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The Impact of Board Structures on Shareholders Returns

Vincent Konadu Tawiah[1], Muhaheranwa Benjamin[2]

[1]M.Com, University of Mysore, India
Chartered Accountant, Ghana

[2]Ph.D Scholar, Institute of Management, MMU
Mullana-Ambala, Haryana, India

Abstract: ***If joint stock companies and agency problem are twins then board of directors will be their after-birth. As opine by Jesen and Meckling (1976) since the separation of ownership from management through joint stock companies, agency problem has never been eliminated. Various approaches such as laws, trustee, auditing, have been used to arrest the agency problem and protect the benefit of shareholders. But board of directors has emerged as an efficient approach to protect shareholders benefit. This paper has revealed the impact of board size, number of promoter directors and independency of the board on the total benefits a shareholder gets for investing. An unbalance panel data was collected from annual reports of 25 companies through purposive sampling for the accounting years 2009 to 2013.The Hussmann's test was used to check the appropriate regression method to statistically test the impact of board structures on total shareholder's return. It was found that, the average board size in companies was 12 members out of which half were independent, 3 are promoters/founders and remaining are other executives. Shareholders also get more than 90% of their returns from changes in share prices. The random effect regression method reports that, all the board variables have a positive relationship with shareholders return with the exception of board size but only board independence is significant @ 5%. Promoter directors have an inverse relationship with capital gain whiles board size and independent directors have positive correlation.***

Keywords: board structures, independent directors, promoters, shareholders' return

1. Introduction

Although board of directors plays a very significant role in the determination of dividend and the share price of a company, yet there is little research on their relationship with shareholders returns. Thus, board of directors proposed dividends and their announcements about the company hit share prices. Majority of the research are on the impact of board and general firm performance of the company. Only a hand full, if any has specifically single out the impact of board on investors' returns. While it can be said that shareholders returns is part of company performance, it is also true that not all the performance flows to the shareholder until directors decide. It is therefore increasing important to the relationship between board structures influence on shareholders' returns. Recent literature on this study was one by Rohana et al (2009) on The Effect of Board Structure on Shareholders' Wealth in Small Listed Companies in Malaysia. Although the study shares much light on the topic, it is limited in its content analysis and covers only board composition and remuneration and size. Again the study concentrated on small and medium enterprise which has limited data covering only 2002-2004.This current study attempts to fill these literature gaps by empirically analysing the impact of board size, board independence and promoter directorship on shareholders returns. The research will bring new findings and knowledge by achieving the following objectives; to find the trend of shareholders return over the period; To determine the relationship between shareholders total return and board size, board independence and promoter directorship; To know the contribution of board structures to capital gain. Board structures include all activities of the board such as composition, the size, the committees, remuneration, and appointments of director, ownership and duality of CEO. MCCG 2000) Malaysia Code of Corporate Governance.

2. Literature Review

Board composition is the number of directors and its categorization into outsider and insider directors. While Promoters/promoter group, top management, shareholders and employee forms insiders, Outsiders on the other hand are those without direct monetary interest in the company.

In an empirical test on agency theory and stewardship, Lex et.al (1991), found that unifying the position of CEO and board chairman into one hand improve the ROE returns to shareholders than the agency theory of separating them. This implies that giving management autonomy without board of directors can improve the stock returns as compared with imposing board of directors to restrict and control the management actions. In this research, shareholders return was measured by ROE (dividend plus capital gain).

Board Size and Shareholders Return

Various studies on board size have found a negative relationship between increase board size and firm performance (Bhagat and Black 1996, Yermack 1996). Jensen 1993 also argues that as the board size increase, there are problems of coordination and decision process which limit performance. Eisenberg et al 1998 on the other hand failed to agree with Jensen by saying that increase board size ensures better decision control because of their diverse background and profession. Some scholars are of the view that board size positively relates to firm performance. The rationale behind their argument is that, there is diverse knowledge and intellect with large size

which increase the strategic decision capability of board (Dhawan (2006), Dwinedi and Jain (2005)). Researchers who argues of a negative relationship are of the opinion that by group dynamics and psychology theory, large board size are less effective due to long decision making process and coordination. Raleja 2005 and Ghosh 2006 confirms these theories by saying, as board size increase its associated cost such as remuneration, communication and coordination also increase.

Notwithstanding the two opposing thoughts, Vetaas (1999) finds a middle way theory that an optimum board size which has positive relationship and negative relationship with performance. This is the "U" theory of board size and performance relationship. The basic assumption of theory is minimum number is necessary but if it crosses the sufficient number, performance is adversely affected. What is the optimum size is the question which is yet to be answered by academician and professionals.

The inconsistency of findings between board size and frim performances means there is possibility of inconclusive relationship between shareholders return and board size, since returns depend on performance. The higher the board size, the better decision results and control. Contrary the higher the board size, the longer decision process and inefficiency in performance.

On this background, it can be assume that, board size does not have significant impact on shareholders return. The descriptive statistics on total shareholders return shows that there is wide variation in the capital gains over the period than dividends. Meaning that, the changes in total returns over the period can be attributed to capital gain which amounts to 95%. Therefore it is necessary to test separate the impact of board structures on capital gain. Promoters will ensure performance which will attract new investors, thereby appreciating capital.

H_0: there is no significant relationship between board size and shareholders return and capital gain

Board Independence and Shareholders Return

Clause 49 of the Listing agreement of Securities Exchange Board of India (SEBI) defines an independent director as'independent director' shall mean a non-executive director of the company who apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director"
Legalistic, class, hegemony, resource dependence and agency theory are the four perspectives about independent directorship. In all these perspectives independent directors are inevitable for board effectiveness (Zahra and Pearce 1989).Till today there has not been any concluding evidence on the optimum size of independent directors and their contribution to firm performance.

Perce and Zahra 2002 claims a positive relationship between firm performance and presence of outside directors using some fortune 500, companies but Banahar et al (2005) finds a negative correlation between board independence and firm performance. Hermalin and Weishach (2006) also argues that though there is no relationship between board composition and firm performance, the presence of independence directors help CEO to maximise value by bringing in expertise and unbiased eyes on the board. Independent directors bring brand credibility and better governance (Prasana 2006).

Although, there is a mix finding on board independence and performance, recent corporate governance rules and codes such as Indian Companies Act 2013, Clause 49 and international standards such as OECD combine Code, Caburry Report SarbanOxly Act recommends the inclusion of more independent directors. This indicates the significance of independent directors on performance. Independent directors brings transparency and investors protection which attractive to new investors. New investors have to paid high share price resulting to capital gains.

It is therefore expected that independent directors will have positive significant impact on returns.

H_0: There is significant impact of number of independent directors on shareholders return and capital gain

Promoters on Board and Shareholders Return

In a related research by Rohana et al (1991) on the effect of board structures on shareholders wealth in Malaysia, concluded that board size and board composition have significant influence on shareholders wealth. The research used content analysis to study three board structures (board size, composition and remuneration impact on shareholders wealth. The research also found that big board size and high proportion of executive directors ensure good decision making. Shareholders wealth is measured as ROI and EPS. The results show marginal significant correlation (0.060) between executive directors and shareholders wealth. The effect of board size and shareholders wealth results demonstrate that higher directors would enhance company's performance and ROI.

Every founder or promoter wants the growth and high performance of its company. But each promoter has different strategies of influencing performance and growth. While some promoters would like to plough back profit and pay lesser dividend, others will pay more dividends to attract new investment (which is rear case). In both cases the total returns to a shareholder can be increase in the short run or long run. Ploughing back profit promise good returns, which can shoot price for capital gains in the short run and higher returns in the long run. Paying dividend in the short-run also sends money directly into shareholders pocket Again literature has proven that high promoter directors improve the performance of the company because of their duality as owners and directors. In owners managed firms, there is a very high motivation for managements to work capital gain that is for a long term share price increase (Business Standard, 29th July).

In this line a hypothesis is developed as:

H_0: there is significant impact of promoter directors on shareholders returns and Capital gain.

3. Data Collection and Method of Analysis

Twenty-five (25) companies were selected from the Nifty (50) companies for 2009 to 2013 accounting years based on availability of data and sectorial representation. The active sectors of India have been represented in the data with corresponding companies. These samples were used to generate an unbalanced panel data of 125 observations. The data is analysed and interpreted by using descriptive statistics, fixed random effect model and Karl Pearson Co – efficient of correlation matrix run by E-views statistical software.

Regression Equations

$SR_{it} = \alpha + \beta_1 Z + \beta_2 P + \beta_3 I + U_{it}$ ……Equation 1

$CG_{it} = \alpha + \beta_1 Z + \beta_2 P + \beta_3 I + U_{it}$ ……Equation 2

$BI_{it} = \alpha + \beta_1 Dv + \beta_2 Cg + U_{it}$ ……Equation 3

Where SR – Shareholders Return (dividend + capital gain)

z – Board size
i – Number of Independent Directors
p – Number of promoters on the board
Cg – Capital gain
Bi – Number of Independent Directors as a dependent variable
Dv – Dividend

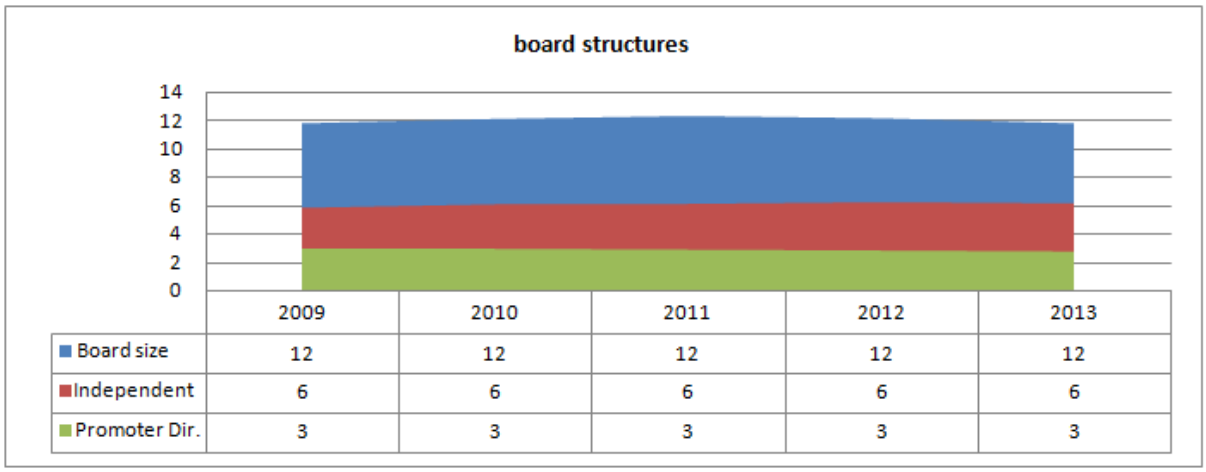
4. Results and Discussions

Univariate Analysis

Figure 1 depicts that the average board size of the companies have been 12 over the period. Out of this, six (6) members are independent and 3 members of every board are promoters or founders, with remaining been executive or professionals. Clause 49 of the listing agreement recommends that, if the chairperson of the board is executive or promoter or founder, then there must be 50% or more board independence. A company should have 1/3 (33%) independent directors if the board chairman is an independent director. It can therefore be inferred from the analysis that, most of the companies have promoter or founder or executive chairmanship so they maintain 50% board independence. The promoter board members that represent 25% of the board size indicate how active promoters are in control and management of their companies. Thus, promoters dominate in the company's decision which may be an opportunity or threat to outside shareholders.

Is an opportunity because, it will be difficult for hostile takeovers and mergers. At the same time most promoters are the founders who have the company at heart. This will ensure better decisions and performance. On the dark side, these promoter directors may have selfish interest of building empire for themselves by taking risky as well as hasty investment. Most of them may not have much experience to take efficient business decisions.

Figure 1: Board Size, Number of Independent Directors and Promoter Director



	2009	2010	2011	2012	2013
Board size	12	12	12	12	12
Independent	6	6	6	6	6
Promoter Dir.	3	3	3	3	3

Extracted from Annual Reports

Total Returns

It can be seen from figure 2 that on average, shareholders had a negative return in 2009 by investing in the companies through fall in share prices. Total returns were Rs. -105.302 due to high capital loss of Rs. 116.36. The global economic crisis could have affected the share prices in 2009. The dividend of mitigated the capital loss marginally. The share prices picked up in 2010 and 2011 because most investors both foreign and domestic saw that India was not much affected with the global crisis and was safe to invest. Companies also attracted investors by paying high dividends in 2010. Since the share price is

determined by demand and supply which cannot be predicted easily, the capital gain does not follow any fixed pattern resulting to fluctuation in the total stock returns. The dividend on the other hand is demonstrating an increasing pattern over the period from Rs. 10.834 in 2009 to Rs. 17.078 in 2013 the data also indicates that sample companies pay less than Rs. 20 dividend per share to shareholders over the period. Dividend also account for less than 10% of the total stock returns for the period.

The data shows wide variation within the total shareholder wealth over the period hence an investor cannot easily predict his/her earnings on the market.

Figure 2: Trend in Shareholders' Return

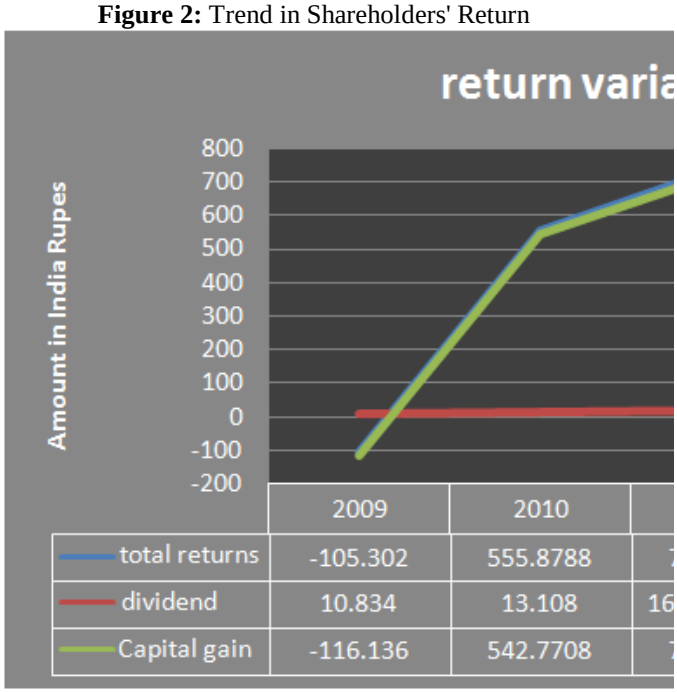


Diagram Based On Data from Annual Reports

5. Regression Results

Shareholders Returns and Board Structures

The Hussmann's test indicated that random effect method was the best method for this model. With the exception of board size all the other variables have a positive relationship with shareholders return but only board independence is significant @ 5%. Therefore the null hypothesis is accepted. As board size increases, the returns to the shareholder may decrease but the board size does not have significant impact. As stated in early literature and reports, independent directors improve performances and returns. This result also confirms this relationship. Promoter directors have positive relationship but not significant meaning; promoters may influence shareholders return but not a strong factor of which shareholders should be worried about.

Capital Gain and Board Structures

Equation 2 results show a positive coefficient for board independence @ 10% significant level while board size has insignificant positive impact on capital gain. Contrary to equation 1, promoters have inverse relationship with capital gain and insignificant in this equation. Thus, the price movement on shares is regardless of the board size of the company and the number of promoter directors although they correlate. Number of independent directors on the board can cause share price movement and capital appreciation. The positive relationship means that, increasing independent directors will attract high price and increase in capital gain. This result leads to the acceptance of $\mathbf{H_0}$ on promoters and capital gain.

Board Independence and Shareholders Return Variable

The third regression equation attempts to answer whether changes in capital gain and dividend can increase or decrease the number of independent directors on the board. The result shows that increasing dividend will have significant positive impact on board independence in terms of numbers. Capital gain also have marginal positive relation but insignificant.

6. Conclusion

The study has revealed that, board structures in sample companies averagely had 12 members from 2009 t0 2013. The companies also maintained 50% board independence and 33% promoter director with executive or promoter or founder as chairperson. This is in fulfilment of Clause 49 the listing agreement by SEBI. The trend analyses also indicate that the board size and its composition did not changed significantly over the 5 years study. Most of the promoter directors are founders who have the company at heart which ensures performance.

India has a special case as most of the promoter directors are related through family ties making it very easy for promoters to control the board. Another interesting feature is the conglomerate board structures of India. Since most companies are owned by same family promoters such as the Tata, Mahindra, Birla, a single person may be the chairperson for all the companies within the group. Further, same board composition and directors are maintained across the companies, making it easy for abuse of power at the detriment of the outside investor.

The share prices picked up in 2010 and 2011 because most investors both foreign and domestic saw that India was not much affected with the global crisis and was safe to invest. Since the share price is determined by demand and supply which cannot be predicted easily, the capital gain does not follow any fixed pattern resulting to fluctuation in the total stock returns. But the dividend experienced an increasing pattern over the periods.

The random effect regression method reports that, all the board variables have a positive relationship with shareholders return with the exception of board size but only board independence is significant @ 5%. Promoter directors have an inverse relationship with capital gain whiles board size and independent directors have positive correlation.

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Appendix

Regression Results

Shareholders' Return and Board Structures

Dependent Variable: SR				
Method: Panel EGLS (Cross-section random effects)				
Sample: 2009 2013				
Periods included: 5				
Cross-sections included: 17				
Total panel (balanced) observations: 85				
Swamy and Arora estimator of component variances				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
BZ	-115.3463	89.69045	-1.286049	0.2021
BP	43.16033	117.3667	0.367739	0.7140
BI	225.5106	161.4948	1.396395	0.0466
C	193.3124	946.2002	0.204304	0.8386

Capital Gain and Board Structures

Dependent Variable: CG				
Method: Panel Least Squares				
Sample: 2009 2013				
Periods included: 5				
Cross-sections included: 17				
Total panel (balanced) observations: 85				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
BZ	25.82126	51.27318	0.503602	0.6162
BP	-34.44207	52.17927	-0.660072	0.5115
BI	109.8896	80.30360	1.368427	0.0087
C	-756.0095	516.1575	-1.464688	0.1478

Board Independence on Shareholders' Return

Dependent Variable: BI				
Method: Panel Least Squares				
Sample: 2009 2013				
Periods included: 5				
Cross-sections included: 25				
Total panel (balanced) observations: 125				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
DVL	0.025397	0.011017	2.305146	0.0228
CG	0.000375	0.000320	1.173152	0.2430
C	5.740317	0.207150	27.71094	0.0000