

Effects of Board Structure on Firm Performance: A Comparison between Consumer Discretionary and Material Industries in Sri Lanka

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Abstract:

The study examines and compares the relationship between board structure and firm performance, using data obtained from 40 consumer discretionary and 40 materials sector companies in Sri Lanka. In this study there are four variables of board structure used: board size, female directors' ratio, independence directors' ratio and director's experience. The purpose of this study is to analyse the effectiveness of board structure and its influence on firm performance in both industries from a comparative perspective to see whether industry classification matters. The statistical analysis provides evidence that there are strong differences in the board size between consumer discretionary and materials sector whereas there is still a lack of female directors in highest-level positions either consumer discretionary or materials industry. The results also reveal that a significant and positive relationship between board size and ROA of consumer discretionary sector companies. For materials sector companies, board structure variables are positively related to ROA and ROE. These findings suggest that a difference between consumer discretionary and materials sector is smaller than might have been expected based upon the differences in the level of industry operations.

Keywords: Board structure, board size, independent directors and performance

I. INTRODUCTION

Corporate governance refers to the organisation of rights and responsibilities among the peoples that have a stake in a company (Aguilera and Jackson 2003). The board of directors is a vital unit in a company, making a relation between shareholders and managers and therefore playing an important role in the governance of a company (Dehaene et al., 2001). The board of directors is assigned with a vital accountability to monitor the company on behalf of the shareholders. Concurrently the report of the corporate governance committee of the corporate governance forum of Japan (1997, pp. 1) notes, "the directors are entitled to govern the company, and to supervise and monitor the company's management in order to promote effective management and ensure prudent accountability to the shareholders. The board of directors therefore is the primary overseer in the company, monitoring management to ensure that it is 1) always endeavouring to maximise corporate value in long term for the shareholders and 2) always prepared to be accountable its actions to all the stakeholders and in particular- to the shareholders". Besides, corporate governance is the structure whereby managers at the organisational apex are controlled through the board of directors, its associated structures, executive incentive, and other schemes of monitoring and bonding (Donaldson, 1990). The directors of the company are one of a number of internal governance mechanisms which are anticipated to ensure that the interests of shareholders and managers are closely aligned, and to discipline or remove ineffective management teams (Barnhart et al., 1994; Park and Shin 2003). Previous studies by Rajagopalan and Zhang (1990), Dehaene et al., (2001), Klapper and Love, (2004), Krivogorsky (2006), Rajagopalan and Zhang (2008), Klapper and Love 2004 and Abidinet al., (2009) note that the effective corporate governance assists in the fulfilment of great level firm performance. Typically, corporate governance studies have focused on developed and developing countries (Daily et al., 2003; Rajagopalan and Zhang, 2008). Though, dearth research exists on the extent to which the corporate governance issues applicable to industry sectors. This paper precisely investigates the influence of industry differences in board structure on firm performance by examining listed companies in consumer discretionary and materials industries in Sri Lanka. A comparison between the board structure in consumer discretionary and materials industries may provide us with a better understanding of the extent to which the assumptions of agency theory can be applied in another context and the types of mechanisms that may influence the agency problem in different sectors. The paper is organised as follows. Section 2 describes research methods. Section 3 presents empirical results and Section 4 concludes the paper.

II. RESEARCH METHODS

In order to assess the board structure and firm performance of consumer discretionary and materials sector companies, this study employed quantitative approach. In order to select the sample, random sampling method used, which implies population has equal chance of being included in the sample (Saunders, et al., 2009). Consistent with this selection, the sample size is 40 consumer discretionary and 40 material sector companies. The evidence needed to answer the research problems were based on published financial statements and consequently derived from secondary sources. Secondary data were obtained from the annual reports of the relevant firms, CSE's database. The quantitative data were

analysed using SPSS (version 21.0) to produce descriptive statistics and regression analysis. In this study, researchers collected the dependent variables for 2014, the last full year of complete data, could find for consumer discretionary and material sector companies. The independent variables were collected for 2013, representing a year lag to the 2014 performance data. To test whether board structure affects the association between board size, female director position, directors' experience and board committee independence and firm performance, researchers use the following regression model:

$$ROA = a_0 + a_1BOS + a_2FER + a_3INDE + a_4DIE \quad (\text{Equation 1})$$

$$ROE = b_0 + b_1BOS + b_2FER + b_3INDE + b_4DIE \quad (\text{Equation 2})$$

Where: a_0, b_0, c_0, d_0 = constant terms

a_1, b_1 = regression coefficients

III. FINDINGS AND DISCUSSION

3.1 Descriptive statistics analysis

A summary of the descriptive statistics are presented in the Table 1.

Table 1: Descriptive Statistics: Consumer discretionary and Material Industry

	Consumer discretionary				Material			
	Minimum	Maximum	Mean	SD	Minimum	Maximum	Mean	SD
BOS	10	32	20.32	3.33	1	16	6.51	3.321
FER	1	40.00	16.42	11.054	1	41.02	6.471	7.365
INDE	22.00	91.00	68.00	14.52	16	77.52	65.32	17.652
DIE	.00	70.40	30.623	16.352	.00	100.00	37.562	25.365

Board Size: Consumer discretionary and Material Industry

Consumer discretionary companies' board size (BOS) as stated in descriptive statistics, the minimum size of a board reported in 2013 was 10 and maximum size was 32. The average size of a board in 2013 was 20. Whilst material, BOS as noted in descriptive statistics, the minimum size of a board stated in 2013 was one and maximum size was 16. The average size of a board in 2013 was 7. This result is inconsistent with some other existing literature by Bostock (1995) who note that average board size in UK was between 12 and 13 directors and also Yermack (1996) reveals that mean board size was 12 in USA. Still, results from earlier literature are often inconsistent. In the existing literature, Hanson and Song (2000) note that number of directors in board has reduced over the years in the USA. Whilst the average number of directors in the 1980s is more than 13, in the 1990s this director size falls below 12. When it compares with the Belgian research by Dehaene, et al., (2001), it shows that the USA results is larger. Dehaene et al., report that the maximum size of the board of directors was 35. Whereas Lipton and Lorsch (1992) note that the maximum size of the board of directors is 10. A level below 10 is best; a smaller board works better and could be less manipulated by the delegated director. Besides the Olivencia report in Spain recommended that the ideal size of directors is between 5 and 15 (Garcia Lara, et al., 2007). From a resource dependency viewpoint, bigger boards should be more effective than lesser boards, as bigger boards can make better shared decisions. In particular, Hillman, et al., (2000) and Palmer and Barber (2001) report that the board directors is an significant resource for companies mainly in terms of the connotation with the operations setting. Van den Berghe and Levrau (2004) argue that increasing the number of board directors provides an increased pool of expertise and thus larger boards are likely to have more knowledge and skills at their disposal than smaller boards. Similarly, resource dependence theory suggests that larger boards may have a better ability to form environmental links and secure critical resources (Goodstein, et al., 1994). Conversely, when the board size is big, the drawbacks, such as lack of cohesiveness, coordination problems and fractionalisation are most severe and they become less prevalent as board size decreases (Bonn, et al., 2004). It is vital to note that Australian boards are usually small, with a mean number of fewer than ten directors (Kiel & Nicholson, 2003) however, this study, it has been observed that 96 percent of Consumer discretionary companies have board of directors more than 10 persons. Instead, 81 percent of material companies have board of directors less than 10 persons.

Gender Diversity: Consumer discretionary and Material Industry

It can be seen from Table 1 that overall, there are very limited female directors in both industry companies. As descriptive statistics, the minimum female directors in board were 1 percent in both industry sectors and maximum was 40 percent and 41 percent in consumer discretionary and material industry respectively. It is also interesting to note that the average female director position was 16 percent in consumer discretionary and 6 percent in material. Moreover, a many companies in both industry in this sample have 0 to 4 female directors, and given the percentage below than 5, this is clearly a very small female director in the board. These results are consistent with the recent study by Kang, et al., (2007) which also reveal that gender diversity in Australian boards is remarkably low, particularly compared to the USA where only 13 percent of Fortune 500 companies did not have a female director (Hyland & Marcellino, 2002). It is, however, slightly higher than the female representation reported in some European and Asian countries. The issue of gender in board diversity is particularly suitable given the recent movement in Europe to increase the figure of female on boards. In Norway, for instance, the coalition government in 2002 threatened to require companies to make their boards 40 percent female if they did not do so voluntarily (Ripley, 2003). Whereas Ireland out of 89 companies only 30 percent

have female on the board, and they comprise 4 percent of all directors (Brennan & McCafferty, 1997). Moreover, in UK 3 percent of the top companies have female directors on their board. Singh, et al., (2001) show that female representation into the UK companies board has increased over the year but the proportion of firms that had at least one female director has dropped by July 2000 from 64 percent 1999 to 58 percent. Although females are progressively being appointed to boards of Canadian private companies, they comprise only about five percent of Canadian directors (Burke, 1994). This results consistent with Japan listed companies where 3 percent of female directors on their board (Hyland & Marcellino, 2002). In conclude that 10 to 14 percent mean value of all board of directors are held by female in Australia, 13 percent in USA, 6 percent in the UK, 5 percent in Sri Lanka and 3 percent in Japan. Undoubtedly, there is still a lack of female in these great level positions either Consumer discretionary or Material Industry.

Board independence: Consumer discretionary and Material Industry

Table 1 notes that most of the selected consumer discretionary companies have the majority (91 percent) of the board including independent directors. Albeit, 22 percent of companies have minimum independent directors on board, with average 68 percent of directors are independent position in the boards. The result of this study are consistent with Stapledon and Lawrence (1996) who find that Australian boards of which the popular of directors are independence position. Whereas results also show that 78 percent of the material companies' directors are independent directors. Especially, the number of independent directors ranged from a minimum mean of 16 percent to a maximum mean of 78 percent, which is above the minimum recommended by the ICASL code of best practice of 2003. In prior studies reveal that the number of independence directors on boards of UK companies has increased considerably over time. For instance Conyon (1994) examined the corporate governance changes in UK and the study consisted of 400 large UK companies in the Times 1000 companies between 1988 and 1993. The results note that the mean percentage of independence directors increased from 38 percent in 1988 to 44 percent in 1993. However Peel and O'Donnell (1995) report that UK boards comprised an average of 8 directors, of which 3 were independence. Only 8 percent of companies had no independence directors. A majority (54 percent) complied with the Cadbury Committee's recommendation that all boards should contain a minimum of three independence directors. In Belgian context, the number and percentage of non-independence directors decreased over time whilst the number and percentage of independence directors increased (Dehaene, et al., 2001). Moreover, most corporate governance rules and codes globally require boards of directors of listed companies to have a grouping of independence and non-independence directors (Jackling & Johl, 2009). The ASX corporate governance board notes that a majority of the board should be independent directors. It is similar with the New York stock exchange 2003, that all listed companies have a majority of independent directors on their boards. The Higgs report, in the UK 2003, suggested that at least half of directors be independent. And also the UK Combined code of 2004 provides that at least half of the board members be independent directors. The Malaysian code on corporate governance (2000) recommends, as a best practice, that there needs to be balance on the board of directors with at least one third of the board directors should be independent directors. It is consistency with corporate governance rules as required by section 7.10 of the listing rules of the Colombo Stock Exchange (CSE). In India the recommendations of the Birla committee 2004, the board directors of a company is required to have an independent and non-independent directors with not less than 50 percent of directors consisting of independent directors. Monitoring is more effective with a larger percentage of independence directors because of better information sharing by directors (Raheja, 2005; Lehn, et al., 2009; Chen, 2014). Consequently this study conclude both industry in Sri Lanka, independence directors have a larger influence on the board similar to existing studies (Jackling & Johl, 2009; Chen, 2014).

3.2 Regression Analysis

The table 2 present regression analysis for all the variables in the study. In this study, it provides information on the impact of an independent variable on the dependent variable whilst simultaneously controlling for the effects of other independent variables. The existing corporate governance employs a multiple regression analysis as a research method for the impact in reflection.

Table 2: Predictors of ROA and ROE – Model summary

	Consumer Discretionary		Material	
	ROA	ROE	ROA	ROE
R	.536	.334	.162	.207
R ²	.287	.112	.026	.043
R ² Adjusted	.264	.011	.022	.038
F-Statistics	4.236	1.328	.236	.777
Sig.	.000	0.301	.660	.489

Of the consumer discretionary the models R² value of two performance ratios indicate that 29 percent and 11 percent to the observed variability in company performance can be explained by the board structure variables. The F-statistics and significance levels (sig) in Table 2 shows that ROA model generate statistically significant outcomes in consumer discretionary. Whereas of the material sector the models R² value of two performance ratios indicate that respectively three and four percent to the observed variability in company ROA and ROE can be explained by the board structure variables. The F-statistics and significance levels (sig) in Table 2 shows that both ROA and ROE models generate statistically insignificant outcomes.

Table 3: Coefficients for predictors of ROA and ROE

Models	Consumer Discretionary		Material	
	ROA	ROE	ROA	ROE
Constant	4.111 (.002)	.193 (.926)	1.635 (.236)	1.325 (.136)
BOS	6.001 (.000)	.789 (.818)	1.236 (.154)	1.231 (.471)
FER	.706 (.714)	.111 (.776)	.805 (.712)	.860 (.339)
INDE	1.311 (.305)	.736 (.721)	.178 (.948)	.321 (.929)
DIE	.833 (.326)	3.122 (.033)	1.235 (.278)	1.999 (.306)

Table 3 displays the results of the coefficient estimation for each performance measure of the study. The results reveal that all variables are not significant impact on ROA excluding BOS ($\beta=6.001$ and $P = .000$) and all have positive relationship with ROA in consumer discretionary whereas BOS is statistically significant at the 1 percent level. The results also presents that all variables are not significant impact on ROE except DIE ($\beta=3.122$ and $P = .033$) and all have positive signs. Of the materials, the results display that not all board structure variables are significantly impact on both performance measures and all have a positive signs with ROA and ROE.

IV. CONCLUSION, LIMITATIONS AND FUTURE RESEARCH

This study investigates whether board structure differs significantly between consumer discretionary and material sector companies in Sri Lanka in terms of firm performance. The results show that the average board size of consumer discretionary companies is relatively big, containing an average of 20 board directors with range from 10 to 32 than material sector companies, the minimum size of a board is one and maximum size is 16. Therefore, it can be concluded that board size is significantly differ between consumer discretionary and material sector companies in Sri Lanka. The results also reveal that there is no difference on female participation in the board between both industry as there is still a lack of female in these great level positions. Moreover this study finds that consumer discretionary and material sector companies, independence directors have a larger influence on the board similar to existing studies. The study also provides that board size has significant and positive effect on ROA in consumer discretionary whereas for material companies, relationship exists between board size and firm performance but the relationship is not significant for ROA and ROE. These findings suggest that a difference between consumer discretionary and material is smaller than might have been expected based upon the differences in the level of industry differences. Although this documents only concerning the relationship between board structure and firm performance in a comparative manner, additional research is needed in this area to evaluate the effect of corporate governance factors that may potentially moderate the association between board structure and firm performance in countries with emerging economics.

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