IMPACT OF BOARD INDEPENDENCE AND CHIEF EXECUTIVE STATUS ON FIRM PERFORMANCE

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ABSTRACT

This paper seeks to examine the relationship between two corporate governance mechanisms (board independence and chief executive status) and firm performance (relying on profit margin, PM) of a sample of twenty six non-financial firms listed on Bombay Stock Exchange. The panel data set covers a 5-year period from 2007 to 2012. Using panel methodology and OLS as a method of estimation, the results provide evidence of a negative significant relationship between the performance proxy, PM, and board independence as well as chief executive status. The implication of this is that the board chair should better be occupied by same person and the board should consist of smaller proportion of independent members.

Keywords: Corporate Governance, Agency Theory, Stewardship Theory, Board Independence, Chief Executive Status, Firm Performance, India.

1. Introduction

In theoretical context, the two main theories, agency theory and stewardship theory, argue in context to associations between board composition and board leadership structure with firm performance. From an agency theory viewpoint, a supervisory board should be dominated by independent non-executive members so that management could be monitored more effectively. In addition, the post CEO and board chair should also be occupied by different people in sequence to separate operational from control responsibilities. However, from a stewardship theory viewpoint, on the other hand, a supervisory board should be dominated by inside members in line to make effective decisions as insiders are better known about the firm in comparison to outside directors. Moreover, this perspective argues that the CEO and board chairman position should be in one hand (CEO duality), rather than to be separated into two positions (CEO non-duality), because this facilitates clear and strong leadership. However, empirical evidence provides mixed results in the context to the association of board independence and CEO duality with firm performance.

These two corporate governance mechanisms, board independence and chief executive status, and their associations to firm performance is controversial issue in each and every field of economics, finance and organization science literatures in both levels empirical as well as theoretical level. This is due to globalization of economy, privatization, internationalization of capital markets and many more other reasons.

Thus, the aim of this paper is to provide robust evidence regarding the relationship between board independence (and chief executive status) and firm performance.

2. Literature Review

This section discusses the literature review on the corporate governance mechanisms, board independence and chief executive status, and firm performance, where studies on previous works are looked into.

2.1 Chief Executive Status and Firm Performance

CEO- duality has significant impact on firm’s financial performance [Kyereboah-Coleman and Biekpe, 2006; Chugh et al., 2011; Raja and Shah, 2014]. Sridharan and Marsinko (1997) investigated the impact of CEO duality on the market value of the firms. They found that firms having dual CEO shows superior performance in comparison to others in terms of margins and productive utilization of assets which reflects in a higher value of firm. On the contrary, Abdullah (2004) argued that neither board structure nor leadership structure is associated with firm performance. Kyereboah-Coleman and Biekpe (2005) reported that the separation of board chairman and chief executive positively influence the performance of firms. Elsayed (2007) shaded light on the extent to which corporate leadership affects corporate performance. Primary result of his research revealed that corporate leadership structure has no direct impact on corporate performance but, addition analysis found that, when an interaction term between industry type and CEO duality on corporate performance is included in the model, the impact of CEO duality on corporate performance is found to differ across industries. His result supports both agency theory and stewardship theory. Kyereboah-Coleman (2007) recommended clear separation of the positions of CEO and board chair, in the paper, to enhance the performance of corporate entities as they found that combining the positions of CEO and board chair has a negative impact on corporate performance. Ponnu (2008) examined the relationship between CEO duality on firm performance as measured by return on assets (ROA) and return on equity (ROE). The findings showed that there is no significant relationship between corporate governance structures and company performance. Chen et al. (2008) re-examined the relationship between CEO duality and firm performance by using more recent data as well as set methodologies to control variables such as firm characteristics, ownership structure, CEO compensation and agency costs. They found that a trend was going on increased number of firms converting from dual CEO leadership structure to non-dual structure while some smaller firms were converted in opposite direction. They found no significant relationship between CEO duality and firm performance because of possibility that CEO duality is endogenously and optimally determined by the characteristics' of the firms as well as their ownership structure. Their paper contributed new evidence to the important issue of dual vs. non-dual structure of corporate performance. Kajola (2008) showed a positive significant relationship of chief executive status with firm performance and it was recommended in their paper that the board chair should be occupied by different persons. Ramdani and Witteloostuijn (2009) studied the effect of board independence and CEO duality on firm performance. For analysis they used Quantile regression, since it can help to reveal, many uncovering hidden relationships which OLS would leave unidentified. Their application of Quantile Regression revealed about the relationship between corporate governance that, the pair of prominent corporate governance mechanism focused in the study (proportion of independent director and CEO duality) had an effect on firm performance only for firms having average performance, and not on the firms which were below or above par. They found that, the firms which were below or above par were engaged by so much other issues that, marginal contribution of corporate governance was close to zero.

Moving to the more recent studies, Chugh et al. (2011) discerned that CEO-duality creates additional agency costs, and impairs performance and does not create any synergies. Tusiime et al (2011) examined ownership structure, board structure and their relationship with public sector entities' performance in Uganda where corporate governance code is not highly developed. The findings of their study indicated that, CEO duality is not yet an issue as far as the performance of public sector entities in Uganda is concerned. It was found that 67% of the variance in public sector entities' performance is explained by ownership structure and board structure. In addition, evidence has emerged that it is necessary to reduce government ownership in public sector entities in Uganda to achieve better performance. Yasser et al. (2011) found no significant relationship between two performance measures (ROE and PM) and CEO / chairman duality. In a study conducted with reference to Jordanian Banks, Manaseer et al. (2012) concluded that the separation of the role of CEO and chairman shows a negative relationship with performance.

2.2 Board Independence and Firm Performance

By Abdullah (2004), board independence was found negatively related with the firm's leadership structure. Kyereboah-Coleman and Biekpe (2005) concluded that the board composition has a negative impact on firms' performance. In his further study, Kyereboah-Coleman (2007) found that large and independent boards enhance firm value. Krishnan and Bandyopadhyay (2009) investigated relationship between the independency of board of directors and firm performance in Indian context. The results revealed, whether the presence of independent directors truly improves firm performance in India, if not, it would suggest that the firms are better off with the controlling family holding the controls of affairs. Ponnu and Karthigeyan (2010) studied empirically about the effectiveness of the provision for outside or independent directors as provided in the Malaysian Code of Corporate Governance on the governance of Malaysian firms. They conducted their study by monitoring the changes occurred in corporate performance of the sampled firms after including these outside directors. They found that the key provisions which were included in the Malaysian code on Corporate Governance in 2000 for inclusion of outside or independent directors on the board seemed totally unjustifiable and had no positive impact on corporate performance. Hence, obvious issue need to be addressed is to include external factors like economical, political and cultural issues in Malaysia to enhance corporate performance of the companies. Kajola (2008) found no significant relationship between PM and board composition. Chugh et al. (2011) explored that an extremely independent board with a high proportion of independent directors lowers profitability while investigating the relationship between the financial performance and some characteristics of corporate governance for Indian firms. Yasser et al. (2011) reported a positive significant relationship between firm performance and three corporate governance mechanisms (board size, board composition and audit committee). Manaseer et al. (2012) also evidenced a positive relationship between the number of outside directors on board and Jordanian banks' performance. Raja and Shah (2014) for their study depicted that board size, board remuneration, board ownership and the number of independent directors on board have very little impact on the financial performance of a firm

In sum, the available empirical evidence from previously done work have provide a mixed results regarding the association of these two corporate governance mechanisms, namely, board independence and chief executive status, with firm performance.

3. Research Methodology

3.1 Objective of the Study

In the present, we propose to investigate the relationship between two corporate governance mechanisms (board independence and chief executive status) and firm performance (relying profit margin) in India.

3.2 Sample/Research Design

The panel data set covers a 5-year period from 2007 to 2012, with a sample of 26 non- financial firms of BSE 30 index. The banks and the other financial institutions are excluded because of their vast debt structure. The data were taken from the annual reports of these firms.

The study uses regression model to test the relationship between two corporate governance mechanisms (board independence and CEO duality) and firm performance and the method of estimation is Ordinary Least Squares (OLS).

3.3 Model Specification

The economic model used in the study is given as:

$PM = ß_0 + ß_1\ BINDEP + ß_2\ CES + e_{it}$

Where, $ß_0$ is constant; $ß_1$ and $ß_2$ are the coefficients of explanatory variables (corporate governance mechanisms). BINDEP and CES are the two explanatory variables taken in the study and e_{it} is the error term (assumed to have zero mean and independent across time period) with i = 1 to 26 firms and t = 2007-2012. PM (Profit Margin) is the dependent variable used to measure firm performance.

3.4 Variable Description

Table 1a and 1b below show the variables and their descriptions as used in this study.

Table 1a: Dependent variable description

Variable	Description/ measurement
PM = Profit Margin	$\frac{\text{Profit after tax}}{\text{Turnover}}$

Table 1b: Independent variable description

Variable	Description/ measurement
BINDEP = Board independence	Proportion of independent directors sitting on the board.
CES = Chief executive status	Value zero (0) for if the same person occupies the post of the chairman and the chief executive and one (1) for otherwise.

4. Empirical Results and Discussion

4.1. Descriptive Statistics

Table 2 below shows the descriptive statistics of all the variables used in the study.

Table 2: Descriptive Statistics

	PM	BINDEP	CES
Mean	0.5457	0.5142	0.5846
Median	0.154370	0.5	1
Std. Dev.	1.83187	0.10633	0.49469
Range	10.32	0.61	1
Minimum	0.04	0.25	0

Maximum	10.36	0.86	1
Sum	70.94	66.85	76
N Valid	130	130	130
Missing	0	0	0

The mean PM of the sampled firms is about 55%. The proportion of independent directors sitting on board is around 51% in average. The results also indicate that about 59% of the sampled firms have separate persons occupying the posts of the chief executive and the chairman of the board, while remaining 31% of firms have the same person occupying the two posts.

4.2. Regression Results and Discussion

Table 3 present the correlations among variables.

Table 3: Correlations (Pearson) - PM as a firm performance proxy

	PM	BINDEP	CES
PM	1.000	-0.227	-0.239
BCOMP	-0.227	1.000	-0.064
CES	- 0.239	-0.064	1.000
Sig (1-tailed) PM	-	0.005	0.003
BCOMP	0.005	-	0.234
CES	0.003	0.234	-
N PM	130	130	130
BCOMP	130	130	130
CES	130	130	130

Table 3, using the Pearson correlation indicates that PM is negatively correlated with both, the Board independence and chief executive status and the relationship is significant (sig 0.005 & sig 0.003).

Table 4: ANOVA-PM as a dependent variable

Model	Sum of Squares	Df	Mean Square	F	Sig
Regression	50.399	2	25.200	8.367	0.000

Residual	382.490	127	3.012		
Total	432.890	129			

- Predictors: (Constant), chief executive status, Board Independence
- Dependent Variable: Profit Margin

Table 4 shows the analysis of variance (ANOVA) of the variables. With F- value of 8.367 (sig 0.000) for PM as performance proxy respectively, it clearly shows that there is a strong relationship between the dependent variable (PM) and the independent variables (board independence and chief executive status) at 1%, 5% and 10% levels.

Table 5: Coefficient Estimates Dependent Variables

Independent variables	**PM**
BINDEP	-4.1976 [-2.915] *** {0.004}
CES	-0.9443 [-3.051]*** {0.003}
R square	0.116
Adjusted R square	0.103
F Statistics	8.367
Number of observation	130
Durbin Watson	0.495

t- Statistics are shown in the form [ ], while probability shown in the form { }.

*, ** and *** indicate significant at 10%, 5% and 1% respectively.

Table 5 exhibits the results of coefficient estimates. Board independence having coefficient value -4.1976; indicates negative and significant relationship between it and PM at 1%, 5% and 10% levels. And chief executive status with coefficient value -0.9443; also indicates negative and significant relationship between it and PM at 1%, 5% and 10% levels. The value for the F-statistics in Table 5 is 8.367, significant at 1%, 5% & 10% levels which endorse the validity and stability of the model relevant for the study.

The results reveal that the board independence and chief executive status, both, have negative significant relation with PM. The implication of this is that board independence and chief executive status have a negative influence on the financial performance of the sampled firms. It suggests that the firms with lesser proportion of independent directors on their board and having same person occupying the post of chief executive and board chair can perform better in comparison to firms with higher proportion of independent directors on their board and having chief executive post and board chair occupying by separate person.

5. Conclusion

This paper has examined the relationship between board independence, chief executive status and firms' performance of twenty six non-financial firms listed at Bombay Stock Exchange. The main objective of the study was to find board independence and chief executive status affects the performance of the firm where, PM is taken as performance proxy. The findings of this empirical study reveal that the board independence and chief executive status, both, have negative significant relation with PM. It implies that firms with having less proportion on independent members on board and having same person occupying the post of chief executive and board chair perform better in comparison to firms with higher proportion of independent members on board and having chief executive post and board chair occupying by separate person. In sum, the results provide evidence in favour of stewardship theory.

6. Scope for further Research

This study conducted from the data taken from the period 2007-2012. For future considerations this period may be extended to the ten years or above and sample can also be extended to more firms for the evaluation. More profitability ratios can be used to establish a relationship of board independence and chief executive status to firm's performance.

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