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**BOARD COMPOSITION AND FINANCIAL PERFORMANCE
AMONG PRIVATE LIMITED COMPANIES IN UGANDA**

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ABSTRACT

Purpose: The study aimed at examining the relationship between board composition and financial performance of private limited companies in Uganda.

Methodology: A positivist approach and a cross-sectional research design were employed to collect data from 394 companies in Central and Western Uganda. An open-ended questionnaire was used to collect data from board members and executives from companies. Pearson correlation and standard linear regression were employed for data analysis.

Findings: Results indicate a positive relationship between non-executive directors on the Board and the financial performance of private companies.

Unique Contribution to practice and policy: Private Limited Companies in Uganda will attain the much-desired insights in the context of how board composition links with their financial performance. The study recommends the management's careful consideration of long survival prospects as well as the formulation of appropriate policies and survival strategies that oversee long existence to guarantee benefits and optimal performance coupled with profitability that emanate from a well-composed board.

Study Limitation: The study was limited to only board composition, leaving out other board characteristics that influence financial performance. Besides, it was only positivistic hence subject to methods bias that could have affected the validity of results.

Keywords: *Board Composition, Financial Performance, Private Limited Companies.*

INTRODUCTION

Board composition is a reflection of the degree of heterogeneity. It is measured by the ratio of non-executive directors to the board size. Board diversity can result in increased information flows and decision making (Oehmichen et al., 2017). On the other hand, financial performance is a measure of how effective a firm can make use of assets to generate revenue over a given period. The influence of the Board on the financial performance among companies has gained enormous attention from various stakeholders such as researchers, policymakers, and investors, given corporate failures in both developed and developing economies (Christofi, Christofi, and Sisaye, 2012; Nawaz and Haniffa, 2017). To this effect, many businesses have been brought on board, merged or purchased because of their weak governance practices. Like other regions, East Africa has had a share of challenges in the private sector where 70% of Small and Medium enterprises collapse within 24 months of their existence over reasons related to governance. Uganda tops countries with the highest rate (30%) of failing businesses (Nkundabanyanga, Ntayi, Ahiauzu, and Sejjaaka, 2014). Uganda has had several recent large-scale corporate failures where indigenous companies such as Greenland bank and Crane Bank collapsed in 1999 and 2016, respectively (Capital Market Authority (CMA) Annual Report 2016/7). As a result of all these scandals, governments and private sector organizations around the world have made various efforts to promote good governance in both the private and public sector hence leading to the emergence of numerous governance guidelines and codes (Black, De Carvalho, and Sampaio, 2014; Macías and Román, 2014).

Nevertheless, there is a growing consensus that well-governed companies tend to achieve high financial performance. It is important to remember that the Board of directors plays an integral role in the practice of corporate governance because it is responsible for managing and overseeing the priorities of a company (Gennari, 2017). Appropriate selection of directors is essential in helping the Board achieve its goal and ensure the company's success (Müller, 2014). Board composition represents the proportion of internal and external directors serving on the Board and has a direct influence on the operations of the company (Scafarto, Ricci, Della Corte, and De Luca, 2017). However, The composition of the Board and its effect on outcomes is highly debatable. Directors may either be graded as Executive (i.e., personnel holding positions of both directors and managers) or non-executive directors. As noted by Jackling and Johl (2009), each of these categories features different incentives and behaviors. Most national and international corporate governance codes advise a combination of both (e.g., The Organisation for Economic Co-operation and Development (OECD) Code, the Combined Code in the U.K., and the Sarbanes-Oxley Act in the U.S.).

According to agency theory, there is a need for adequate monitoring systems to protect shareholders against manipulation by management, and this is best governed by Non-Executive Directors (NEDs). Consequently, a higher proportion of non executive directors (NEDs) on Board are expected to indicate improved monitoring and thus reduce agency problems (Cabello et al., 2019). Adams et al. (2010), Rao and Tilt (2016) argue that because of their expertise and firm-specific knowledge, executives are intrinsically valuable to boards but can be driven by self-interest at the detriment of the company and its shareholders.

Non executive directors (NEDs), on the other hand, provide objective monitoring and boost the efficiency of companies but have a less in-depth understanding of the company's day-to-day

operations compared with executives. A growing consensus is that a vigilant, strong, and diverse board positively influences firm value, given their superior strategic innovation and decision making (Hamidi and Gabrielsson, 2018). Although Adnan and Ahmed (2019) recognized the role of monitoring by NEDs and their responsibility for disciplining management, they discovered no significant connection between the Board's share of NEDs and firm financial results. According to Hamidi and Gabrielsson (2018), a higher proportion of NEDs enhances the Board's power over the executive; thus, the Board's oversight role under the agency theory involves the existence of NEDs to protect shareholders' interests by overseeing the executive.

Besides agency theory, specific theoretical insights were developed to understand the positions and configuration of the boards. From a resource perspective, the Board is a critical and more strategic resource responsible for the co-ordination of interdependence across different firms (O'Hagan, 2017). Furthermore, the capabilities and capacities of a company's internal environment are essential to its competitive advantage, and the Board has an advisory role to play in this regard (Khurshi et al., 2019; Pisano, 2017), especially for NEDs that can bring their external skills and knowledge to a firm's management team. It also helps a firm to compensate for the deficiencies of management where NEDs will not only control management but also improve the Executive's resource and service needs (Ogunseyin et al., 2019; Maseda et al., 2016). Therefore, since the advisory role of the Board is associated with their strategic networks and service potential, NEDs can link the internal and external environments of a firm to enhance managerial activities (Bird et al., 2019; Dixon-Fowler et al., 2018). As argued by O'Hagan (2017), NEDs are notable and influential people that can leverage their networks to promote the legitimacy, reputation, and value of a firm. They can also meet the human resources deficits that are usually characteristic of sophisticated large firms, hence enhancing decision making processes and supervision (Khurshid et al., 2019). It can therefore be deduced that NEDs mediate shareholder conflicts of interest and management, thus improving firm performance.

Conversely, since they lack professional skills and experience of the internal workings of a business, the stewardship theory posits that NEDs cannot oversee managers compared to insider directors. Farhan et al. (2017); Hussain (2019) posit that NEDs are, in most cases, irregular workers—a factor restricting their capacity to guide the Board and monitor management given that they lack information concerning a firm's operations. As a consequence, a council dominated by high NED rates will lead to uninformed decisions, and that, in effect, will have a negative impact on firm results. Besides, Gyapong et al. (2020) and Paniagua et al. (2018), assert that NEDs not only suffer information asymmetry but also are too busy in their firms or affairs; thus, they do not bring the expected skills to the Board. Their irregularity negatively affects their ability to supervise management behavior, which could begin to work for their preferences rather than those of the shareholders and the company hence adversely affecting firm financial performance. Ahmed et al. (2018) observed that since NEDs are part-time employees, they are not indeed acquainted with all the operations. This factor undermines their ability to understand the uncertainties faced by the firm. Furthermore, Wells et al. (2019) highlight three main factors that can limit NEDs from adding value to the firm. Firstly, there can be private connections between the NEDs and the CEO. Secondly, the incentive for NEDs to perform positively reduces when they are appointed on to the Board for long. Thirdly, NEDs could be pre-occupied by their roles as executive directors elsewhere hence undermining their efficiency on the Board.

This paper is anchored on the quest to exhume empirical scrutiny about the affiliation of board composition to the financial performance of private limited companies in Uganda. Private limited firms have invited momentous attention concerning their profit inclination as well as a palpable constituent of stakeholders. The projection of this study is the ultimate benefits to stakeholders in several aspects. First, Private Limited Companies in Uganda will attain the much-desired insights in the context of how board composition links with its financial performance. Second, It demands the management's careful consideration of long survival prospects as well as the formulation of appropriate policies and survival strategies that oversee long existence to guarantee benefits and optimal performance coupled with profitability that emanate from a well-composed board.

This paper is organized into five sections. The first section is a brief overview of the research and the contribution of the study. It is followed by a literature review and hypotheses in the second section to discuss the theoretical background of the study and previous studies on Board composition and financial performance. The third section is to discuss the source of data, research methodology, and framework. The fourth section concentrates on the discussion of results. Finally, the fifth section concludes and gives study implications, study limitations, and recommendations for areas for future research.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Despite a positive relationship between NEDs and financial performance suggested by agency theory, empirical evidence exhibits conflicting results (Baranchuk and Dybvig, 2009; Hashim, 2012). Abatecola et al. (2014) analyzed the impact of NEDs on the board on the financial results of a company, using a sample of 950 Italian small family businesses, and established an appositive association. Abatecola et al. (2014) found that NEDs enhanced firm performance by adding value to their contributions in the form of experiences, skills, and networks. In a related case, Khan and Awan (2012) also report a significantly positive association between NEDs and the financial performance of a firm as measured by ROE, Tobin's Q, and ROA. Khan and Awan (2012) conclude that a higher proportion of outsiders on the Board could add value to the firm, given their close monitoring and their valuable advice to the company.

Besides, Mburu and Kagiri (2015) found a positive association between the board composition of banks listed on the Nairobi stock exchange and their financial performance. Müller (2014) obtained similar results that established a strong positive relationship between firm performance and board composition. Such findings are consistent with the agency theory and the resource dependency theory, where NEDs are effective managerial behavior control and disciplining device. On the Contrary, Cruz et al. (2010); Domadenik et al. (2016) established a negative relationship between financial performance and NEDs. Besides, Arosa et al. (2013); Farhan et al. (2017) provide evidence indicating no association between the two. Similarly, (Rashid 2011) found that independent directors do not add value to the economic performance of companies in Bangladesh. Besides, Ongore et al. (2015) found an insignificant effect of independent directors on the financial performance of Nairobi Securities Exchange Listed companies. In a related case, Muchemwa et al. (2016) found no connection between the board composition and the financial performance of Johannesburg Stock Exchange-listed companies.

From the above conflicting views and mixed results from various theories and empirical studies, it is inferred that the effect of board composition on financial performance is still inconclusive,

especially in the context of private limited companies in Uganda. Thus, the researcher hypothesized as follows;

H1: *Non-executive directors on the Board are positively associated with firm performance*

RESEARCH METHODOLOGY

The study employed a positivist paradigm, collecting quantitative data through scientific procedures. This enabled the generalization of results and maintaining the impartiality of the researcher and participants (Zuckweiler et al., 2016). A cross-sectional study design was followed, with data obtained at a single point in time on more than one case, to detect patterns between variables (Bell et al., 2018). Given a population of 30,000 private limited companies in Uganda (Uganda Bureau of Statistics, 2016), the study surveyed 394 companies determined using a formula by (Yamane 1973). i.e.

$$n = \frac{N}{1 + N(e)^2}$$

Where n, N and e represent the sample size, population, and standard error of estimate (5%), respectively.

Emphasis was on Western and Central Uganda since 80% of private companies are located there (Uganda Bureau of Statistics, 2016) hence a good representative sample. Private limited companies were categorized using stratified sampling with companies categorized by region and sector. Only companies limited by shares and fully private (no joint ventures) were considered because of their profit orientation and clarity of their ownership and control. Firms were selected from each district and sector using a simple random sampling technique (Standage et al., 2006). The researcher used a self-administered questionnaire for collecting data from board members and the executive. The questionnaire enhanced the anonymity of respondents and enabled them to respond more freely and at their convenience hence a high response rate (Creswell and Creswell, 2017). All companies returned questionnaires, thus achieving a response rate of 100%.

Pearson Correlation and standard linear regression were the data analysis techniques used in testing the relationship between financial performance and board composition (Tabachnick et al., 2007). The following analytical regression model for testing the relationship between financial performance and board composition was defined.

$$FP = \beta_0 + \beta_1NEDs + e$$

where, FP = Financial performance, β_0 constant, β_1NEDs coefficient of non-executive directors and e = error term.

Measurement of Variables

Board composition was investigated in terms of the number of non-executive directors compared with the total number of board members in limited companies. A dummy variable was created with the presence of NEDs on the board coded “1,” and their absence coded “0”. This is consistent with several studies that have used NEDs as a parameter for corporate governance and financial performance (Heenetigala et al., 2016; Hendry et al., 2010). Profitability, liquidity, financial

efficiency, and solvency ratios were used as proxies of financial performance (Imam et al., 2017; Sengur, 2011).

RESULTS

Demographic Characteristics

Frequency distributions were generated to assess the demographic characteristics of private limited companies in Uganda, shown in Table 1.

Table 1: Demographic Characteristics of Companies

Sector of Private Limited Companies			
	Frequency	Percent	Cumulative Percent
Agriculture	62	15.7	15.7
Industry	139	35.3	51
Services	193	49	100
Total	394	100	
Location of Private Limited Companies			
	Frequency	Percent	Cumulative Percent
Western Region	119	30.2	30.2
Central Region	275	69.8	100
Total	394	100	
Frequency Distribution by Board Composition			
	Frequency	Percent	Cumulative Percent
NEDs Below 50%	351	89.1	89.1
NEDs 50% and Above	43	10.9	100
Total	394	100	

Source: Primary Data

Results (Table 1) indicate that a significant proportion (49%) of private limited companies that participated in the study operated in the service sector with a substantial (35%) in the industry sector and 15.3% in agriculture. This means that most companies in Uganda are in the service sector with those in agriculture operating informally. The majority (68.9%) of these companies were in Central Uganda, compared to 32.2% in Western Uganda. As regards board composition, it was established that most (89.1%) of private companies had the majority of board members serving as executive directors, and 10.9% had their boards comprising of a higher proportion of non-executive directors (outsiders). This implies that board members of most companies were not independent in their execution of tasks.

Table 2: Regression Analysis

(a) Model Summary						
Model	R	R Square		Adjusted R Square		Std. Error of the Estimate
1	0.16	0.02		0.02		0.40
b) ANOVA						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	1.57	1.00	1.57	9.70	0.00
	Residual	63.48	392.00	0.16		
	Total	65.05	393.00			
(c) Coefficients						
Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	2.38	0.07		31.79	0.00
	NEDs	0.20	0.07	0.16	3.11	0.00

Source: Primary Data

The regression model (Table 2b) was significant ($F(1,392) = 9.7, p < 0.01$), indicating that the model fits the data and results were not generated by chance (Sengur, 2011) thus, confirming NEDs as a valid predictor of financial performance. The results (Table 2a) suggest that NEDs had a significant positive relationship with the financial efficiency of private limited companies ($r = 0.16, p < 0.01$). This implies that a higher proportion of non-executive board directors (NEDs) is related to high levels of financial performance, supporting hypothesis H1. However, the results (Table 2a) revealed that NEDs account for a mild 2% ($r^2 = 0.02$) of the variation in the financial performance of private limited companies, with 98% being explained by other factors not specified in the model. Likewise, a beta coefficient ($B = 0.2, t = 3.11, p < 0.01$) indicates that for every non-executive member recruited on the Board, the financial performance of a company increases by a significant 0.2 units (Table 2c). This is true because non-executive directors have a wide range of experience, external networks and make decisions independently hence improving the performance of a company

DISCUSSION

Board composition was measured as a proportion of the non-executive directors appointed on the Board of private limited companies. Results indicated that most (89.1%) of private companies in Uganda had the majority of their board members serving as executive directors (insiders) compared to a marginal 10.9% that had their boards comprising of a higher proportion of non-executive directors (outsiders). This practice is against the agency theory, which asserts that a more significant percentage of NEDs on the Board indicates enhanced monitoring and therefore eliminates issues with the agencies (Giannakopoulou et al., 2016). They also contradict the views of Gabrielson (2017), who posits that a higher proportion of NEDs enhances the Board's power over the executive, thus protecting shareholders' interests by overseeing the executive. In Uganda, the companies Act (2012), Financial Institutions Act (2004), and Capital Markets Authority Guidelines on corporate governance (2003) require companies to have a more substantial proportion (75%) of NEDs on their boards for effective monitoring of the executive. Therefore, the above practice by private limited companies in Uganda partly explains their poor financial performance.

Furthermore, results (Table 2a) revealed that NEDs on the board are strongly correlated with an organization's financial performance. This means that a higher proportion of NEDs on the Board of directors leads to higher business performance, thus supporting hypothesis H1. This finding rhymes with the views of (Hamidi and Gabrielson, 2018), who posits that a strong, vigilant, and diverse Board positively influences firm value given their superior strategic innovation and decision making by NEDs. These results also coincide with findings by other researchers. For instance, while examining the impact of outsiders on the financial results of an organization with a study of 950 small Italian family businesses (Gordini, 2012) established a positive association. Gordini confirmed that NEDs improve firm performance by adding value to them through their contributions in the form of experiences, skills, and networks.

García-Olalla and García-Ramos (2010), Khlif et al (2016), Machold et al. (2011); and Pandey (2020) reported similar findings. They established that given the board's close supervision and useful advice to the executive, a higher proportion of outsiders on the Board could add value to the business. Additionally, the results of this study are also consistent with the suggestions of agency theory and resource dependency theory, where NEDs are an efficient monitoring and disciplining

instrument for managerial actions. The agency theory suggests that NEDs support an organization to compensate for the deficiencies of management, where they will not only control management but also increase the resource and service requirements of the executive hence improving a firm's financial performance (Zahra & Pearce, 2008).

Theoretical Implication

From the agency theory viewpoint, although there are conflicting views on the composition of corporate boards, the present study has confirmed that board composition plays a critical role in influencing financial performance. From the findings, the study has highlighted the positive effect of non-executive directors on the board on the financial performance among the private limited companies in Uganda, thus serving its purpose.

Managerial Implication

First, the study highlighted the crucial role non-executive directors play in the financial performance of private limited companies in Uganda. The study findings highlight the need for shareholders to ensure that the boards of their companies bear dynamic characteristics such as having more non-executive directors. From the study findings, such attributes are vital in determining the efficiency of the Board in monitoring the executive and improving the financial performance of private limited companies.

CONCLUSION

It can be concluded that an independent board of directors is an essential factor in monitoring and controlling the actions of management hence improving the financial performance of a company. Besides, private companies can only benefit if their shareholders appreciate the need for more non-executive directors in governance processes. Accordingly, board members who are part of the management team may be able to control business processes but can be driven by self-interest at the detriment of the company and shareholders hence negatively affecting the financial performance of an organization.

RECOMMENDATIONS

The study recommends that private companies should improve their Board's efficiency by appointing a higher proportion of non-executive directors on their boards than insiders for effective monitoring of the executive. This will protect shareholders against the selfish interests of the executive hence improving financial performance. The study also recommends that private limited companies in Uganda recruit more NEDs on their boards for effective monitoring of the executive.

LIMITATIONS

The study only focused on board composition, as a predictor of financial performance, leaving out other board characteristics such as board size, leadership structure, audit committee, among others that constitute effective corporate governance. A mild (2%) contribution of the model to variation in financial performance implied that many other predictors were not specified. Besides, the study only relied on positivist rather than pragmatic approach, thus being subject to methods bias.

AREAS FOR FURTHER RESEARCH

The present study has pointed out a positive relationship between financial performance and board composition. More research can cover other board characteristics that influence financial performance. More so, future researchers can adopt a pragmatic paradigm collecting both quantitative and qualitative data on the same study to minimize methods bias. Future studies could also seek to test the mechanism through which board characteristics influence financial performance rather than merely testing direct relationships.

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