

Müller, Victor-Octavian; Ienciu, Ionel-Alin; Bonaci, Carmen Giorgiana; Filip, Crina Ioana

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BOARD CHARACTERISTICS BEST PRACTICES AND FINANCIAL PERFORMANCE. EVIDENCE FROM THE EUROPEAN CAPITAL MARKET

Victor-Octavian Müller¹, Ionel-Alin Ienciu², Carmen Giorgiana Bonaci^{3*}
and Crina Ioana Filip⁴

^{1) 2) 3) 4)} *Babes-Bolyai University, Cluj-Napoca, Romania*

Abstract

This study investigates board characteristics best practices in the particular context of European listed companies. The theoretical grounding of the paper is done by discussing board composition and board compensation related studies, mainly belonging to the corporate governance literature. The main objective of the paper is to contribute to the debate on whether certain board characteristics can be documented to represent best practices. In doing so, we investigate if such board characteristics significantly influence companies' financial performance. We use econometric regression models in order to assess the impact of a series of corporate governance board related characteristics on the performance of companies (constituents of FTSE100) listed on the largest European capital market (London Stock Exchange), for the 2010-2011 period. An accounting measure of operating performance, namely the operating return on assets (ROA), is used. The profoundness of a potential impact of corporate board characteristics on companies' performance is investigated by considering both contemporaneous and subsequent operating performance. Results document best practices through the existence of several significant associations between considered board characteristics and firm performance.

Keywords: board composition, board compensation, best practices, operating return on assets, corporate governance, FTSE 100, OLS regression.

JEL Classification: M12, M40, G30

Introduction

As Solomon (2009) emphasizes, in order for a company to be successful, it has to be well governed, a well-functioning and effective board of directors therefore being the "holy grail" searched for by every ambitious company (Solomon, 2009, p. 77). The UK Combined Code of Corporate Governance (Financial Reporting Council -FRC, 2003) states that each company should be headed by an effective board that is collectively responsible for its success (FRC, 2003, p. 4). The dynamic of the business environment, as well as evolutions in stakeholders' expectations led to significant scrutiny of listed companies' boards. While it would be difficult to develop a recipe for a board that guarantees the

* Corresponding author, **Carmen Giorgiana Bonaci**, carmen.bonaci@econ.ubbcluj.ro

success of the company, a significant body of literature (mainly falling in the area of corporate governance) investigates the potential association between corporate board characteristics and corporate performance. To a larger extent, our paper contributes to the literature exploring this association, while focusing on best practices.

More precisely, this study aims at informing the debate on whether certain board characteristics can be documented to represent best practices. Undoubtedly, a well-functioning and effective board would require focus on elements such as structures, roles, responsibilities, processes, but also on competences and abilities of the directors. The first step of our analysis is based on discussing research literature in the approached area with the purpose to identify corporate board characteristics that can be argued to represent best practices. In doing so, we present arguments being put forward by previous studies. Such an approach allowed us to select corporate board characteristics that were further considered in the developed empirical analysis. The analyzed corporate board characteristics belong to two big categories covering board composition and board compensation.

The empirical analysis helps document board characteristics best practices which are expected to present potential for a positive impact on companies' performance. In this regard we develop research methodology mainly based on econometric regression models. We therefore investigate if such board characteristics significantly influence companies' financial performance. The latter is explored with the help of an accounting proxy, namely operating return on assets.

Among the particularities of our study we must mention its positioning in the European context as our sample companies are the constituents of FTSE100. We consider the companies being listed on the largest European capital market (LSE) to offer an interesting research setting due to the complexity of their activities imposing an extremely well thought governance. The period under analysis is between 2010 and 2011. Another particularity of the study is that it looks into the profoundness of the potential impact of corporate board characteristics on companies' performance by considering both contemporaneous and subsequent (next year's) operating performance, following an idea suggested by Bhagat and Bolton (2008). Our paper therefore contributes to the literature by bringing insights on board characteristics best practices in the context of the European capital market.

The remainder of the paper is organized as follows. Section one synthesizes previous studies in the area of corporate governance and informs the selection of the considered board characteristics. Section two displays the details of the employed research methodology. Section three presents and discusses the results obtained by performing the empirical analysis. The final section of the paper concludes upon the obtained results and its contribution together with research limitations and perspectives for future extensions of the study.

1. Literature review

A significant number of studies investigate the role of boards in corporate governance, mainly drawing from the agency theory, the finance paradigm of corporate governance and boardroom effectiveness (Solomon, 2009, p. 104; Paun and Paun, 2010). In the context of listed companies growingly challenging environment, the optimal mix of boards remains a

highly debated topic. Questions have been raised both within the boards, as well as coming from stakeholders. Among such highly debated issues related to corporate boards, we find their composition and compensation which also represent the focus of our analysis. Developing a brief analysis of literature supports our study by identifying best practices in this area from a theoretical point of view, together with the arguments on their behalf.

Buniamin et al. (2008 cited by Ienciu, 2012) and Neamtu (2012) discuss the idea in accordance to which a larger board size can bring directors with experience and this may translate into a multitude of values on the board. Board size is a variable being considered by many studies (Jensen, 1993; Xie et al., 2003; Buniamin et al., 2008; Sun et al., 2010; Allegrini and Greco, 2011; Ranasinghe, 2011) and generating mixed evidence. While benefits such as leading towards more experienced independent directors (Xie et al., 2003) may help diminish managers' opportunistic behavior, Jensen (1993) discusses that idea of board size being negatively related to the ability of the board to pursue long-term strategic goals (cited by Sun et al., 2010).

Non-executive directors' and independent directors' role in corporate governance is also discussed in a number of studies (Haniffa and Cooke, 2002; Haniffa and Cooke, 2005; Khodadadi et al. 2010; Arora and Dharwadkar, 2011 and Michelon and Parbonetti, 2012). Solomon (2009) emphasizes that non-executive directors need to have integrity and high ethical standards, sound judgment, the ability and willingness to challenge and probe on issues, as well as strong interpersonal skills (Solomon, 2009, p. 82). Non-executive directors have to monitor insider directors and meanwhile contribute to corporate strategy, tasks which are not easy to balance (Ezzamel and Watson, 1997; Spira and Bender, 2004). Overall, evidence on the role of non-executive directors is also mixed, pros mainly relating to their monitoring role on the rest of the board, while cons discussing them to be "superfluous" and merely another impotent element in an unnecessary structure (Solomon, 2009).

Gender represents another characteristic that generates intense debates. Macarie and Moldovan (2011) argue different psychological mechanisms to determine individual manifestations in the form of discrimination against females. Ernst & Young (2013) develops a study on board diversity at S&P 1500 companies, documenting that, as of 2013, 85% of board seats were held by men, despite more women joining boards. Therefore, change seems to be slow in this direction. Another element of board composition that should be considered is tenure (see Goodwing et al., 2009). The previously mentioned study also documents (for the same time period) that about 45% of board seats were held by individuals who seem to have served for ten years or longer, while 27% of these seats were held by persons with age 68 or older (Ernst & Young, 2013). Our analysis also investigates foreign directors due to the fact that, when companies enter new markets, their international experience might prove extremely helpful.

When it comes to stimulating directors and making sure the company benefits of an appropriate board, we must also turn our focus towards compensation related issues. As Larcker (2011) emphasizes, board compensation should be sufficient in order to attract, retain, and motivate qualified directors. The second set of variables being considered in our analysis therefore fall in the category of board compensation related characteristics. As Solomon (2009) emphasizes, a large number of studies relate to executive remuneration, focusing on several aspects such as remuneration committees (Bostock, 1995), disclosure of executive remuneration (Cheffins, 2003), pay levels (Thompson, 2005), voting directors'

remuneration (Mayo and Young, 2002), etc. Summing up, as Larcker (2011) discusses, compensation should cover time directly spent on board matters, the cost of keeping schedule flexible, as well as corporate financial and reputational risk, while fees are meant to compensate expertise, time and potential risk of committee role. Faulkender et al. (2010) develop a study on board compensation practices and reforms, informing the debate on corporate executive compensation. More precisely, their research analysis covers the level and structure of executive pay while also debating the pay-setting process. Discussing the recent financial crisis, they conclude that, despite the fact that executive pay was one of its factors, an approach preventing such future occurrences will not be reached through changes that focus on pay alone. They advise that any future proposals related to board compensation should be approached as a part of the much larger process of financial regulatory restructuring.

All the above discussed characteristics offer the theoretical grounding for the variables considered in our empirical analysis meant to document best practices in the context of the European capital market. Some of the considered variables in our study combine board composition and structure (such as non-executive remuneration). Considering fees being paid in shares also allows us to construct a dummy variable based on board compensation characteristics. Further details on the board composition and compensation characteristics being included in our analysis (together with the manner in which they were determined) are presented in the following section being dedicated to research methodology related aspects.

2. Research methodology

Within this paper we analyze the association between board composition and compensation characteristics on the one hand, and company performance on the other, for companies listed on the London Stock Exchange (LSE). We consider the chosen stock exchange to represent an appropriate setting in relation to the paper's objective of documenting best practices, as LSE is the largest European stock market. The analysis covers the 2010-2011 period. We selected those companies belonging to the main index (FTSE 100), which is comprised of the first 100 largest and most traded companies on the respective stock exchange.

We based our empirical research on an accounting measure of company performance (as opposed to stock market based measures), and therefore we used operating return on assets (dependent variable) as a proxy for company performance. According to previous literature, stock market based measures of company performance can be susceptible to investor anticipation (Bhagat and Bolton, 2008, p. 264). Consequently, if investors anticipated the effect of corporate governance characteristics on company performance, then long-term stock returns would not be correlated with corporate governance, even in the case when a significant correlation between firm performance and governance would exist (Bhagat and Bolton, 2008, p. 264).

The financial information regarding operating performance, total sales, total assets, shareholders equity, as well as industry related information for the constituents of FTSE 100 has been manually collected from the official London Stock Exchange webpage. Regarding the data on corporate board composition and compensation characteristics, it has been obtained from the 2011 SpencerStuart UK Board Index. Several dependent and

independent variables, including control variables (for size, respectively for industry) have been constructed. With regard to the elimination of outliers, we chose the following approach: we truncated those observations for which the dependent variable (return on assets) was below the 5th, respectively above the 95th percentile.

Our research involves four hypotheses, which are based on prior findings in research literature. The first two are as follows:

Hypothesis 1: Corporate board composition characteristics (board size, board independence, percentage of foreign directors, average service, tenure, age, percentage of women directors) can significantly influence the companies' operating performance in the current year.

Hypothesis 2: Corporate board compensation characteristics (chair remuneration, non-executive director remuneration, additional remuneration for board committee meetings, fees paid in shares) can significantly influence the companies' operating performance in the current year.

With the purpose of testing these research hypotheses regarding the influence of board characteristics on the current year operating performance, the following econometric model has been developed, whose parameters are to be estimated using ordinary least square (OLS):

$$ROAn_i = \alpha_0 + \alpha_1 * NumDir_i + \alpha_2 * IndNEX_i + \alpha_3 * ForDir_i + \alpha_4 * WomDir_i + \alpha_5 * AvServNEX_i + \alpha_6 * ChairTenure_i + \alpha_7 * CEOTenure_i + \alpha_8 * AvAgeNEX_i + \alpha_9 * AvAgeExec_i + \alpha_{10} * ChairRem_i + \alpha_{11} * SenNEXRem_i + \alpha_{12} * NonExBasFee_i + \alpha_{13} * FeesInShares_i + \alpha_{14} * AddRemBComMemb_i + \alpha_{15} * TA_i + \sum(\alpha_i * Ind_i) + \epsilon_i \quad (1)$$

Where:

- ROAn_i = Operating Return on Assets for company i in year n
- NumDir_i = Number of Board Directors for company i
- IndNEX_i = Independent non-executive directors divided by number of directors for company i
- ForDir_i = Foreign directors divided by number of directors for company i
- WomDir_i = Women directors divided by number of directors for company i
- AvServNEX_i = Average service of non-executive directors for company i
- ChairTenure_i = Chairman tenure for company i
- CEOTenure_i = CEO tenure for company i
- AvAgeNEX_i = Average age of non-executive directors for company i
- AvAgeExec_i = Average age of executive directors for company i
- ChairRem_i = Chairman remuneration for company i
- SenNEXRem_i = Senior non-executive total remuneration for company i
- NonExBasFee_i = Non-executive director basic fee for company i
- FeesInShares_i = Fees paid in shares for company I (dummy variable)
- AddRemBComMemb_i = Additional remuneration for board committee members for company i
- TA_i = Natural logarithm of total assets for company i
- Ind_i = Industry dummy variable for the industries: Basic Materials, Industrials, Consumer Goods, Consumer Services, Utilities, Financials, Other

Additionally, we designed our empirical research to also investigate the impact of board composition and compensation characteristics on companies' operating performance in the subsequent (next) year. This follows up a research idea discussed by Bhagat and Bolton (2008). Accordingly, the next two additional hypotheses based on the previous ones have been formulated:

Hypothesis 3: Corporate board composition characteristics (board size, board independence, percentage of foreign directors, average service, tenure, age, percentage of women directors) can significantly influence the companies' operating performance in the next year.

Hypothesis 4: Corporate board compensation characteristics (chair remuneration, non-executive director remuneration, additional remuneration for board committee meetings, fees paid in shares) can significantly influence the companies' operating performance in the next year.

In order to test these research hypotheses regarding the influence of corporate board characteristics on the company's next year performance, a second (similar) model was developed, whose parameters are to be estimated using ordinary least square (OLS):

$$ROAn+1_i = \alpha_0 + \alpha_1 * NumDir_i + \alpha_2 * IndNEX_i + \alpha_3 * ForDir_i + \alpha_4 * WomDir_i + \alpha_5 * AvServNEX_i + \alpha_6 * ChairTenure_i + \alpha_7 * CEOTenure_i + \alpha_8 * AvAgeNEX_i + \alpha_9 * AvAgeExec_i + \alpha_{10} * ChairRem_i + \alpha_{11} * SenNEXRem_i + \alpha_{12} * NonExBasFee_i + \alpha_{13} * FeesInShares_i + \alpha_{14} * AddRemBComMemb_i + \alpha_{15} * TA_i + \sum(\alpha_i * Ind_i) + \varepsilon_i \quad (2)$$

Where:

ROAn+1_i = Operating Return on Assets for company i in year n + 1

Similar to other previous studies (such as Allegrini and Greco, 2011; Sun et al., 2010; Guest, 2009; Buniamin et al., 2008; Vafeas and Theodorou, 1998), our regression models have been designed to include control and dummy variables. More precisely, we use a control variable for company size (natural logarithm of total assets), as well as dummy variables to control for the industry the companies primarily operate in (namely Consumer Services, Consumer Goods, Industrials, Basic Materials, Utilities, Financials, and Other). These control variables are used in order to capture the influence of company size and sector on company's operating performance, hence improving the explanatory power of the two regression models being developed. For confirming each of the four research hypotheses, the coefficient of at least one variable related to the particular board characteristic must be statistically significant at the 0,1 level and it also has to record a VIF (Variance Inflation Factor - which tests the correlation between the independent variable and other independent variables) below 5. Otherwise, the particular hypothesis would be considered infirmed.

3. Results

The main results for the relationship between the companies' operating performance (return on assets) for the current period and the corporate governance characteristics (board composition and compensation) are summarized in Table no. 1. These results indicate a statistically significant relationship (at least at 0,1 level) between the current year operating performance (ROA) and some of the board composition characteristics (number of

directors, board independence, proportion of foreign directors, average service of non-executive directors, CEO Tenure, and proportion of women directors), respectively board remuneration characteristics (non-executive director basic fee, the additional remuneration for board committee members, and the fees paid in shares).

Table no. 1: Regression model 1 - empirical results

Variable	Coefficients (α)	t	Sig.	VIF
(Constant)	0,238**	2,147	0,036	
NumDir	0,005**	1,998	0,050	2,448
IndNEx/NrDir	0,091*	1,749	0,086	1,703
ForDir/NrDir	0,088***	3,069	0,003	2,898
WomDir/NrDir	0,127*	1,715	0,092	2,464
AvServNonEx	0,007**	2,54	0,014	1,669
ChairTenure	-0,001	-1,104	0,274	1,598
CEOTenure	-0,002**	-2,222	0,030	1,92
AvAgeNonEx	-0,002	-1,258	0,214	1,682
AveAgeExec	0,000	-0,437	0,663	1,526
ChairRem	0,000	-0,474	0,637	2,833
SenNExRem	0,000	-1,48	0,144	3,213
NonExBasFee	0,002***	3,375	0,001	3,222
FeesInShares	0,025*	1,697	0,095	1,564
AddRemBComMemb	0,037***	3,674	0,001	1,611
TAn	-0,033***	-5,628	0,000	4,943
IndBasMat	0,045	2,596	0,012	2,814
IndInd	-0,048	-2,770	0,008	2,796
IndConsGoods	-0,008	-0,428	0,67	2,004
IndConsServ	0,000	-0,032	0,975	2,21
IndUtilities	0,028	1,349	0,183	2,012
IndFinancials	0,012	0,648	0,519	3,353
IndOther	0,020	0,973	0,334	1,684
<i>Model Summary ROAn</i>	<i>AdjR² 0,561</i>	<i>F 4,879</i>		

The relatively strongest, as well as statistically significant, influence of the characteristics regarding board composition on the operating performance (ROA) can be identified for board independence, proportion of foreign directors, respectively the proportion of women directors. Worth mentioning are also other two relationships which involve the number of directors and the average service of non-executives. Noticeable is also the negative significant relationship between operating performance (ROA) and CEO Tenure (0,002).

The relatively strongest as well as statistically significant influence of the characteristics regarding board remuneration on the operating performance (ROA) can be attributed to the additional remuneration for board committee members. Worthwhile to remark is also the relationship between operating performance (ROA) and the (dummy) variable for the fees paid in shares. Regarding the potential multicollinearity between independent variables of the two models, which can generate instability of the empirical results, we computed the variance inflation factor (VIF) for each coefficient of the independent variables. The

computed VIF values (which are less than 5) do not indicate (serious) autocorrelation problems between the considered independent variables.

Thus, taking into account the empirical results obtained from the first regression, we can undoubtedly confirm both *hypothesis 1*, (referring to a significant relationship between board composition and current performance) and *hypothesis 2* (referring to a significant relationship between board compensation and current performance). As mentioned within research methodology, we designed our empirical research also to investigate the influence of board (composition and compensation) characteristics on companies' operating performance in the subsequent (next) year. Statistically significant coefficients based on next year's ROA would clearly strengthen a supposed conclusion concerning the existence of a relevant influence of corporate board (composition and compensation related) characteristics on firm performance. In Table no. 2 we summarize the obtained empirical results.

Table no. 2: Regression model 2 - empirical results

Variable	Coefficients (α)	t	Sig.	VIF
(Constant)	0,327***	2,837	0,006	0
NumDir	0,004	1,386	0,171	2,842
IndNEx/NrDir	0,146**	2,531	0,014	1,812
ForDir/NrDir	0,049*	1,513	0,136	3,282
WomDir/NrDir	0,053	0,685	0,496	2,441
AvServNonEx	0,003	1,144	0,258	1,619
ChairTenure	0,000	-0,674	0,503	1,536
CEOTen	-0,001	-1,058	0,294	2,052
AvAgeNonEx	-0,002	-0,954	0,344	1,815
AveAgeExec	-0,002	-1,251	0,216	1,513
ChairRem	0,000	-1,34	0,186	3,026
SenNExRem	0,000	-0,419	0,677	3,536
NonExBasFee	0,001*	1,977	0,053	3,36
FeesInShares	0,021	1,31	0,195	1,536
AddRemBComMemb	0,043***	4,086	0,000	1,601
TAn	-0,028***	-4,299	0,000	5,857
IndBasMat	0,050	2,965	0,020	2,814
IndIndustrials	-0,048	-2,77	0,008	2,796
IndConsGoods	-0,037	-1,759	0,084	2,616
IndConsServ	-0,049	-2,683	0,01	2,805
IndUtilities	-0,055	-2,57	0,013	2,219
IndFinancials	-0,079	-3,765	0	3,505
IndOther	0,005	0,215	0,83	2,272
<i>Model Summary ROAn+1</i>	<i>AdjR² 0,511</i>	<i>F 4,887</i>		

The tabulated results show a statistically significant association, at least at 0,1 level, between next year's company performance (ROA) and board characteristics such as board independence, the proportion of foreign directors, non-executive basic fee, as well as the additional remuneration for board committee members. It has to be underlined that the

coefficient for the board independence variable and the coefficient for the variable concerning the additional remuneration for board committee members even record a higher statistical significance (and also a higher positive value) in comparison to model 1 (which is based on current ROA). This indicates that board independence and the respective compensation component might have a stronger impact on the companies' operating performance on a longer term.

As for the potential multicollinearity between independent variables of the second model (which might generate instability of results), the obtained variance inflation factor (VIF) (less than 5), does not indicate (serious) autocorrelation problems between the considered independent variables. Based on the statistical results obtained from the second considered regression model including statistically significant coefficients, we may confirm both *hypothesis 3* (concerning a significant relationship between board composition and next year's operating performance) and *hypothesis 4* (concerning a significant relationship between board compensation and next year's operating performance).

Conclusions

Our study informs the debate on whether certain board characteristics (regarding its composition and compensation) can be documented to represent best practices in the particular context of European listed companies. In doing so, we first discuss previous studies in the area of corporate governance. This provides us with the necessary theoretical grounding of board characteristics (related to board composition and board compensation) which are further empirically investigated through our analysis. Assessing what board characteristics might be considered best practices is done by testing their potential association with firms' financial performance. Thus, to a larger extent, our paper contributes to the research literature on the unsettled debate regarding the relationship between corporate performance and corporate governance.

The literature review section of the paper allowed us to identify a series of board characteristics together with the arguments putting them forward as best practices in the area of corporate governance. The identified best practices were grouped into two main categories: board composition (covering characteristics related to number of board directors, independent non-executive directors, foreign directors, women directors, average service of non-executive directors, chairman tenure, CEO tenure, average age of non-executive directors, average age of executive directors) and board compensation (covering characteristics related to chairman remuneration, senior non-executive remuneration, non-executive director basic fee, fees paid in shares, additional remuneration for board committee member).

By using econometric regression models, we investigate the impact of a series (14) of board composition and compensation characteristics on contemporaneous and subsequent performance while using a sample of companies listed on the largest European capital market (LSE) for the 2010-2011 period. The selection of the companies was done by including the constituents of FTSE 100. The analysis employs an accounting measure of operating performance, more precisely the operating return on assets (ROA). We also analyze the profoundness of the potential impact of corporate board characteristics on company performance by considering the influence of the investigated characteristics both on contemporaneous and on next year's operating performance.

The obtained results document a statistically significant relationship between company performance and the considered board characteristics. This is true when considering both contemporaneous and subsequent firm performance. We were therefore able to confirm all the hypotheses that we formulated in the research methodology section of the paper. Furthermore, the obtained results are in accordance to other previous studies in literature, such as Vafeas and Theodorou (1998), Gompers et al. (2003), Bhagat and Bolton (2008), Tian et al. (2009), Guest (2009), Ujunwa (2012) and Shukeri et al. (2012).

We manage to document a statistically significant relationship between company performance and corporate board composition and compensation characteristics. Among the main conclusions of our study, we document that board independence and the proportion of foreign directors in the total number of directors have a significant strong positive influence on company performance (both contemporaneous and subsequent). The relationship between non-executive directors' basic fee, fees paid in shares and additional remuneration for board committee membership, on one hand, and company performance (both contemporaneous and subsequent), on the other, was also documented to be statistically significant. Interestingly, chair remuneration as well as senior non-executive remuneration were not documented to exert a statistically significant influence on operating performance.

The developed empirical analysis mainly serves the purpose of our paper by documenting current board characteristics best practices in the context of the European capital market. The obtained results allow us to consider the following board characteristics as best practices (due to recording significant strong positive influence on both contemporaneous and subsequent company performance): board independence, foreign directors, non-executive directors' basic fee, fees paid in shares and additional remuneration for board committee membership.

Summing up, we must mention the limitations of the study mainly referring to sample representativeness and potential endogeneity related issues. In relation to sample representativeness, we must display caution in interpreting results when approaching large European capital markets as opposed to the whole European capital market. As limitations also point potential future developments, further extension of the analysis might include considering other stock exchanges in Europe and maybe even companies which are not part of their main index. Endogeneity related issues refer to potential relationships between the main considered elements (corporate governance, corporate structure, ownership structure and operating performance).

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