

The Effect of Board Composition on Firm Performance: A Review

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Abstract

The relationship between board composition and corporate performance is a long-standing and central topic in corporate governance research. The existing literature mainly adopts an agency theory perspective, emphasizing the monitoring role of external directors; however, previous studies have reached conflicting conclusions. In contrast, research adopting a resource dependence theory perspective is relatively limited. According to resource dependence theory, boards not only fulfill oversight duties but also influence corporate performance by providing critical resources, expertise and external connections. This paper provides a critical review of the prior literature on board composition, focusing on summarizing the functional differences among different director types in terms of resource provision and external linkages. By integrating findings from agency theory and resource dependence theory, the paper reveals the various mechanisms through which board composition influences corporate performance. It also offers new theoretical perspectives and research directions for future corporate governance studies.

Keywords: Board Composition, Resource Dependence Theory, Agency Theory, Firm Performance

Introduction

Board of directors is one of the most important segments of corporate governance in an organization and it has caught hot attention in the recent decades (Ibrahim & Angelidis, 1995). Board of directors is a group of individuals who are elected by owner of company to establish corporate management related policies and make decisions on strategic issues. Boards oversee top executives on behalf of shareholders, mitigating agency problems (Merendino & Melville, 2019) and ensuring management acts in owners' interests (Garad et al., 2021). Beyond monitoring, Boards hire and dismiss CEOs and senior managers and design incentive contracts that align managerial behavior with firm value (Ozdemir & Kilincarslan, 2021).

Based on director affiliations and the functions they perform, Baysinger and Butler (1985) classified board of directors into three key components, which are executive, monitoring, and instrumental. Directors in executive components are closely aligned with top management team of the corporation. Insiders are one of them. They provide a source of expertise that will help firm's decision makers to formulate and implement strategic decisions. Besides, they also provide valuable information to outsiders about how to evaluate the performance of senior managers and contribute to enhance the effective government (Fama & Jensen, 1983).

In monitoring component, directors play role as policeman of management practice who will be administering managers' behavior, ratifying management decisions and monitoring their performance as a way to make sure that managers and shareholders have aligned interests and no conflicts are exist (Baysinger & Butler, 1985). Generally, they are formed by truly independent or outside directors (also called as outsiders), therefore they are able to exercise independent judgments of managerial conduct and performance (Eisenberg, 1976). To stay independent, they cannot engage in business activities and must not be the current employee of the firm or someone who has close connection, either psychologically or economically, with its managers.

It is obvious that extremes in board composition will unfavorably affect the board effectiveness, ultimately affect the corporate financial performance. For instance, if the entire board is placed with all insiders, agency cost must rise in result of high conflict of interests, sources of valuable resources such as information, expertise, advice, etc., will be disappear, and linkages with other organizations will be sacrificed (Baysinger & Butler, 1985).

Agency problems are always an issue concerned by board of directors. It arises when there are conflicting interests between principals and agents. Even worse, the managers may pursue their own interest at expense of shareholders (Agrawal & Knoeber, 1996). Although the agents are appointed by directors to manage the corporation, sometimes they may make decisions and executive actions based on their personal interests, instead of interests of shareholders. This phenomenon emerges the agency costs which include costs of structuring, monitoring, and bonding contracts among agents with conflicting interests (Fama & Jensen, 1983). The problem is bothering board of directors because its ultimate costs would be the ineffective and inefficient overall performance of the corporation. They are expected to minimize the conflicts of interests between the residual risk bearers (shareholders who are owner of the corporation) and the decision maker or executor (management team members who operate the corporation) (Baysinger & Butler, 1985).

Furthermore, what if a person is a principal and agent simultaneously? There is a group of directors who are present or former members of the top management team and employee of the firm or its subsidiaries (Hillman et al., 2000; Pearce & Zahra, 1992; Rosenstein & Wyatt, 1990). They are called insiders or executive directors. Since insiders are directors and active employees in the same time, the public must be concerning their ability to fulfill both-sides responsibilities without any bias (Daily & Dalton, 1994).

On one hand, some parties argue that insiders are not able to complete their work perfectly independently due to conflicts of interest. The conflicts of interest between director

and managers will negatively affect the performance of an insider, especially during making decision to the question: interest of which party should be prioritized? On the other hand, many believe the insiders, of course the astute or opportunistic managers one, may influence the inclinations of the boards which become the premises for their deliberations and decisions (Allen, 1974; Herman, 1981; Jones & Goldberg, 1982; Pfeffer, 1972; Vance, 1964). For example, the CEOs can use their power as executive directors to hire and compensate directors or exploit personal ties with them, in ultimate purpose of dominating the board.

Not surprisingly, many will question the suitability of appointing insiders in boards and whether they should limit either all or significant majority directorships to truly independent outsiders. However, The optimal board structure, including the number of outsiders, is influenced by a trade-off between maximizing the incentive for insiders to reveal information and minimizing coordination costs among outsiders (Raheja, 2005). Larger boards with more outsiders are not always beneficial and can sometimes negatively impact firm performance (Iturralde et al., 2016). In the concern of board independence and board composition which will ultimately influence the performance of corporation (Naciti, 2019; Nahar et al., 2022), the composition of directors in board would be a worthy and interesting topic to be monitored.

In short, previous studies have reached highly inconsistent and conflicting conclusions regarding the relationship between board composition and firm performance. Over-reliance on Agency Theory and Lack of Integrated Perspectives lead to the following questions:

1. What is the composition of directors (in terms of number of insiders and business experts) that can constitute optimal outcomes and help the firm to perform superior?

Literature Review

Agency Theory

In the earliest stage, the concept of risk sharing among individuals and groups due to the different risk perception between two parties is proposed by Arrow (1971) and Wilson (1968). Later, this risk sharing concept is developed into agency theory by including the agency problem that cooperating parties have different goals (Meckling & Jensen, 1976; Ross, 1973). In agency theory, there is a contract between a principal (owners) and the agent (manager) who is employed by the principal to perform some work on his behalf (Kathleen M Eisenhardt, 1989; Meckling & Jensen, 1976; Ross, 1973). The contract is the agreement that regulates the principal-agent relationship by identifying their rights, the performance measure and the consideration they will receive (Fama & Jensen, 1983; Tosi Jr & Gomez-Mejia, 1989).

The parties in the organization, including the principals and agents are assumed to act on their own interest and may prefer different action. (Kathleen M. Eisenhardt, 1989) It leads the agency problem to be arisen when there is goal conflict between the principals and agents, and it is difficult or costly for the principals to monitor the actions of the agents. According to (Gomez-Mejia & Balkin, 1992), the agents may engage in self-serving behaviours to make personal gain using work time and resources of the company. Thus, agency cost is incurred to monitor the actions of the agents, and it also includes the principals' losses due to the conflict of interest. (Hill & Jones, 1992; Tosi & Gomez-Mejia, 1989) The difference between the principals' actual return and what they could get by controlling the organization directly is called as agency loss (Meckling & Jensen, 1976).

According to agency theory, there are two ways that help principals to limit the loss. These include monitoring the agents' action and rewarding agents to ensure the goal alignment (Fama & Jensen, 1983).

The studies by Jensen and Meckling (1976) and Singh (1985) defined monitoring as "direct and indirect observation of the agent's effort or behavior over some period of time". It can be done through information systems and the board of directors. (Donaldson & Davis, 1991; Kathleen M. Eisenhardt, 1989) Since the information system informs principal the information on the agents' behavior, agents will tend to act in the principal's interest. Board of directors plays an important role in monitoring the managers on behalf of the shareholders to ensure the managers act in accordance to shareholders' interest. CEO duality is happening when the chairman of the board is also the CEO of the firm and it leads to two possibilities. Firstly, the return on shareholders may decrease due to the ineffectiveness of the board in monitoring the managers. Secondly, the return of shareholders may also increase due to goal alignment of managers and shareholders.

According to Kathleen M. Eisenhardt (1989), there are two propositions in determining an effective way in governing the relationship between principal and agent; it is to reduce the so-called agency loss. The first proposition is to reward the agent with a behaviour-oriented contract, and the agent will receive salary as compensation. The second proposition is to reward the agents with an outcome-oriented contract. It makes the compensation of agent received proportional to its performance outcome by giving commissions or stock options to the agent. Research by Argawal and Mandelker (1987) proved the effectiveness of outcome-oriented contract in curbing managerial opportunism by examining whether executive security holdings (outcome-based contract) affects the financing and acquisition decisions (Agrawal & Mandelker, 1987). The result shows that the decisions made by managers are more consistent with the stockholder's preference if they also hold the company's share. However, in the case that principal is able to identify the action of agents, a behavior-based contract will be more effective as it is unnecessary to transfer risk to agents that are assumed to be more risk averse. (Kathleen M. Eisenhardt, 1989) The use of outcome-oriented or behaviour-oriented compensation may also be affected by outcome uncertainty, risk aversion of the agent and principal, goal conflict between principal and agent, task programmability, outcome measurability and the length of the agency relationship.

Although the monitoring and rewarding effort had been done, there will still some managerial actions that diverse from the preference of shareholders. (Hill & Jones, 1992) It is said to be the residual loss as it would reduce the shareholders' return and cause a loss to the shareholders.

Despite the agency theory had risen substantial studies (Barney, 1986) and popular interest, there are some critics of the theory. It is criticized as minimalist by other organizational theories (Hirsch et al., 1987; Perrow, 1986) because the view of agency theory limited to the relationship of shareholders and managers only. It is also criticized by microeconomists as "tautological and lacking rigor" (Fama & Jensen, 1983).

Resource Dependence Theory

Jeffrey Pfeffer and Gerald Salancik publicize resources dependence theory through their book "The External Control of Organizations: A Resource Dependence Perspective" in 1978. The theory describes organizations as an open system that dependent on uncertainty and contingencies in the external environment. (Pfeffer & Salancik, 1978) Organizations are argued as coalitions that change structure and behaviors in order to acquire certain resources from environment. (Ulrich & Barney, 1984) It is a study of the effects of external resources on behavior of the organization. The fundamental assumption of resource dependence theory is the behaviors of organizations will be influenced by its dependence on significant resources. (Nienh et al., 2008)

Resource dependence theory supposes the organization depends on important resources which are available from the environment. The importance of a resource is determined by the relative magnitude of the exchange and its criticality. On one hand, the relative magnitude of a resource can be measured by assessing the proportion of total inputs or the proportion of total outputs accounted for by the exchange. For instance, organizations with single input or single output will more dependent on external resources, therefore the resources will be more important for the organization. On the other hand, the criticality of a resource on an organization can be defined by measuring the ability of the organization to continue functioning without the specific resource. (Pfeffer & Salancik, 1978) A resource which is just a tiny portion of the total input can be critical to an organization. Example from Pfeffer and Salancik (1978), electric power is one of the critical resources in the organization because almost no office could function in absence of it. Due to the conditions in organization's environment changing, the criticality of a resource for the organization will be different, and so do the dependency of organization on the resources.

Situation of dependency in organizations can only occur when both two conditions are met, which are the resources is very important and there is high concentration of control over the resources. In other word, the organization's dependency is determined by the concentration of the control over resources and the importance of the resources.(Pfeffer & Salancik, 1978) The organizations will try to reduce other's power over them in order to lessen its own dependence, in the same time expanding the dependence on other organizations. (Hillman et al., 2009) Pfeffer and Salancik (1978) suggest five options that firm can use to minimize environmental dependence, consists of (a) mergers/vertical integration, (b) joint ventures and other inter-organizational relationships, (c) boards of directors, (d) political action, and (e) executive succession. The third option will be emphasized in this research.

The Relationship between Board Composition and Firm Performance

Board of directors is an inevitable element of corporate governance in managing business corporations (Fama & Jensen, 1983). The important matter to discuss about board of director is its composition because it will affect the ability of director to make strategic decisions and exercise control over top management, ultimately will influence the corporate performance (Baysinger & Hoskisson, 1990; Cochran et al., 1985; Kosnik, 1990; Pearce & Zahra, 1992). The board composition reflects the board size and type of membership where the former is determined by the number of directors in a firm and the latter by proportion of insider or outside (Pearce & Zahra, 1992).

Insiders are director who are current employee (includes top management team member) of the company (Barney, 1991). Hillman et al. (2000) included those who have served in the past (former) as active managers, employees or owners of the firm into the scope of insiders. Outsiders are directors besides insiders and can be further grouped into affiliated or non-affiliated directors. The only difference is insiders do serve in managerial capacity in the corporation whereas the outsiders do not. Although affiliated outsiders are not employees of the firms, they have close relationships with the firms. In contrast, non-affiliated outsiders are independent from the company’s executive, thus it is also known as independent director.

Ratio of insiders and outsiders on board is an important indicator of board independence. The issue that must be concerned is whether a board with high proportion of inside director want to be or can be exercising independent and no bias judgment and decision, especially in the matters of management control (Dalton & Kesner, 1987). The public will wonder how can an insider fulfill his responsibilities as a director to monitor and evaluate the top management team (such as CEO) when they are the people who give orders to the insider in day-to-day activities. Some negative arguments are made:

I think a subordinate to the chief executive officer who works for him has to be either a saint or a fool to treat him severely and negatively. I don't think it's going to happen (Securities & Commission, 1980)

The disadvantages of the ... inside director in general stem from the fact that he spends most of his time in an operating position, subordinate to the chief executive ... whether he can be entrusted to review adequately his own performance and that of his colleagues with whom he must continue to "live" and do business in an operating capacity (Feuer, 1965).

Table 1
Board Composition and Organizational Performance (adapted from Zahra and Pearce (1989))

Study (Year)	Dimensions	Organization Performance Criteria	Sample	Analytical Approaches	Major Findings
(Arosa et al., 2010)	Insiders vs outsiders	ROA	369 non-listed family firms (2006)	Regression	inside directors have a positive impact on firm performance
(Song et al., 2017)	Insiders vs outsiders	return on assets Tobin's q	25 restaurant firms (2007-2013)	Regression	a higher proportion of inside board members increases market-based performance
(Ameer et al., 2010)	Insiders vs outsiders	Tobin's q ratio	277 non-financial listed Malaysian firms (2002-2007)	Regression	a high representation of outside is associated with better performance

(Adams & Jiang, 2016)	Insiders vs outsiders	Profit margin ROA ROE	92 property-casualty insurance companies (1999–2012)	Two-Stage Least Squares	proportion of board outsiders is unrelated to firm performance
(Khan et al., 2024)	Insiders vs outsiders	ROA ROE market-to-book ratio Tobin's Q	152 non-financial firms listed on the Pakistan Stock (2003-2018)	dynamic GMM	non-executive directors' ratio negatively related to the financial performance
(Arnoldi et al., 2025)	Insiders vs outsiders	Sales	5183 Danish new ventures (2015–2020)	Regression	the percentage of independent directors has an inverted U-shaped effect on firm performance.

As Table 1 shows, 6 studies discussed the relationship between the insiders' proportion in board and the firm performance. The existing literature presents conflicting evidence regarding the relationship between board composition, particularly the proportion of inside and outside directors, and firm performance. Song and Arosa posited that a higher proportion of inside directors contributes positively to firm performance (Arosa et al., 2010; Song et al., 2017). In contrast, Ameer and Choi proposed that more outside directors enhances firm performance, supporting the board's monitoring roles (Ameer et al., 2010). However, other studies find no significant relationship between the proportion of inside and outside directors and firm performance (Adams & Jiang, 2016), or report a negative association or an inverted U-shaped effect (Arnoldi et al., 2025; Khan et al., 2024). This inconsistency in empirical findings suggests that the impact of board composition on firm performance remains inconclusive and warrants further investigation into its underlying mechanisms.

Agency theory focuses on the agency cost that yield from conflicts of interest between shareholders (principals) and the managers (agents) (Kathleen M. Eisenhardt, 1989; Jensen & Meckling, 1976). Managers who hold control power may pursue maximum their self-interest by carrying out activities at the expenses of the shareholders. One of the mechanisms designed to monitor the conflict is board of directors. From an agency perspective, board should stay independent of management and, therefore, having a preponderance of outside directors is encouraged. This is because insiders will rise up the agency cost (Baysinger & Butler, 1985) due to their close ties with agents or self-interest may prevail over their responsibilities to protest the best interest of shareholders (Post et al., 2011). However, stewardship theory stands on opposite side. Referring to the theory, managers are good stewards of the company assets who will not misappropriate corporate resources at the cost

of others (Van den Berghe & Levrau, 2004). Unlike agency theory, stewardship theory argued managers have non-financial motives, such as recognition, satisfaction of superior performance, the need for achievement, responsibilities and etc. Muth and Donaldson (1998) suggested that corporate financial performance and shareholder returns will be maximized when reallocating of control from shareholders to managers. Following the reasoning, board which is dominated by insiders are preferable.

Many literatures on corporate have been done to investigate the relationship between boards of directors and the firm performance, but most are focusing on the agency role of the directors, instead relatively less explore it based in resource dependence theory. (Hillman & Dalziel, 2003) Besides monitoring the management of a firm to ensure the interest of shareholders, called agency role, board of directors play resource dependence role simultaneously that providing different beneficial resources to the firm and reducing the uncertainty. (Hillman et al., 2000) Thus, resource dependence perspective is as important as agency perspective, although they are theoretically and practically distinct. Resource dependence theory is likely used to examine the relationship between the boards of an organization, such as the board size, board composition, board diversity or board's ability of contribution of resources, and the variables of firm performance or financial performance. (Hillman et al., 2009)

In resources dependence perspective, Pfeffer (1972) claims board of directors can help firms to minimize dependence and gain resources. Board of directors plays role as the provider of resources including information, skills, access to key constituents, legitimacy, expertise, administrative advice, counsel and access to resources. (Hillman & Dalziel, 2003) In the same time, board of directors is the connector of the firm to the external environment (Hillman & Dalziel, 2003). Four primary benefits for the external linkages that the boards can provide are suggested by Pfeffer and Salancik (1978), encompassing provision of resources, legitimacy, channels for communication with important constituents, and provision of commitments of support from external environment. The higher extent to the directors able to contribute these resources or external linkages, the more environmental uncertainty and external dependencies can be reduced and the higher benefits brought to the firm. (Daily & Dalton, 1994) To sum up, within the resource's dependence perspective, board of directors is provider of resources and/ or connector of external factors, instead of evaluator of management.

As a provider of resources, each director may be bringing specific extraordinary resources to the board. Therefore, besides the board size, the type and degree of diversity of the directors bring the impact to the firm (Hillman et al., 2009). Carter et al (2010) believe there is highly positive relationship between board diversity and the firm performance, even though the resource dependence theory does not specifically mention the linkage. When the diverse directors hold various special resources, diversity in boards definitely increases the resources that available to the management team (Carter et al., 2010). For example, diverse directors will likely access more talent, and they may bring diverse different perspectives or unique methods to the management. From the four primary benefits for external linkages that mentioned above, Hillman, Cannella, and Paetzold (2000) develop taxonomy of director types, comprising insiders, business experts, support specialists, and community influentials, which are argued that each group of directors will distribute different resources to a firm. The

extension of resource dependence theory describes that higher board diversity will help a firm to perform better because there are more beneficial resources available to the firm. (Carter et al., 2010)

The resource dependence perspective proposes that board's provision of resources and firm's linkage with its environment will directly affect the firm performance. (Boyd, 1990; Hillman & Dalziel, 2003). Pfeffer and Salancik (1978) *argue that* ability to acquire and maintain resources *is the* main factor in how organizational to survive. When a firm has a stronger linkage with external factors, it is able to acquire additional access to the resources which will help to reduce the firm's dependency on its environment. Apart from that, the board's provision of resources will compress firm's uncertainty (Pfeffer, 1972), reduce transaction costs, depreciate the firm's environmental dependency. (Pfeffer & Salancik, 1978) Both functions that board of directors can bring to the firm will result in enhancing firm's performance and its sustainability. (Singh et al., 1986)

From resource dependence perspective, diverse type of directors play roles as providers of vary certain valuable resources to the board (Hillman et al., 2000; Hillman & Dalziel, 2003). Insiders are responsible to supply useful information to the board, such as information about the firm or its competitive environments. Hillman et al. (2000) had categorized directors into insiders, business experts, support specialists and community influential. They proposed that the insiders should provide resources of expertise, general strategy and firm direction, and specific useful knowledge. However, it does not means that board can stack with all insiders because it will sacrifice link with outside organizations and valuable advice as well as information which can only provide by outsiders (Baysinger & Butler, 1985). In their study, Fama and Jensen (1983) and Baysinger and Butler (1985) also agreed that an optimal board of director should have a combination of insiders and outsiders which will generate the best financial value.

Besides providing various kind of resources to the corporate, board diversity is likely to enhance board independence because directors with different background, regardless different in gender, culture, occupation or else, might query different area of questions (Carter et al., 2003). This will emerge a more active board. To assure a diverse board, insiders are necessary in the board.

Prior study noted that reduction of insiders will bring negative impacts. (Dalton et al., 2007) presented that the representation of insiders will lead to the decimation of their expertise, experience and reputation. Insider are involved in day-to-day corporate decision, hence they will be more sensitive to organization's economic needs (Ibrahim & Angelidis, 1995). If all of them are being represented, in result the strategic decision-making process will be impaired (Judge & Zeithaml, 1992). Besides that, the presence of outside directors on the board may harm the intensity of R&D and corporate entrepreneurial activities (Van den Berghe & Levrau, 2004). In contrast, insiders play useful function on the board because they are able to provide valuable information during assessing both strategic initiatives and managerial performance (Baysinger & Butler, 1985; Fama & Jensen, 1983). Walls et al. (2012) and Post et al. (2011) agreed that insiders on board will help to acquire higher environmental strengths and fulfill the environmental performance goal. It is because outsiders seem to be more concern corporate social responsibility than economic performance. In a research with data of 103

large companies, inside boards of directors was concluded to be likely performing outstandingly, compared to outside board (Vance, 1964). All of these show the importance of including insiders on the board. Clearly, insiders' proportion on the board is potentially relevant to the corporate performance and success of the corporation.

Conclusion

This paper investigates whether composition of directors can enhance firm performance. According to the resources dependence theory, board of directors also plays distinct role as essential resources providers (Boyd, 1990; Daily & Dalton, 1994; Johnson et al., 1996; Pearce & Zahra, 1992; Pfeffer, 1972; Pfeffer & Salancik, 1978; Zahra & Pearce, 1989). They are probably able to contribute certain useful resources which may help firm to grow or gain competitive advantage. During doing their jobs, the board of directors will use their expertise, experience, skills, information, knowledge, and sometimes power, to shape a favorable corporate strategic management which will make the corporation to perform superior (Jones & Goldberg, 1982; Vance, 1983).

However, our paper show that the instrumental component is conceptually not alike previous two because directors in this component plays functions beyond advising, monitoring and disciplining management (Baysinger & Butler, 1985). They are described as support specialists in Hillman et al. (2000) and decision supporters in Baysinger and Zardkoohi (1986). In term of function, they serve board by providing the source of managerial wisdom and specialized expertise which can help management to enhance the decision making (Hillman et al., 2000; Mace, 1971). Compared to business experts, they lack of general management experience. They also offer the channel of linkages to link different interdependent organization together (Burt, 1980; Pfeffer, 1972). Besides, they are vital to help firm secure commitment from external organizations and access precious resources such as financial capital and legal support (Pfeffer & Salancik, 1978). The director in instrumental component normally consists of, for example, lawyers, financiers, consultants, bankers, public relations experts etc.

This research study contributes to growing the awareness of the essential to control the board composition and views it as one of the factors of firm financial performance. The findings of study help to understand better how boards can refine their composition with the purpose of enhancing board effectiveness as instruments of corporate governance.

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