The impact of the board of director's composition on financial performance of LLC's in Kosovo

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Abstract

The purpose of this paper is to identify, analyze and evaluate the potential impact of the Board of director's composition on financial performance of Limited Liability Companies (LLC) in Kosovo. Composition of the Board of Directors of LLC's in Kosovo, in terms of corporate governance, plays a crucial role in two aspects as to the responsibilities for the quality of financial reporting as well as in enhancing financial performance. The research describes the impact of the Board of Directors composition (existence, independence, and meetings of the Board) on the financial performance of LLC's in Kosovo, evaluated by ROA, ROE and ATR. Data has been collected through questionnaires in 99 LLC's within different activities. Data analysis has been conducted through SPSS. Findings of the research is going to help on highlighting the importance of the composition of the Board of Directors and the impact of it on raising the financial performance of LLC's in Kosovo.

Keywords: independence of board of directors, corporate governance, financial performance

Introduction

Corporate scandals and the economic crisis associated with these scandals have resulted on investigating the possible ways to eliminate failures in corporate management. Therefore, corporate governance has become an indispensable factor in managing organizations in the current complex global environment. Corporate governance can be defined as well managing process, by which corporations, taking into consideration the interests of all stakeholders to the maximum, comply with the principles of transparency, justice, accountability and responsibility (Van Horne and Machowicz, 2005). And it's precisely the evaluation of financial performance of a business that allows decision makers to judge the results of a business strategies and activities in objectiv monetary terms. Therefore, performance or "doing" as the process of measuring the results of the company's policies and operations in monetary terms, is used to measure the overall financial health over a period, the comparison between companies, and between different periods. Meanwhile not just the appearance, the quality of the achieved results refers to the performance too. Thus, performance is used to indicate success, and the company's compliance requirements. Given that firms with poor corporate governance are less profitable, have poor performance, have high-risk and low dividends and lower dividend payments than those with stronger corporate governance (Brown and Caylor, 2004a: 1-3). Corporate governance is particularly important for developing countries, where the injection of foreign investment is essential for economic growth. Therefore, this study is dedicated to the limited liability company (LLC) in Kosovo for the period 2013-2015. The aim of this study is to explore the relationship between corporate governance and financial performance of the LLC's in Kosovo during the period 2013-2015. Whereas the main idea is to consider whether the factors (independent variables) considered in this study could determine the performance indicators of companies through corporate governance. These independent variables are: the board, the independence of the board, board meetings; whereas performance indicators (dependent variables) are ROA - return on assets, ROE - return on equity and ATR - Asset turnover.

Literature review

At the time of the ownership compartment from the control, it is difficult for managers to care and work in the same way as the owners of capital. Thus, the real challenge was finding the ways to make professional managers to manage the daily operations with responsibility for owners as well as society. Respectively, finding mechanisms that would motivate managers taking decisions that would in turn improve the performance of the company. And precisely corporate governance mechanisms assure corporate investors to ensure enough income for their investment (Emmo and Schmid, 1999). If these mechanisms do not exist or function properly, foreign investor will not invest in companies, thus economic performance will be suffering since the loss of many good business opportunities. Therefore, companies with high level of implementation of corporate governance principles and best practices of corporate governance are most rewarding and tend to have better performance (Todorovic, 2013: 6). And also the assessment of corporate governance has a positive impact, although insignificant in corporate profitability (Aggarwal, 2013: 1).

Consequently, numerous studies have been conducted as to how much and in what way corporate governance is associated with financial performance. Always taking into account the direction of causality and stressing that good governance causes good and strong performance, and not vice versa (Selvaggi and Upton, 2008: 7); Especially, the importance of the quality of corporate governance that significantly determines the performance of the firm (Azeem et al, 2013: 8). In general, many scholars agree that both are connected (Sridhar and Murugan, 2015) and that there is positive impact of corporate governance on financial performance (Brown and Caylor, 2004a; Adjaoud et al, 2007; Bauer et al, 2008; Bhagat and Bolton, 2008; Selvaggi and Upton, 2008; al-Haddad et al, 2011; Achim, affair for the Borlees and Mare, 2016; Waseem et al, 2011; Tornyeva and Wereko, 2012; Azim, 2012; Malik and Makhdoom, 2016). The relationship where corporate governance is qualitative, company can perform up to 15% per year higher (Bauer et al, 2008: 15), and this role is important especially during the economic downturn (Yusoff et al, 2015).

Not only corporate governance has significant relationship with performance, but also the capital structure of the ownership of corporations (Bhagat and Bolton, 2008: 14), and the composition of the board is the most important identified factor (Brown and Caylor, 2004a). The impact of corporate governance is studied through its special meters, not only in corporate governance generally, to find the impact of different meters. And most of the studies concerned with the relationship between corporate governance and company performance explore some meters of corporate governance such as board size, external / internal ownership, composition of the board, the compensation of executives, duties of the board etc.

Data and research Methodology

Considering the specific nature of the research it was necessary to combine different methods for obtaining data of the research. Firstly, data was collected through questionnaire which was used as a tool of designing a database for the solution of practical problems as well as developing a conceptual framework. 81 cases have been collected. The cases were discussed and classified into three (3) themes of independent variables (dimensions that affect financial performance). Furthermore, secondary data has been obtained from audited financial statements of LLC's published by the Kosovo Financial Reporting Council (KFRC) on their official website, from which we calculated three (3) indicators as a reliable measure of financial performance, ROA (Return on assets), ROE (Return on equity) and ATR (Asset turnover), as dependent variables (dimensions which are influenced by independent variables).
The population included in this study consists of all LLCs which have their financial statements audited for the years 2013 - 2015 and published on the official website of the Kosovo Financial Reporting Council (KFRC). For the selection of the sample, random method has been conducted, where 99 LLCs have been selected, including enterprises with various activities in order to represent all fields.
The variables used in this study include: 1) the dependent variable (financial performance of the company) and 2) the independent variable (corporate governance). Financial performance we have measured through accountancy performance measures as:
- Return on assets (ROA) and return on equity (ROE) as well as in studies of Al-Sahafi et al (2015), Azeez (2015), Al-Haddad (2011), and Sayilir Coşkun (2012), etc., and
- Asset Turnover (ATR).
While the structure of corporate governance was measured through: board of directors, the independence of the board and the frequency of board meetings.

Hypothesis

H_1: The existence of the board is positively related to financial performance of LLC's in Kosovo.
H_2: The independence of the board has a positive relationship with the financial performance of LLC's in Kosovo.
$H_{3:}$ The frequency of board meetings during the year, is positively related to financial performance of LLC's in Kosovo.

Analysis

The values of performance indicators (ROA, ROE and ATR) are taken as the average of three years (2013, 2014 and 2015), as the relationship between corporate governance and financial performance is a long-term one and takes several years to crystalize (Selvaggi and Upton, 2008). Thus the focus on short-term relationships between corporate governance and financial performance can be misplaced. Moreover, the data are normalized so that we could conduct parametric statistical tests that provide more opportunities, and are more powerful statistically.

4.1 Relationship between the existence of the board and financial performance

- For testing of the degree of relationship between the board of directors and performance indicators (ROA, ROE and ATR) Pearson's Correlation is used, as shown in the following table.

Table 1: Correlation between Board of Directors and performance indicators

		Board of Directors	ROA	ROE	ATR
Board of Directors	Pearson Correlation	1	.789**	.647**	.500**
	Sig. (2-tailed)		.000	.000	.000

**. Correlation is significant at the 0.01 level (2-tailed).

The correlation coefficient between the Board of Directors and the return on assets (ROA) is calculated to be r = .789. Accordingly, there is a high positive correlation, which is significant between having the board of director's and return on assets (ROA). The correlation coefficient between the Board of Directors and the return on equity (ROE) is calculated to be r = .647. Accordingly, there is a positive medium correlation between having board of directors and the return on equity (ROE). The correlation coefficient between the Board of Directors and asset turnover (ATR) was calculated to be r = .500. Accordingly, there is a positive the medium correlation between having the board of directors and asset turnover (ATR). Which suggest that those companies that have the board of directors on their governance structure perform better or have higher financial performance.

- Independent samples T-Test has been conducted on testing the hypothesis, if the relationship between variables is statistically significant. Following table reflects this data:

Table 2: Summary of T-Test results

	Board of Directors	N	M	DS	T	Df	*p*	95% Confidence Interval of the Difference
ROA	With board	37	2.2066	.6325	10.149	63	.000	1.61225 - 2.40285
	Without board	28	.1990	.9610				
ROE	With board	38	3.1195	.8681	6.059	44.436	.000	1.18147 - 2.35862
	Without board	29	1.3495	1.3783				

ATR	With board	43	.4496	.7082	2.891	79	.005	.14732 - .79839
	Without board	38	-.0233	.7635				

The group of companies which have board of directors is related to the financial performance measured by ROA, with mean M = 2.21 (SD = 0.63), as measured by ROE with mean M = 3.12 (SD = 0.87) and measured by ATR with mean M = 0.45 (SD = 0.71). For comparison, the group of companies that don't have board of directors are related with numerically lower performance measured by ROA with mean M = 0.20 (SD = 0.96), as measured by ROE mean M = 1.35 (SD = 1.38), and measured by ATR mean M = -0.02 (SD = 0.76). To test that the group of companies that do not have board and those that have board are associated with statistically significant different mediums of the performance indicators ROA, ROE and ATR is conducted independent samples T-Test. As it can be seen in the table above (Table number 2), according to this test we have to do with a statistically significant effect on performance as measured by ROA: t = 10.15, p = .000, or measured by ROE: t = 6.06, p = .000 and ATR: t = 2.90, p = .005. Thus companies which have the Board of Directors implemented on their governance structure, they are tied with statistically significant higher mediums of financial performance than those that don't have board of directors. So having better financial performance. Supporting the hypothesis that:

H_1: The existence of the board is positively related to financial performance of LLC's in Kosovo.

4.2 Relationship between the independence of the board and financial performance

➢ Pearson's Correlation has been used on testing the degree of relationship between the independence of the board of directors and financial performance indicators: ROA, ROE and ATR, as shown in the following table.

Table 3: Correlation between Independence of Board of Directors and performance indicators

		Independence of the Board of Directors	ROA	ROE	ATR
Independence of the Board of Directors	Pearson Correlation	1	.543**	.216	-.244
	Sig. (2-tailed)		.001	.207	.152

**. Correlation is significant at the 0.01 level (2-tailed).

The correlation coefficient between the independence of the board of directors and the return on assets (ROA) is calculated to be r = .543. Accordingly, there is a positive, medium, and significant association between the independence of the board and return on assets (ROA). So, boards with external members have a higher performance. Whereas, the correlation coefficient between the independence of the board of directors and the return on equity (ROE) is calculated to be r = 216. Accordingly, there is a positive but weak relationship between having an independent board and return on equity (ROE).

On the other hand, the correlation coefficient between the independence of the board of directors and asset turnover (ATR) was calculated to be r = -.244. Accordingly, there is a negative and very weak correlation between independence of the board of directors and asset turnover (ATR).

- Independent samples T-Test has been conducted on testing the hypothesis, if the relationship between variables is statistically significant. The data is drown in the following table.

Table 4: Summary of T-Test results

	Independence of the Board of Directors	N	M	DS	T	Df	*p*	95% Confidence Interval of the Difference
ROA	Only by internal members	14	1.7632	.2565	4.732	31.361	.000	.40597 - 1.02055
	By external members too	23	2.4765	.6438				
ROE	Only by internal members	13	2.8201	.7537	1.563	36	.127	.13543 - 1.04573
	By external members too	25	3.2752	.8966				
ATR	Only by internal members	18	.4354	.8981	.110	41	.913	.42304 - .47172
	By external members too	25	.4598	.5532				

The group of companies that have external members on the board is linked to the financial performance measured by ROA with mean M = 2.48 (SD = 0.64), as measured by ROE with mean M = 3.28 (SD = 0.90) and measured by ATR with mean M = 0.46 (SD = 0.55). For comparison, the group of companies that have a board of directors consisting only of internal members, are related with numerically lower performance measured by ROA with mean M = 1.76 (SD = 0.26) measured by ROE with mean M = 2.82 (SD = 0.75) and measured by ATR with mean M = 0.44 (SD = 0.90). To test that the group of companies that do not have external members on their boards and those who have, are associated with different statistically significant medium performance indicators ROA, ROE and ATR, it's conducted independent samples T-Test. As it can be seen in the table above (Table number 4), according to this test we have to do with a statistically significant effect on performance, measured by ROA: t = 4.732, p = .000; but measured by ROE: t = 1,563, p = .127, and ATR: t = .11, p = .913, this relationship was not statistically significant. So, independent companies are related

in a statistically significant way with higher financial performance as measured by return on assets (ROA), than those that don't have external members on their board of directors.
Supporting the hypothesis that:
***H_2*:** The independence of the board has a positive relationship with the financial performance of LLC's in Kosovo.

4.3 Relationship between the frequency of the meetings of the board and financial performance

- The testing of the degree of relationship between the frequency of meetings of the board of directors and performance indicators (ROA, ROE and ATR), is made with Pearson's Correlation, as shown in the following table.

Table 5: The correlation between the frequency of Board meetings and performance indicators

		Frequency of Board meetings	ROA	ROE	ATR
Frequency of Board meetings	Pearson Correlation	1	.818**	.460**	-.224
	Sig. (2-tailed)		.000	.005	.189

**. Correlation is significant at the 0.01 level (2-tailed).

The correlation coefficient between the frequency of meetings of the board of directors and the return on assets (ROA) is calculated to be r = .818. Accordingly, there is a high positive and significant correlation, between the frequency of board meetings and return on assets (ROA). So boards that have meetings more frequently have higher performance, and frequency of meetings, goes along in the same direction with performance measured by return on assets (ROA).
While, the correlation coefficient between the frequency of meetings of the board of directors and the return on equity (ROE) is calculated to be r = .46. Accordingly, there is a positive but weak correlation between the frequency of board meetings and return on equity (ROE).
On the other hand, the coefficient of correlation between the frequency of meetings of the Board of Directors and asset turnover (ATR) was calculated to be r = -.224. Accordingly, there is a negative but very weak correlation between the frequency of board meetings and asset turnover (ATR).

- Testing the hypothesis, if the relationship between the frequency of meetings of the board of directors and performance indicators: ROA, ROE and ATR) is statistically significant is conducted through one-way ANOVA, as shown in the following table.

Table 6: Summary of ANOVA's results

	Frequency of meetings	N	M	DS	95% Confidence Interval of the Difference	F	*p*
ROA	Once a year	6	1.5162	.03067	1.4841 - 1.5484	39.340	.000
	Four times a year	21	2.0208	.31760	1.8762 - 2.1653		
	Every month	10	3.0111	.50812	2.6476 - 3.3745		
ROE	Once a year	6	2.7577	.71200	2.0105 - 3.5049	7.927	.001
	Four times a year	21	2.8310	.63144	2.5436 - 3.1184		
	Every month	11	3.8678	.93163	3.2419 - 4.4936		
ATR	Once a year	8	.6839	.77818	.0333 - 1.3345	.531	.592
	Four times a year	24	.3875	.69453	.0943 - .6808		
	Every month	11	.4145	.71994	-.0691 - .8982		

The group of companies boards of directors of which have monthly meetings is associated with financial performance measured by ROA with mean M = 3.01 (SD = 0.51), as measured by ROE with mean M = 3.87 (SD = 0.93) and as measured by ATR with mean M = 0.41 (SD = 0.72).

For comparison, the group of companies boards of directors which meet four times a year have numerically lower performance as measured by ROA with mean M = 2.02 (SD = 0.32), as measured by ROE with mean M = 2.83 (SD = 0.63) and measured by ATR with mean M = 0.39 (SD = 0.69).

On the other hand, also the group of companies boards of directors of which meet once a year have numerically lower performance compared to the two groups mentioned above, as measured by ROA with mean M = 1.52 (SD = 0.31), as measured by ROE with mean M = 2.76 (SD = 0.71) and as measured by ATR with mean M = 0.68 (SD = 0.78).

To test if the group of companies boards of which have monthly meetings, the group of companies boards of which meet four times a year and the group of companies boards of which that meet once a year are linked to statistically significant different medium performance indicators ROA, ROE and ATR, was done one-way ANOVA test. As it can be seen in the table above (Table number 6), according to this test we have to do with a statistically significant effect on performance, measured by ROA, $F(2, 36) = 39.34$, $p = .000$ and ROE: $F(2, 37) = 7.93$, $p = .001$, while measured by ATR the relationship is not statistically significant.

So we can conclude that there is a significant change of financial performance (measured by ROA and ROE) of companies whose boards meet more often, which have shown a higher performance of those that meet more often. Supporting the hypothesis that:

$\boldsymbol{H}_{3:}$ The frequency of board meetings during the year, is positively related to financial performance of LLC's in Kosovo.

It was also performed post hoc Tukey HSD test, to compare means of different groups with, as shown in the following table:

Table 7: Summary of results of post hoc Tukey HSD test

	Frequency of meetings	Frequency of meetings	Mean difference	*P*
ROA	Once a year	Four times a year	.50452*	.012
		Every month	1.49482*	.000
	Four times a year	Once a year	.50452*	.012
		Every month	.99030*	.000
	Every month	Once a year	1.49482*	.000
		Four times a year	.99030*	.000
ROE	Once a year	Four times a year	.07328	.975
		Every month	1.11004*	.015
	Four times a year	Once a year	.07328	.975
		Every month	1.03676*	.002
	Every month	Once a year	1.11004*	.015
		Four times a year	1.03676*	.002

As shown on the table number 7 above, test revealed statistically significant differences among companies (measured by ROA) whose boards meet every month to those that meet four times a year and those that have meetings once a year, as well as between those whose boards meet four times a year to those boards that meet once a year. So those who meet more often had higher performance than those with meetings once a year. Measured by ROE, test also revealed statistically significant differences among companies whose boards meet every month to those that meet four times a year and those that have meetings once a year. But not between companies whose boards meet four times a year to those boards that meet once a year.

Conclusions and Recommendations

There is no doubt that quality financial reports are based on the well functioning of corporate governance. Although a number of LLC's in Kosovo have already created a structure of corporate governance, lack of control of the functioning of this structure represents a lack of the strategic objectives fulfillment of LLC 's, one of which is the quality of the financial statements on the basis of which can be consider their financial performance, as well.

This research resulted that LLC's that also have outside members on their boards, meet more often, have an audit committee and internal auditor, have better financial performance compared to LLC's that on their boards have internal members only, that meet less frequently, that don't have audit committee or internal auditor, stressing the importance of corporate governance for better performance. However the survey showed clearly that a large part of limited liability companies in Kosovo dont't have the board of directors, as well. Although most of the limited liability companies are small in terms of turnover, assets and number of employees, some existing boards are mainly the internal type and also they're composed of members of the same family.

Some of the companies have board meetings, but within these meetings they do not keep records about the aspects discussed. Their performance is dicussed nominally,

but there is not enough action to increase performance or even less control for proper implementation of the recommendations of improving performance.
Due to the aim of strengthening the functioning of the system of corporate governance, the results of a current research renders the following conclusions, herby we recommend to:

- Establish regulations whereby it would adi on selection of a structure based on best practices, which should contain mandatory elements as well as voluntary, but which should be adapted to the specifics of limited liability companies in Kosovo;
- Establish a control mechanism for the implementation and enforcement of regulations that addresses corporate governance;
- To insist on the composition of the board of directors have 50% of the members without executive functions, be independent and experienced in the industry;
- The meetings of the board should happen on regular intervals, for example: at least four times a year;
- Maintain records of these meetings, which must be placed in folders in chronological order;
- In the meetings of the board of directors among other things, the financial performance of the company should be discussed as well, therefore recommend measures for its establishment.

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