Corporate Governance, Board Structure and Firm Value: A Review of Literature

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Abstract

This paper reviews both theoretical and empirical literature on the relationship between board structure and firm value. Focusing on the theoretical literature it provides an overview of the dominant theories on the board structure –firm value debate. The review reveals that although agency and the resource dependency are the main theories, they do not provide a comprehensive explanation of the effect of board structure on firm value. Further, the empirical review shows that documented evidence does not provide conclusive results on the association between corporate governance, board structure and firm value. Additionally, the methodologies adopted in the reviewed empirical studies differ. Further, most of the studies are concentrated in developed and emerging economies while developing countries tend to be lagging behind. In view of the differences in methodologies and the inconclusive evidence, this paper concludes that the debate on the relationship between board structure and firm value is far from over. Consequently, the paper suggests that further studies need to be carried out using more advanced techniques and focusing on developing economies

Keywords: **Corporate governance, firm value, board structure**

1. Introduction

Corporate governance refers to the procedures and processes according to which an organisation is directed and controlled (Organisation for Economic Co-operation and Development [OECD], 2015). Following the collapse of the Enron Corporation in the United States, in 2001, corporate governance has continuously become a topic of discussion not only in financial markets but in academia as well. Consequently, the corporate governance debate has increasingly attracted great interest from both academic scholars and practioners across the globe (Ammann, Oesch & Schmid, 2011). In addition, Claessens and Yurtoglu (2013) concur that this lively debate has dominated discussions in corporate boardrooms, academic meetings, as well as policy circles around the world. Furthermore, Bebchuk and Weisback (2010) agree that interest in corporate governance and its relevance has been rapidly growing, both inside and outside academia. For instance, in academia, the importance of corporate governance is seen in various disciplines as evidenced by many past studies in areas such as, finance, accounting, law and management (Krafft, Qu, Quatraro & Ravix, 2013).

Corporate governance challenges came into focus again in the wake of the global financial crisis in 2008 (OECD, 2011). Ongore and K'Obonyo (2011) concur that many high profile corporate failures, coupled with generally low corporate profits across the globe cast doubts on the effectiveness and credibility of existing corporate governance structures. Further, Capital Markets Authority [CMA] (2014) emphasizes the need for developing countries to establish adequate corporate governance frameworks so as to attract foreign investors, enhance sustainability of their firms as well as cushion themselves against global financial crises.

Policy makers continue to make efforts to enhance corporate governance structures and systems through reviews of existing corporate governance frameworks. Accordingly, Krafft et al. (2013) point out that in an attempt to improve governance structures for listed companies many countries have reviewed their existing corporate governance regulations and guidelines. For instance, in 2015, OECD reviewed its corporate governance framework by adopting G20/OECD Principles of Corporate Governance to replace the existing ones (OECD, 2015). Also, developing countries increasingly recognised that corporate governance is an essential element for their prosperity and economic growth (Kyereboah-Coleman, 2008).

As a result, countries took steps to improve their corporate governance framework. For example, in Kenya, the important role of corporate governance is recognised in the 2010 constitution (CMA, 2014). Empirical research shows that the effect corporate governance on firm value may depend on the firm-level governance characteristics as well as the country in which the study is carried out. In connection, Balasubramanian, Black, and Khanna (2010) suggest that the benefits of particular corporate governance practices may vary depending on firm and country characteristics. In fact, findings from a study by Black, Gledson de Carvalho and Gorga (2009) show that country characteristics influence what aspects of firm-level corporate governance are associated with firm value. Therefore, both firm-specific and country specific contexts are crucial in the corporate governance – firm value debate.

There is a belief that enhancement of firm value is influenced by corporate governance as evidenced by existing studies. In connection, Claessens and Yurtoglu (2013), in a review of corporate governance research in emerging markets indicate that firms with good corporate governance practices benefit from greater access to cheaper financing and higher performance. Besides, Henry (2008) indicates that positive valuation effects from strong corporate governance mechanisms come from risk and cost of capital reduction, effective decision making processes, establishment of suitable incentive structures and lower agency costs. Furthermore, Ammann et al. (2011) established that firms with better corporate governance practices exhibit statistically and economically significant higher values. Similarly, Claessens and Yurtoglu (2013) agree that good corporate governance structures enhance market valuations because better governance practices make firms improve the efficiency of their investment decisions which leads to increased future cash flows distributed to shareholders. Ammann et al. (2011) are of the view that firms should understand corporate governance as an opportunity rather than an obligation.

One of the most important corporate governance mechanisms is the board of directors (OECD, 2015; Claessens & Yurtoglu, 2013). In fact agency theory underscores the importance of the board of directors in mitigating the conflict of interests between shareholders and managers in a firm and there is empirical evidence to this effect. According to Carter Simkins and Simpson (2003), from an agency theory perspective, the role of the board is to resolve agency problems between managers and shareholders by setting compensation and replacing managers that do not create value for the shareholders. Furthermore, proponents of the resource dependency theory acknowledge that directors appointed to a firm's board provide important resources to the firm (Dill, 1981; Masdoor, 2011). In addition, Bebchuk and Weisbach (2010) are in agreement that as a governance mechanism, shareholders elects the board of directors who monitor the work of management on shareholders' behalf.This approach of this paper is to review existing literature on the relationship between the board and firm value. Specifically, it reviews theories that explain the importance of board of directors in a firm and as well as empirical studies that examine the effect of board structure on firm value.

2. Statement of the problem

The debate on board of directors as an important mechanism is evidenced by the increased interest from policy makers, corporate sector and scholars. In connection, capital markets regulators and other stakeholders in the global arena continue to put efforts to enhance corporate governance practices with respect to firms' boards. For instance, in 2015 the OECD replaced its existing corporate governance framework by adopting new principles where the effectiveness of the board plays a very crucial role. Developing countries have also taken steps to make sure the corporate governance frameworks with respect to boards of directors are effective. Consequently, it is important to investigate whether the efforts being made are bearing fruits by assessing firm value contribution from boards of directors.

Furthermore, the importance of the board as a corporate governance mechanism that enhances firm value is supported by the increased documented research in this area. Although, debate on the relationship between board structure and firm value effect is on-going, there has been no conclusive evidence from literature to date (Cunat, Gine& Guadalupe, 2012). While some studies reported a positive relationship, others reported a negative association between the board of directors and firm value. On the contrary other studies found no relationship. Furthermore, among the corporate governance theories, no single theory can fully explain the relationship between firm value and board structure. On the other hand, empirical literature does not provide consistent results. Existing evidence on board structure and firm value tend to be concentrated in developed economies and emerging economies while research in developing countries is limited.

Further, different methodologies have been adopted ranging from Ordinary Least Squares (OLS) to advanced techniques such as Generalized Method of Moments (GMM). Despite, all these efforts from scholars, there seems to be mixed results. Consequently, the inconclusive evidence from existing literature points to the need to investigate the board structure and firm value association so as to provide direction for further research. In connection, this paper seeks to provide more insights on board structure as an important corporate governance mechanism and its effect on firm value.

3. Objectives

The objectives of this paper are

i) To review both theoretical and empirical literature on board structure and firm value
ii) To establish research gaps to be filled by further research

4. Theoretical review

a) Agency theory

Agency theory supports the importance of board of directors in the corporate governance debate. Borlea and Achim (2013) define agency theory as the study of the agency relationship between firm owners and managers and the issues that arise from that relationship. This theory forms the basis of the debate on corporate governance which revolves around the separation of ownership and control in a firm associated with the works of Berle and Means (1932). Subsequent developments in this theory are associated with economists in early 1970s whose research focused on how individuals share risks (Eisenhardt, 1989). Specifically, Ross (1973) introduced the economic theory of agency by arguing that proper compensation schemes can be used to align the interests of agents with those of the principal.

Mitnick (1973) identified three aspects of the agency problems which are motivation of the agent, agent's decision making process and use of policing mechanism and incentives to align the agent's interests with those of the principal. Jensen and Meckling (1976) explained that the conflict between interests of shareholder and managers arise because managers tend to focus on their own self-interests. In fact, Eisenhardt (1989) points out that agency theory assumes that agents are likely to act in their own self-interest. The separation of ownership and control has been recognized as the main cause of the agency problem (Jensen &Meckling, 1976;Kyereboah-Coleman, 2008).

The assumptions underlying this theory form the basis of corporate governance frameworks that focus on boards of directors. In fact, Yusoff and Alhaji (2012) underline that various governance mechanisms discussed by agency theorists revolve around protection of shareholder interests, reduction of agency costs and motivating managers to acts in shareholders' interests. The board of directors is put in place to provide oversight over a firm's operations and ensure that managers act in shareholders' best interests (Jensen &Meckling, 1976). Furthermore, Tornyeva and Wereko (2012) maintain that the board plays a very important governance function by monitoring actions of managers.

b. Resource dependency theory

This theory is associated with Pfeffer and Salancik (1978) who focused on the benefits a firm derives by virtue of its linkages with external parties. In connection, Dill (1981) explains that the proponents of this theory were mainly concerned with the extent to which firms rely on outsiders for provision of resources that contribute to the success of the firm. Additionally, Borlea and Achim (2013) argue that this theory offers an explanation to the complex character of network relationships that are typical of corporate governance relationships. Furthermore, Kyereboah-Coleman (2008) indicates that this theory introduces accessibility to resources by firms, as a critical dimension to the debate on corporate governance. Similarly, this view is supported by Masdoor (2011) and Wanyama and Olweny (2013) who point out that the resource dependency theory explains the role of board of directors in ensuring that management access the resources they require to run firms successfully.

Further, Nguyen et al. (2014) arguing from a resource dependency theory perspective emphasize that a firm's board of directors provides an avenue for it to access crucial resources. Yusoff and Alhaji (2012) point out that this theory explains the importance of board as a resource for the firm. Therefore, the role of a firm's board is wider and it goes beyond the traditional control responsibility stipulated by the agency theory (Yusoff&Alhaji, 2012).

Kyereboah-Coleman (2008) agrees that this theory helps to explain the importance of a firm's presence on the boards of other companies to establish networks that provide important access to beneficial information resources to the firm. Moreover, Nguyen et al. (2014), point out that this theory explains the positive relationship between board diversity and firm value.

5. Empirical review

The board of directors is an important governance mechanism (Claessens &Yurtoglu, 2013; OECD, 2015). And this is evidenced by the empirical studies examining the relationship between boards and firm value. Consequently, there are studies that focused on the overall board structure while others focused on some aspects of the board such as board independence, size, composition, committees and leadership. Some of these studies reported a significant relationship between board structure and firm value while others document mixed results. For instance, in their Kenyan study, Ongore and K'Obonyo (2011) found the role of boards to be of very little value, mainly due to lack of adherence to board member selection criteria. In a study of Malaysian listed companies, Yusoff and Alhaji (2012) used three corporate governance components, that is, proportion of non-executive directors, board leadership structure, and board size. The findings from their study based on data from 2009 to 2011 showed that some board aspects had a positive effect on firm performance while others have no effect.

Furthermore, in a study of 9 ADR issuing emerging markets, Ficici and Aybar (2012) used an OLS model to examine the impact of corporate governance structures on firm value. While their corporate governance index based study found a positive relationship between corporate governance and value their results also show that increase in board and management process scores cause value to decline. Wintoki, Linck and Netter (2012) used the dynamic panel GMM approach examined the effect of board structure on firm performance and found no causal relationship between board structure and firm performance. Besides, focusing on the overall board structure, other studies have examined certain aspects of the board.

One of the aspects of board structure that is considered very important if a board is to be effective in safeguarding shareholders' interests is independence (Carter et al., 2003). Consequently, there are studies that investigate the effect of board independence on firm value and performance. While some report a positive relationship others document a negative or no association between board independence and firm value and performance. For instance, Rouf (2011) used an OLS model to study the relationship between board characteristics in Bangladesh. This study based on cross-sectional data reported a positive relationship between board independence and firm value as measured by ROA and ROE. Nyamongo and Temesgen (2013), in a panel study of 37 commercial banks in Kenya, found a positive relationship between board independence and performance measured by ROA and ROE. Their study data scope was from 2005-2009 and they used fixed effects and pooled regression models.

Furthermore, Kyereboah-Coleman (2008) used the generalized method of moments (GMM) to study the effect of board characteristics on firm performance in Ghana, Kenya, Nigeria and South Africa. He used a questionnaire to collect data from the 103 sampled firms in the four countries. His findings show that board independence enhances firm value. In a study of listed banks in Turkey, B. Dincer and Dincer (2013), found a positive relationship between director independence and performance as measured by ROA and ROE. A study in Korea by Black Jang and Kim (2006) shows that greater board independence causally predicts higher share prices in emerging markets. Additionally, Tornyeva and Werko (2012) studied insurance firms in Ghana using questionnaire collected data and found that board independence has a positive association with financial performance.

On the other hand some studies report a negative relationship between independence and firm value and performance while others indicate no relationship. In a study of private Brazilian firms, Black et al. (2009) and Black et al. (2010) constructed a broad corporate governance index to determine what corporate governance elements predict value. They found a negative association between board independence and firm value. Also Bhagat and Bolton (2008) report a negative relationship between board independence and subsequent operating performance. In their study of 263 firms in Canada, Klein et al. (2005) found that although board independence was the most heavily weighted provision it had no positive effect on firm performance. In a study of 62 Nigerian listed manufacturing firms, Babatunde and Olaniran (2009) collected data from annual reports for the period 2002-2006. They used an OLS model with ROA as the measure of firm performance. Their findings do not report significant evidence that presence of outside directors enhance firm performance.

On the impact of board size on firm performance, some studies report evidence of a positive relationship between board size and firm performance. Beiner et al. (2006) studied 109 listed firms at the Swiss Exchange and found a positive relationship between board size and value. Amran and Ahmad (2009) found that board size contributes positively towards better performance in non-family firms. Tornyeva and Werko (2012) found that large board sizes are positively associated with financial performance of insurance firms in Ghana. Similarly, Kyreboah-Coleman (2008) found that large boards lead to greater firm value.

However, other studies report a negative relationship between board size and performance. In a study of Turkish banks, B. Dincer and Dincer (2013) used regression analysis to examine the relationship between corporate governance and firm value. Their 2003-2009 data based study found that board size is negatively related to both firm profitability and valuation. In their study on Kenyan commercial banks Nyamongo and Temesgen (2013) reported that a large board size had a negative impact on performance. The study by Wanyama and Olweny (2013) found a negative relationship between board size and performance of listed insurance firms in Kenya. Their study used OLS model based on questionnaire collected data and performance was measured by ROA and ROE. In a study in Bangladesh, Rouf (2011) found no significant relationship between board size and performance.

Board composition has also been found to influence firm value. Carter et al. (2003) studied 638 from the listed Fortune 1000 firms in the USA and found a positive relationship between board diversity and value. Further, their study shows a significant positive relationship between the fraction of women or minorities on the board and firm value. Also, Black et al. (2006) in their Korean, study report a strong connection between board composition and share price. In a study of 2 Kenyan listed insurance firms, Wanyama and Olweny (2013) used a questionnaire to collect data. The study based on an OLS model found that board composition is positively related to performance. However, Sanda, Mikailu and Garba (2005) did not find evidence to support the idea that boards with higher proportion of outside directors perform better than other firms in Nigeria. In their Kenyan study of commercial banks, Wachudi and Mboya (2012) used stepwise regression to examine the effect of gender diversity and firm performance. Their results indicate that board diversity has no effect on performance.

Studies relating to the existence and effectiveness of audit committees in boards show mixed results on influence of audit committees on firm value. Kyereboah-Coleman (2008) found that the size of audit committees and the frequency of their meetings have a positive effect on market based performance. Similarly, Tornyeva and Werko (2012) found board audit committee size to be positively related to financial performance. Rouf (2011) found no significant relationship between board audit committee and firm performance as measured by Return on Equity (ROE) and Return on Assets (ROA).

Board leadership affects the effectiveness of the overall board functions. Findings from studies focusing on CEO duality and its effect on firm value are mixed. According to Larcker, Richardson, Tuna, (2007), CEO duality has an effect on board independence and consequently on firm value. A dual CEO-chairperson in a firm tends to erode the independence of the board and therefore negatively affect value creation. Therefore, the separation of the board chairman and CEO position is believed to lead to greater transparency of corporate information, improved internal governance structures and better firm performance. On one hand this proposition is supported by prior studies such as Bhagat and Bolton (2008) who found that CEO-Chair separation is significantly positively correlated with better contemporaneous and subsequent operating performance. Similarly, in a study of four African countries, Kyereboah-Coleman (2008) found that combining the position of CEO and board chair has a negative effect on the firm performance.

On the other hand Rouf (2011) found a positive relationship between CEO duality and firm performance. In their Kenyan study, Nyamongo and Temesgen (2013) found that CEO duality has no effect on performance of commercial banks. The role of the CEO in a firm has also been a subject of concern in corporate governance-firm value studies. Tornyeva and Werko (2012) and Kyereboah-Coleman (2008) found that CEO tenor has a positive effect on firm performance while Sanda et al. (2005) found that firms ran by expatriates tend to achieve higher levels of performance than those ran by indigenous CEOs.

6. Discussion of Findings

The review of literature provided in this paper shows that although there are many theories associate with corporate governance, those that dominate the board structure and firm value debate are two. These are agency and resource dependency theory.

Although agency theory advocates for the importance of a board in the representing shareholders' interests it does not fully provide a solution to the conflict of interest managers and all stakeholders. Similarly, the resource dependence theory shows that directors appointed to firm's board provide very crucial resources to the firm. However, the resource dependency theory does not provide a solution to the conflict of interests that exist in a firm's environment.

From the review of empirical literature, documented evidence tends to focus on individual aspects of board structure such as independence, leadership, size, diversity and composition. On the other hand, studies focusing on the overall board structure are scanty. Furthermore, the review shows that most of the past studies done in this area have focused on the developed and emerging economies while research in developing countries remains limited. Additionally, the available literature on the developing countries, indicate that studies focus on individual board structure components unlike the case of developed countries where the focus is on the overall board structure.

On the measure of firm value, Tobin's Q is evidently the most frequently used proxy for firm value, although other studies used measures such as the return on assets (ROA), return on equity (ROE) and dividend yield. Besides board structure, other firm specific factors such as firm size, risk, leverage, age, profitability, listing status and industry have been used as control variables in some studies. This shows that there are other firm characteristics that may influence firm value and may also affect the board's contribution in value creation. However, studies did not consider the effect of control variables.

Another dimension revealed in this paper's review is the study context. While some studies focus on corporate governance, board structure and firm value in individual countries, others have focused on firms in different countries. Therefore, existing empirical evidence comprises of single country studies and cross country studies. In connection, some studies concentrated on listed firms only while others included both listed and unlisted firms in their investigations. This shows that the importance of firm-specific and country-specific factors in the board structure –firm value relationship was recognized.

On the methodology, the study reveals that studies have used varied techniques. For instance, on data, most of the studies tend to use cross-sectional data while the use of panel data is scanty especially in developing countries. For the cross-sectional studies, primary data was collected either through questionnaires while others used secondary data from annual reports. On research design, some studies have used the basic descriptive design while others are causal studies. Similarly, the review shows that different data analysis approaches have been employed. Consequently, this review shows that regression techniques such as the OLS, Two Stage Least Squares (2SLS), Three Stage Least Squares (3SLS) and GMM have been used in existing empirical literature. With advanced regression techniques such as GMM, the studies addressed endogeneity concerns as well as dynamic nature of the relationship between firm value and boar structure.

7. Conclusions

A review of both theoretical and empirical literature shows that there are gaps which can be filled by further research. The theoretical review shows that the agency and resource dependency theories provide support for the crucial role that board of directors play in minimizing the agency problem and providing crucial resources to the firm. However, none of the theories provide a solution to the conflict of interests that exist in a firm's environment. For instance, while agency theory seems to dominate the discussion on board structure and firm value, it does focuses only on the shareholders' interests and value. On the other hand, the resource dependency theory shows that directors provide very important resources to firms, but it does not provide a solution for the conflict of interest between managers and stakeholders. Therefore, individually, these theories do not seem to fully explain the effect of board structure on firm value. Subsequently, further studies should consider the combination of both theories in order to understand the association between board structure and firm value.

Although there is a large volume of published empirical research examining the relationship between firm board structure and firm value, there is no conclusive evidence documented. This implies that the debate on the board structure as an important corporate governance mechanism that influences firm value is far from over. Furthermore, there are methodological inconsistencies which point to the need for further research in this area. Consequently, arising from the gaps in existing studies, this paper suggests further areas of research.

For instance, given that board aspects such as independence, size, diversity and composition are complimentary and contribute to a board's effectiveness, studies could attempt to capture all the board structure components, through the use of an index.

Furthermore, studies could adopt more advanced regression techniques such as GMM which takes of endogeneity issues and dynamic nature of the relationship between board structure and firm value. Also, further research could employ panel data models which document consider individual and time specific effects in the relationship between board structure and firm value.

Additionally, studies could be done focusing on developing countries to shed light on the country specific factors and their role in determining the association between board structure and firm value. This may provide new evidence compared to the existing empirical literature. Generation of more consistent and possibly more reliable results will provide policy direction in this important and contemporary issue which continues to dominate in boardroom, policy and academic circles in the global arena.

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