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The relationship between firm performance and board characteristics in Ireland

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Summary In this study we explore the association between firm performance and both board size and board composition for companies quoted on the Irish Stock Market. We also investigate the impact of firm size on the relationship between firm performance and the aforementioned board characteristics. We find evidence that: (i) board size exhibits a significant negative association with firm performance, (ii) the relationship between board size and firm performance is significantly less negative for smaller firms, and (iii) a positive and significant association between firm performance and the percentage of non-executives on the board is apparent. While the latter finding is entirely consistent with *a priori* theoretical predictions, studies in a number of other countries generally fail to report any significant association between board composition and firm performance and potential reasons for this contrast are considered.

Introduction

Contemporary boards of directors are charged with the task of monitoring the performance and activities of top management to ensure that the latter act in the best interests of the owners (Jensen and Meckling, 1976). From this perspective boards have a potentially critical role to play in mitigating agency problems arising from the ubiquitous separation of firm ownership from control (Fama, 1980; Jensen, 1993; Shleifer and Vishny, 1997). In addition, Ruigrok et al. (2006) point out that boards also have important roles with respect to activities such as designing and implementing strategy and fostering links between the firm and its external environment. Given their multifaceted tasks it seems plausible that boards may impact firm performance and, if so, questions naturally arise as to what types of board structures are optimal from the perspective of maximizing stockholders' wealth. Hence, it is hardly surprising that questions about the impact of board characteristics on firm performance have attracted significant research attention across a range of countries in recent years (Denis and McConnell, 2003).

One important topic within the aforementioned research agenda is the potential influence of board size on firm performance. While larger boards may result in a wider pool of expertise (Zahra and Pearce, 1989) and greater external linkages (Goodstein et al., 1994), larger

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boards may also lead to lower group cohesion (Evans and Dion, 1991) and greater levels of conflict (Goodstein et al., 1994). A second and related research question is the potential effect of board composition — in particular, the proportion of independent non-executive (i.e., outside) directors — on firm performance. Contemporary guidelines on corporate governance practices consistently emphasize the critically important role of non-executive directors in mitigating manager—shareholder conflicts. For example, both Hampel (1998) and Higgs (2003) recommend that independent non-executive directors should comprise at least 50% of UK boards. Meanwhile, from an agency perspective, greater board independence should result in more effective monitoring (Stiles and Taylor, 2001). However, many corporate governance researchers have questioned the true impact of board independence on firm performance (Dulewicz and Herbert, 2004).

The empirical literature on the relationship between firm performance and board characteristics — such as size and composition — is quite extensive and while generalizations of such an impressive body of work are inevitably flawed, two overarching findings are apparent. First, prior research provides mixed evidence with regard to the impact of board size on firm performance (e.g., Yermack, 1996; Dalton et al., 1999). Second, prior work has largely failed to establish a convincing link between the proportion of outside directors and firm performance (e.g., de Andres et al., 2005). However, as Brennan (2006) points out, the impact of corporate governance characteristics on firm performance is likely to vary across jurisdictions and from this perspective, cross-country research can provide valuable incremental insights.

Motivated by the need for additional comparative work, the present study presents the first empirical evidence on the relation between firm performance and board characteristics in Ireland. Our specific objective is to contribute to extant governance research in four ways. First, we explore the question of whether the negative relation between board size and firm performance observed in many other countries is apparent in the Irish context. Second, we test whether firm size has a moderating influence on the relation between firm performance and board size. This issue has been largely ignored in prior research. More specifically, we explore whether larger boards may be comparatively less disadvantageous in the context of smaller Irish firms. Third, we investigate whether having a higher proportion of non-executive directors on the board is positively associated with firm performance. While research in many other countries reports no association between firm performance and the proportion of outside directors we believe that certain characteristics of the Irish corporate environment — such as the comparative absence of interlocking directors — may lead to significant contrasts between the results for Ireland and other jurisdictions. Fourth, since we use a range of alternative measures of firm performance in our empirical analysis our study highlights the potential sensitivity of empirical work in this strand of the governance literature to alternative conceptualizations and definitions of performance.

The remainder of the paper is structured as follows. The three hypotheses are developed in Hypothesis development section while the research design is outlined in Research design section. Corporate governance for listed Irish firms section provides some background information about corporate governance in the Irish context and this discussion is followed in Sample section by a summary of the sample selection procedures. The core findings from the empirical work are outlined in Empirical findings section. In Conclusions section we present a summary of our main findings, an overview of the key managerial implications of our results as well as an outline of potential avenues for future research and the limitations of our study.

Hypothesis development

The impact of board size on firm performance

The nature of the relationship between board size and firm performance has come under increased scrutiny in recent years. For example, Yermack (1996) investigates the impact of board size on firm value for a sample of large US industrial corporations between 1984 and 1991 and finds an inverse relation between firm value (measured by Tobin's Q) and the number of directors. Yermack (1996) also shows that financial measures, such as return on assets and return on sales, are negatively related to board size. In contrast, the meta-analysis presented in Dalton et al. (1999), which draws on the results from a number of prior US studies, indicates a positive relationship between board size and firm performance. In a sense, these contrasting findings suggest that there may be advantages as well as disadvantages to larger boards.

The results discussed above are based exclusively on US data. From an international perspective, Conyon and Peck (1998) find a negative relationship between return on equity and board size for a sample of European firms although their results with respect to market-based measures of performance are less clear-cut. More recently, de Andres et al. (2005) report a negative association between firm value and board size (controlling for a number of additional factors) in 10 OECD countries. Taken as a whole, these internationally-based results are consistent with Jensen's (1993) argument that that the benefits resulting from larger boards are outweighed by the incremental costs of the potentially poorer communication and decision-making processes associated with larger groups. Hence, in line with the core findings from prior international research, we predict that board size is negatively associated with firm performance in Ireland:

Hypothesis 1. Firm performance exhibits a negative association with board size.[1]

[1] At the outset, it is important to emphasize that we test for 'association' rather than 'causality'. Freedman (1999) presents a comprehensive overview of the difficulties involved in drawing definitive conclusions about causality from regression analysis. Further, Listokin (2008, p. 100) points out that some of the most influential papers in corporate governance research ''emphasize that the cross-sectional results prove associations rather than causation''. 'Causation' has fundamentally stronger conations than 'association' and as Gujarati (2006, p. 23) states ''a statistical relationship in itself cannot logically imply causation''. 'Association' in the present paper means that the dependent and independent variables exhibit a statistically significant relationship with one another within the context of the model presented in Eq. (1). The terms 'relationship' and 'association' are treated as interchangeable throughout the study.