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Full Length Article

Board independence and firm performance: Evidence from Bangladesh

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Abstract

This study examines whether board independence influences firms' economic performance among listed firms in Bangladesh. By using data from 135 listed firms on Dhaka Stock Exchange and by using accounting and market performance measures, this study uses simultaneous equation approach to control the potential endogeniety problem. This study finds that, board independence and firm economic performance does not positively influence each other. This study also finds that, board size has significant positive influence on both board independence and firm performance. These findings raise the questions of whether 'one size fits all' type corporate governance practices can be exercised around the world. Bangladesh has imitated the requirement of having outside directors sit on corporate boards to make corporate boards independent and accountable, ignoring the underlying institutional differences. While board independence is an important attribute of corporate board practices in many developed countries, board independence still may be an illusion in Bangladesh.
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Keywords: Agency theory; Bangladesh; Board independence; CEO; Power; Stewardship theory

1. Introduction

Corporate boards are the primary and dominant internal corporate governance mechanism and play a key role in monitoring management and aligning the interests of shareholders with management (Brennan, 2006; Rose, 2005). Boards are responsible for care and diligence, including ensuring that financial controls are effective. Boards may give management strategic guidelines and may even act to review and ratify management proposals (Jonsson, 2005). Boards also spot problems early and can exercise a whistle-blower function (Salmon, 1993). However, there is a

Abbreviations: 3-SLS, three-stage least square; AGM, annual general meetings; ASX, Australian Securities Exchange; AUR, asset utilisation ratio; BCCI, bank of credit and commerce international; CEO, Chief Executive Office; CGN, Corporate Governance Notification; CLERP, Corporate Law Economic Reform Program; DIC, Dhaka Stock Exchange Industrial Classification Code; EBIT, earnings before interest and taxes; ER, expense ratio; NACD, National Association of Corporate Directors; OLS, Ordinary Least Square; ROA, return on assets; SECB, Securities and Exchange Commission Bangladesh

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considerable debate in the literature concerning the extent to which corporate boards are able to monitor management (see Mizruchi, 2004, p 614; Braun & Sharma, 2007).

A corporate board's ability to monitor management has attracted attention following the collapse of the Maxwell Publishing Group, BCCI and Poly Peck in the United Kingdom. Also influential in reviving this question was the wave of mega corporate collapses that broke out in early 2000s, including those of Enron, WorldCom and HIH insurance (see Mizruchi, 2004, p 614; Braun & Sharma, 2007). It is alleged that the boards' inabilities to monitor management within these corporations was due to insufficient monitoring stemming from the consolidation of power by the management and its general hold over board members, preventing them from providing independent advice (Rose, 2005). Thus, boardroom reform attracted significant attention, particularly the idea of board independence (representation by outside independent directors). A number of global corporate governance codes of best practices, such as the Cadbury Committee Report of 1992, the Higgs Report of 2003 and the Smith Report of the same year in the United Kingdom; the 2000 NACD Blue Ribbon Commission Report and the 2002 Sarbanes-Oxley Act in the United States; the Toronto Stock Exchange Corporate Governance Guidelines of 1994 in Canada; and Australia's 1995 Bosch Report, the Australian Stock Exchange's (ASX) Principles of Good Corporate Governance and Best Practice Recommendations and CLERP 9, advocated for boardroom reform in favour of independent board members. The Higgs Committee Recommendations, along with many other codes of best practices around the world, attracted significant international attention.

This study aims to examine whether board independence influences firm performance for listed firms in Bangladesh. By estimating a simultaneous equation model and using three-stage least square (3-SLS), this study controls for endogeneity, as any cross-sectional regression of performance on board independence will be biased because changes in board independence may result from the endogeneity problem in past performance (Hermalin & Weisbach, 2003). This study contributes to the literature and increases knowledge on corporate board practices in the context of an emerging market. The remainder of the paper is organised as follows: section two presents the literature review; section three presents board independence in the context of Bangladesh; section four presents this study's theoretical positioning; section five presents the hypothesis; section six presents the research method; section seven presents the empirical results; and the section eight presents the discussion and conclusions, section nine presents the implications and final presents the limitations of the paper.

2. Literature review

The idea of board independence mainly arises from the Anglo-American context, where there is a dispersal of ownership. Outsider-dominated boards (boards with more outside than inside directors as members) have been very popular in the United States since the 1960s (Kesner, Victor & Lamont, 1986) and therefore the outsider board reform agenda fell in line with orthodox Anglo-American corporate governance practices. Until very recently, however, there has been a broad debate in the literature as to whether board independence adds any value to firms, with no definitive conclusion reached thus far. Some empirical evidence has documented that, board independence is associated with superior performance in the United States (see Pearce & Zahra, 1991; Zahra & Pearce, 1989) as well as in the United Kingdom (Ezzamel & Watson, 1993), New Zealand (see Hossain, Prevost & Roa, 2001) and Korea (see Choi, Park & Yoo, 2007; Joh & Jung, 2012). However, many past studies have also documented a negative relationship between board independence and firm performance in Anglo-American countries, for example in Australia (see Grace, Ireland & Dunstan, 1995) and the United States (Baysinger & Butler, 1985; Bhagat & Black, 2002; Chaganti, Mahajan & Sharma, 1985; Hermalin & Weisbach, 2003; Rechner & Dalton, 1986; Yermack, 1996). Past studies have also documented a negative relationship between board independence and firm performance in an emerging market, for example in Bangladesh (see Rashid, De Zoysa, Lodh & Rudkin, 2010; Rashid, De Zoysa, Lodh & Rudkin, 2012). Due to the conflicting results on board independence and firm performance, Dalton and Daily (1999) view these results as “vexing”, “contradictory”, “mixed” and “inconsistent”. Summarising these findings, suggest that “there is no predicate, either in logic or in experience, to suggest that a majority of independent directors on a board will guarantee good corporate governance or better financial returns for shareholders” (p. 35). Likewise, have declared that there is “no relation between director independence and performance, whether measured by accounting or stock return measures” (p. 1814). The mixed evidence on board independence and firm performance may be attributed to limited methodological procedures or a lack of methodological rigor as well as model misspecifications in the

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