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The Effect of Board Size and Structure on Firm Financial Performance: A Case of Banking Sector in Pakistan

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Abstract: A board of directors, in today corporate world, assumed responsibility for devising corporate strategy, evaluating managerial performance, providing strategic direction, putting corporate governance policies in place and ensuring an adequate return for the shareholders. Consequently, board was transformed into a powerful centre of authority and played decisive role in firm performance. Therefore, the entire thrust of corporate governance shifted on dynamics and demographics of board i-e size and structure. This study empirically investigated the role of board in firm performance in banking sector of Pakistan for the period 2007-2011 by using annual secondary panel data. The study tested the likely impact of different determinants of board size and structure (Number of Directors, Inclusion of Non-Executive Directors, Presence of Women Directors, CEO Duality and Number of Board Committees) on firm financial performance using linear regression technique. The estimated results revealed positive relationship between number of directors, inclusion of non-executive directors, presence of women directors, CEO duality and firm financial performance. But the number of board committees adversely affected the firm financial performance.

Key words: Board of Directors % Corporate Governance % Firm Financial Performance

INTRODUCTION

During the last two decades, new and stricter requirement for corporations in form of disclosure, transparency, surveillance and formalization caused a paradigm shift in world economy. Consequently, capital markets across the world underwent essential changes to cater to these new requirements. Restructured and reorganized capital markets required corporations address corporate governance concerns without choice. Better corporate governance helped corporations grow quickly, attract higher capital and earn superior returns.

Different corporate scams across the world ranging from Enron, WorldCom to Tyco International highlighted the ineffective role of boards in governing a corporation and precipitated the active role of an effective, powerful and balanced board [1]. Many other developments on corporate landscape helped firms to accept the renewed role of board. Below-average performance of the firms caused dissatisfaction among shareholders who raised their voice against incompetent and inefficient boards.

The number of institutional investors increased extraordinarily in form of Banking Institutions and Non-Banking Financial Institutions that exploited the role of board with their professional acumen and helped firms achieve above-average performance. Corporations themselves recognized the effective role of board in attracting higher investment and providing superior returns to shareholders in the long-run. Corporations acknowledged the fundamental role of good governance in encouraging growth of corporate sector [1].

Like other countries of the world, Pakistan has also been facing different corporate governance challenges. Inter alia, the board did not discharge its duties as per letter and spirit. Improper size and inappropriate structure of the board prevented it from performing its prescribed role. Moreover, ownership structure also caused serious setback for corporate governance in Pakistan. Family Owned Businesses resisted strongly against the inclusion of Outside Directors in board. They thought that ceding control would challenge their authority and personal

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interests. A comparative study conducted in Pakistan to measure the financial performance of Family Owned Businesses and Non-Family Businesses revealed that firms owned by different families had low transparency and weaker corporate governance compared to firms of non-business groups. Consequently external shareholders had lower interest and value for the firms of business groups [2].

In 1999, Corporate Law Authority (CLA) was established to look after corporate affairs in Pakistan which was later on, in 2001, replaced with Securities and Exchange Commission of Pakistan (SECP). SECP immediately started building capacity of corporate sector to meet emerging corporate governance challenges. In December 1998, the Institute of Chartered Accountants of Pakistan (ICAP) along with the Institute of Cost and Management Accountants of Pakistan (ICAMP), Securities and Exchange Commission of Pakistan (SECP) started to develop Corporate Governance Framework in Pakistan.

On March 28, 2002, SECP issued Code for implementing and promoting Corporate Governance in Pakistan. The Code was designed to guide and help corporations manage their affairs in line with promulgated law and prevailing best practices. This Code learnt from experience of different countries and included best practices of the Cadbury Committee (U.K.), Hampel Committee (U.K.), King's Report (South Africa) and OECD Principles, 1999[3].

Board of directors is a principal policy making institution of a corporation and plays fundamental role in implementing governance by supervising management, controlling agency costs [4], selecting top management [5] providing adequate resources [6] to strategizing for the firm [7]. Research work on corporate governance till date recognized the increasing importance of boards overwhelmingly. An independent and balanced board played dynamic and effective role in firm performance by bridging the gap between firm and its environment to capitalize on opportunities. Boards continuously monitored the working of management and thus boosted the firm performance.

Corporate Governance in Banking Sector of Pakistan: Banks played pivotal role in reshaping economy of a country by mobilizing necessary funds for businesses and helped in generating employment, promoting economic activity, improving corporate governance and consequently fostering economic growth. Therefore, well-governed banking sector would help businesses flourish and poorly governed banking sector would retard progress [8].

Being the chief regulator of banking sector in Pakistan, State Bank of Pakistan (SBP) closely monitored the corporate governance state of affairs through implementation of Banking Companies Ordinance, 1962. SBP issued Fit and Proper Test (FPT) for ensuring independence and professional competence of directors and top management of banks. SBP also issued a comprehensive handbook of corporate governance containing guidelines to banks for establishing and improving corporate governance. This handbook provided information on primary instruments for sound corporate governance and shared global developments on best practices of different areas in corporate governance like board of directors, management, audit committee, internal and external audit functions, financial reporting procedure, business ethics and stakeholders.

Currently, banking sector in Pakistan consisted of thirty eight banks. Total branches were 9838 by June 30, 2012 against 9,291 Real Time Online Branches with 5745 ATMs,1231 Credit Cards and 15984 Debit Cards. Total assets of banks stood Rs 8179.667 billion against the liabilities of 7392.659 billion with Non Performing Loans of Rs 634.8 billion. Total number of employees working for banking sector in Pakistan as on June 30, 2013 was 148,717 [9].

Profitability of banking sector squeezed as net income increased by 7.1% in 2012 against 43.6% in 2011 (based on sample of 13 large and mid-size banks). “Big 5” Banks* collectively registered meager increase of 4.9% to Rs 89bn from Rs 85bn in 2011. While the earnings of “Mid-Tier” Banks** went up by 23.3%. Aggregate deposits of banking sector grew by 16.9% to Rs 5,884bn in 2012 against total advances of Rs 3,038bn registering an increase of 13.2%. Investments flourished by significant margin of 30.6% to Rs 3,188bn in 2012. Non-performing loans (NPLs) of banking sector swelled to Rs 249bn in outgoing year of 2012. Non-interest income also surged to Rs80bn from Rs 31bn during last year [9]. List of Big 5 and Mid-Tier banks is provided below along with their financial health;

Sr. No	* Big 5 Banks	** Mid-Tier Banks
1.	Allied Bank Limited (ABL)	Askari Bank Limited (AKBL)
2.	! Habib Bank Limited (HBL)	! Bank Al Habib Limited (BAHL)
3.	! MCB Bank Limited (MCB)	! Bank Alfalah Limited (BAFL)
4.	! National Bank of Pakistan (NBP)	! Faysal Bank Limited (FABL)
5.	! United Bank Limited (UBL)	! Habib Metropolitan Bank Limited (HMBL)
6.		! NIB Bank Limited (NIB)
7.		! Soneri Bank Limited (SNBL)
8.		! Summit Bank Limited (SMBL)

Mid-Tier Banks list was subject to availability of financial accounts by March 19, 2013.

Profitability Snapshot	* Big 5 Banks		** Mid-Tier Banks	
Indicators	2012 (Rs Million)	YoY Change	2012 (Rs Million)	YoY Change
Net Interest Income	199,211	6.2%	68,468	3.6%
Non-Interest Income	79, 888	29.1%	30, 762	23.0%
Profit After Tax	89, 142	4.9%	14, 492	23.3%
Return on Equity	18.2%	1.6%	10.0%	0.8%
Advances/Deposits Ratio	50.6%	2.2%	53.7%	0.4%
Non-Performing Loans (NPL)	248, 555	2.3%	163, 944	7.2%
Investments/Deposits Ratio	53.8%	7.9%	54.9%	1.3%
Cost/Income Ratio	43.7%	4.3%	63.5%	0.2%

Source: Banks' Financial Statements

Literature Review: In business organizations, the role of board has always been defining and versatile in nature. Different scholars studied the role and effect of board from different aspects. This paper investigated the effect of size and structure of the board on performance of the firm. Different theories of corporate governance discussed the dynamics of relationship between different characteristics of the board and firm financial performance. Agency Theory, [10] termed separation of management (agent) from ownership (principal) against the owners' interests [11]. Agents worked for their self-interest disregarding shareholders' concerns [12]. Managers comfortably expropriated the interests of shareholders precipitating the need for strong supervision and tight control by the board [11]. Consequently agency perspective favoured inclusion of Non-Executive Directors (NED) in board and separate persons for Chairman and CEO.

Stewardship Perspective [13] considered agents (directors and managers) as trust-worthy and watchful steward of the resources and argued that stewards worked in the larger interest of the organization. As the organization performance improved, consequently, stewards benefited from this superior performance and were rewarded with different incentives. This theory favoured powerful stewards for earning higher financial gains for the firm and therefore recommended Executive-Directors on the board. Likewise, it recommended same CEO and Chairman as it provided unity of command.

Resource Dependence Perspective [14] treated directors as a source of strength for the firm [15]. Resource Dependence theory viewed board helpful for firms in scanning resources from external environment and bringing them to firm. So the outside directors played important role [16]. Outside directors possessed essential information, skill and developed liaison with different stakeholders [15]. Resource Dependence theory favoured the representation of Outside Directors on the board. One study confirmed that Outside Directors were elected to reinvigorate the firm performing below average [17].

Stakeholder Perspective [15] contrary to Agency Perspective, required directors to take care of all the diverse stakeholders [18]. This perspective argued that stakeholder might range from employees, managers, customers, creditors, community, government, regulators to business partners and even include environment, coming generations and other than human species [19]. However, majority of firms simultaneously worked for maximizing shareholders' value and safeguarding interests of other stakeholders. So organization needed board with combination of Executive and Non-Executive Directors. Nonetheless [18] termed stakeholder view as a better model for shared purpose of firm.

Literature suggested that participation of board in strategic decision making varied from minimum and indirect to direct and maximum [20]. But, now researchers recommended more dynamic role for boards in formulating strategy [6]. OECD principles supported vibrant role of boards in strategy paradigm for making real difference in protecting the interests of diverse stakeholders [21].

A significant number of studies substantiated the productive role of board in performance of the firm. These studies investigated different aspects of board like size, composition and other characteristics and their impact on performance of the firm and failed to give final verdict. For example, studies conducted by [22] could not endorse affirmative relationship between different dynamics of the board and performance experienced by the firm. On the other side, some studies approved significant relationship of different board dynamics and firm performance [23].

However, most of the studies found that of the board played key role in firm working [24].Apt number of directors remained a matter of debate among the corporate governance circles. Some studies recommend small number of directors for representing board [25]. Some studies recommend small size board for preventing loafing and free-riding [26]. A study conducted by Jensen also supported undersized boards for prompt decision making, closer coordination and lesser communication gap [27]. Another study studied that small boards earned above-average returns for the firm as compared with the larger boards [25].

Some studies recommended bigger boards for improving performance of the firm. Larger boards were recommended for closer and regular monitoring, greater and timely advice. Some opined that Twelve (12) directors would be able to play constructive and fruitful role by providing margin for greater number of board committees. Some studied that when the number of directors on the board surpassed seven or eight, they lost their control over management and consequently CEO dominated. Similarly Code of Corporate Governance in Pakistan, 2012 recommended at least seven directors for public listed company [28]. A survey conducted in Pakistan revealed that 82% of organizations had 7 to 10 directors [29].

The structure of the board included Presence of Outside Directors, Presence of Women, CEO Duality and Number of Board Committees. Some research studies pointed out affirmative relationship between Presence of outside directors and efficiency of the firm. Some observed that the boards with higher percentage of outside directors resulted in abnormal profits for the firm [30]. Another study observed that more number of Non-Executive Directors added to performance significantly [31]. A research study conducted on declining firms revealed that all the firms had higher proportion of Executive Directors [32]. Some studied confirmed in their study that composition of the board affected the financial position of firm considerably [33]. They further found that boards with greater number of Non-Executive Directors witnessed superior returns than boards with smaller number of outside directors. This study concluded that skills and knowledge of the outside directors made visible difference to performance of the firm [23].

On the other hand, some research studies portrayed inverse relationship between the presence of outside directors and firm performance. There are also some research studies that observed no relationship between Non-Executive Directors and performance of the firm. Some studies did not find any relationship between Presence of Non-Executive Directors on board and performance of the firm [34]. Some researches [35] could not determine any association between presence of Non-Executive Directors and efficiency of the firm in his study. Code of Corporate Governance 2012, in Pakistan appreciated to have a combination of inside and outside directors and recommended that they should have the necessary skills, knowledge and experience [28].

For better performance, board also required balance with respect to gender. Boards should have right blend of gender to portray different perspectives. The representation of women on boards across the corporate world was very low. Like percentage of women directors in United States is just 12.4 percent. The proportion of women directors in United Kingdom is more abysmal of 6.4 percent. In Canada, the situation is even worse and this percentage is less than five.

Different studies examined the effect of presence of women directors on performance of the firm. Some observed an affirmative relationship between Presence of Women Directors and firm performance [36]. Some studies identified positive relationship between gender diversity and efficiency of the firm [23]. According to one study, eighty six (86) per cent firm treated women as a significant factor for performance of the firm. Women were likely to possess some better managerial skills related to law, human resources management, communications skills and public relationships as compared to men. Moreover, the study confirmed that presence of women on board affected business positively as they were better at buying decisions as compared to men" [37]. Another study observed that presence of women on the boards contributed to performance of the firm positively. On the other hand, some studies could not confirm any noteworthy association between presence of women directors on the board and performance of the firm [38].

Board leadership is one of the most important mean of structuring a board. Leadership of the board rests either with chairman or CEO. Dual leadership or combined leadership structure of board is where CEO occupies both positions i-e CEO as well as the chairman [39]. Separate leadership structure is one where chairman and CEO are different persons.

Different studies had different findings regarding relationship of board leadership and firm performance. A study observed that firms practicing combined leadership witnessed above-average performance for shareholder calculated through return on equity. Some studies recommended separation of Chairman and CEO for better performance [40]. Boards with separate chairman were considered independent, capable of strong oversight. Some empirical studies [41] found no connection between separate leadership and firm performance of the firm while a study found an affirmative association between separate leadership of the board and firm performance. Some studies pointed out that same CEO and chairman helped the firm achieve higher performance.

Code of Corporate Governance 2012 in Pakistan strongly rejected combined leadership structure of the board [28]. A survey conducted in Pakistan also recommended separate CEO and Chairman of the Board [29]. Another survey conducted in Pakistan by Pakistan Institute of Corporate Governance also supported Separate Leadership Structure.

Another important mechanism of structuring a board is constitution of different committees. Board committees provided professional prudence and wisdom to oversee the management initiatives for protecting interests of diverse shareholders. Business world acknowledged the very significance and usefulness of board committees. One study reported that shareholders had greater trust in boards which had different committees to handle different issues. This study further advised that boards should disclose these committees to the investors [42].

Another study observed that presence of independent audit committee improved the quality of financial statements [43]. This study by reported that board committees also balanced the power of CEO and strengthened the supervision and evaluation function of the board. Board committees also removed the CEO if firm was performing poor continuously. Accordingly, board committees were considered important mechanism of check and balance for keeping firm performance on track.

Code of Corporate Governance 2012 in Pakistan recommended Audit Committee and Human Resource and Remuneration Committee for the board [28]. This code further recommended majority of Non-Executive Directors for these committees of boards. A survey conducted in Pakistan recommended audit committee, Nomination Committee and Human Resource and Remuneration Committee for board [29].

Conceptual Framework: During the previous decade, many empirical studies were conducted to determine relationship between size and structure of the board on performance of the firm [44]. In past, many studies observed direct relationship between board variables and firm performance.

Following figure 1 provided the theoretical or conceptual framework of this study on the basis of discussion of different theories of corporate governance and review of past studies. On the one side (left), different characteristics of the board which comprised of five variables namely, Number of Directors, Presence of Non-Executive Directors, Presence of Women Directors, CEO duality and Number of Board Committees are given. On the other side (right), Return on Assets (RoA) which measured financial performance of the firm is provided.

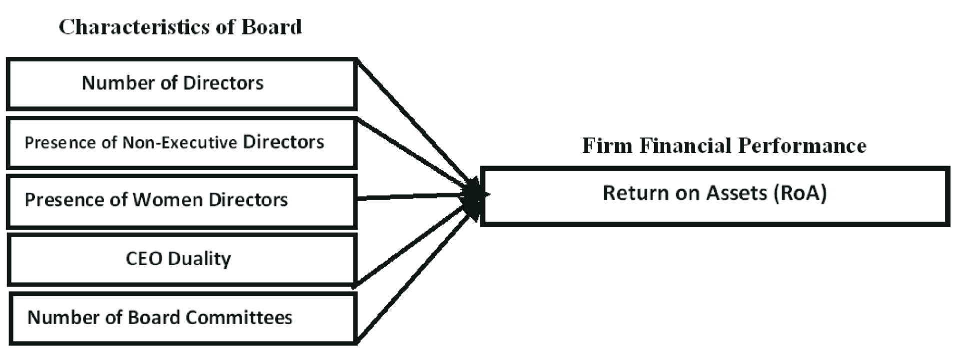

Fig. 1: Relationship between Board Characteristics and Firm Financial Performance

MATERIALS AND METHODS

This study attempted to explore the relationship between different characteristics of the board and firm financial performance. This study used quantitative approach which employed survey of annual reports. Burns and Grove described quantitative approach as a formal and systematic process to testify association relationship among the variables.

Sample Selection and Data Collection: For this study, convenience sampling was used and thirty (30) out of total thirty eight (38) banks were selected on basis of availability of annual reports for 2007-2011. However, the selected banks were leading performers and were more likely to engage competent and efficient professionals on the board. These banks had easier and greater access to capital and other resources needed for growth and long run survival. Annual reports for the five years 2007 to 2011 were downloaded and data was compiled for all variables. In case of discrepancy, websites of the selected banks were also accessed and data was confirmed. For eight banks (8), either annual reports or required information on selected variable was not available at the time of collection.

Variables and Model:In this study, Number of Directors (NoD) Presence of Non-Executive Director (NED), CEO Duality (CD), Presence of Women Director (WD) on the board and Number of Board Committees (CoB) were Independent Variables. For measuring financial performance, different researchers used different financial measures: for example some studies used Tobin's Q, Return on Investment (RoI), Return on Assets (RoA), Sales Revenue, Return on Equity (RoE), Stock Returns, Earnings Per Share (EPS), Net Profit Margin and Economic Value Added.

In this research, Return on Assets (ROA) is used for measuring firm financial performance. Many studies used Return on Assets for analyzing firm performance [45, 1]. Return on Assets (ROA) reflected the return earned with the firm available resources (Assets). Agency theory explained that managers usually misappropriated profits and other resources and paid lower returns to shareholders. Return on Assets (ROA) manifested the management capacity and capability to utilize the firm assets efficiently and effectively. A lower rate of return on assets would reflect inefficiency of the firm management. Moreover, some observed that ROA also helped in measuring Tobin's Q and firm value [36]. For all these logical reasons, Return on Assets was selected as an appropriate measure for firm performance.

Following regression model was estimated in this study:

$$RoA = \$_0 + \$_1 NoD + \$_2 NED + \$_3 WD + \$_4 CD + \$_5 NoBC$$

Where:
RoA= Ratio of EBIT/Total Assets
$\$_1$NoD= Total Number of Directors on the board
$\$_2$NED=Inclusion of Non-Executive Direction in Board
$\$_3$LnWD=Presence of Women Directors on Board
$\$_4$LnCD=CEO Duality
$\$_5$LnNoBC=Number of Board Committees

RESULTS AND DISCUSSION

This study tested the likely influence of board characteristics on Firm Financial Performance. This study assumed that Number of Directors (NoD) Presence of Non-Executive Director (NED), Presence of Women Director (WD), CEO Duality and Number of Board Committees (CoB) would influence Firm Financial Performance. Panel data was processed on Stata Software to generate results and determine the nature of relationship between the variables. Descriptive Statistics were calculated for dependent and Independent variables. Data was regressed through Linear Regression to determine the nature and strength of relationship between dependent and independent variables.

Table 1: Descriptive Statistics

Variable	N	Minimum	Maximum	Mean	Std. Deviation
Number of Directors	150	7.00	15.00	8.6700	1.91251
Inclusion of Non-Executive Directors	150	.00	1.00	.5600	.49889
Presence of Women Directors	150	.00	1.00	.1000	.30151
CEO Duality	150	.00	1.00	.8700	.33800
Number of Board Committees	150	.00	9.00	3.4500	1.94560
Return on Assets	150	-17.76	57.69	3.3180	9.76285
Valid N (list wise)	150				

Table: 2 Regression Estimates

Dependent Variable: RoA
Method: Linear Regression
Included Observations: 150

Variable	Coefficient	Std. Error	t-Statistics	Prob.
Number of Directors	1.50346	.4991177	3.01	0.003
Inclusion of Non-Executive Directors	7.7163	1.884772	4.09	0.000
Presence of Women Directors	8.292127	5.096734	1.63	0.107
CEO Duality	18.24808	4.894252	3.73	0.000
Number of Board Committees	-3.35205	.4994479	-6.71	0.000
-cons	-19.1786	5.675825	-3.38	0.001

R-squared 0.4086
Adj. R-squared 0.3771
F-statistics 12.99
Prob(F-statistics) 0.0000

Mean for Number of Directors reflected that every firm had nine (9) directors. Mean for Presence of Women Directors highlighted the resistance of firms to take women as directors on board. However, firms are inclined toward inclusion of Non-Executive Directors. Statistics underlined the prevailing trend of same person being CEO and Chairman. Study witnessed that every firm board constituted its three to four committees.

F statistics of 12.99 reflects high fitness of model. Adjusted R- squared is 0.3771 that is considered somehow reasonable for panel data. It shows change in dependent variable due to change in ID variables. T-value shows fitness of each independent variable. Negative sign is irrelevant and its value should be more than 1.95 and it is more than the required level with one exception of presence of women directors. P value shows confidence level and it should be less than 0.05.

Regression Table reflects that all the independent variables have relation with dependent variable. # value for number of directors is 1.50346, for non-executive directors is 7.7163, for women directors is 8.292127, for CEO duality is 18.24808 and for board committees it is 3.35205. All these values show very strong relationship between dependent and independent variable. For number of directors (t-value is 3.01 p, 0.003), in case of non-executive directors (t-value is 4.09, p, 0.000), for women directors, (t-value is 1.63, p, 0.107), for CEO duality is (t-value is 3.73, p, 000) and for board committees it is (t-value is -6.71 p, 0.000). All these values confirm significant relationship between dependent variable and independent variable.

Furthermore, results explained that board size affected firm financial performance significantly and positively and this result was endorsed by some other studies [41]. Number of Directors increased the board freedom and encountered managerial hegemony [17]. The Inclusion of Non-Executive Directors also was also found supportive in boosting firm performance. This result was authenticated by another study [46]. Executive Directors were unable to monitor the working of CEO precipitating checks and balance mechanism in form of outside directors [22]. This finding defended Agency Perspective.

The results determined that Presence of Women Directors on Board encouraged superior firm performance but insignificantly. Various studies pointed out that woman board members contributed to quality of decision making by questioning the conventional wisdom and provoking live discussion [47]. The results of the study termed as a source of invaluable input rather merely a token of representation. Moreover, findings justified Resource Dependency Perspective that recommended diversity for performance boost.

The findings on CEO duality pointed out positive relation between Combined Leadership Structure and Firm Financial Performance. It supported Stewardship Perspective that favored combined leadership structure. The Number of Board Committees also influenced firm financial performance but inversely. This finding was contrary to the findings of Cadbury Report and many other research studies [46]. This study contributed significantly by helping banks top management to understand the Board Characteristics and Firm Performance relationship. This approach reinvented functioning of top management by promoting the concept of strategic teams for decision making process [35].

To my best knowledge, impact of Women Directors on Firm Performance has been estimated first time in Pakistan and findings regarded Women Directors encouraging element for Firm Performance. The study would also help firms in composition of an effective board. This study focused on certain characteristics of board, so more may be added for in-depth analysis. Moreover, different diversity variables like age of directors, educational and professional background and ethnicity could also be considered. Future research could have qualitative insight on women role in boards. Future research may also focus on identifying the necessary skills and competences of directors to enhance Firm Performance. It is recommended that while firms constitute their board, they must strike balance with respect to power, skills, attitude and gender.

CONCLUSION

To conclude, I believe that the theoretical framework and the findings of this paper will motivate scholars in strategy, organizational behaviour and corporate governance, as well as practitioners, to examine the board characteristics from a multiple theoretical perspectives. Researchers should also consider not only the structure and characteristic of the top management teams, but also other strategic choices of firms regarding the process and dynamics of functioning of internal governance systems. It is also necessary to examine how these internal governance systems align with the external governance mechanisms to provide for effective performance in a turbulent and competitive global environment.

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