THE RELATIONSHIP BETWEEN BOARD COMPOSITION, LEADERSHIP STRUCTURE AND FIRM PERFORMANCE: EVIDENCE FROM PAKISTAN

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ABSTRACT: *Board of directors has been recognized as an important element of the governance mechanism in a firm; particularly after the high profile catastrophes like Enron, Andersen, AOL, Parmalat, WorldCom and many more around the globe; that led to huge economic losses; and ultimately resulting in devastation of financial sectors around the globe. These losses have raised serious concerns regarding governance issues in the corporate sector; particularly questioning the capability of the boards in terms of securing stockholders' wealth. As a result, majority of the corporate governance reforms (codes, practices, regulations, recommendations, etc.) have directly linked corporate governance practices to increased functioning of the board members. This study aims at advancing the global corporate research agenda by collecting fresh evidence from Pakistan. We shall be studying listed companies working under the corporate governance regime in Pakistan; and will be looking at the association between board compositions and firms' performance. The aim of this study is to look at the impact of board composition on two performance measures (return on assets and return on equity) of the firm. Using linear regression on actual sample of 100 listed companies on the Lahore Stock Exchange, Pakistan, we have found that board composition (i.e. independent directors and chairman elected from non-executive director) and leadership structure (CEO duality) significantly related to the firm performance. Furthermore, we found that two accounting measures demonstrate different results.*

Keywords: corporate governance; board composition; leadership structure; firm performance

1. INTRODUCTION

For more than three decades, the corporate world has experienced high-profile cases of corporate malfeasance resulting in massive corporate disasters [1, 25], and the global financial crises like that of occurring in 1997-98 and 2007-08; which, fortified the usefulness of good corporate governance structures, codes and practices [26]. These high profile cases and financial crises led to extensive debates regarding the effectiveness of corporate governance [9] and called for better governance [27]. Consequently, growing attention is being paid to corporate governance or good governance not only in the developed economies; but, also in the developing countries [32]. Corporate governance is presumed to prevent, stop and defeat deceitful practices.

Corporate governance is an emerging a universally debated phenomenon its development is rooted in different complex disciplines; especially, finance, management, accounting law. Corporate governance is defined as: "a set of arrangements through which organizations are accountable to their stockholders and other stakeholders" [30].

Good governance involves the effectiveness of boards through board composition board size; improved internal control's systems; effective audit committee's external auditors; transparent corporate policies, reporting disclosures [25]. Continuous assurance in all these key areas of corporate governance is essential for varieties of organizations in different industries; for the sake of protecting the shareholders' wealth; potential means for minimizing the risk of corporate frauds. It is now perceived affirmed that the corporate governance arrangements play a vital role in increasing firms' performance; help them in becoming sustainable organizations [26].

A commonly accepted precept in governance theoretical discussion is; that the boards of directors; represent protect the interests of different stockholders enhancing the firm value corporate social performance [38]. For the governance of any organization, boards of directors play a crucial role [29, 37]. Literature on governance exhibits that the board of directors is a primary mechanism that serves as a check balance while monitoring managers' activities [34]; guides them in important matters; evaluates their performances; motivates the directors to take measures consistent with the maximization of shareholders' wealth. Thus, directors' specialized experience of complex business environment lets them direct monitor top management effectively; prevents possible conflict of interest with the firm; other stakeholders; or the regulatory bodies [29].

The "characteristics of the board" or "structure of the board of directors", has gained substantial attention from academicians, practitioners watchdogs; has become the most prevalent corporate governance factor [26, 33]. A growing amount of literature proposes that the composition of board substantially affects the corporate affairs [32] and stockholders' wealth [29] as well as the financial value of the firm [8]. However, most of the global debate empirical work on board composition has been in the context of developed countries like the USA the UK [24]. Therefore, the objectives of this study are to advance the global corporate research agenda, but in the context of developing countries. The study gathers empirical evidence from studying the current corporate governance practices in Pakistan. The aims of the study are three-fold.:-the first aim is to look at the impact of independent directors on firm performance; the second objective is to explore the impact of the CEO duality on firm performance; finally, the third objective is to see the role of a chairman, elected from amongst the non-executive directors; on firm performance. Another contribution of this study is the use of 'return on equity (ROE)' as a measure of firm-performance. Whereas, most of the existing empirical evidence has so far relied on the 'return on assets (ROA)' as the most common traditional accounting measure of performance; which, has recently attracted wide criticisms [5, 33]. Therefore, the current study uses both the accounting measures as a firm's financial-performance i.e. return on assets (ROA) return on equity (ROE).

2. Literature Review

2.1 Board composition

The role and proportion of the insider, outsider and independent directors in any firm's board, finds a lot of emphasis in the corporate governance literature [36, 38]. The independence of directors is considered as an effective governance mechanism and a critical governance aspect [38]. Empirical studies suggested the need for independence of directors for overseeing and monitoring the management effectively [38]. Extensive research has found numerous elements that are related with independence of directors, such as CEO duality number of outside directors [11].

Agency theory suggests that a board with a large number of outside directors, no CEO duality, is more conscientious in pursuing its monitoring role [10]. According to studies, the outside directors perform their fiduciary responsibilities more effectively efficiently; whereas the insider directors, rather than looking after the more important stockholders' interests; are mostly caught up in protecting their firm's management interests [38]; hence increasing the number of outsider directors in a board can ensure better monitoring more control over the opportunistic behaviors of management.

Numerous empirical studies have investigated the influences of independent directors on firm performance. Studies suggest that, having majority of the outside directors in a board promotes corporate governance [38] firm performance [21]; mainly because a CEO or a director tied to a firm would find it hard to oppose a proposed merger; or turn down an excessive remuneration package; or have the skepticism necessary for effective monitoring. The finding of these studies suggest, that the outside board of directors would be more able to foster a more open governance process, that helps in eradication of opportunistic managerial behavior [38].

There are two main theoretical approaches that form the basis for the reliance on inside or outside dominated board. Agency theory has been a leading theoretical perspective in corporate governance research [2, 17]. The theme behind this theory is to align the interests of stockholders managers [23]. It states that there is an inherent conflict among both the parties, i.e. the principal the agent [18]. According to the perspective of this theory, satisfactory monitoring control mechanism are needed for safeguarding stockholders from managers' conflict of interests. Agency theory leads the notion that boards should have more outside directors; preferably, more independent directors [24].

In contrast to the agency theory, the stewardship theory suggests that the managers are principally trustworthy individuals; and hence, are the best stewards of the wealth they are controlling [16]. The theory states that the admirable firm performance will be associated with a significant proportion of the inside directors [1]. The reason is that their basic role is to enhance the wealth of the stockholders. Under this theory, the inside directors, as compared to the outside directors; are more capable of figuring out the business they are governing and thus are in a better position to make good decisions [13, 14, 15]. Theory also contends that the board should have a majority of inside directors to ensure more effective and efficient decision making.

The above mentioned theoretical notions; discussions and empirical results support both our theoretical perspectives. It is stated that the non-executive directors enhance firm's wealth by providing their expertise, knowledge and monitoring [6, 19] and thereby support the stewardship theory. There are, however a fewer studies, that have been unable to establish any systematic relationship between board composition and firm performance [3, 4, 22]. Furthermore, Staikouras et al. (2007) have found insignificant impact of board composition on two different types of performance measures i.e. ROA and ROE. Therefore, our objective is not only to look at the role of board's composition on a firm's performance; but, also with two measures of performance.

2.2 CEO duality

CEO duality [joint leadership structure] has been found crucial to corporate success; both, the agency theory and the stewardship theory provide the basis for the leadership structure [12]. CEO duality denotes a situation when the CEO also holds the position of the chairman of the board. Agency theory recommends need for a separate leadership structure to rule out the possibility of potential dominance of the board; the dual role of a CEO ultimately decreases the effectiveness of board monitoring and leads to conflict of interests [20]. Agency problems are more likely to arise, when an individual possesses two different positions [7]. Studies have also shown that the separate board leadership structure is more effective when relying on return on equity [31]. However, stewardship theorists argue that the dual role of CEO may enhance a firm's performance because there is one clear leadership and such a structure eradicates ambiguity regarding responsibilities. Consistent with the agency theory, study aims to see the impact of separate structure (CEO duality) on firm performance.

2.3 Research questions

The research questions for the study are;

1: does the presence of independent directors on the board enhance a firm's performance?

2: Do the firms with separate chairman and the CEO show better firm performance?

3: would a firm perform better if the chairman is elected from the non-executive directors?

4: Would two different measures of performance (i.e. ROA and ROE) yield different results?

2.4 Objectives

The objectives of the study, thus are;

1: To examine the impact of independent directors on firm performance,

2: To investigate the impact of CEO duality on firm performance,

3: To investigate the impact of elected (non-executive) chairman on firm performance, and

4: To see if there is any difference in results of firm performance, with two different measures.

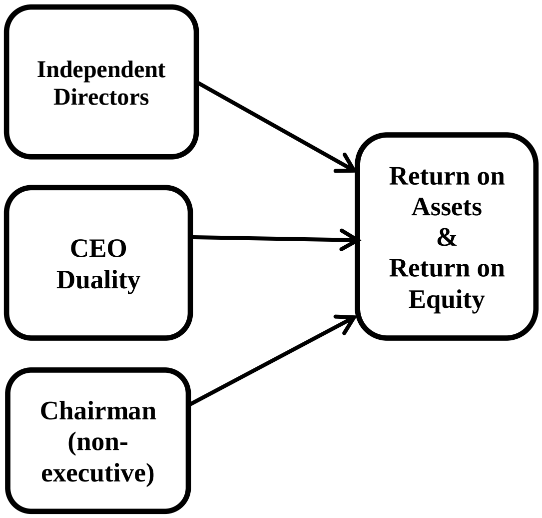

Figure 1: Conceptual

3. Research Design

3.1 Sample data sources

The data for the study was obtained from the annual reports of the firms listed on the Lahore Stock Exchange (LSE) [28]. LSE is the second largest stock exchange; and the only domestic exchange to have more than one trading floors; it is also the only exchange in the region to have established a unified order book with another domestic stock exchange in the country. It is Regulated by the Securities & Exchange Commission of Pakistan (SECP), LSE acts as the front line regulator and responsible for regulating the market along with the listed companies and their directors. There are companies listed on the LSE, and data from 100 of these companies for the financial year 2013-2014 were taken as the actual final sample for this study (LSE 2012). The annual reports were used for assessing board composition with reference to CEO duality; chairman elected from non-executive and number of independent directors; as compliance with these corporate governance requirements are to be incorporated in the annual reports. The code of corporate governance in Pakistan was first issued by SECP in 2002, and later on was made part of the listing regulations of the three stock exchanges in Pakistan; and being part of the listing regulations of the stock exchanges, is applicable to all entities listed on the exchanges. Hence, the annual reports of the listed companies were taken from the official website of LSE as it ensured the reliability of the data relating to the compliance of the code, as well as the availability of end of year financial statements for public. The accounting performance measures were calculated by the researchers.

3.2 Measures

3.2.1 Performance variables

Empirical studies on the influence of board characteristics upon firm performance necessitate the use of suitable performance parameters for objective analysis [35]. Although, there is serious debate concerning what constitutes firm performance [35]; however, most researchers have commonly used two accounting based parameters for measuring the firm performance i.e. return on assets (ROA) and return on equity (ROE). The current study uses both these accounting measures for calculating firm-performance.

ROA is an important measure that reveals how profitable a firm is relative to its total assets. ROA is linked to management's capability to effectively efficiently utilize the firm's assets to generate earnings. ROA is measured as profit after tax divided by firm's total assets; a higher ROA ratio signifies better performance, because it means that the firm is generating more profits on less investment. Using the same formula, we calculated ROA for each firm in the sample; for the fiscal/financial year 2013-2014.

ROE measures the ability of firm to generate earnings from every unit of stockholders' equity. It demonstrates how well a firm utilizes available means to generate earnings growth. ROE is very important useful measure for linking comparing the profitability of firms with same industry. ROE is measured as a profit after tax divided by total shareholder's equity; and a higher ROE ratio signifies better performance; as it indicates that the firm is generating more profits on less equity. Using the same formula, we calculated ROE for each firm in the sample; for the fiscal/financial year 2013-2014.

3.2.2 Variable of interest

The two major variables identified for the study were Board composition and Firm performance; Board composition was measured using measures like number of *independent directors in a board, CEO duality (whether the posts of chairman and the CEO were held by the same person or by separate persons;* and whether the chairman was *elected from non-executive directors,* for the prescribed year of 2014 for each firm. The data on these measures was gathered using the section:' compliance of corporate governance section' in all the companies' annual reports.

CEO duality and chairman elected from non-executive directors are used as dummy variables; the value of '0' is assigned if two positions of CEO chairman were occupied by one individual [dual role]; '1' is used if the CEO…… and …the chairman were different individuals. Similarly, for an elected chairman from amongst the non-executive directors, the value of '1' is used if the chairman was elected from non-executive directors; and '0' if the chairman was elected from executive directors.

4. RESULTS

4.1 Linear regression results for return on assets (ROAs)

To see the impact of independent variables on firm performance, taking return on assets (ROAs) as a measure of firm performance, we used linear regression to investigate our objectives. Table 1 exhibits the effects of independent variables on dependent variable (ROA). The first objective of the study was to see the impact of independent directors on firm performance, and it was tested by taking the independent director as a predictor/independent variable. The results exhibit and support our objective. We find a significant positive impact of the majority of the independent directors on ROAs (β=0.228, $P<0.05$). *The resulting beta value i.e. 0.288 with a significance level less than 0.05 depicts that majority of independent directors on the board enhances the performance of the firm.*

Similarly, the second objective of the study was to investigate the impact of CEO duality on firm performance. It was tested by adding 'CEO Duality' as an independent variable. The results are in accordance with our expectations; and show that firms with separate CEOs and chairmen exhibited better performance and splitting the roles of the CEO and the chairman had a significant positive impact on return on assets (β=0.315, P<0.01). *Thus result depicts that separate leadership structure enhances performance of a firm.*

Finally, the third objective of the study was to investigate the impact of elected chairman (non-executive) on firm performance. It is tested by adding 'Chairman Elected from Non-Executive directors' as an independent variable. The results are contrary to our expectations, since we find no significant association between a chairman elected from non-executive directors and return on assets (β=0.093, P>0.10). *Thus there is no ample support for our assumption that the role of chairman elected from non-executive directors will enhance a firm's performance.*

Table 1 Linear Regression for Return on Assets (ROA)

Variables	Return on Assets			
	Standardized Beta	P Value	F	Sign
Independent Directors	**0.228****	**0.022**	5.383	0.022^{b}
CEO Duality	**0.315*****	**0.001**	10.799	0.001^{b}
Chairman Elec. from Non-Exec.	0.093	0.355	0.863	0.355^{b}

*P < 0.10; **P < 0.05; ***P < 0.01; Sample 100

4.2 linear regression results for return on equity (AOE)

To see the impact of independent variables on firm performance, researchers secondly adopted ROE as a measure of firm performance. We again used the linear regression. Table 2 exhibits the effect of independent variables on dependent variable (ROE). First objective of the study was to see the impact of independent directors on firm performance. It is tested by adding the independent director as a predictor or the independent variable. The results are contrary to our expectations and presence of majority of the independent directors on the boards, exhibited no significant impact on return on equity (β=0.017, P>0.10). *Thus there is no ample support for the role of majority of independent directors in enhancing firm performance.*

Similarly, the second objective of the study was to investigate the impact of CEO duality on firm performance. It was tested by adding 'CEO Duality' as an independent variable on 'Return on Equity'. The results are in accordance with our expectations, and we found a significant positive impact of the separate roles of chairman and CEO, on return on equity (β=0.234, P<0.05). *Thus our results show that the leadership structure with separation of the roles of CEO and the chairman may enhance the performance of a firm.*

Finally, the third objective of the study was to investigate the impact of elected chairman (non-executive) on firm performance. It is tested by adding 'Chairman Elected from Non-Executive Directors' as an independent variable on 'Return on Equity. The results are in accordance with our expectations; the chairmen elected from non-executive directors exhibited a significant enhancement in our measure of performance, i.e. the return on equity (β=0.176, P<0.10). *Thus results depict that the chairman, if elected from non-executive directors, may enhance the performance of a firm.*

Table 2 Linear regression for return on equity (ROE)

Variables	Return on Equity			
	Standardized Beta	P Value	F	Sign
Independent Directors	0.017	0.867	0.028	0.867^{b}
CEO Duality	**0.234****	**0.019**	5.685	0.019^{b}
Chairman Elec. from Non-Exec.	**0.176***	**0.080**	3.120	0.080^{b}

*P < 0.10; **P < 0.05; ***P < 0.01; Sample 100

5. DISCUSSION & CONCLUSION

This study contributes and enriches the domain of corporate governance specifically the board composition and leadership structure; as it attempts to shed light on the impact of independent directors on firm performance [i.e. ROA and ROE]. Secondly; it conducted an empirical investigation on the impact of leadership structure on firm performance [i.e. ROA and ROE]. Furthermore, our study investigated and analyzed the influence of chairman (if elected from non-executive directors), on firm performance. Finally, we wanted to see whether the two different accounting measures of firm performance would yield different results.

The results of our empirical study on the Pakistan's public companies, listed on the Lahore stock exchange, not only portray the present situation of corporate governance practices in Pakistan; but also, update the recent discussion on corporate governance. The study affirms positive and significant relationship between CEO duality and firm performance with both the measures of firm performance. It is pertinent to note that when we have regressed the independent directors on ROA, the relationship is positive and significant. It became insignificant when we regressed the independent directors on ROE. It is also noteworthy, that when we regressed the explanatory variable i.e. chairman selected from non-executive directors upon return on assets, we found no relationship between the two. The relationship became significant when we regressed it on ROE.

Board of directors is recognized as a vital governance mechanism; and itis widely held responsible for the firm it governs [35]. High profile corporate disasters like Enron, Andersen, AOL, Parmalat, WorldCom many more around the globe leading to huge economic losses [1], have put serious question marks on the capability of boards in terms of securing the stockholders' wealth. As a result, majority of the corporate governance reforms (codes, practices, regulations, recommendations, etc.) are directly linking corporate governance with functioning of the boards its members. There is no doubt about the boards being vital for the long term survival of firms; but, there is lack of understanding on how these boards actually operate; or what are the most apt board compositions, that may have a significant impact on a firm's performance. In the majority of the developing economies, the activities of boardrooms are normally concealed from other stakeholders, which make it difficult to investigate their impact.

This study has a few limitations as well. Firstly, it involves a cross sectional design of data collection for all the study variables; may not provide a good basis for establishing causality. Future studies should take this factor into consideration check whether these relationships exist in a longer period of time. Secondly, it is also important to investigate the extent to which the changes in composition of board leadership structure are associated with the firm growth profitability.

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