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Board Diversity and Firm Financial Performance of Sri Lankan Listed Companies

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Abstract

Corporate governance which provides the legal structure for organizational activities emphasises the essence of having directors in managing and controlling the organizational activities. The attitudes, characteristics, behaviours, lifestyles of directors cause directly to the performance of the organization. As a result, the corporate governance structure highly emphasized board characteristics. Prominence on diversified characteristics of a board is imperative in Sri Lanka since financial institutes collapsed recent past due to the incapacities of directors in managing organizational resources effectively. This study aims to determine whether board diversity measured by ethnic diversity, gender diversity, educational diversity, diversity in nationality, and board independence is associated with the financial performance of firms in Sri Lanka. Ethnic diversity, gender diversity, educational diversity, diversity in nationality, and board independence are considered independent variables whereas firm financial performance is a dependent variable. Firm size and ownership of the board are the control variables of this study. Data were collected from 2014 to 2018 annual reports of the 100 sample companies in the Colombo Stock Exchange (CSE). The data were analysed and hypotheses were tested through descriptive statistics, correlation analysis, and regression analysis by using EVIEWS 8. The findings revealed that national diversity has a positive and significant association with firm financial performance whereas ethnic diversity, gender diversity have a positive insignificant influence on firm financial performance. And also, educational diversity and board independence have a negatively insignificant influence on firm financial performance. The control variable of firm size is significant in affecting the firm financial performance. In conclusion form, national diversity implemented in Sri Lankan listed companies significantly affects the firm financial performance, and shareholders, corporate governance authorities, scholars, can practice the research findings further.

Introduction

The indiscernible hand of controlling and directing a company's system is called corporate governance. The shareholders who are the principal stakeholders of the company have a duty in the corporate governance system to appoint the directors who are the foremost individuals accountable for maintaining corporate governance practices and auditors to examine whether the corporate governance practices are continuing effectively. Directors of the company involved in formulating the strategic policies, procedures, observing and leading master strategies, accommodating guidance for management, and eventually reporting to shareholders (Cadbury, 1993). Having an effective board in every Sri Lankan public company is required by the Sri Lankan code of best practice on corporate governance. In the contemporary framework, the company's stakeholders comprise the society at prodigious, meantime earlier perception of board accountability to shareholders has been altered now toward all stakeholders of the company while tracking the interest of the shareholders (Rose, 2004). Board needs to be broadened to better represent society to achieve accountability to stakeholders. Board members from diverse backgrounds enable better representation to empower the board to be balanced. Diverse backgrounds include directors with different ethnicities (Sinhalese, Muslims, Tamil), gender (Female, Male), nationalities (Sri Lankan, Foreign), various educational levels (degree holders, Ph.D. holders), etc.

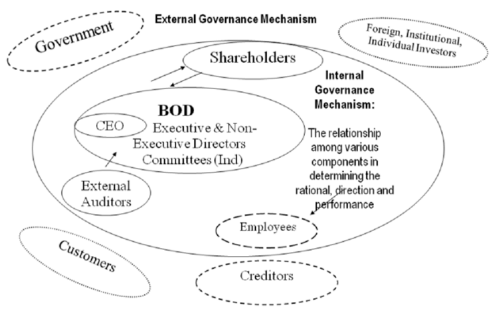

Figure 01: Sri Lankan Corporate Governance Structure

Source: Securities & Exchange Commission of Sri Lanka

Financial healthiness of the organization can be demonstrated by financial performance and further, explains how the foremost parties of the organization subsidize their concentrated effort to accomplish organizational goals and objectives in short run. Higher financial performance of the company exhibits smooth usage of organizational properties in effective and efficient means,

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thereby contribute to the economic enlargement at national level (Almajali et al., 2012).

The number of public listed companies in Sri Lanka has been sharply increased by approximately 105 percent in the recent 10 years. As a developing economy, the Sri Lankan government endowments foreigners the chance to buy the shares in the Colombo stock exchange with limitations (Samarakoon, 1999) . The interior issue of corporate governance in today's context is that a small number of shareholders regulate the grander quantity of shares thus control the company in a manner they want by employing incapable directors. In the recent past, Sri Lankan great scandal of bankruptcy in financial institutes such as Pramuka Bank, Vanic Incorporation, Lanka, Marine Services Ltd, Sri Lanka Insurance Corporation, Golden Key Credit Card Company (GKCC), and Edirisinghe Trust Investments Finance Limited should be accountable by the directors who devastate intensively the organizational financial performance showing the diversified characteristics of their board of directors. The crucial result of the bankruptcy of enormous financial institutes extremely affects diminution in national income and investment. In such a situation addressing the diversified characteristics of the board to achieving the sound financial performance of the company is imperative to shareholders, financial analytics, researchers to analyse how far the diversified characteristics of the board affect the firm financial performance.

Most of the researches conducted in corporate governance emphasize on the board characteristics and firm financial performance (Ntim, 2015). Even though investigates from developed countries and emerging countries conducted the studies in corporate governance, the results are different to one country to another based on the corporate governance structure and culture of country (Tricker, 2012 & Arora & Sharma, 2016). Julizaerma & Mohamad (2012) exhibit positive association between gender diversity and firm performance but in Ujunwa (2013) explains board size, CEO duality and gender diversity were negatively linked with firm performance and board nationality, board ethnicity and the number of board members with a PhD qualification were found to impact positively on firm performance. Age ,gender and firm size affect firm financial performance negatively while ethnicity affect positively firm financial performance (Abdullah & Ismail, 2013). Carter et al., (2010) & M. Anis; A. Chizema, X. Lui, (2017) in their research establish no relationship to gender diversity or ethnic minority diversity, neither positive nor negative to firm financial performance. Most of the studies examine the board common characteristics such as CEO duality, number of board meetings while uncommon scholars concentrated on gender, ethnicity, and age diversity of boards and firm performance (Abdullah & Ismail, 2013)

Research Question

What is the impact of board diversity on firm financial performance?

Research Objective

The main objective of this study is to determine whether board diversity measured by ethnic diversity, gender diversity, educational diversity, diversity in nationality and board independence is associated with financial performance of firms in Sri Lanka.

Literature Review

According to Berle & Means (1932), agency theory is one of the principal theory elaborates a precarious role in a firm according to the Anglo-American model. Shareholders appoint directors who manage organizational works on behalf of shareholders or owners. The separation of ownership and control from shareholders creates an agency cost to the firm.

Agency theory expounds agency relationship as an agreement under which the principal(s) (shareholders) involve the agent(s) (managers) to achieve amenities on their behalf which comprises covering rational decision making a command to the agent (Jensen & Meckling, 1976). The research was to buildup a model indicating the association between owners and directors similar to one between a principal and an agent. The possessors appoint the managers to achieve the scheming tasks of the organization's daily operation to exploit the firm's wealth, but both are self-interested in their assistance and try to rise their wealth. The ultimate result of that one is a conflict of interest. Managers have the responsibility to control the firm effectively, they can earn more beneficial rewards and can consume benefits at the expense of the shareholders. The cost incurred on behalf of conflict of managers and shareholders is called agency cost that is an observing cost, residual loss, and connection cost to the firm. Additionally, outdoor shareholders also convoluted agency costs to monitor the manager's accomplishments and thus increase the agency budget.

According to the view of, Hillman, et al., (2000) resource dependency theory proposed that since the capacity of each director is different from one to another, the benefit provided by those diversified directors is unique. And also explained that the basic responsibilities of the board are described by this theory. The Board of directors is not only the members of a board but also the principal of the organization. That means they can maximize the value of the firm by bringing assets to the organization like data, abilities, knowledge, access to important elements, and authority (Ranasinghe & Sugandhika, 2018). In the recent past, Barrose et al.,(2010) explained that the board role is further extended and encompassed providing of services that includes providing legality, governing and counseling, performing as a link to imperative stakeholders or other substantial bodies, enabling access to resources such as investment, building outside relations. That means, differentiated board members will deliver more prised resources, which should harvest better firm performance. Diversity embraces the prospective to improve the information provided by the board to managers due to the distinctive information apprehended by dissimilar directors. Differences in gender, ethnicity, age, nationality will generate inimitable information that is obtainable to management for superior decision making.

Stewardship theory explains that managers can be motivated by the work satisfaction which they obtain by performing their job well and emphasize managerial behaviour. Both shareholders and managers acting comparatively and no conflict of interest between these two parties (Glinkowska, 2015). As Donald & Davis (1991) says stewardship theory, explains there is no conflict of interest because the ultimate object of both principal and agent is towards the same direction. That means, the behaviour of the Steward is directed towards collective and organizational goals rather than individual and achieving greater and better results through cooperative behaviour. Managers acting in faithful mind toward owners and resources are managed well. According to the theory, managers are labelled as honest individuals (Donaldson & Preston, 1995) and there is a chance to minimize agency cost because of the fear of losing their status, they will performance to achieve the interests of the shareholders (Donaldson & Davis, 1994). The theory of stewardship designates that to accomplish grander performance by their establishments, the CEO should workout comprehensive authority over the firm and they have a certain and incontrovertible duty (Donaldson & Davis, 1991) When CEO becomes the chairman of the board, the condition is achieved.

Literature gap

Most of the corporate governance theories like agency theory which enlightens almost agents can be motivated through financial motivations while stewardship theory clarifies agents can be motivated through progress, achievements, self-actualization, etc. are related to illuminating the relationship between individuals' behaviours in the workplace. Any one of these theories does not provide a clear framework to measure individual characteristics and firm performances. Further, most of the corporate governance researchers emphasize the fact that agents are working toward their interests. But there is no clear structure to identify the contribution of agents made on behalf of increasing or plummeting the firm performance. In such kind of situation, this research provides a clear framework for identifying how the diversified characteristics of board members affect to achieve the financial performance of the organization.

Conceptual Framework

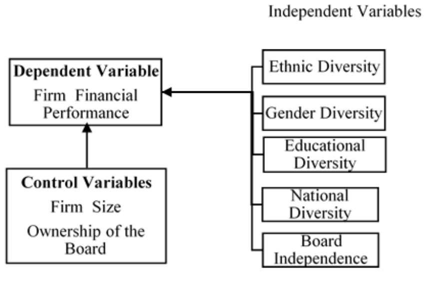

Figure 02: Conceptual Framework

Research Methodology

The geographical position of this quantitative study was Sri Lanka; this study population for the supplement market reaction to accounting information consisted of all the listed companies on the Colombo Stock Exchange (CSE) that authorizes to monitor 314 companies. The required secondary data were collected from the annual reports of the selected sample based on the purposive sampling of sixty (100) companies from twenty (20) sectors listed in the CSE for five years' period starting from 2014 to 2018. Sample listed companies were selected based on the highest market capitalization as of 31.03.2019, companies with the financial year-end of 31st March, and companies with data availability. This quantitative study included inferential statistics, which involved concluding a population based on sample data. Descriptive Analysis and Correlation analysis which are suitable to demonstrate and analyse the relationship of quantitative studies are used to find the association between board diversity and firm financial performance. And also, multiple regression analysis is used to examine the impact of board diversity on firm financial performance. Eviews 8 is used for analysing the collected secondary data.

Operationalization

Table 01: Summary of the Operationalization of variables

Nature of the Variable	Variables	Notation	Measurements
Dependent Variable	Firm Financial performance	FFP	ROA =PBIT / Total Avg. Assets
Independent Variable	Ethnic Diversity	ETD	a dummy variable; "1" if main two ethnic groups among Sinhalese, Tamils or Muslims are represented on the board, and "0" otherwise.
	Gender Diversity	GD	(Number of Female Directors) / Total Number of Directors
	Educational Diversity	ED	(Number of Degree holdering Directors) / Total Number of Directors
	National Diversity	ND	(Number of Foreign Directors) / Total Number of Directors
	Boards Independence	BI	(Number of Independent Directors) / Total Number of Directors
Control Variable	Firm Size	FS	Natural Logarithm of Total Assets
	Ownership of the Board	OB	(Number of Director's shares) / Total Number of Shares

Hypotheses of the Study

The hypothesis was formulated based on the nature of the relationship between determinants of board diversity on firm financial performance there could be positive or negative relationships between the variables which would be testing in the study.

Erhardt, et al., (2003) have examined the relationship between gender and ethnicity on firm financial performance and concluded that ethnic diversity was positively associated with both returns on investment and return on assets.

H1: There is a positive significant relationship between ethnic diversity and firm financial performance

The positive association between gender diversity and firm performance was confirmed by Julizaerma & Sori (2012).

H:2 There is a positive significant relationship between gender diversity and firm financial performance.

The number of board members with a Ph.D. qualification was found to impact positively on firm performance (Unjuwa, 2013) while Wellalage & Locke (2013) concluded the negative effects on firm financial performance.

H:3 There is a positive significant relationship between educational diversity and firm financial performance.

Assenga, et al., (2018) identified the positive relationships among foreign directors and firm financial performance but Bosch (2014) has investigated nationality is found to relate insignificantly to each of the firm performance.

H4: There is a positive significant relationship between nationality diversity and firm financial performance

One independent variable of board independence is significantly related to an accounting-based performance measure. (Mishra & Kapil 2018)

H5: There is a positive significant relationship between board Independence and firm financial performance.

Research Model

A multiple regression model with an error term (e) is specified in following equation.

$$FFP = \beta0 + \beta1ETD + \beta2GD + \beta3ED + \beta4ND + \beta5BI + \beta6FS + \beta7OB + \varepsilon\ldots$$

Where FFP indicates firm financial performance, β0 is constant, β1- β7 is coefficients of the concerned Explanatory variables, ETD refers to ethnic diversity, GD represents gender diversity, ED indicates educational diversity, ND is National Diversity, BI is Board Independence, FS indicates firm size, ε is error term and OB represents ownership of board.

Results and Interpretations

Findings and discussion are designed to present and analyse the gathered data concerning the objectives and hypothesis of the study.

Descriptive Analysis

According to the results of descriptive statistics for the 500 observations, the minimum, and maximum value, the result indicates no unexpected outcome in this analysis. And also results indicate that there is no considerable variance of ROA since the standard deviation for ROA is 0. 158. Therefore, this model is useful for analysing dependent and independent variables.

Correlation Analysis

Table 02 represents the correlation between the variables. It demonstrates that ROA has a positive and significant relationship with ethical diversity and national diversity since provides positive values of 0.162 and 0.442 as correlation value, whereas educational diversity demonstrates a positive but insignificant relationship with ROA.ROA has a negative and significant relationship with firm size since the correlation value is -0.187, while gender diversity board independence and ownership of board have a negative insignificant relationship. There is a positive and significant correlation between the independent variable of ethnic diversity and national diversity, and also educational diversity and board independence. Further ethnic diversity is negatively related to gender diversity but significantly. Gender diversity also has a significant and negative relationship with educational diversity and national diversity. Overall, there is a moderate level of correlation relationship among independent variables.

Table 02: Correlation Matrix

	ROA	ETD	GD	ED	ND	BI	FS	OB
ROA	1							
ETD	0.162	1						
GD	-0.073	-0.178	1					
ED	0.065	-0.046	-0.140	1				
ND	0.442	0.243	-0.136	0.239	1			
BI	-0.108	0.032	0.068	0.144	-0.069	1		
FS	-0.187	-0.132	0.250	-0.034	-0.134	0.309	1	
OB	-0.095	0.006	-0.019	-0.067	-0.154	-0.213	-0.043	1

Note: () is Probability

Source –Eviews output

Regression Analysis

Table 03 exhibits the results of coefficient estimates of the dependent variables with their p values and t-statistics. According to the regression analysis, the overall model this was used to demonstrate the independent variables have adjusted R square value is 0.20039 that is moderate level with this result and therefore the overall model is not highly explained and 0.79996 affect the other unknown variables. Thus, 20.039% variation on the dependent variable which is firm financial performance is explained by the independent variables and, however, 79.996% variation of the dependent variable is explained by other unknown variables. In this study, the F statistic is 11.70432, and the probability of f statistics is 0.000. Therefore, this result revealed that the overall model is statistically significant and valid in explaining the outcome of the dependent variable. Results of regression analysis show national diversity is significant in assessing the firm financial performance among other four (4) independent variables and the study also found that the control variable of firm size is significant in affecting the firm performance.

Table 03: Regression results of coefficient estimator

	ROA		
Independent variables	Coefficient	t-Statistic	Prob.
C	0.3809	2.8053	0.0054
ETD	0.0188	0.9300	0.3531
GD	0.0308	0.3686	0.7127
ED	-0.0220	-0.5051	0.6139
ND	0.2825	7.2644	0.0000*
BI	-0.0639	-0.9437	0.3461
FS	-0.0120	-2.0588	0.0404**
OB	-0.0551	-0.9330	0.3516
No of observations	500		
R-squared	0.21911		
Adjusted R-squared	0.20039		
F-statistic	11.70432		
Prob (F-statistic)	0.00000		

Note: () is Probability, * is 5% and ** is 10% level of significance

Source –Eviews output

Regression Model

According to regression analysis the mode of this study is,

FFP=0.3809+0.0188ETD+0.0308GD-0.0220ED+0.2825ND-0.0639BI – 0.0120 FS – 0.0551OB + ε

Hypotheses Testing

According to the results of Erhardt, et al., (2003) Ethnic diversity was positively associated with both returns on investment and return on assets. As same, the results of this study showed a positive impact of ethnic diversity (ETD) on firm financial performance. But the impact is not significant. Accordingly, the first hypothesis (H1) is rejected. Further, the positive association between gender diversity and firm performance was confirmed by Julizaerma & Sori (2012). But in this study, the impact of gender diversity (GD) on firm financial performance shows a positive but, insignificant impact. Our results and literature findings are contradictory. A negative and insignificant impact of educational diversity (ED) on firm financial performance can be observed by the results whereas Wellalage & Locke (2013) has received the same findings on educational diversity. Assenga, et al., (2018) identified the positive relationships among foreign directors and firm financial performance. in line with those results, this research results demonstrate a positive and significant impact of national diversity (ND) on firm financial performance. Board Independence (BI) shows insignificant and negative impacts on firm financial performance. Eventhough Mishra & Kapil (2018) illustrated that board independence is significantly related to an accounting-based performance measure.

Conclusion and Recommendation

The study desired to find out whether board diversity measured by ethnic diversity, gender diversity, educational diversity, diversity in nationality, and board independence is associated with the financial performance of firms listed at Colombo Stock Exchange in the period 2014-2018 Sri Lanka. After analysing the relationship between independent variables, results revealed that the independent variables are moderately associated with each other. Regression results represent that there is an insignificant positive impact of ethnic diversity (ETD) on return on assets (ROA), As well as gender diversity (GD) and return on assets (ROA) are having an insignificant positive relationship. But National diversity (ND) also has a significant positive impact on return on assets (ROA). That means, when the board includes foreign directors as well as Sri Lankan directors, it affects to increase firm financial performance by a considerable level. Educational diversity (ED) has an insignificant negative impact on return on assets (ROA). Board Independence (BI) is negatively related to return on assets (ROA). The control variable of firm size (FS) has a negative impact on return on assets (ROA) and that impact is significant. But control variable of ownership of board (OB) has an insignificant negative impact on return on assets (ROA). Finally, results conclude that national diversity among other diversity variables that are used in this study is significant to the firm financial performance of Sri Lankan listed companies. In terms of analysis carried out by the researcher, the main objective of the study was achieved, as it was able to find that ethnic diversity, gender diversity, educational diversity, diversity in nationality, and board independence are associate with firm financial performance.

Results conclude that national diversity among other diversity variables that are used in this study is significant to the firm financial performance of Sri Lankan listed companies. Therefore, increase foreign directors on board is an advantage for a company to enhance firm financial performance. Skills and abilities are different among various nationalities, so the representation of various nationalities in one board will be beneficial. Not only that Coverage of Sinhalese and Tamil directors also enhances firm financial performance. There is no barrier to include various ethnicities in a board since Sri Lanka is a very peaceful country after the civil war. Therefore, it is advisable to include various ethnicities on board. Further, it is advisable to comprise of female directors with compared to male directors also increase firm financial performance since research shows a positive impact of firm financial performance and gender diversity. Not only for rational shareholders and managers, but these research findings are also valuable to the policymakers in corporate governance. As a regulatory body, they can impose some regulations, laws, and policies for composing the direct board to be well balanced. Not only for Sri Lankans wise but stakeholders from international context also have a good chance to invest in other countries' companies fundamentally, because that creates value as explained in the research. Since this research covers a practical issue in corporate governance up to some extent, researchers, scholars, and students can continue the researches from this point onwards.

Limitations of the study

Even though this research provides a higher value it may consist with some limitations. This study is based on secondary data which were already collected by another party and collected for another publishing purpose. Therefore, the reliability of the data may below. Collected data represent only for a period of five (5) years from 2014 to 2018. It may be a shorter period for understanding the long-term patterns. Generalization by sample may not represent the population in reality. This study was conducted within six (6) months' time frame-work, which is not enough to collect a wider range of information to add more value to research.

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