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Impact of Board Structure on Firm Performance of Hotel and Travel Sector: Litreature Review with Developing Hypothesis

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Abstract: *Complementing to the inferences of scholarly works, it is worth to seek impact of Board Structure on Firm performance. This study examines the effect of corporate governance practices to the financial performance of Hotel and Travel sector companies in Sri Lanka. Corporate governance has become one of the major issue since the collapse of major companies around the world. Because of those major failures of the companies, it is essential to make legislative reforms to strengthen corporate governance practices. Now, it is highly believed that good corporate governance is an important variable in improving firm financial performance. Corporate governance is the framework of rules and practices which the large organizations and public corporations use to retain the financial interest of all stakeholders. And corporate governance is the framework of rules and practices by which a director board ensures accountability, fairness, and transparency in a company's relationship with its stakeholders. Good corporate governance creates a balance in the company where one group is unable to dominate the actions of the company. Through this study it is attempted to examine the effect of board structure variables on the firm performance .Based on the literature, it was identified as the independent variables, which possible to effect on firm performance as Board Size (BZ), Non-Executive Director Proportion (NED), Female Director Proportion (FDP) and Insider Ownership Percentage (IOP). The other factors which may impact on the firm performance have identified as control variables in the study, as Firm size and the leverage.*

Key Words: *Corporate Governance, Return on Assets(ROA), Return on Equity(ROE), Tobin's Q(TBQ), Board Size(BZ), Non-Executive Directors(NED), Insider Ownership Percentage(IOP), Female Director Proportion(FDP)*

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I. Introduction

Corporate governance is the framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with its all stakeholders. A company is managed not for share price but to ensure that it's short-term and long-term objectives and goals. It is the main responsibility of the directors to involve in the entire process of achieving these goals and objectives. This involves creating a sustainable value for all the stakeholders, which is really what good corporate governance means. Good corporate will create a balance in the company where one group is unable to dominate the actions of the company.

Good Corporate governance practices are not a new phenomenon in the world although recent collapses of several companies which were considered successful have emphasized the need for good business practices and governance structures. Good business practices and governance structures are especially important for the success of business as it brings in better risk management practices through enhanced accountability and transparency.

This study examines the effect of corporate governance practices to the financial performance of Hotel and Travel sector companies in Sri Lanka. Corporate governance has become one of the major issues since the collapse of major companies around the world. Because of those major failures of the companies, it is essential to make legislative reforms to strengthen corporate governance practices. Now, it is highly believed that good corporate governance is an important variable in improving firm financial performance. Corporate governance is the framework of rules and practices which the large organizations and public corporations use to retain the financial interest of all stakeholders.

The purpose of this study is to emphasis the importance of board structure for organizations and to examine whether there is a significant impact of the board structure variables on firm performance.

II. Problem statement

Some scholars have stated that weakness in corporate Governance as one of the major causes for financial Crisis that occurred in the world (Rajan and ingales,2000 In Butts,Mitchell&Betkoh,2012) (Butts, Mitchell, & Berkoh, 2012) *and (Prowse, 1998)*conclude that poor corporate governance on top of concentrated ownership structure paved the way for crisis. The Failure of some firms was due to weak corporate governance mechanisms that provided an opportunity to the firm's executives to commit the fraud. As an example, in Sri Lanka, some banks and some other firms were failed because of lack of corporate governance practices. Therefore study about the poor corporate governance is timely important especially in tourism sector.

Significance of the Study.

This study helps to get an idea on the affiliation of the board structure and firm performance in Hotel and Travel sector Sri Lanka. Although most of the researchers have concerned about this issue, still there is a research gap to do further researches related to effectiveness of board structure and impact of this effectiveness on financial performance of the organization in Hotel and Travel sector in Sri Lanka.

The output of this study is an opinion on the relationship between board structure and firm performance. The result of this study helps to formulate organizational structure for organizations. This study focuses on board size, non-executive director proportion, insider ownership percentage and female directors on the board to provide an image on board structure in accordance with information denoted in organizational published annual reports. Organizational annual reports are a symbol of their performance to stakeholders. It also provide good grasp of language on the board structure of the firm and its effectiveness on firm performance.

Objectives of the study

By performing this study, it is expected

- to determine what are the possible independent variables impact on firm performance

And

- to build the propositions to illustrate the relationship between the board structure and firm performance

III. Literature Review

This section provides a review of the theoretical literature on corporate governance of hotel and travel sector Companies. Furthermore it is focused on the, corporate governance in Sri Lanka, impact of board size, and Non-executive directors in the board, insider ownership, and Female directors on the board and firm characteristics on corporate governance practices.

There are several studies that have carried out in the area of Corporate Governance and Firms' Performance in different countries around the world. Maria and Tomas (1999) studied a system suggesting the term corporate governance has been used in many different ways and the boundaries of the subject vary widely. In the economics debate concerning the impact of corporate governance on performance, there are basically two different models of the corporation, the shareholder model and the stakeholder model. Shareholder model describes the formal system of accountability of senior management to shareholders . And in widest sense shareholder model can be used to describe the network of formal and informal relations involving the corporation. An extension to this view is proposed by Morin and Jarrell (2001) argue that corporate governance mechanism is a framework that controls and safeguards the interest of the relevant players in the market which include managers, employees, customers, shareholders, executive management, suppliers and the board of directors. Previous academic researchers identified various components which affect to structure of the board. Those components are Board size, Non-Executive Director Proportion, Insider ownership percentage and female directors on the board. Next sub sections discuss the literature of above mentioned variables.

Corporate Governance Theoretical Background

The simple meaning of Corporate Governance is the framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with its all stakeholders. A company is managed not purely for share price, but to ensure that its short-term and long-term objectives and goals are achieved. The entire process of achieving these goals and objectives are headed by the board of Directors. This involves building sustainable value for the shareholders and all its other stakeholders, such as customers, employees and even the general public at large, which is really what good corporate governance means. The term 'governance' denotes institutional structures that are formal (i.e. regulations and laws) or informal (e.g. norms, values and assumptions) and which create constraints on the behavior of a party (Gayle et al. 2003). Cadbury (1992) has broadly defined corporate governance as 'the systems by which companies are directed and controlled'. Moreover, OECD (1999) stated that corporate governance is a set of relationships between a company's management its board, its shareholders and other stakeholders. In contrast to the Cadbury definition on corporate governance, OECD definition addresses a great extent of, multiple stakeholder groups. OECD specifies the importance of building strong and sustainable relationship with all the stakeholders of the company. There are several theories to describe this such as Agency Theory, Stakeholder theory etc.

Corporate Governance in Sri Lanka

Good Corporate Governance would undoubtedly have played a leading role in achieving impressive results. The first Sri Lankan corporate governance code was introduced in 1997 by the Institute of Chartered Accountants of Sri Lanka (ICASL) to deal with financial aspects of corporate governance of Sri Lankan listed companies.

Good corporate governance practices are not a new phenomenon in the world although recent collapses of several companies which were considered successful have emphasized the need for good business practices and governance structures. These structures and processes are especially important for the success of business as it brings in better risk management practices through enhanced accountability and transparency. It also promotes the development of the community, the economy of the country and ensures a better relationship between the company, its shareholders, employees and the community. The Securities and Exchange Commission of Sri Lanka is committed to improving and promoting the use of international best practice which is essential for the development of the capital market, improvement of professionalism among market participants and raising the profile of the Sri Lankan capital market, in keeping with its objectives. In 2002 a voluntary code on corporate governance was published jointly by the Securities and Exchange Commission of Sri Lanka and the Institute of Chartered Accountants of Sri Lanka. It has been amended to reflect the standards which have been mandated through the Listing rules of the Colombo Stock Exchange. Another significant piece of legislation established in Sri Lanka in 2007 was the Companies Act No 7 of 2007 which replaced the 25-year-old Companies Act 17 of 1982. The Companies Act No. 7 of 2007 is a significant development in company law in Sri Lankan, but it still exits some shortfalls. First, it fails to recognize essential practices adopted by a company. E.g: the treatment of issuing bonus shares. Secondly, the new Act includes some compulsory responsibilities for directors that appear burdensome in the context of Sri Lanka's economic climate. Finally, the Sinhala version of the Act, which takes superiority, has inconsistencies with the English version.

Pyramid ownership, cross-shareholding, and dual class shares are common features of concentrated ownership structure. Another characteristic of the Sri Lankan corporate structure is a financial sector dominated by banks. Most of the Sri Lankan listed companies exhibit a predominance of equity rather than debt in their capital structure. The level of corporate debt in Sri Lanka is significantly less than developed countries.

The Board Size.

Board size refers to the total number of directors on the board of each sample firms which is inclusive of the CEO and Chairman for each accounting year. This will include outside directors, executive directors and non-executive directors. The statistics for board size shows that in general the hotel sector firms have large boards. Averagely around 8 directors are recommended by Abdullah (2004). Andres ***et al***. (2004) reveals that the board size of Malaysian property firms, mean board size of 12 or 13 directors can be small if it is compared to board sizes of American, British, Canadian, Spanish, French and Belgian firms. Bonn ***et al***. (2004) studied the most appropriate absolute number of directors that should be present in a board to obtain better performance and has been regarded as one of the important corporate governance variable.

Yermack (1996), Eisenberg ***et al***. (1998) and Barnhart and Rosenstein (1994) have reported a negative association between board size and performance. Yermarck (1996) analyzed a sample of 452 large U.S industrial corporations between 1984 and 1991 and found an inverse relationship between board size and firm value. Further he denote that not only firm value is represented by Tobin's Q but also performance is represented by ROA, return on sales and sales/assets, the negative relation can be seen. Eisenberg ***et al***. (1998) tested the relationship between board size and profitability on small and mid size Finnish firms. They presented evidence of a negative association between board size and profitability; it is supporting the theory denoted by Lipton and Lorch (1992). Jensen (1993) finalized that more effective monitoring can be obtained by a small board than a large board. That particular research emphasizes a negative association between board size and firm performance. On contrary, Bacon (1973) emphasizes a positive correlation between board size and firm performance. Also, Zahra and Pearce (1989) and Kiel and Nicholson (2003) reveal board size is positively related to corporate performance.

Barnhart and Rosenstein (1994) found that firms with smaller board size perform better than firms with large board size. According to Lipton and Lorsch (1992), Limiting board size is improved firm performance because the benefits by communication and decision-making of larger groups. As per Roselina Shakir (2001), a large board has less meaningful discussion, since expressing opinions within a large group is generally time consuming and difficult and frequently results in a lack of cohesiveness on the board. As a result of his research, found that board size, within 7 directors, are preferred by the market.

Chaghadari M.F. (2011) has found that 9 directors are good to be in a firm director board. And also to Lipton and Lorch (1992) recommended limiting the number of directors on a board to seven or eight is difficult for the CEO to control. This is fairly a large number for a board in hotel sector organization, when compared to average of 7.56 per board for all the listed companies in Sri Lanka. Brazilian Institute of corporate governance has emphasis that board of directors should be as small as possible and may vary in size between 5 and 9 members, according to the needs of the company.

Accordingly when consider the hotel sector organizations in Sri Lanka following hypothesis can be developed

H1: There is a negative relationship between board size and firm performance

Non-Executive Directors (NED)

Corporate governance reveals that two or at least 1/3 of the total number of directors should be NEDs. Boards mostly compose of executive and non-Executive directors. Shah ***et al***., (2011) describe NED from a legal aspect, as the responsibilities of executive and non-executive directors are the same. And they refer executive directors to dependent directors and non-Executive directors to independent directors. Khan A. defined as at least one third of independent directors are preferred in board, for effective working of board and for unbiased monitoring.

However, executive directors have an active role in leading the company and its affairs for the best interests of stakeholders. Some researchers have looked for direct evidence of a link between board composition and corporate performance. Study by Baysinger and Butler (1985) indicated that the proportion of independent non-executive directors in 1970 was positively correlated with return on equity.

Forsberg (1989) finds no relation between the proportion of outside directors and various performance measures. John, K. and L.W. Senbet (1998) present two studies to examine effective corporate boards to have effects on organizational performance when composed of outside directors. The study indicated that, on average, the greater presence of outsiders is associated with higher performance.

On the other hand, studies by Klein (1998), Bhagat and Black (1997, 1998) and Hermalin and Weisbach (1991) have found that a high proportion of independent directors do not predict better future accounting performance. The studies of Klein (1998) and Bhagat and Black (1997, 1998) also found that the proportion of independent non-executive directors had no consistent effect on market-adjusted share-price performance.

However the non-executive directors play supervisory and balancing roles, controlling the activities of the executive directors and the board in general. Sri Lanka‘s code of best practice on corporate governance (2008) has as its fifth mandatory principal the appointment of non-executive directors on the board. According to that code, a Sri Lankan listed companies’ board should include at least two non-executive directors or such number of non-executive directors’ equivalent to one third of total number of directors, whichever is higher. (A.5.1 - Code of best practice on corporate governance – Issued jointly by The Securities and Exchange Commission of Sri Lanka & The Institute of Chartered Accountants of Sri Lanka on 1st July 2008).

The investors’ becoming more aware of non-executive directors on corporate boards has increased in recent years in Sri Lanka. According to the corporate governance survey in Sri Lanka, over 90% of participating companies had non-executive directors on their boards and among them 87% considered that the balance between executive and nonexecutive directors was appropriate.**(**Corporate Governance Survey in Sri Lanka 2007). The impact of the proportion of non-executive directors in the board on performance was different in various contexts. Therefore the second hypothesis is developed as

H2: There is a negative relationship between the Proportion of NED and Firm Performance

Insider Ownership

Insider ownership means Proportion of general ownership on the board. Insider ownership has important implications for corporate governance. Shleifer, and Vishny (1997) find a mean combined stake of all board members of 10.6% for listed US firms, which is close to the 12.1% which were found by Cho (1998). According to Davies, Hillier, and Mc Colgan (2005) the mean ownership stake held by the management of UK firms is 13.0%, the meaning of that is, insider ownership plays a more important role in every country.

Insider ownership has important implications for corporate governance. Using 648 German firms Christoph & Moldenhauer (2005) also find a positive relationship between insider ownership and stock performance. Iturralde ***et al***(2011), argued that if insider ownership is between 0 and 35%, increases in ownership will result in higher firm performance. The reason lies in the greater incentives for insiders to maximize performance, as their equity holding grows. On the other hand, if insider ownership is between 35% and 70%, the performance of firms falls when their percentage of ownership increases. Demsetz and Lehn (1985) find no significant correlation between ownership concentration and accounting profit rates for 511 large corporations. Morck ***et al*** (1988) report a piecewise linear relationship of Tobin’s Q with board member ownership for 371 Fortune 500 firms. Holderness ***et al***. (1988) analyze 114 NYSE- or AMEX-listed corporations in which a majority shareholder owns at least 50.1% of the common stock. Tobin's Q is higher if the majorities owners are corporations, while Tobin's Q as well as the accounting profit rates are significantly lower for firms with individual majority owners. McConnell and Servaes (1990) find for a sample of more than 1,000 firms that Tobin's Q is positively correlated with the fraction of shares owned by institutional investors.

Nevertheless, a number of studies failed to detect any evidence that insider ownership affects financial performance (Demsetz & Villalonga, 2001; Loderer & Martin, 1997). Demsetz and Lehn (1985) show that ownership structure of US companies is plausibly determined by firm size, stock price volatility, industry affiliation, and some other variables. According to their view this corroborates the understanding that ownership structure is endogenously determined. Himmelberg***et al***. (1999) extend Demsetz and Lehns' results by using a fixed effects panel data model and instrumental variables to control for possible unobserved firm heterogeneity. They conclude that most variation in managerial ownership is explained by unobserved firm heterogeneity and that managerial ownership does not affect firm performance to an econometrically observable extent. Research presented by Loderer and Martin (1997) points in the same direction. They construct a simultaneous equation system for a set of companies involved in acquisitions which handles performance and insider ownership as endogenous variables. As a result, insider ownership does not have a predictive effect on performance in their model, but the other way round performance has a negative effect on insider ownership.

Insider ownership which supported by the research carried out by Agrawal and Knoeber (1996) and Cho (1998), who show that a positive impact of insider ownership on corporate value is a mere result of failing to control for endogeneity. In contrast, findings are roughly in line with those of Beiner ***et al***. (2005) who also find a positive impact of insider ownership on corporate performance, Using a data set of 245 companies for the year 2003 Kaserer C. and Moldenhauer B. (2003) found evidence for a positive and significant relationship between corporate performance, as measured by stock price performance as well as by Tobin's Q, and insider ownership. Hence it is develop the following hypothesis as

H3: There is a positive relationship between the Insider Ownership Percentage and the Firm Performance.

Female Directors

According to Singh & Vinnicombe (2004), female directors are averagely in U.S.A. is 12.4% and U.K. 4%. Carter, Simkins and Simpson, (2003) finds that firms with at least two women on the board performed better on Tobin's Q and ROA when comparing to men-firms.

Erhardt ***et al***. (2003) find that the percentage of female directors is positively related to larger US firms' two accounting measures; return on assets and return on investments. In addition, recent research by Wilson & Altanlar (2009), finds that the presence of at least one female board director reduces company bankruptcy costs. Adams & Ferreira (2008) present a significant positive relationship between gender diversity and firms' financial performance when performance is measured by Tobin's Q and ROA. However, they find gender diversity on a board of directors has a positive effect only when firms have a weak governance structure.

Shrader ***et al***. (1997) which find a significant negative relationship between the percentage of women on the board and firm value in some tests. The women participation in all most all the activities around the world is increasing. Although the number of women directors has grown somewhat rapidly during the last decade, their representation in the boardrooms remains very low. Farrell and Hersch (2005) report that women tend to serve on boards of better performing firms and suggest that a shortage of supply allows women to self-select the firms, or that these firms are able to focus more on diversity goals. Shrader ***et al***. (1997) investigate the relationship between the percentage of female board members and two accounting measures of financial value (e.g. ROA and ROE) for a sample of approximately 200 Fortune 500 firms.They find a significant negative relationship between the percentage of women on the board and firm value in some tests.

There are various views noted by various researchers regarding the presence of female directors in the board. Some have revealed positive relationships between financial performance and presence of female directors in the board. Erhardt ***et al***. (1903-2003) also find that the percentage of female directors is positively related to larger US firms' two accounting measures; return on assets and return on investments.

Joana Marinova et.al. (2010) examines whether board gender diversity has a positive effect on firm performance, based on evidence from the Netherlands and Denmark. The research resulted that almost 40% have at least one woman in the boardroom based on 186 listed firms. The empirical research findings indicated that there is no effect of board gender diversity on firm performance. Dezso and Ross (2008) found that having a female CEO had no positive effect on firm performance; while female participation below the CEO level was positively associated with firm performance for companies pursuing an innovation intensive strategy. Rose (2007) found that female board representation had no impact on firm performance.

Smith ***et al***.(2006) showed that the share of women among top executives and on boards of directors tended to have a significantly positive effect on firm performance. Research in the UK, Wilson and Altanar (2009) has shown that having at least one female board director reduces the risk of bankruptcy.

By looking at the scholarly views researchersbuildthe following hypothesis to test the impact of board structure on firm performance.

H4: There is a positive relationship between the proportion of Female Directors and the Firm Performance.

Firm Performance

There are several ways of measuring firm performance and there is hardly any agreement on which is the most efficient one. Market based ones (Tobin's Q and portfolio returns) and financial statement ratio (ROA, ROE, ROI) are two main types of performance measurements which have been widely used in prior corporate governance researches. Based on prior studies, the researcher selected to measure the firm performance Return on Assets (ROA), Return on Equity (ROE) and Tobin's Q, as majority of prior studies has used ROA, ROE and Tobin's Q to measure the firm performance.

Return on Assets (ROA), which shows the amount of earnings have generated from an invested capital assets (Epps and Cereola 2008). They defined ROA as net income before interest expenses for the fiscal period divided by total assets for that same period. The reason to calculate ROA is to measure the benefit of the common stockholders. ROE, as a performance measure, that shows, an investor how much profit a company generates from the money invested from its shareholders. ROE is the income before interest expense for the fiscal period divided by total shareholders' equity for that same period (Epps and Cereola 2008).

Firm performance is studied and measured by different researchers using different measures. Klein (1998) has used return on assets (ROA) as an operating performance indicator while Lo (2003) is using return on equity (ROE) as an operating performance indicator of his research. Browns and Caylor (2005) also used ROA and ROE as their performance measures. Matolcy and Wright (2011) measured firm performance using by ROA (Return on Assets = EBIT / Average total assets - in book value) and ROE (Return on Equity = Net profit / Equity - in book value).

Yasser ***et al***. (2011) used Return on Equity (ROE) and profit margin (PM) for the measurement of firm performance. Market based measures of company's performance, Tobin's Q (market value of equity + book value of debt / total of assets – in book value) used by shah ***et al*** (2011). Bhagat & Black (1999) measured dependent variables firm performance by Tobin's Q, ROA (operating income / assets), Turnover ratio (sales / Assets), operating margin (operating income / sales), sales per employee and also by growth of assets, operating income, employees and cash flows. Rose (2007) used accounting performance measures of return on asset (ROA) and return on equity (ROE) largely depend on the asset-valuation method and Tobin's Q, even though not flawless, is relatively easily to interpret. According to prior studies, it can be seen that many of researches has used ROA, ROE and Tobin's Q to measure the firm performance.

IV. Summary and Conclusion

Based on the literature four independent variables have been identified which affect the performance of the firm. Those are Board size (BZ), Non- Executive Director Proportion (NED), Female Director Proportion (FDP), and Inside Ownership Percentage (IOP). The other factors which may impact on firm performance has identified as control variables in the study such as firm size and leverage. And the dependent variables which are used to measure the firm performance are Return on assets, Return on Equity, and Tobin's Q. Concerning these things four hypothesis were developed in order to identify the relationship between Dependent and Independent variables.

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