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Board Composition and Corporate Performance: An Analysis of Evidence from Nigeria

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Abstract

This study examines the impact of board composition on the economic performance of firms in Nigeria. This study is significant because it attempts to analyze the relationship between corporate governance practices and financial performance in Nigeria thus providing a basis for a framework for institutional regulations. Board composition in this study is in terms of the proportion of the board of directors in Nigeria that is represented by outside non-executive directors. The hypothesis for the study is that there is no significant positive relationship between board composition and firm performance in Nigeria. The study uses a cross-sectional design, using a survey of a sample of 38 firms during the 2009 financial year. Results show that outside non-executive directors do not create any economic value added though may have some benefits. The results of the study are consistent with those of earlier studies for both developed and developing economies that there is no explicitly clear relationship between board composition and firm performance.

Key words: Board composition, Corporate performance, Corporate governance, Non-executive directors.

1. Introduction

Corporate failures and massive corporate scandals in recent years have led to considerable interests in literature and research into corporate governance principles and codes of best practices with a view to improving corporate governance and enhancing corporate performance/survival. A key component in corporate governance implementation is the role of the board of directors. The board monitors the

management and set the strategic direction for the organization. The board reviews and ratifies management proposals, and it is the primary and dominant internal corporate governance mechanism in the organization (Brennan, 2006 and Jonsson, 2005).

Corporate failures and scandals such as those of Enron, WorldCom and HIH, amongst others, have raised the question as to the ability of the board to effectively monitor management (Rashid, 2011 and Migruchi, 2004). This question is particularly relevant given that the boards were apparently not effective enough to have been able to present a check on some of the corporate governance failures, as they later came to be identified. This then calls to question the structure and composition of such boards. According to Rashid (2011) this raises an important question, that is, "who will monitor the monitors? Although it is agreed that the shareholders will monitor the board by exercising their ownership right by appointing and removing board members, shareholders may not be aware of the inside activities of the firm.''

It is therefore often argued that the board should be structured and composed of in such a way that it will act to monitor its own activities. Rashid (2011) further notes that "corporate governance literature debated within two extreme streams of board practices examining whether the board composition in the form of representation of outside independent directors and structural dependence of the board influence the firm performance.

The question therefore is "does the composition of the board of directors influence the firm performance or does firm performance influence the composition of the board of directors?" (Davidson & Rowe, 2004). Existing literature on the relationship between the board composition and firm performance reflects mixed results. The idea of endogenous relationship between board composition and corporate performance was advanced by Hermalin & Weisbach (2000), that is, board composition and corporate performance jointly influence each other rather the board composition influencing corporate performance or corporate performance influencing board composition Davidson & Rowe (2004) note that board composition and financial performance influence each other but the effect is delayed. That is the idea in their intertemporal endogeneity in board composition and financial performance..

Universally accepted corporate performance measures are difficult to come by. Davidson & Rowe (2004) note that, "There are several measurement issues (such as differences in accounting and reporting across industries) that may make finding a relation between board composition and financial performance difficult at best." While Sahin, Basfirinci & Ozsalin (2011) measure corporate performance in terms of financial performance and social responsibility performance, commonly used measures of firm performance are Return on Assets (ROA) and Tobin's Q (a market based performance measure) (Rashid, De Zoysa, Lodh & Rudkin, 2010). Others measures of performance that have been used include average gross turnover, average growth rate of turnover, and ordinary shares held by the corporate sector - corporate holding (Siriwardhane, 2003). Eklund, Palmberg & Wiberg (2009) used market value (defined as the total value of outstanding shares plus total debt) as a measure of performance, in this study the measures adopted are: return on equity (ROE), return on capital employed (ROCE), return on asset managed (ROAM), earnings per share (EPS) and dividends per share (DPS).

This study aims to investigate the relationship between board composition and company performance, using Nigerian corporate entities. This is to determine if the Nigerian situation is in line with global trend or if we can find a definite pattern of relationship between board composition and corporate performance for the Nigeria corporate world.

To achieve this purpose, the remainder of this paper is organized as follows: Section 2 reviews previous literature and findings of previous researches. Section 3 presents the methodology and the sample data of the study. Section 4 presents the findings of the study and discusses the empirical results. The final section provides the discussion of the findings and conclusions of the study.

2. Review of Literature

2.1 Corporate Governance Principles - The Board of Directors

The Report of the Committee on Corporate Governance of Public Companies in Nigeria (2003) puts the board of directors at the centre of the implementation of corporate governance principles of public companies in Nigeria. The Report notes that the board of directors should be responsible for the affairs of the company in a lawful and efficient manner in such a way as to ensure that the company is constantly improving its value creation. The board should ensure that the value being created is shared among the shareholders and employees with due regard to the interests of other stakeholders. To perform these responsibilities the board should amongst others, ensure the integrity of financial controls and reports and ensure that ethical standards are maintained and that the company complies with the laws of Nigeria.

To be able to play the required role effectively and efficiently the Report recommends what the composition of the board of directors should look like. The Report recommends that the board should be composed in such a way as to ensure diversity of experience without compromising integrity, compatibility, availability and independence. The board should comprise of a mix of executive and non-executive directors, the board should not exceed fifteen (15) and not less than five (5) persons in total. The Report also recommends that the board should not be dominated by one individual, and that the position of chairman, and chief executive officer should be separated and held by different persons since a combination of the two positions in one individual would represent undue concentration of power. While the chief executive officer and his management team are in charge of the day-to-day operations of the company, the chairman's primary responsibility is to ensure effective operations of the board and should as far as possible maintain a distance from the day-to-day operations of the company.

The Central Bank of Nigeria (CBN) (2006) attributed weaknesses in corporate governance of banks in Nigeria to include the following, amongst others:

- Ineffective board oversight functions;
- Disagreements between board and management giving rise to board squabbles;
- Fraudulent and self-serving practices among members of the board, management and staff;
- Overbearing influence of chairman or MD/CEO, especially in family-controlled banks.

All these weaknesses have to do with the structure and composition of the board of directors. The strategic importance of the board of directors in the promotion of corporate governance practices led the CBN to maintain that the board of directors for a bank in Nigeria should essentially be one that is committed and focused in the discharge of its responsibilities with a high degree of independence from the management and individual shareholders and so composed that there is a balance of power and authority so that no individual or coalition of individuals has unfettered powers of decision making. Still on the composition of the board, the CBN recommends that "The number of non-executive directors should exceed that of executive directors.'' On the issue of executive duality, the CBN clearly outlaws the combination of the role of the head of the board (the chairman) and that of the chief executive officer on one person as this will create individuals with unfettered powers of decision making. It even goes further to recommend that "no two members of the same extended family should occupy the position of the chairman and that of chief executive officer or executive director of a bank at the same time.''

2.2 Theories of Corporate Governance

As noted by Rashid (2011) a ''number of theoretical perspectives are used in explaining corporate governance practices and problems'' Among these perspectives are agency theory, stewardship theory and resource dependence theory. The agency theory is built on the separation of ownership and control. It holds the view that an individual is self-interested and self-opportunist and not altruistic. The managers (the agents) who have control of the organization may not always act in the best interest of the owners (the principals) and may be driven by self-interest to pursue their self-activities to the detriment of the welfare of those they represent. The thrust of this theory is that the interest of the principals (the shareholders) is best protected when the board composition is such as is dominated by outside independent directors who will be able to monitor any self interest activities of managers and so enhance board performance (Rashid, 2011; Kaymak & Bektas, 2008 and Luan & Tang, 2007). The theory suggests that CEO duality diminishes the monitoring role of the board of directors over the executive manager, and this may in turn have a negative effect on corporate performance, also that CEO duality reduces firm performance because of CEO entrenchment and a decline in board independence (Elsayed, 2007 and Kang & Zardkoohi, 2005). The tenet of this theory is based on the premise that there is an inherent conflict between the interest of the firm's owners and its management (Kiel & Nicholson, 2003).

In contrast, the stewardship theory adopts a more optimistic view of humans. The theory believes that the agent may not be self-opportunist, motivated by individual goals but may actually be motivated to work in the interest of the principal. The implication of this theory is that insiders are better than outsider directors since outside independent directors ''are not as agents be the best stewards to their corporations and are not motivated by individual goals,'' The theory also argues for CEO duality (Ong & Lee, 2000; Luan & Tang, 2007 and Rashid, 2011).

The resource dependence theory maintains that the board is an essential link between the firm and the external resources that a firm needs to maximize its performance. A mayor criticism of this theory is that empirical findings can be interpreted according to the paradigm of the researcher (Kiel & Nicholson, 2003 and Pettigrew, 1992). According to this theory the board is an important strategic resource for the firm in terms of knowledge, contact with the business world, source of capital, new markets/competitors, so that increased diversification on the board is positive for firm performance (Eklund, Palmberg & Wiberg, 2009)

2.3 Board Composition and Corporate Performance

Board composition is measured in terms of different degrees of heterogeneity. Common assessments of board composition are usually, insider/outsider director ratio, executive/nor-executive directors ratio, age and gender diversity among board members and board size. There are inconclusive findings between the relationship between board composition and firm performance (Finegold, Benson & Hecht, 2007; Frick & Bermig, 2009; Rashid, De Zoysa, Lodh & Rudkin, 2010 and Tang, Panasian, Prevost & Bhabra, 2004). Board heterogeneity has a lot of advantages due to enhanced decision making from more information, but this would come at a considerable cost. It is in light of this that Eklud, Palmberg & Wiberg (2009) note that:

> *Board heterogeneity is associated with a trade-off between increased costs in terms of longer decision time and lower external costs. That is, a trade-off between increased information efficiency associated with heterogeneous boards and decision efficiency associated with homogenous boards. Heterogeneous boards tend to be better informed regarding issues outside the firm and thereby better equipped to question and discuss corporate strategic decisions, whereas homogenous boards to a larger extent is based on trust, cooperation, as well as shared experience and values.*

On composition in terms of the insider-outsider director ratio, the agency theory tends to favour more outsider directors. Insider directors are directors who are also executives and serve in at least one of the following categories: Management of the company or advisers of the company, and insider directors are those who are not executives (Davidson & Rowe, 2004). Sahin, Basfirinci & Ozsalih (2011) observe that

previous literature does not offer consistent findings on the impact of insider-outsider director proportion on financial performance. Many of the studies suggest a positive relationship between outsider-dominated boards and the performance of the company. Some other studies however found no significant relationship between the proportion of insider/outsider directors and company performance (compare Pearce & Zahra (1992), Daily & Dalton (1993) and Krivogorsky, (2006) on one hand with Bhagat & Black(1999), Daily & Johnson (1997) and Dulewicz & Herbert (2004) on the other hand).

Finegold, Benson & Hecht (2007) note that:

> *The many empirical studies that have examined the impact to the insider-outsider ratio on boards have found no consistent evidence to suggest that increasing the percentage of outsiders on the board will enhance performance. If anything, they suggest that pushing too far to remove insider and affiliated directors may harm firm performance by depriving boards of the valuable firm and industry specific knowledge they provide.*

The argument challenging the beauty of outsider independent directors has been that of information asymmetry between insider directors and outsider directors. It is argued that insider directors live in the company they govern and so have better understanding of the business than outsider directors hence are better able make useful decisions, while the outsider directors lack day to day inside knowledge of company and so may have a reduced control role of the firm (Kiel, 2007 and Rashid, De Zoysa, Lodh & Rudkin, 2010).

The arguments for increasing the proportion of outsider independent directors have been based on the agency theory that such outsider independent directors are better able to protect the interest of the shareholders. It is argued that the insider directors will not be able to effectively monitors the day-to-day activities of the managers since that will effectively mean that they are monitoring their own operation which is operationally impracticable.

It seems therefore that this debate will remain open-ended moreso as there are no empirical findings to tilt the argument in any particular direction. There are many explanations for the inconclusive results on this relationship: one of such explanations is that boards that are optimally weighted between insiders and outsiders would result in an insignificant relation being expected. Another explanation is that simultaneity between key variables of interest confounds the interpretation of results in studies that focus on a direct relation. Another explanation is that performance and board characteristics, such as composition are jointly endogenous: firm performance is a function not only of past board independence but, also a predictor of the future board structure (Panasian, Prevost & Bhabra, 2004).

Corporate governance literature tends to advocate expanding the independent/outsider elements in corporate boards. It is therefore portrayed in literature that board composition is in some way related to corporate performance. The Nigerian Codes of Best Practices also seek to strengthen the independent/outsider elements on the board (Central Bank of Nigeria, 2006 and Report of Corporate Governance of Public Companies in Nigeria, 2003). Panasian, Prevost & Bhabra (2004) remark that: “Despite the inconclusive results of empirical literature on the effectiveness of outsider directors on the board, an international movement advocating greater board independence continues to strengthen.”

CEO duality exists when the same person doubles as the chairman of the board and chief executive officer of the company at the same time. This is usually considered as improper as the board is expected to monitor the operations of the chief executive officer and his management team. It is always argued that this role cannot be effectively performed by the board if the CEO is also the chairman of the board. Empirical studies on the relationship between CEO duality and performance have yield conflicting conclusions (Sahin, Basfirinci & Ozsalih, 2011). Some studies favour CEO duality, suggesting that it may improve corporate performance. Others believe that CEO duality has a negative effect on firm performance (compare Kula (2005; Tian & Lau (2001) with Kaymak & Bektas (2008)).

In terms of board size, most studies examining the relation between board size and the effect on financial performance have affirmed that "board size and financial performance are negatively correlated. The reason advanced for this is that as the size of a group increases, the problems of communication and coordination increase (Yermack, 1996 and Sahin, Basfirinci & Ozsalin, 2001). The argument is that large boards would tend to be more diverse, more contentious, and more fragmented than small boards. Keeping boards small therefore can help improve their performance since as has been suggested by research findings, as a group increases in size, they become less effective because co-ordination and process problem would outweigh the advantages gained by having people of diverse background (Siriwardhane, 2003).

3. Data and Methodology

This study uses the cross-sectional design in organizing the study subjects for the study. Particularly, the survey procedure was used in this study. The results of operations of the companies for the 2009 financial year were used in this study. This study used a sample of Nigerian firms (sample size of 38), randomly drawn from a list of companies quoted on the Nigerian Stock Exchange (NSE). This simple random sampling procedure was used in the exercise.

The data used in this study were obtained from the published annual reports and accounts of these companies (secondary sources). The study uses simple regression to evaluate the relationships between the variables. This is calculated as:

$$r = \frac{\sum XY}{\sqrt{\sum X^2}\sqrt{\sum Y^2}}$$

The predictive strength of this is examined by the coefficient of determination.

3.1 Variables Definitions

3.1.1 Independent Variable

Board composition is used in this study as the independent variable. Board composition is here defined as the percentage of membership of the board constituted of by non-executive directors (Rashid, De Zoysa, Lodh & Rudkin, 2010). This satisfies the definition of board composition provided by the Report of the Committee on Corporate Governance of Public Companies in Nigeria (2003).

3.1.2 Dependent Variables

Corporate performance is used in this study as the dependent variable. The different performance measures used in this study are: Return on Equity (ROE), Return on Capital Employed (ROCE), Return on Asset managed (ROAM), Earnings per Share (EPS) and Dividend per Shares (DPS). The different measures are used to provide a comprehensive examination of different angles of performance. They are also used because they represent very simplistic measures of performance.

3.2 Research Hypothesis

The research hypothesis tested in this study is: "there is no significant positive relationship between board composition and corporate performance"

4. Empirical Results

4.1 Descriptive Statistics

The descriptive statistics of all the variables used in the model are shown in Table I. From Table I, the average proportion of non-executive directors in the sample is 64.6% ranging from 42% to 91% with a standard deviation of 12.2%. With respect to all the performance measures used to the mean ROE is 9.01% and ranges from negative 57.92% to 49.9%, a mean of 39.8% ranging from negative 32.4% to 499% under the ROCE measure. The average ROAM is 6.97%, ranging from negative 25.14% to 29.32%. The average EPS is ₦0.92, with a range of ₦19.8 from negative ₦8.48 to ₦11.32 and a standard deviation of ₦2.97. Average DPS is ₦0.76 ranging from 0 to ₦12.80.

Table 1: Descriptive statistics of the sample

Variable	Number	Mean	Minimum	Maximum	Std dev
Non-Executive directors	38	0.646	0.42	0.91	0.122
ROE	38	9.01%	(57.92%)	49.9%	29.61%
ROCE	38	39.8%	32.38%	499.%	103.5%
ROAM	38	6.97%	25.14%	29.32%	10.39%
EPS	38	₦0.92	(₦8.48)	₦11.32	₦2.97
DPS	38	₦0.76	0	₦12.80	₦2.07

Source: Computed from various annual reports.

The results of the analysis carried out to examine the relationship between the dependent and independent variables are presented in the correlation matrix in Table 2. The model uses the simple regression analysis in evaluating the relationship between board composition and the different performance measures (ROE, ROCE, ROAM, EPS, and DPS). The different performance measures are separately regressed on board composition in terms of the proportion of the board constituted of by non-executive directors.

Table 2: Correlation matrix of explanatory variables

Performance measure	Regression coefficient	Coefficient of determination
ROE	0.345	11.9%
ROCE	0.3386	11.46%
ROAM	0.5290	27.98%
EPS	02934	8.61%
DPS	0.3209	10.3%

Source: Researchers' computations

The model shows that none of the dependent variables is significantly correlated with the independent variable (board composition). In fact, only ROAM is correlated with board composition, though at a very weak level. This is further confirmed by the coefficients of determination which show that none of the variations explained by the relationships between board composition and all the performance measures is

meaningful. The coefficients of determination for the different relationships are all less than 30% with the highest being 27.98% and one as low as 8.61%, and the average being 14.05%.

The results indicate that there is no significant relationship between board composition and corporate performance in Nigeria, using any of the performance measures. The implication of this is that a firm cannot enhance its economic performance by increasing the non-executive directors on its board. These results are consistent with similar studies conducted for both developed and developing economies that no explicitly clear relationship exists between board composition and firm performance (Judge, Naoumova & Koutzevol, 2003 and Rashid, De Zoysa, Lodh & Rudkin, 2010).

5. Discussion and Conclusion

This study seeks to examine the influence of board composition in the form of the representation of outsider non-executive directors on the economic performance of firms in Nigeria. The empirical results of the study suggest that there is no significant relationship between board composition and any of the performance measures used (that is, ROE, ROCE, ROAM, EPS and DPS). This means that non-executive directors do not add any economic value to the firms in Nigeria.

In our opinion, outsider non-executive directors play a significant role in providing independent advice during corporate decision making process, while such advice may enhance overall corporate governance, such advice may not be significant enough as to create any economic value added to the overall corporate performance. This may, in part, be due to the fact that as outsiders, the non-executive directors may be constrained in term of information. They rely on the insiders for the information required for informed decision making. And there may be information asymmetry. It seems difficult to see how non-executive directors can provide effective differential judgmental contributions to firms. From the analysis therefore we would like to conclude that the introduction of regulations stipulating the proportion of outsider, non-executive directors on the boards of companies, while is appealing from agency theory point of view, such regulations may not create any economic value added. Even if outsider non-executive directors enhance firm performance, such enhancement must be indirect and not in measurable terms. We therefore suggest that further studies be carried out on how outsider non-executive directors might indirectly contribute to corporate performance so as to provide an institutional framework for formulating policies in such regards.

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