banks since their funding and often ownership of other companies makes them a significant stakeholder in their own right.

The Board of Directors stands at the heart of many systems and structures encompassing the totality of corporate governance. In the financial system, corporate governance is not only vital at the individual company level, but it also is a critical element in maintaining a sound financial system and a robust economy. A good example of this is the case of Banco Latino CA in Venezuela. Banco Latino CA collapsed on 16thJanuary 1994, triggering a real banking crisis in Venezuela and throwing the Venezuelan economy into a deep recession.

According to the Central Bank of Sri Lanka (2008) the global financial environment was marked by intensifying turbulence, particularly since mid-September 2008. As the effects of US Sub-Prime mortgage market Crisis spread to other parts of the world, the result was a worldwide credit crunch. The drying up of liquidity in financial markets the world-over had ripple effects on real variables as well.

Now the attention has turned to corporate governance as an important instrument to avert banking crises, From the experiences in the Banco Latino Group case and US Sub-Prime mortgage market Crisis we have learned some painful lessons. An institution's Board of Directors, hereafter referred to as “the Board”, ultimately is responsible for the conduct of the institution's affairs. The Board controls the institution's direction and hence its overall policy. In so doing, the Board determines how the institution will conduct its business in the long term. In general, the Board establishes or approves and monitors the policies by which management will operate.

The financial stability and continuity of an institution is very much dependent on the strength and quality of the Board, its independence from management, and its degree of involvement in the institution's affairs. In favorable and unfavorable times, the Board contributes by setting tone and direction; it oversees and supports management's efforts by testing and probing their recommendations before approving them.

The Board also makes sure that adequate systems and controls are in place to identify and address problems before they become a threat. In adverse times, an active and involved Board can help an institution survive by taking the necessary corrective actions and when needed, keep the institution on track until effective management can be re-established.

Therefore the present study intend to identify whether there are significant relationship between board structure and firm performance and how its impact on firm performance of listed commercial banks in Sri Lanka.

4. Objectives of the study

The main objectives of the study are follows

1. To identify the relationship between board structure and firm performance.
2. To find out the impact of board structure on firm performance.

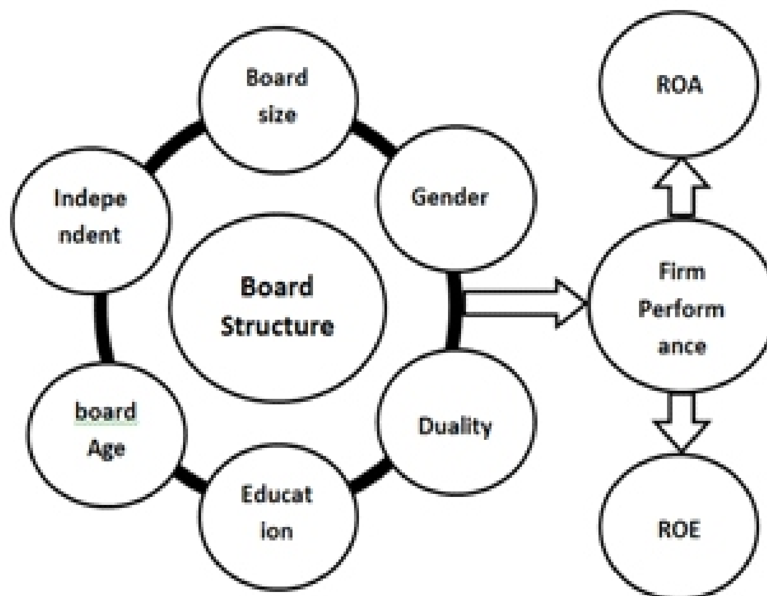
5. Sample and data collection and

Secondary data were collected from annual reports and financial publications of 10 listed commercial banks and from Colombo Stock Exchange records inSriLanka for the period of 2010 to 2014.

6. Methodology

To test the relationships suggested in the hypotheses stated and in the conceptual framework, (Micro Soft Excel 2007 and SPSS Statistical Package for Social Science) were used to analyze the data ,and Spearman's correlation test, regression analysis were performed to test the hypothesis. Sample was selected from listed firms at Colombo Stock Exchange (CSE), it has 296Companies representing 20 business sectors as at 03rd March 2015. The sample includes 10 listed commercial banks from the Banking, finance and Insurance sector.

6.1. Conceptual Framework



Operationanal Definition of variables

Concept	Variables	Indicator	Measurement
Firm Performance	*ROA*	Return on asset	Profit after tax / Total Assets
	ROE	Return on equity	Profit after tax / Shareholders' funds
Board Structure	*Board size*	Board members	Number of inside and outside directors on the board
	Gender	Female board members	Number of women present on the board
	Duality	CEO Dual	Coded "1" if Chairman also holds the position of CEO and "0" otherwise
	Education	Board's educational level	Number of directors holding postgraduate degrees
	Board Age	Board's working experience	Average age of all directors on the board
	Independent	Outside director	Number of independent and non-executive directors on the board.

6.2 Operationalisation

A wide variety of definitions of firm performance have been proposed in the literature (Barney 2002, Velnampy 2005, Velnampy & AloyNiresh 2012, Velnampy 2013).

For example, both accounting and market based definitions have been used to study relationships between corporate governance, corporate social responsibility and firm performance (Orlitzky, Schmidt &Rynes 2003). Conversely, stakeholder views regard firm performance as being the total wealth generated by the firm before distribution to the various stakeholders rather than the accounting profit allocated to the shareholders (Riahi-Belkaoui 2003).

7. Hypotheses

1. Board structure and firm performance are significantly correlated.
2. Board structure impact on firm performance.

8. Analysis and Interpretation

8.1 Descriptive Statistics

Descriptive statistics describe the characteristics of board structure prevalent among listed commercial banks in Sri Lanka and the variables used to measure firm performance. A summary of the descriptive statistics are presented in the Table.1

Table 1. Descriptive Statistics

	N	Range	Minimum	Maximum	Mean	Std. Deviation
Board Size	10	7	8	15	10.40	2.591
Gender	10	3	1	4	2.10	1.101
Duality	10	1	0	1	.60	.516
Education	10	8	2	10	5.30	2.312
Board Age	10	2.00	2.00	4.00	3.1660	.71973
Independent	10	6	0	6	3.10	2.558
ROA	10	2.10	.90	3.00	1.5460	.59272
ROE	10	15.93	4.03	19.96	15.2730	4.99758

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According to the descriptive statistics in table 1, average size of the board is 10 numbers of directors including chairman, and the number maximum is 15.Average female members are 2 and maximum is 4 in a board. Mean of 5 members have post graduate education level in the board. Further, average independent non executive directors 3 with a maximum of 6.Average board age is 3 years.

8.2 Correlation analysis

Table 2 presents Spearman's correlation for all the variables in the study. It examined the association between the board structure variables and firm performance variables.

The results of the correlation analysis in table 2 shows that there are no significant relationships among determinants of board structure namelyboard size, gender, duality, education, board age and independent with ROA and ROE as the measurement of firm performance. Anyhow proper method of board structure should be formed by the listed banks based on the role of corporate governance aspects.

8.3 Regression analysis

The regression analysis was performed to evaluate the impact of board structure on firm performance which is presented Table.3.

The specification of the six variables namely board size, gender, duality, education, board age and Independent in the model revealed the ability to predict performance.

The results of the regression analysis in table 4 shows that coefficient for all six variable such as board size, gender, duality, education, board age and Independent are not significant even at the conventional levels. This means that these variables are not contributing to the performance of banks measured by ROA and ROE. The reason is that, banks are still not properly practicing corporate governance practices proscribed in the code of best corporate governance practices and guideline. These results are consisted with the findings of Dixon et al. (2015) who shows that boards are ineffective in monitoring manager's opportunistic behavior in the context of China.

Table 2. Spearman's Correlation Matrix

	Board Size	Gender	Duality	Education	Board Age	Independent	ROA	ROE
Board Size	1	.647*	.299	.516	-.047	.245	-.310	-.335
Gender		1	.274	.642*	.203	-.083	-.173	.068
Duality			1	.391	-.414	-.303	-.445	-.099
Education				1	-.129	-.137	-.353	-.169
Board Age					1	.589	.149	.554
Independent						1	-.367	-.107
ROA							1	.536
ROE								1

Table3.Regression Analysis

Model Summary a&b				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
a	.817a	.667	.002	4.99164
b	.855a	.731	.194	.53217

a & b Predictors: (Constant), Board size, gender, duality, education, board age and Independent
a.Dependent Variable: Return On Equity
b.Dependent Variable: Return On Assets

9. Conclusion and recommendation

The purpose of this research is to examine the importance of one of corporate governance aspects, namely board structure. Following previous literature on board structure and performance, this study uses ROA and ROE to measure firm performance, which includes the physical and intellectual resource bases of the firm. In general, the results of this study provide evidence that there are no significance relation between the variables of board structure and firm performance even at the 5% level. This study hopes to contribute to this line of research. Based on the results of this study, it was found that there is no significant relationship between board size, gender, duality, education, board age and Independent to bank performance. Therefore our hypotheses (H_1) and (H_2) are rejected. The empirical evidence gives some insights on the effective of boards structure in the listed commercial banks in Sri Lanka. Our results indicate that firms have to pay attention to establishing some corporate governance mechanism consistent with the recent amendments, such as appointment of senior independent directors and the qualities of the directors. Nevertheless, to fully develop the dogma of corporate control and governance is still longway for Sri Lankan. Further research will be extremely beneficial to understand the developments and importance of such mechanism in Sri Lanka.

Table4. Coefficient for predictors of performance

Model	Un-standardized Coefficients				Standardized Coefficients					
	B		Std. Error		Beta		t		Sig.	
Dependent Variables	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA
(Constant)	-4.387	-0.072	17.265	1.841			-0.254	-0.039	0.816	0.971
Board Size	0.095	0.152	1.233	0.131	0.049	0.664	0.077	1.156	0.943	0.331
Gender	-1.307	-0.348	3.287	0.350	-0.288	-0.645	-0.398	-0.992	0.717	0.394
Duality	2.260	-0.487	3.914	0.417	0.234	-0.424	0.577	-1.166	0.604	0.328
Education	-0.120	-0.045	1.021	0.109	-0.055	-0.175	-0.117	-0.413	0.914	0.707
Board Age	7.985	0.688	4.355	0.464	1.150	0.836	1.833	1.483	0.164	0.235
Independent	-1.479	-0.285	1.190	0.127	-0.757	-1.228	-1.243	-2.243	0.302	0.111

Dependent Variables: ROE & ROA

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