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Corporate Governance & the Role of Boards of Directors on Firm's Performance

Umar Mohammed Tela, Sule Ahmadu and Babagana Talba Monguno
Department of Public Administration, Mai Idris Alooma Polytechnic Geidam, Yobe State, Nigeria

Abstract: *The study reviewed and analyzed relevant existing theoretical and empirical literature on corporate governance, board role and their impact on firm's performance. The aim is to contribute to the field of knowledge in the domain of corporate governance. Using a qualitative approach and drawing on relevant multiple-source secondary data, the study concludes that a board consisting of a significant proportion is healthy for a firm, as they will effectively derive the firm to both economic and financial success.*

Key words: *Corporate Governance, Boards of Directors, Firm's Performance*

1. Introduction

There have been increasing concerns, issues and debates over the years on how boards should be structured in order to avoid corporate failures. The increasing concern was brought about due to increasing evidence of scandals, financial turmoil, bubbles and failures that have hit corporate firms over the years. This failure has brought a refreshed need for effective corporate governance monitoring, as put forward in the research work by (Defond and Francis, 2005; cited in Alzoubi and Selmat, 2012). The performance of the board members has been argued to have contributed largely to a number of corporate failures, which has led to much more involvement in research and strategic developments, which seeks best practices for efficient performance in corporations.

Alzoubi and Selmat (2012) provides in their research paper that good corporate governance plays a significant role in helping the board members perform efficiently and conclusively leads to gaining the confidence/trust of its stakeholders. This paper provides brief details on the domain of corporate governance within the role of boards, critically review and analyse both theoretical and empirical papers on corporate governance, board roles/independence and their impacts on firms' performance. A summary of findings was

provided, after generating relevant and reasonable conclusions as to which key recommendations on board independence and firm's performance were provided.

2. Review of Corporate Governance & Theories in the Context of Board Roles/Independence

Corporate governance is "*the system by which companies are directed and controlled*" (Cadbury, 2000: 8). It has been detailed to consist of a bundle of regulations, rulings and guidelines that drive organisations/company's commitment to work in line with their objectives and principles as laid down in the governance code, which includes; the right of the owners of the businesses, fair and equitable treatment of the providers of funds/capital, stakeholder's obligations, accountability, accurate reporting and also the board of director's responsibilities (To Thi, 2011). Scholars over the years have not been able to provide a precise meaning/explanation of the term "Corporate governance", but it has been detailed to be that which is essential, relevant and key in organisations, as it helps in the formulation, facilitation and implementation of strategic decisions (Abu-Tapanjeh, 2008). The board of directors are responsible and accountable for the outcomes/situations that arises in their organisations, this has given rise to the fact that competent, highly skilled, experienced, reputable and success/performance driven individuals should be sitting on the board. Taylor, (2003) puts forward his point of view on some findings, which significantly placed corporate governance in the spotlight. His research detailed on the level of high profile collapses, misappropriation, inflated pay, corruption and other anomalies that have struck big companies over the years, which had its spill-over effect on general public trust and confidence in the market.

A code of best practice for companies was presented in the Cadbury report in the year 1992; this report sets out various recommendations on how corporations should design their governance model in line with best practice. The report made provisions on several issues such as the "separation of ownership and control, nomination of board of directors, outside directors, independence of directors, remuneration, auditor's independence, information flow to directors" etc (Boyd, 1996). While attempting to provide discussion on the roles of the board of directors, it is noteworthy to start such discussion in line with the concept of strategy. However, strategy has been tagged to be a shared frame of reference within the confinement of a corporation, which sets the grounds for setting and establishing the overall objectives of the organisation as per (Noda and Bower, 1996; cited in Hendry and Kiel, 2004). Looking at the strategic role of the board from both the legal and managerial perspective; "*the corporate board's roles entail identifying and communicating the mission, vision and objectives of the business, evaluating and scanning of the environment for opportunities and strengths, observing, reviewing and monitoring of strategy"* (Conforth and Chambers, 2010). There are two schools of thoughts which provided varying perspectives as to board's involvement in strategy, they include the *passive school of thoughts* and also the *active school of thought* as detailed in the research paper put forward by (Golden and Zajac, 2001; cited in Hendry and Kiel, 2004). From the perspective view of the passive schools of thought, boards are defined to be a potent instrument that helps facilitate compliance with the requirements of the company law. The board of directors was held-out to be the essential ingredients that could guide an

organisation for high performance, but there could be the presence of some powers which could militate against effective performance. The viewpoint from this statement is that the decision made by the board members are largely subjectible to management control, most especially where there is an existence of very strong and influential CEO.

The 2nd school of thought (active school) came from a different perspective by submitting that corporate boards are *independent thinkers,* whose decision affects the direction as to which an organisation is going (strategic terrain). The two schools of thought mentioned above have a fundamental basis in some organisational strategic theories, such theories includes the agency theory which has expanded into what is called the "stewardship theory". Others include; the *managerial hegemony theory, resource dependency theory, political theory* etc.

3. Theoretical Perspectives

Board roles must be adequately detailed and well clarified, so as to bring about good corporate governance practice in an organisation, which was put forward by the *Securities and Exchange Commission* through the *Code of Corporate Governance,* which was issued in the year 2002 (Yasser et al., 2011). The roles of the directors as detailed in the code, includes the way and manner a firm should be managed and that it is required by the directors to supervise, delegate to the necessary people (CEO and staffs) the obligation to run the daily operations of the firm. The board of directors is also saddled with the responsibility of attending to issues or affairs relating to appointment, remuneration, reward, monitoring and changing of executives if required. The board of directors are also tasked with the obligation of exercising adequate skill, diligence and care, while carrying out the roles in the firm. Inside conflict, minimised, conflicting interests, misappropriation of funds, misuse of the asset must be avoided in order to achieve the overall goal of the firm, which is to maximise shareholder wealth. The code of conduct that has been put forward largely serves a guiding instrument for directors in driving effective and efficient management (Yasser et al., 2011).

Key corporate governance theories have provided different but encapsulating views to the issue of corporate governance, board independence and performance both from the passive school and active school of thought. The *Managerial Hegemony Theory- usually called a rubber stamp model*, the theory provided arguments in relation to the separation of ownership and control in firms (Ghaya, 2011). The argument put forward here was that, even though the owners of the business or firms are the shareholders, the control of the business should be clearly distinct from those that own it, as they do not control the corporation in an effective and efficient manner. Another argument for the need to put the obligation to "control" in the hands of the management has arisen as a result of the identified weaknesses in shareholders control in corporations over the years, which largely tends to be self-serving in nature; this was put forward in an old paper presented by (Jensen and Meckling, 1976). Evidences from some empirical papers have shown support for the placement of control into the hands of the managements rather than boards. The work of (Mace, 1971; cited in Ghaya, 2011) showed evidence based on a research carried out in the United States, which shows that boards of directors are usually not involved in the control processes in most corporations, they only tend

to come in when it relates to intervening issue in a crisis situation.

The agency theory also came into existence with a view of defining the various relationships, duties, obligations, task and roles that are required of the parties in the agency relationship. The theory also entrenched on the need to effectively distinguish between the ownership and control of firms in order to ensure good performance. The providers of finance or capital are the shareholders (principal), whom secure the services of the others (agents) such as the directors and management to act or perform some duties on their behalf (Clarke, 2004). However, this relationship or dealings is not void or free from conflict, as self imposing motives might creep in, which therefore has a spill-over effect on goal congruence and simultaneous achievement of objectives (Padilla, 2000). The role of the board has been detailed within the context of control to include minimising conflicting interests between the owners of capital and management. The establishment of ownership and control has been argued to necessary in order to effectively protect shareholders from management conflict of interest (Kiel and Nicholson, 2003). This was said to be key as per the minimisation of agency cost and maximisation of shareholder's value.

The resource dependency theoretical proposition basically follows the fact that boards serve and operates as a consultant to the management of the corporation, which is an addition to their central role. This assertion was supported in the work of (Hillman and Dalziel, 2003), when they provided that the board are obliged to perform two roles and that is to control the management and also sources for resources that will make the corporation function effectively thereby leading to high performance. The resource dependency theory also holds that the board should make use of their expertise, knowledge, experience, network and skills to gain access to potential resources, however the work of (Hillman et al., 2009) detailed that boards of directors are inclined into the world of getting resources alone and not doing all they can to ensure that such resources is being used efficiently and effectively.

The *stewardship theory* sees the management team and the executives of the organisations as individuals with integrity, whom will represent the interest of the owners of the business in good faith. In this theory, the top management is being perceived to be good drivers of effectiveness and efficiency, as they will truthfully and faithfully represent the interest of the company.

From the above theoretical perspective, we could infer that the board of directors is obliged to take-up three different roles in a company, which includes the *service role, control role and strategic role*, and the failure or success of their firms will determine on how they have performed their functions and roles. Various perspectives as per board roles and independence has shown mixed outcomes from various research that has been presented, some have shown strong support for boards to be independent and fully take-up the control process of the company, while some have shown no support for board independence. It is preferred that control should either be in the hands of the management or in the hands of the owners of the business (shareholder).

4. Empirical Perspectives

The independence of the board and their impacts on the performance of corporations has been a vital issue in corporate governance over the years. This has led researchers to continually carry out studies in order to uncover the facts, gather relevant information and propose guidelines as to how organisations should structure their boards. However, various suggestions have put forward on how corporations should be governed; board independence in relation to the number of independent directors to be sitting on the board has been one of the key propositions (Lei and Jie, 2011).

The board independence is basically the extent to which the (CEO) and other management staffs are dependent on the independent directors; this could be linked to the monitoring role put forward in the review above on the agency theory. The research carried-out by (Duchin et al., 2010) found significance for board independence as they truly perform their monitoring role and can drive the management to high level of performance which in turns helps increase shareholder value. A high level of support has put forward to support outside directors, as they can effectively pursue the interest of the shareholders, they are financially distinct from management and they tend to drastically reduce the level of management conflicting interest (Rhodes et al., 2000).

There have been some empirical findings on the link between independent directors and firms' performance, this evidence has therefore provided mixed outcomes. While some empirical evidences have found a strong for independent directors and high firms' performance, some have found negative outcomes. The findings in the empirical paper presented by (Kumar and Singh, 2012) provided a relatively strong support for independent directors as they play a significant role in driving companies to high performance. The main findings in this paper showed that having a high proportion of independent directors, whom are giving the free role to perform their obligations will bring about better stock price returns and also good revenue generating. Also the research work of (Ezzamel and Watson, 1993; cited in Kumar and Singh, 2012) which was carried out in the UK, found a positive relationship between outside directors among profitability among UK firms. The field research carried out by (Bhagat and Black, 2000) found both positive and relatively weak links between director's independence and firms' performance in countries based on two grounds, which are the *presence* or *absence* of shareholders' right. This field research was carried out in quite a significant number of firms amounting to 799 in 22 nations. A series of other researches has also found strong positive outcomes, such as the findings in the work of (Weir, Talavera and Muravyev, Nd), which found the same outcome for board independence and firms' performance.

However, a negative relationship was found between outside directors on corporate performance in the empirical paper presented by (Dalton and Daily, 1999). The work of (Yermack, 1996; cited in Bhagat and Black, 2000) also found an inverse relationship between the ratio of outside directors and contemporaneous Tobin's q, and also no degree of association with other performance indicators. The work of Agrawal and Knoeber (1996) was largely consistent with the empirical paper put forward by yermack, but slightly differs as it found no significance between equity value and the number of outside directors sitting on the board. The work of (Erickson et al., 2005; cited in Kumar and Singh, 2012) also uncovered facts

in some Canadian companies that proportion of outside directors do not have any impact on the firm's value. The efficacy of outside directors has also been brought to the limelight due to the presence of some other governance mechanisms that exist in the external environment such as M&As, market dominance and territorial control. The various outcomes and findings from the empirical papers that have been consulted has produced mixed outcomes and the continuous research on the subject matter can be linked to the need to stabilise corporations in terms of their composition and structure in order to reduce the amount of corporate failures.

5. Conclusion and Recommendations

This careful review of the empirical and theoretical papers consulted in this work has provided vital information, perspectives view and facts of which inferences could be drawn from in order to come-up with strong proportions, which will help companies function effectively in order to furnish and maximise shareholder value. It has been found from the review above a board which consist of a significant proportion is healthy for a firm, as they will effectively drive the firm to both economic and financial success. This stand has some strong foundation in it, as the independent board comprises of individuals whom do not have strong ties and affiliation of firms, thereby bringing down to the barest minimum the potentialities for conflict as they have no personal interest in the corporation (Amir and Sajid, 2012). Having independent directors is also a key for corporations most especially when come to getting access to external information and resources, as the internal directors might not have such network to access such information. Also by the virtue of the position held by the inside directors, they tend to be responsible to the Chief Executive Officer for different types of guidance and counsel, as it is implied into their employment functions, however the outside directors are not subjected to such conditions as a fulfilment of their roles and duties in the organisation.

More of the research outcome after reviewing and critically analyse the theoretical and empirical papers, it was discovered that most outcomes of the research on the link/relationship between board independence and firms' performance showed strong relationships, while only a few papers presented a negative outcome. In order for board independence to be effective in corporations, excessive powers must not rest in the hands of the CEO, as it may likely impact on how such a corporation will be managed and controlled. The likely implication for the company is that its board members will not have the final say in terms of its decisions or propositions, as the CEO may either reject or accept such propositions or decisions. Shareholders being the owners of the business do not give rise to the fact that they could effectively control the activities of the corporation, it is somewhat important to note that relying on the shareholders to regulate and control the activities of the organisation might not be the best practice to guide a corporation to high performance.

As a way of recommendation, we will propose a board structure and composition that encourages and calls for more outside directors to sit on the board; this will help accelerate the actualisation of corporate goals. This proposition is centred on the ground that independent directors are usually responsible to the shareholders and they will act in the best interest of the shareholders, as against that of the self interested management. They effectively play the

monitoring role, which will help curb unethical practices, behaviours or dealings in the company, such as the evidence that was shown in the work of (Hwang and Kim, 2009) where it was detailed that the absence of independent directors could give rise to unethical/fraudulent transactions or dealings such as the top management remunerating an under-performing CEO excessively. Therefore, it's worthy to note that having an adequate proportion of independent directors on the board is good for companies, as they serve as a good drive towards maximising shareholder value and in all lead the company to success.

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