BOARD COMPOSITION, BOARD LEADERSHIP STRUCTURE AND FIRM PERFORMANCE: EVIDENCE FROM BANGLADESH

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ABSTRACT

This study examines if the corporate board composition in the form of representation of outside independent directors and structural independence of the board influence the firm economic performance in Bangladesh. By using 2-stage least square regression (2SLS) analysis, it is found that neither the board composition, nor the CEO duality influence the firm performance. The finding of this study supports the agency theory, but refutes the stewardship theory implying that the outside independent directors and combined leadership role is not good for firm performance in Bangladesh. The outside directors can not add any value as they do not have any supervisory position in the board; they may have a close relationship with inside board members; many of them may not have adequate qualification and expertise of the independent directors. Similarly, the CEO duality may have reduced the board's ability to exercise the governance function in the context of Bangladesh. Therefore, without legislative requirement of having the adequate qualification and expertise of the independent directors and without restructuring the board, the board independence may not provide any beneficial outcome to the firms.

Keywords: Agency Theory, Bangladesh, Board Composition, Board Leadership, CEO, Stewardship Theory.

***JEL Classification*:** G34, G39

1. Introduction

A corporate board is the primary and dominant internal corporate governance mechanism (Brennan, 2006). Board monitors or supervise management, gives strategic guidelines to the management and even may act to review and ratify management proposal (Jonsson, 2005). A board will work to enhance the firm performance due to legally vested responsibilities or due to its fiduciary duty (Zahra and Pearce II, 1989). "…the board must spot the problems early and must blow the whistle" (Salmon, 1993, p 75).

Although the board may play an important role in corporate governance by monitoring the management, the "board culture is an important component of board failure" (Jensen, 1993, p 863). The wave of recent corporate scandals at Enron, WorldCom and HIH raise the question to what extent the board is able to monitor the management (Mizruchi, 2004, p 614; Brick *et al,* 2006, p 421). The board members of the Penn Central Railroad in 1970 were lulled by the management and accountants (Weidenbaum, 1986; Mizruchi, 2004, p 614). Geneen (1984) in a study found that among the board of directors of fortune 500 companies, 95% are not doing what they are legally, morally, and ethically supposed to do. It is criticized that (1) the board is a rubber stamp, (2) the board is dominated by CEO, and (3) the board is plagued with the conflicts of interests (Weidenbaum, 1986); board responds to the wishes of a controlling shareholders (Jesover and Krikpatrick, 2005, p 128). Therefore, an important question of monitoring the board may arise. That is, who will monitor the monitors? Although it is argued that the shareholders will monitor the board by exercising their ownership right by appointing and removing board members, shareholders may not be aware of the inside activities of the firm.

Corporate governance literature debated within two extreme streams of board practices examining whether the board composition in the form of representation of outside independent directors and structural independence of the board influence the firm performance. This study

also investigates whether the board composition and structural independence of the board influence the firm performance in Bangladesh.

2. Motivation of This Study

Following the large number of corporate collapses around the world, considerable research on corporate governance is conducted within the developed countries context, such as the United States, the United Kingdom, Australia, Germany and Japan. However, there is a dearth of studies on corporate governance in less developed and emerging economies (Shleifer and Vishny, 1997; Rwegasira 2000; Gibson, 2003; Denis and McConnell, 2003; Machold and Vasudevan, 2004). Further, such studies are not adequately conducted to date for an emerging economy, such as Bangladesh. Studies by Imam (2000) on corporate social performance reporting; Belal (2001) and Rashid and Lodh (2008) on corporate social disclosure; Ahmed (2004), Akhtaruddin (2005) and Karim *et al* (2006) on corporate financial reporting; Farooque *et al*, (2007) on corporate ownership structures and firm performance in the context of Bangladesh are not adequate. None of these studies cover the corporate board practices in Bangladesh and to my knowledge there is no study so far on board attributes and structure and their effect on firm performance. This study on corporate board practices in Bangladesh reduces the dearth of literature on corporate governance in emerging economy and Bangladesh. It may also contribute significant knowledge on corporate board attributes and structure in Bangladesh both for the academics and/or practitioners.

3. Theoretical Background

The United Kingdom Cadbury Report (Cadbury, 1992, p 15) defined corporate governance as "the system by which companies are directed and controlled". Due to large a

number of recent corporate collapses good corporate governance has emerged as a global issue. A number of theoretical perspectives are used in explaining corporate governance and problems.

3.1 Stewardship Theory

Although due to effective separation of ownership and control, the agent may be opportunistic, stewardship theory argues that the agents are not necessarily motivated by individual goals, but rather they are motivated to work in the interest of their principal (Barney, 1990; Donaldson, 1990a, 1990b; Davis *et al,* 1997; Donaldson and Davis, 1991). Therefore, this theory suggests that outside independent directors are not necessary as agents are best stewards to their corporations and are not motivated by individual goals (Davis *et al,* 1997; Luan and Tang, 2007). However, this theory argues for CEO duality. This theory suggests that the power of the executives and best stewardship role can only be exercised when the role of the CEO and Chairperson of the board is combined, (Donaldson and Davis, 1991; Ong and Lee, 2000).

3.2 Agency Theory

Agency theory in contrast holds a less optimistic view of human (managerial behavior) arguing essentially that an individual is self-interested and self-opportunist, rather than altruistic. This theory assumes that due to separation of ownership and control, managers (the agent) may not have significant interest in the firm in the form of stock ownership and they may be driven by self-interest, and unless restricted from doing otherwise, will undertake self-serving activities that could be detrimental to the economic welfare of the principals (Deegan, 2006, p 225). This theory suggests that board composition in the form of representation of outside independent directors will be able to monitor any self interested actions by managers (Zahra and Pearce II, 1989; Bathala and Rao, 1995; Nicholson and Kiel, 2007; Kaymak and Bektas, 2008), which may

in turn enhance firm performance (Luan and Tang, 2007). However, this theory suggests that "CEO duality diminishes the monitoring role of the board of directors over the executive manager, and this in turn may have a negative effect on corporate performance" (Elsayed, 2007, p 1204). This theorist also suggests that CEO duality reduces the firm performance due to CEO entrenchment and a decline in board independence (Kang and Zardkoohi, 2005).

3.3 Theoretical Consideration of this Study

This study considers that due to the separation of ownership and control, the agent may be driven by self-interest. The board composition in the form of representation of outside independent directors will be able to provide important monitoring functions in an attempt to resolve the agency conflict between management and shareholders (Bathala and Rao, 1995). Therefore, this study is conducted within the 'agency theory' perspective. It can be argued that the outside independent will bring independent advice which stewardship theory ignores (Nicholson and Kiel, 2007). Similarly, consistent with 'agency theory', this study argues that the CEO duality will reduce the firm performance. The "CEO duality diminishes the monitoring role of the board of directors over the executive manager, and this in turn may have a negative effect on corporate performance" (Elsayed, 2007, p 1204).

4. An Overview of Corporate Governance in Bangladesh

Similar to corporations in Germany, Japan and East Asia the corporate control mechanisms in Bangladesh are mostly insider oriented, such as ownership structures as the core investors own the significant stakes of shares which is also known as *ownership control* approach (Xu and Wang, 1999) and, in general, are the board of directors. Due to highly concentrated ownership, lack of takeover regulations, a non-efficient market, and due to huge

transaction costs associated with the takeover process, some of the important external control mechanisms such as market for corporate control or takeovers are largely absent in Bangladesh corporate sector (Franks and Mayer, 1990; Sarkar, *et al*, 1998; Asian Development Bank, 2000). Due to the absence of a liquid capital market some other dominant control mechanisms, such as compensation in the form of stock options, debt covenants (even though banks are the major source of corporate financing), and effects of dividend policy in corporate monitoring are also absent in the Bangladesh corporate sector (Rashid and Rahman, 2008). However, similar to corporate boards in Anglo-American countries, there are the representations of the outside independent directors in the corporate boards in Bangladesh. Therefore, it can be concluded that the corporate control mechanisms in the Bangladesh context is a hybrid of internal and external control systems.

Unlike the corporate boards in continental Europe such as Germany, Finland, Holland and the Netherlands, traditionally the corporate boards in Bangladeshi are a one-tier board or management board. There is no supervisory board and both the executive and the non-executive directors perform duties together in one organizational layer, which is most common in Anglo-Saxon countries such as, the United States, the United Kingdom and Canada, Australia, and New Zealand. Therefore, the CEO duality is very common in Bangladeshi corporate sector. The "Corporate Governance Notification 2006" requires that the office of the Chairperson of the Board and the Chief Executive Officer (CEO) should preferably be filled by two different individuals. It also leads to some incidences of CEO duality in some listed companies, giving enormous powers to the CEOs, which reduces the check and balances and ultimately the monitoring function of the board. In general board does not have any committee other than the 'Audit Committee'.

5. Board Composition

Board composition refers to the combination of executive directors (including the chief executive officer) and non-executive directors in the board. Sometimes non-executive directors are appointed from outside and they may not have any material interest into the firm also known as independent directors[1]. They are appointed due to huge qualifications, expertise and experience and they may effectively influence the board's decision and ultimately add value to the firm (Fields and Keys, 2003). Independent directors can play a useful role in relation to strategic planning risk management (Farrar, 2005). "…….outside directors may contribute both expertise and objectivity in evaluating the manager's decisions" (Byrd and Hickman, 1992, p 126).

It is widely debated in the corporate governance literature whether board composition in the form of representation of outside independent directors may add any value to the firm's performance. The outside directors are more vigilant as they mainly focus on the firm's financial performance, may dismiss the CEO following poor performance to maintain their personal reputation as directors (Finkelstein and Hambrick, 1996, p 225); can freely evaluate management's performance and act to remedy inappropriate and unacceptable situations (Kesner *et al,* 1986); "resolve the problem of information asymmetry" (Ozawa, 2006, p 104). The higher proportions of outside directors and smaller board are tend to make decisions, such as acquisitions, executive compensation and CEO replacement (Hermalin and Weisbach, 2003). In the absence of the outside directors the insider dominated board in one hand will get enormous

[1] According to United Kingdom Higgs Report 2003 "a non-executive director is considered to be independent when the board determines that the director is independent in character and judgment and there are no relationships or circumstances which could affect, or appear to affect, the directors' judgment". This study considers the independent directors as the directors who do not have any material interest into the firm also fits the definition of 'Independent Director' provided in the 'Corporate Governance Notification 2006' issued by Securities and Exchange Commission Bangladesh.

powers and the board may abuse such powers; on the other hand without the expertise of the outside directors, the board may not be effective (Dalton and Daily, 1999).

However, the representation of outside independent directors as a commonly used measure of board vigilance to promote shareholder interests is sometimes controversial. Although directors hire and fire the managers and executive but in practice they are nominated by the management. It is argued that the outside director candidates are known by CEO or other inside directors. The new outside board members who are proposed by inside board members may have relationship with them. Further, most effective directors are insiders as they have more information of the firm than the outsiders and thus outside directors must rely on them to make a decision (Finkelstein and Hambrick, 1996, p 225); "inside directors lives in the company they govern, they better understand the business than outside directors and so can make better decisions" (Nicholson and Kiel, 2007, p 588). Many outside directors may not be competent to perform their assigned tasks as many of them are part-timers and they do not have inside information of the firm (Brennan, 2006). Such information asymmetry may reduce the control role of the outside directors in the firm.

Flanagan (1982) noted that 80 percent of the outside director(s) candidates in the United States firms are known by either CEO or by other board members. Some studies (such as, Patton and Baker, 1987; Jensen, 1993) argue that outside directors are the 'creatures of CEO' and are more likely to be aligned with top management rather than shareholders, as top management has great influence over who sits in the board. Some other studies (such as, Brickley *et al*, 1994) argue that, due to reputation concerns and due to fear of lawsuits outside directors will motivate to represent shareholders. However, the ability to issue commands and instructions by these directors are limited as they do not ordinarily have formal authority to do so (McNulty and Pettigrew, 1996). These directors only monitor in case of crisis (Dayton 1984). The WorldCom

board was composed of more than 50% of non-executive directors; however the board could not prevent the bankruptcy (Kaplan and Kiron, 2004). Further, there is no consensus of common definition of independent director (Brennan and McDermott 2004, p 326); they are neither the employee of the company, nor have any business or personal relationship with the firm (Hulbert, 2003); outside directors serve on too many boards and grow older as there is no age limit on them (Core *et al*, 1999).

6. Structural Independence of the Board

Structural independence of the board refers to the board leadership in the form of Chairperson and management leadership in the form of CEO. Both the Chairperson and the CEO's contributions are equally important in a corporation. Although, there is a sacred and secret relationship between them (Kakabadse *et al*, 2006), monitoring by the board depends on the distribution of power between the Chair of the board and the CEO (Pearce II and Zahra, 1991; Finkelstein and Hambrick, 1996). The professional integrity and trust to each other are the salient features that may influence the firm performance (Kakabadse *et al*, 2006). Leadership skill of the Chairperson is an important factor in determining board process, optimal decision making and overall effectiveness of a board of directors (Leblanc, 2004); 'the chief executive officer' (CEO) is the executive who has overall responsibility for the conduct and performance of an entire organization' (Finkelstein and Hambrick, 1996, p 7). It is argued that the board will not involve in the day-to-day operational activities of the management or not become the part of management, as it may lead a conflict of interest between the management and board (Morck *et al*, 1988; Rechner and Dalton, 1991; Tricker, 1994; Yermack, 1996; Abdullah, 2004). Due to legalistic perspective boards is responsible for corporate leadership without actual interference in day to day operations, which are duties of CEO and senior executives (Zahra and Pearce II,

1989, p 292).The CEO will bridge between the corporate board and management (Rechner and Dalton, 1989). Firms having one individual serving as both Chairperson and CEO are considered to be the so called CEO duality. It is the situation in which the title of both the Chairperson of the board and CEO go to one individual. In the words of Rechner and Dalton (1991, p 155), it is "a board leadership structure in which the CEO wears two hats; one as the CEO of the firm, the other as chairman of the board of directors".

The CEO non-duality, which separates the executive function of the board from its monitoring function, is commonly found in the two-tier board, which is most common in continental Europe, such as Germany, Finland, Holland and the Netherlands (Tricker, 1994; Maassen, 2002). The CEO duality is very unusual in the two-tier boards as the CEO has no seat in the supervisory board; such supervisory function of the board is formally independent from the executive (management) function. The management functions of the board mostly oversee the operational issues and headed by Chief Executive Officer (CEO) and supervisory functions of such board deals with the strategic decision and oversee the management function of the board headed by Chairperson as non-executive director (Solomon, 2007). In one-tier board, which is most common in Anglo-Saxon or Anglo-American countries such as, the United States, the United Kingdom and Canada, Australia, New Zealand, both the executive and the non-executive directors perform duties together in one organizational layer. In such a board there may be any combination of executive and non-executive directors (Maassen, 2002; Solomon, 2007).

The proponents of the CEO duality suggest that the CEO duality may be required when such duality can enhance conformity and encourage performance (Tricker, 1994) and the firm requires strong leadership (Finkelstein and Hambrick, 1996). CEO duality has several advantages, such as it places the CEO in a powerful position in managing the firms operations and enables to make quick decision (Finkelstein and Hambrick, 1996). Kang and Zardkoohi

(2005) by reviewing extant literature identified five antecedents of CEO duality, such as (1) duality as a reward for CEO′s good performance, (2) Duality is a solution to the environmental resource-scarcity, complexity and dynamism, (3) duality is conforming to institutional pressure, (4) duality as result of social exchange reciprocity and (5) duality as imposed by powerful CEO.

However, such duality is criticized in the literature that there is a problem of monitoring the management by the board if the Chair of the board and the CEO is the same person. In the context of agency theory, CEO duality (the combined leadership structure) may give enormous power and authority to the CEO, which may weaken the board. It also reduces the check and balances and CEO tends to be motivated by self-interest (Tricker, 1994). The CEO may not want a capable board as the capable board may challenge their power and authority; therefore with their power, the CEO dominated board may select, reward or replace a director. Such a powerful CEO can influence the board activities, such as formation of board committees in pursuant to his personal interest; manipulate the board meetings by not raising an important agenda. As the CEO duality board is usually dominated by the management, it may reduce the board's ability to exercise the governance function and creates a conflict between management and board (Morck *et al*, 1988; Zahra, 1990; Rechner and Dalton, 1991; Tricker, 1994; Yermack, 1996; Solomon, 2007). It is also argued that the CEO can not represent the shareholders and the management at the same time (Rechner and Dalton, 1991). In the words Abdullah (2004), "who will watch the watchers?"

To avoid these conflicts of interests, some studies advocate the separation of the positions of CEO and Chairperson and appoint the position of Chairperson as an outside independent director. Separating the position of CEO and board Chairperson reduces the CEO and inside directors to exercise the opportunistic behavior which will in turn allow the board to better exercise its control (Daily and Dalton, 1994a). It also facilitates the objective assessment of CEO

and top management performance (Weidenbaum, 1986). Therefore, the proponents of CEO non-duality further argue that the separation will lead to a powerful board (Pearce II and Zahra, 1991), may reduce the agency problems (Solomon, 2007), which is associated with corporate superior (improved) financial performance (Donaldson and Davis, 1991). Without such separation CEO tend to be motivated by self interest, ignoring the interest of the various other stakeholders. The separation of the positions of CEO and board Chairperson reduces the CEOs dominance over the board (Daily and Dalton, 1994b; Maassen, 2002). Therefore, it enhances the board effectiveness and reduces the 'self-opportunism' behavior of the CEO.

Despite such debate it is still a puzzle whether the independent leadership structure will enhance the board effectiveness that may lead to the better performance. There is no optimal board leadership structure; both form of leadership structure may have potential costs, as well as benefits (Boyd, 1995; Brickley *et al*, 1997; Elsayed, 2007). In other words, leadership structure has no particular advantages for shareholders (Kang and Zardkoohi, 2005). Enron Corporation had its CEO also served as Chairperson of the board (i.e. CEO duality) while both WorldCom and Global Crossing separated the positions of CEO and Chairperson (i.e. CEO non-duality); although, the role of Chairperson of the board is a powerful position within these firms, the holder of this position did not have the ability to control corporate wrongdoings within these three corporations (Petra, 2005).

7. Review of Literature

7.1 Board Composition

The board composition refers to the ratio of non-executive (outside independent) directors and executive directors (including the chief executive officer) on the board as a means of monitoring the management. Following the popularity of outside dominated board since 1960,

it became the most widely discussed research issue linking whether the outside independent directors may add any value (Kesner *et al,* 1986; Petra, 2005) and influence the firm economic performance (Hermalin and Weisbach, 2003).

Several studies attempts to identify if the board composition (outside independent directors) may influence firm performance. Studies for example by Kaplan and Reishus (1990), Brickley *et al* (1994), Beasley (1996); Byrd and Hickman (1992) found a positive impact of appointing outside independent directors into the board. Kesner *et al* (1986) found that, although independent director are not involved in illegal acts, adding outside independent directors can not lessen a firms illegal acts. Fernandes (2005) documented that the firms with non-executive directors have less agency problems and have a better alignment of shareholders and managers interest. Rosenstein and Wyatt (1990) show that the firm stock price goes up when an additional outside director is appointed. Denis and Sarin (1999) in a study using a time-series analysis over 10-year period found that the changes in ownership and board structure are correlated with one another. Changes in ownership and board structure are strongly related to top executive turnover, prior stock price performance, and corporate control threats. Cotter *et al* (1997) studied the role of independent outside directors during takeover attempts by tender offer. It is found that independent outside directors enhance target shareholder gains from tender offers and a majority of independent directors are more likely to use resistance strategies to enhance shareholders wealth.

The empirical evidence of outside independent directors and firm performance is mixed. Some studies, such as, Schellenger *et al* (1989), Daily and Dalton (1992), Tian and Lau (2001) and Luan and Tang (2007), found that having more outside independent directors on the board improves firm financial performance supporting the agency theory. Some other studies, such as Chaganti *et al* (1985), Baysinger and Butler (1985), Rechner and Dalton (1986), Zahra and

Stanton (1988), Fosberg (1989), Hermalin and Weisbach (1991), Grace *et al* (1995), Dalton *et al* (1998), Dalton and Daily (1999), Davidson III and Rowe (2004), Fernandes (2005) and Cho and Kim (2007) could not find any relationship between board composition (outside independent directors) and firm performance. However, some studies (such as, Barnhart *et al,* 1994; Barnhart and Rosenstein, 1998), could not find conclusive evidence on board composition and firm performance.

Due to high degree of diversity of the results on the earlier studies on board composition and firm performance, Dalton and Daily (1999), viewed these results as 'vexing', 'contradictory', 'mixed' and 'inconsistent'. Baysinger and Butler (1985) argued that these differences are due to differences in various factors, such as corporate law, managerial talent, capital markets and the internal capital structure of the firm. Further, Zahra and Pearce II (1989) pointed several reasons for such inconsistencies and these are summarized by Finkelstein and Hambrick (1996, p 239), as (1) not considering the contextual factors, such as life cycle and corporate strategy, (2) not effectively considering as how board members interact to make decision, (3) considering one or two attributes in univariate analysis, etc. Finkelstein and Hambrick (1996) further argue that despite such variances, board may indirectly influence the firm's performance by quality of monitoring.

7.2 Structural Independence of the Board

Corporate governance literature examined whether the board structure (structural independence of the board or CEO non-duality) may enhance the firm performance. Similar to the board composition, the evidence on the board leadership structure and firm performance are mixed and non-conclusive.

Studies for example by Pearce II and Zahra (1991), Daily and Dalton (1992), Boyd (1995), Tian and Lau (2001), Lin (2005) found that the combined leadership structure (CEO duality) is associated with better firm performance than those with independent leadership structure (CEO non-duality) supporting the stewardship theory. Whereas the studies for example by Berg and Smith (1978), Chaganti *et al,* 1985; Molz (1988), Rechner and Dalton (1989), Rechner and Dalton (1991), Donaldson and Davis, (1991), Dalton *et al* (1998), Judge *et al,* (2003), Abdullah (2004), Elsayed (2007) and Braun and Sharma (2007) found no evidence between the combined leadership structure (CEO duality) and firm economic performance supporting the agency theory. Rather the bankrupt firms are likely to have CEO duality (Daily and Dalton, 1994b) and the agency problems are higher when the CEO is also the board Chair (Yermack, 1996). Some studies (such as, Chaganti *et al,* 1985; Daily and Dalton, 1992), could not find conclusive evidence on CEO duality and firm performance. Elsayed (2007) made a study on Egyptian listed firms and revealed that the CEO duality does not influence the firm performance. However, when he included an interaction term between CEO duality, the impact of CEO duality on corporate performance found to vary across industries. The study concluded that the CEO duality is good for some firms, while it is opposite for other firms.

8. Hypothesis Development

The outside independent directors are good monitors as they are not the part of the management (Jensen and Meckling, 1976; Fama, 1980; Beasley, 1996). The outside independent directors have advance pragmatic qualifications, expertise and experience and thereby can effectively influence the board's decision and ultimately can add value to the firm (Fields and Keys, 2003). Therefore, the following hypothesis can be stated,

Hypothesis 1: *There is a significant relationship between the board composition (proportion of outside independent directors) and firm performance.*

The CEO duality reduces the checks and balances by the board. The CEO may not want a capable board as the capable board may challenge his/her power and authority (Zahra, 1990); the CEO can not represent the shareholders and the management at the same time (Rechner and Dalton, 1991). To avoid these conflicts of interests, agency theorists argued for the CEO and Chairperson to be filled by two different individuals. Therefore, the following hypothesis can be stated,

Hypothesis 2: *CEO non-duality is positively related to firm performance.*

9. Research Method

9.1 Sample Selection

This study considers 104 non-financial firms listed in Dhaka Stock Exchange for the period of 1999-2007, representing the 38.38% of the total listed companies as on 30th June 2007. Depending on the availability of company annual reports a total of 774 observations was made.

The audited financial report was the basis for obtaining the company's accounting information, such as, total assets, total liabilities and equities, net sales, net income, operating income, operating expenses, executive's pay, etc. Market value of the closing share price was also collected from Dhaka Stock Exchange web page (at www.dsebd.org) and from the 'Monthly Review' of Dhaka Stock Exchange.

9.2 Variable Definitions

9.2.1 Dependent Variable: Firm Performance

Dependent variables in this study are the firm performances under different performance measures such as, the Return on Assets (**ROA**), Return on Equity (**ROE**), **Tobin's Q** and Market to Book Value Ratio (**MBVR**). Consistent with Yammeesri and Lodh (2004), Yammeesri *et al* (2006), Rashid and Lodh (2008), Return on Assets (ROA) is calculated as the Earnings before Interest and Taxes (EBIT) scaled by the book value of total assets. Return on Equity (ROE) is calculated as the Earnings before Interest and Taxes (EBIT) scaled by the book value of equity and reserves. Reserves includes retained earnings, revaluation reserve, tax holiday reserve, dividend equalization funds and any special reserve; excluding non-performance reserves such as, capital reserve and share premiums. Tobin's Q, is the ratio of the market value of the firm to the replacement cost of their assets. MBVR is calculated as the number of equity shares outstanding times the closing share price on the last day of the financial year scaled by book value of equity and reserves.

9.2.2 Independent Variable: Board Composition

Traditionally the corporate boards in Bangladesh are a one-tier board. Monitoring is mainly conducted within one organization layer. There is no supervisory board and both the executive and the non-executive directors perform duties together in one organizational layer. Representatives of the concentrated owners hold the position in the company board and management, leading to poor monitoring and control. The 'Corporate Governance Notification 2006' requires that $1/10^{th}$ or at least one independent director is to be appointed into the board. Therefore, a variable of board composition (**BDCOM)** in this study refers to the percentage of seat held by the outsiders or independent directors, who do not have any material interest into the

firm (Rechner and Dalton, 1986; Zahra and Stanton, 1988) who also meets the definition of independent directors as provide in the 'Corporate Governance Notification 2006' issued by Securities and Exchange Commission Bangladesh.

9.2.3 Independent Variables: CEO duality

The CEO duality is the situation when the chair of the board and the CEO or Managing Director holds the same position. Consistent with the study by Boyd (1994), Daily and Dalton (1994b), Conyon and Peck (1998), Core *et al* (1999), Abdullah (2004), the CEO duality variable is a binary and defined as a variable of **CEOD**, which is equal to be one (1) if the post is hold by same person as the CEO and Chairperson, otherwise zero (0).

9.3.4 Control Variables

A number of control variables, such as, board size, ownership structures, debt, firm size, firm age and firm growths are considered. Board size has number of implications for board functioning and thereby firm performance (such as, Raheja, 2005; Coles *et al,* 2008). "Larger boards were assumed to have directors with diverse educational and industrial backgrounds and skill and with multiple perspectives that improves the quality of action taken by the firm……as board size increased, CEO domination of the board become more difficult and directors were in improved position to exercise their power in governing the corporation" (Zahra and Pearce II, 1989, p 311). However, a smaller board is manageable and plays a controlling function, whereas a larger board is non-manageable, may have greater agency problems and may not be able to act effectively leaving management relatively free (Chaganti *et al*, 1985; Jensen, 1993; Hermalin and Weisbach, 2003). A variable BDSIZE is considered as the natural logarithms of total board members. In most of the companies in Bangladesh, the CEOs are the

representative of the concentrated shareholders, family members of the controlling shareholders. Their qualification and expertise does not always prevail in appointing them into the firm. Therefore, the ownership structures may have significant influence in monitoring the CEOs and thereby firm performance. Consistent with Kula (2005) and Elsayed (2007), this study also considers directors (DIROWN) and institutions (INSTOWN) ownership as the control variable to identify the impact of ownership on board leadership structure and firm performance. Debt may act as disciplinary device, may reduce the shareholder-debtholder agency problem and may influence the performance (e. g. Jensen and Meckling, 1976). Therefore, in consistent with McConnell and Servaes (1990), Agrawal and Knoeber (1996), Short and Keasey (1999) and Xu and Wang (1999), the studies considered the control variable debt to identify the impact of debt on firm performance. Two measures of debt such as, Total Debt to Total Assets (TDTA), Total Debt to Total Equity (TDTE) are considered in this study. The Total Debt to Total Assets (TDTA) is calculated by scaling the total debt by total assets; Total Debt to Total Equity (TDTE) is calculated by scaling the book value of total debt by total book value of equity plus book value of reserve and surplus. The firm size is an important variable. Large firms have more capacity to generate internal funds (Short and Keasey, 1999); large firms have a greater variety of capabilities (Majumdar and Chhibber, 1999); large firms may also have problems of coordination, which may negatively influence its performance (Williamson, 1967). This study considers the natural logarithm of total sales as the firm size, SIZE1, as well as natural logarithm of total assets as firm size, SIZE2. Firm performance may also be influenced by firm age; the older firms are likely to be more efficient than younger firms (Ang *et al,* 2000). A variable of AGE is defined as the natural logarithm of the number of years firm have been listed on the stock exchange. Consistent with Morck *et al* (1988) and Short and Keasey (1999), this study

considered a control variable of growth measured as the percentage of annual change in sales. A variable of GROWTH is considered to denote the impact of growth on firm performance.

The descriptive statistics in table 1 reveals that the average firm performance is 5.4%, ranging from -114.2% to 34.1% under ROA; average firm performance is 22.2% ranging from -787.5% to 2961.0% under ROE; average firm performance is 102.0% ranging from 2175.3% to 7,950.1% under MBVR; average firm performance is 91.1% ranging from 8.5% to 806.9% under Tobin's Q. From this descriptive statistics it appears that the firm performance is very poor under accounting performance measures, whereas it looks like that firms are performing well under the market based performance measures.

Table 1: Descriptive Statistics of the Sample (N=774)

Variables	Mean	Median	Standard Deviation	Minimum	Maximum
ROA	0.054	0.059	0.093	-1.142	0.341
ROE	0.222	0.186	1.618	-7.875	29.610
MBVR	1.020	0.703	4.236	-21.753	79.501
Tobin's Q	0.911	0.761	0.696	0.085	8.069
Board Composition	0.111	0.167	0.049	0.000	0.333
Board Size	1.740	1.792	0.302	1.099	2.485
Director Shareholding	0.448	0.000	0.160	0.000	0.976
Institution Shareholding	0.178	0.160	0.156	0.000	0.570
TDTA	0.535	0.419	0.636	0.000	7.754
TDTE	2.562	0.724	25.476	-89.356	435.120
Firm Age (Log)	2.545	2.639	0.457	0.693	3.401
SIZE1 (Log Assets)	5.939	6.042	1.473	1.899	9.613
SIZE2 (Log Sales)	5.268	5.591	1.934	-3.917	9.308
GROWTH	0.103	0.054	0.739	-1.000	12.059

The average board size is 5.931 ranging from minimum 3 directors to maximum 11 directors. The average director ownership is 44.80 percent ranging from 0 to 97.60 percent. The

average institutional ownership is 17.80 percent which ranges from 0 to 57.00 percent. The total debt to total assets (TDTA) ranges from 0 percent to 775.434 percent with an average of 53.951 percent, implying that almost more than 50 percent of the assets are financed by debt. The average firm age in the sample is 12.57 years, ranging from 2 to 30 years. The average firm growth is the 30.80 percent, ranging from -100 percent to 13,819.656 percent. It implies that some firms are tending to be default, whereas some other firms are growing at very faster rate.

9.3 Regression Model Specification

In order to examine the relationship between board composition and firm performance, the following model is developed.

$$\mathbf{Y_{i,t}=\alpha+\beta_1 BDCOMP_{i,t}+\beta_2 CEOD_{i,t}+\beta_3 BDSIZE_{i,t}+\beta_4 AGE_{i,t}+\beta_5 SIZE1_{i,t}+\beta_6 SIZE2_{i,t}+\beta_7 GROWTH_{i,t}+\varepsilon_{i,t}}$$

Where, $Y_{i,t}$ is alternatively $ROA_{i,t}$, $ROE_{i,t}$, $MBVR_{i,t}$ and Tobin's $Q_{i,t}$. $BDCOMP_{i,t}$ is the board composition, $CEOD_{i,t}$ is the CEO duality, $BDSIZE_{i,t}$ is the board size, $AGE_{i,t}$ is the firm age. $SIZE1_{i,t}$ and $SIZE2_{i,t}$ is the firm size, $GROWTH_{i,t}$ is the firm's growth representing the changes in sales. α is the intercept, β is the regression coefficient and ε is the error term.

In order to examine the relationship between CEO duality and firm performance, the following model is developed. This is the modification of the model used by Elsayed (2007).

$$\mathbf{Y_{i,t}=\alpha+\beta_1 CEOD_{i,t}+\beta_2 BDSIZE_{i,t}+\beta_3 DIROWN_{i,t}+\beta_4 INSTOWN_{i,t}+\beta_5 TDTA_{i,t}+}$$

$$\mathbf{\beta_6 TDTE_{i,t}+\beta_7 AGE_{i,t}+\beta_8 SIZE1_{i,t}+\beta_9 SIZE2_{i,t}+\varepsilon_{i,t}}$$

Where, $Y_{i,t}$ is alternatively $ROA_{i,t}$, $ROE_{i,t}$, $MBVR_{i,t}$ and Tobin's $Q_{i,t}$. $CEOD_{i,t}$ is the CEO duality, $BDSIZE_{i,t}$ is the board size, $DIROWN_{i,t}$ and $INSTOWN_{i,t}$ is the percentage of shares owned by directors/sponsors and institutions respectively, $TDTA_{i,t}$ is the total debt to total assets and $TDTE_{i,t}$ is the total debt to total equity, $AGE_{i,t}$ is the firm's age, $SIZE1_{i,t}$ and $SIZE2_{i,t}$ is the firm's size. α is the intercept, β is the regression coefficient and ε is the error term.

10. Empirical Results

10.1 Board Composition and Firm Performance

This section presents the board composition and firm performance. The model developed above is regressed by 2-Stage Least Square (2SLS) regression analysis. The categorization of the sample revealed that approximately 51.92 percent of the sample firms have the CEO duality. This figure is higher than Japanese, United Kingdom, Italian and Belgian Companies as firms in these countries only have 10-20 percent CEO duality (Kang and Zardkoohi, 2005). However, this figure is fairly lower than that of U. S. firms as there are almost 80 percent corporations in U.S. have CEO duality (Kang and Zardkoohi, 2005).

The regression results of the board composition and firm performance under different performance measures are presented in Table 2. The regression coefficients suggest that there is no significant relationship between board composition and firm performances under any performance measure. The Adjusted R squared and F-statistic being significant indicates reasonable overall fit. The results also indicate that CEOD has significant explanatory power in influencing firm performance. Consistent with Zahra and Stanton (1988), BDSIZE (Board Size) has significant positive explanatory power in influencing the firm performance under MBVR and Tobins's Q. AGE has significant positive explanatory power firm performance under Tobin's Q and SIZE2 has significant positive explanatory power in influencing firm performance under ROA. SIZE1 has significant negative explanatory power in influencing firm performance under ROA and Tobin's Q.

The correlation matrix of the explanatory variables is presented in table 3. It is revealed that there is no correlations among them as the correlation coefficients are very small (less than 0.75 or negative).

Table 2: Board composition and firm performance under different performance measures

This table presents the summary results of the board composition and firm performance under different performance measures. Column (a), (b), (c) and (d) represent the various coefficients of various performance measures. The *t*-tests are presented in the parentheses.

	Dependent Variables							
	(a) ROA		**(b) ROE**		**(c) MBVR**		**(d) Tobin's Q**	
Intercept	-0.066	**	-0.570		-4.021	**	0.441	**
	(-2.320)		(-1.023)		(-2.781)		(1.983)	
BDCOMP	0.021		-0.016		-0.012		0.012	
	(0.604)		(-0.407)		(-0.298)		(0.318)	
BDSIZE	0.039		0.114		0.164	***	0.252	***
	(1.116)		(2.863)		(4.159)		(6.848)	
CEOD	0.001		0.011	**	0.004		-0.021	
	(0.023)		(0.295)		(0.092)		(-0.589)	
AGE	0.021		-0.033		0.030		0.091	**
	(0.605)		(-0.840)		(0.770)		(2.474)	
SIZE1	-0.165	**	-0.028		0.002		-0.380	***
	(-2.878)		(-0.432)		(0.032)		(-6.334)	
SIZE2	0.587	***	0.046		0.026		0.096	
	(10.319)		(0.711)		(0.400)		(1.610)	
GROWTH	0.001		0.000		-0.018		0.019	
	(0.023)		(0.009)		(-0.479)		(0.530)	
Adjusted R^2	0.223		-0.004		0.021		0.142	
F-Statistic	29.033	***	1.391		3.095	**	17.226	***

* At 10% level of significance, ** at 5% level of significance and *** at 1% level of significance respectively.

Table 3: Board composition and firm performance: Correlation matrix of the explanatory variables

		1	2	3	4	5	6	7
1	BDCOMP	1.000						
2	BDSIZE (Log)	-0.132	1.000					
3	CEO	0.012	0.042	1.000				
4	AGE	-0.151	-0.108	0.125	1.000			
5	SIZE1	-0.013	-0.074	0.107	0.142	1.000		
6	SIZE2	-0.058	-0.042	-0.045	-0.109	-0.793	1.000	
7	GROWTH	-0.064	-0.024	-0.009	0.083	0.061	-0.056	1.000

The result of this study is consistent with earlier studies (such as, Rechner and Dalton, 1986; Fosberg, 1989; Barnhart *et al*, 1994; Grace *et al,* 1995; Dalton *et al,* 1998; Dalton and

Daily, 1999; Cho and Kim, 2007) implying that board composition in the form of outside independent directors does not influence the firm economic performance. However, it contradicts with a number of earlier studies (such as, Schellenger *et al*, 1989; Daily and Dalton, 1992, Tian and Lau, 2001; Luan and Tang, 2007) implying that outside independent directors enhance firm performance. While this relationship was not quite clear in case of developed economies (Judge, *et al,* 2003), the results clearly supports the agency theory, but refutes the stewardship theory in case of emerging economy, such as Bangladesh implying that the outside directors are not good monitor. It may be due to the absence of the legislative requirement of having the adequate qualification and expertise of the independent directors. Based on this analysis the hypothesis 1 is rejected.

10.2 CEO duality and Firm Performance

This section presents the structural independence of board and firm performance. The model developed above is regressed by using 2-Stage Least Square (2SLS) regression analysis. The regression results of the CEO-duality and firm performance under different performance measures are presented in table 4 and correlation matrix of the explanatory variables are shown in table 5. The regression coefficients of relationship between the CEO duality and firm performance suggest that there is no significant relationship between CEO duality and firm performance under any performance measure. Rather, there is a significant negative relationship between CEO duality and the firm performance under Tobin's' Q. The Adjusted R squared and F-statistic being significant indicates reasonable overall fit.

The results also indicate that 'board size' has significant positive explanatory power under all the performance measures. Director ownership has significant positive explanatory powers in influencing the firm performance under ROA, MBVR and Tobin's Q. Institutional

ownership has no explanatory power in influencing the firm performance. TDTA has significant negative explanatory power under ROA and MBVR performance measures and has significant positive explanatory power under Tobin's Q performance measure.

Table 4: CEO duality and firm performance under different performance measures

This table presents the summary results of the CEO-duality and firm performance under different performance measures. Column (a), (b), (c) and (d) represent the various coefficients of various performance measures. The *t*-tests are presented in the parentheses.

	Dependent Variables							
	(a)		**(b)**		**(c)**		**(d)**	
	ROA		**ROE**		**MBVR**		**Tobin's Q**	
Intercept	-0.027		-0.275		-3.217	**	-0.739	***
	(-1.119)		(-0.804)		(-3.143)		(-5.032)	
CEOD	-0.012		-0.018		-0.032		-0.059	**
	(-0.422)		(-0.810)		(-1.231)		(-2.581)	
BDSIZE (Log)	0.103	***	0.042	**	0.106	***	0.134	***
	(3.618)		(1.815)		(4.010)		(5.834)	
DIROWN	0.215	***	0.038		0.087	**	0.134	**
	(7.184)		(1.557)		(3.123)		(5.524)	
INSTOWN	0.044		-0.007		-0.021		0.010	
	(1.522)		(-0.294)		(-0.757)		(0.440)	
TDTA	-0.512	***	-0.023		-0.086	**	0.795	***
	(-17.166)		(-0.972)		(-3.101)		(32.912)	
TDTE	-0.006		0.815	***	0.730	***	-0.038	**
	(-0.221)		(36.97)		(28.966)		(-1.724)	
AGE	-0.029		-0.014		0.037		0.105	***
	(-1.020)		(-0.617)		(1.426)		(4.603)	
SIZE1	-0.287	***	-0.048		-0.025		-0.105	**
	(-6.070)		(-1.253)		(-0.577)		(-2.750)	
SIZE2	0.508	***	0.072	**	0.035		0.164	***
	(11.119)		(1.936)		(0.834)		(4.422)	
Adjusted R^2	0.501		0.672		0.572		0.672	
F-Statistic	77.256	***	156.511		102.366	**	156.998	***

* At 10% level of significance, ** at 5% level of significance and *** at 1% level of significance respectively.

TDTE has positive explanatory power under ROE, MBVR performance measures, but has a negative explanatory power under Tobin's Q performance measure. AGE has significant explanatory power in influencing firm performance only under Tobin's Q performance measure. SIZE1 has significant negative explanatory power in influencing firm performance under ROA and Tobin's Q performance measures. SIZE2 has significant positive explanatory power in influencing firm performance under ROA, ROE and Tobin's Q performance measures.

Table 5: CEO duality and firm performance: Correlation matrix of the explanatory variables

		1	2	3	4	5	6	7
1	CEOD	1.000						
2	BDSIZE (Log)	0.055	1.000					
3	DIROWN	-0.116	-0.091	1.000				
4	INSTOWN	0.089	-0.063	0.345	1.000			
5	TDTA	-0.035	-0.162	0.118	0.085	1.000		
6	TDTE	-0.019	-0.083	-0.005	0.053	-0.009	1.000	
7	AGE	0.151	-0.125	-0.128	0.037	0.035	0.040	1.000
8	SIZE1	0.082	-0.114	0.143	0.071	0.216	-0.015	0.124
9	SIZE2	-0.039	-0.054	-0.078	-0.048	0.055	0.023	-0.102

The correlation matrix of the explanatory variables is shown in table 5. It is revealed that there is no correlations among them as the correlation coefficients are very small (less than 0.75 or negative).

The result of this study confirms the earlier studies (such as, Berg and Smith, 1978; Chaganti *et al,* 1985; Molz, 1988; Rechner and Dalton, 1989; Rechner and Dalton, 1991; Donaldson and Davis, 1991; Dalton *et al,* 1998; Judge *et al,* 2003; Abdullah, 2004; Braun and Sharma, 2007; Elsayed, 2007) implying that CEO duality does not influence the firm performance. However, the results of this study contradicts with number of earlier studies (such as, Pearce II and Zahra, 1991; Daily and Dalton, 1992; Boyd, 1995; Tian and Lau, 2001; Lin, 2005) implying that CEO duality enhance firm performance. The result of the analysis supports

the agency theory, but refutes the stewardship theory implying that the combined leadership role is not good for firm economic performance. Based on this analysis the hypothesis 2 is accepted.

11. Discussion and Conclusion

This study seeks to examine if the board composition in the form of representation of outside independent directors and structural independence of the board may influence the firm economic performance in Bangladesh. The empirical finding suggests that there is relationship between the board composition in the form of representation the outside independent directors and firm performance, implying that the outsiders can not add any value to the firm. Similarly, there is no significant relationship between CED duality and firm performance.

It is quite interesting to investigate why the outside independent directors can not influence the firm performance. It is noted in this study that, due to the one-tier board culture in Bangladesh corporate sector, the independent directors in no way have a supervisory position on the board. Further, the 'Corporate Governance Notification 2006' allows them to be appointed by existing elected directors. Therefore, there is a provision to appoint them into the board due to having a close relationship with the existing (inside) board members. Due to absence of the legislative requirement of having the adequate qualification and expertise of the independent directors, many of them may not be competent to perform their assigned tasks. They may not have required expertise in providing adequate guidance/professional advice. They also may not have inside information of the firm (Finkelstein and Hambrick, 1996, p 225; Nicholson and Kiel, 2007, p 588). Such information asymmetry may have reduced the control role of the outside directors in the firm or they may have failed to perform their assigned tasks due to having lack of appropriate support by the insiders. Therefore, without restructuring the board and defining the board members qualification and expertise, the board independence may not provide any

beneficial outcome to the firms. This finding does not capture the agency theory implying that the outside directors can not influence firm performance in the context of Bangladesh. Therefore, the regulatory body may consider defining the qualifications and/or professional expertise for appointing 'Independent Directors' into the board.

It is also quite interesting to investigate why dual leadership structure does not influence the firm performance. One probable reason is that, the CEO duality may reduce the effectiveness of the board and may create a conflict between management and board that may reduce the firm economic performance (Zahra, 1990; Solomon, 2007). Another probable reason is that duality may have been imposed, rather than adopted in a usual organization practices to consolidate CEOs power (Kang and Zardkoohi, 2005). It may have reduced the board's ability to exercise the governance function in the context of Bangladesh. This finding captures the agency theory implying that the combined leadership structure does not enhance the firm economic performance in the context of Bangladesh.

It is noted that the existing board culture in Bangladesh allows both the executive and the non-executive directors to perform duties together in one organizational layer; therefore there are some incidence of CEO duality. While the dual leadership structure may work well in some Anglo-American countries; due to institutional differences it may not work well in a developing country, such as Bangladesh. It is suggested to separate the executive function of the board from the monitoring function by splitting the role of Chairperson and CEO, which is also recommended in the United Kingdom 'Cadbury Report 1992'and 'Higgs Report 2003'.

12. Limitations of this study

This study may have some limitations. *Firstly*, the data were data mainly collected from the company annual report. As the accounting standards are very poor in developing countries,

the annual report may not truly represent the company's state of the affairs and performance. *Secondly*, the data are collected from the large number of observation of different corporate entities ignoring the underlying differences in organizations as in no way two organizations are same (Deegan, 2006). The extreme value of some observed variables such as, EBIT, accumulated profits of a few firms for certain years may severely impact the outcome of this study. *Finally,* this study examined the impact of board composition in the form of representation of outside independent directors and firm performance. The requirement of appointing the independent directors in the board was mandatory just from 2006. There was no outsider representation in the board before 2006 and it may have severely influenced the outcome of the study.

13. Area of Further Research

Although "there is universal agreement on the need for outsiders, preferably independent, to be involved in the direction of companies" (Clarke, 1998, p 118), this study could not find a relationship between outside independent directors and firm performance. The finding of this study is surprising. It may be due to several reasons; firstly, there was no outsider representation in the board before 2006 which led to smaller data size, secondly, the cost and benefits of different board structures may vary across firms or industry (Mak and Li, 2001). Therefore, it can be argued 'outside directors do not have expertise' is still a speculation and further study may be conducted by increasing the sample size and examining the industry specific impact of board structure and firm performance.

Similarly board structure is an endogenously institution and its organization depends on a number of firm characteristics (Barnhart *et al,* 1994; Hermalin and Weisbach, 2003; Linck *et al*, 2008; Bennedsen *et al*, 2008). Although some of the CEOs are found to be in involved in

corporate malpractice that led to the corporate scandals in USA, it does not necessarily mean that CEO duality is a bad governance structures (Kang and Zardkoohi, 2005). The cost and benefits of different leadership structures may vary across firms or industry (Mak and Li, 2001; Elsayed, 2007) or "because the practice is prevalent in the industry" (Kang and Zardkoohi, 2005, 794). CEO duality is good for some firms, while it is opposite for other firms (Boyd, 1995; Brickley *et al*, 1997; Elsayed, 2007); a particular firm may adopt CEO duality under an appropriate or inappropriate organizational condition (Kang and Zardkoohi, 2005, p 786). Therefore, it is too early to make a conclusion and further study may also be conducted examining the industry specific impact of board leadership structure and firm performance.

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