

Ethnic Diversity on Boards of Directors and Its Implications on Firm Financial Performance

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Abstract

This paper makes an attempt to understand the extent to which ethnic diversity in top level management affects firm financial performance. Thus, the purpose of this paper is to empirically examine the relationship between ethnic diversity on boards of directors with firm financial performance. This paper uses secondary data from the top 100 non-financial companies listed on the Main Board over a period of 2000 to 2005 (six years). It involves a non-probability sampling as there is a need to meet some specific criteria and requirements. Top 100 companies are determined by ranking them based on their market capitalization. Relevant concepts, propositions and a hypothesis are developed to suit the parametric statistical procedures. Ethnic diversity is measured by the percentage of Non-Malay directors and performance is viewed in terms of Return on Asset (ROA) and control variables are also considered. Statistical techniques such as correlation and regression analyses are considered and the details of the findings explain the impact of ethnic diversity on firm financial performance. This paper is expected to make a significant contribution to the workforce diversity literature particularly at top level management by proving that ethnic diversity on boards of directors is more likely to lead to superior financial performance.

Key Words: diversity, financial performance, board of directors, non-financial companies, top management

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INTRODUCTION

The board of directors plays a very significant role in view of maximizing shareholders' wealth via exercising control over top management (Kose and Senbet, 1998). As a corporate governance mechanism, the board of directors will have direct impact in assuring adequate returns for shareholders (Vafeas, 1999; Weir and McKnight, 2001). The board has the obligation to optimize shareholder value (Coles et al., 2001). The general principles outlined by the Malaysian Code of Corporate Governance in 2000 includes board structure, board size and independent board of directors and subsequently, Bursa Malaysia decided to impose restriction on the number of directorship of a person in 2002.

Obviously, there is no clear emphasis made on the need of instituting workforce diversity on board of directors. This research however, does not investigate the characteristics or discrimination within the boards of directors rather this work is specially designed to investigate the impact of diversity within boards of directors on firm financial performance. Hence, the purpose of this study is to empirically examine the relationship between ethnic diversity on boards of directors with firm financial performance. In relation to this, the conceptual understanding is essentially important as illustrated below.

Definition

Diversity is the variation of social and cultural identities among people existing together in a defined employment or market setting, social and cultural identity refers to the personal affiliation with groups that research has shown to have significant influence on peoples' major life experiences. These affiliations include gender, race, national origin, religion, age cohort and work specialization, among others (Cox, 2001).

Primary categories of diversity include age, race, ethnicity, gender ..., secondary categories of diversity include education, experience, income, marital status, ... (Slocum and Hellriegel, 2007).

As the terms multi-ethnic and multi-culturalism are inter-changeably used, Kabilan and Hassan (2005) ... *prefer the use of the term 'multi-ethnic' to 'multi-culturalism'...multi-culturism is a misled concept or a misnomer, when applied to Malaysia. Hasan, Samian and Silong (2005) ...managing diversity is very much based*

on tolerance and respect ...to preserve inter-ethnic harmony. Hence, ethnic would be the right term to address racial composition in Malaysia.

Studies on diversity can be viewed in two perspectives; demographic and cognitive. Demographic diversity includes gender , age, race and ethnicity and cognitive diversity includes knowledge, education, values, perception, affection and personality characteristics (Maznevski, 1994; Milliken and Martins, 1996; Pelled, 1996; Boeker, 1997; Watson et al., 1998; Peterson, 2000; Timmerman, 2000).

There have been many contemporary studies on demographic diversity and its effect on performance (Lee and Far, 2004; Evans and Carson, 2005; Bergen and Massey, 2005). Some researchers even studied specifically on the impact of demographic diversity on top management team or boards of directors and its implications on firm performance (Roberson and Park, 2007; Erhardt, et al., 2003; Certo et al., 2006; Carson, et al., 2004;). However, very few studies found on racial/ethnic diversity at top management (e.g. Roberson and Park, 2007) and meanwhile, increased racial diversity on boards of directors is being experienced in the U.S. (burke, 1995). For this study, diversity is defined as the representation of ethnic difference (Malay, Chinese, Indian and others) on boards of directors.

Diversity and Organizational Performance

The current literature reveals the fact that the relationship between diversity and organizational or group performance can be either positively correlated or negatively correlated or even some studies show that there is no relationship (somewhat mixed findings) between diversity and performance.

Some empirical findings indicate that diversity results in greater knowledge, creativity and innovation and thus, organizations tend to become more competitive (Watson et al., 1993). In addition, improvement in decision making at strategic level can also be seen in the presence of diversity (Bantel, 1993).

Meantime, both educational and cognitive diversity are positively correlated with organizational performance (Simons and Pelled, 1999). Siciliano (1996) found that board diversity paves a way for positive results in performance. Cultural heterogeneity results in issue-based conflict which in turn enhances greater organizational performance. Heterogeneity is positively linked to better problem solving and offering creating solutions (Michael & Hambrick, 1992). Hence, diversity is positively related to performance. However, there could be no relationship between diversity (cultural heterogeneity and member diversity) and group cohesion. Murray

(1989) suggested that the infusion of homogeneous groups would result in better performance.

On the other hand, diversity can be disadvantageous to organizational performance (Hambrick et al., 1996), In which, homogeneous top management tends to produce better results as compared to heterogeneous top management. Similarly, Knight et al. (1999) also argues that team performance tends to deteriorate as diversity level increases.

Diversity, Board Diversity and Firm Performance

A very important theory dealing with diversity within top management and its impact on firm performance that should be considered here is the **Upper Echelon Theory** by Hambrick and Mason (1984). In view of this, top management members could with greater demographic diversity, influence decision making process in the top management and positively contribute to firm performance. The basic foundation of this theory could be linked to the earlier concepts on the characteristics at the top management and competitive behaviours (Cyert and March, 1963). Thus, firm performance could be positively impacted by the competitive behaviours at top level of an organization.

Admittedly, to a large extent (as discussed above), diversity enhances greater creativity, innovativeness and quality decision making, thus this study expects the similar outcome at strategic level particularly involving the boards of directors (Zahra and Pearce, 1989) and boards are the most influential actors, boards are also to carry out the monitoring role representing shareholders (Hambrick 1996). Significantly, some research shows that increasing diversity on boards of directors would be beneficial to organization in terms of gaining critical resources (Pfeffer and Salancik, 1978) and where corporate governance is concerned, benefits at strategic level are positively related to diverse top management (Eisendardt and Bougeois, 1988). Occupational diversity among board members is also positively related to performance in the context of social obligation (Siciliano, 1996). Zander (1993), stresses that efforts must also be taken to make fullest use of the talents of board members.

Obviously, the presence of the demographic heterogeneity at top management level tends to increase firm performance, hence, heterogeneity is suitable for complex, ambiguous business operations and the decision making processes are structured in nature whereas, homogeneity in top management is more effective especially when faced with unstructured decision making processes (Hambrick and Mason, 1984).

However, advantages associated with homogeneous top management can not be ignored. In fact some argue having homogeneous management team would be more beneficial with regard to firm performance (Williams and O'Reilly, 1998). Evidence shows that heterogeneity tends to lead to conflicts and negatively affects the effectiveness of communication in top management (Pelled et al., 1999; Amason, 1996; Carpenter, 2002).

Hypothesis Formulation

The Upper Echelon Theory by Hambrick and Mason (1984) becomes a very important platform in connecting heterogeneity in top management team (TMT) with firm performance. In view of this, a closer look at the model and its components would be of great help to expand our knowledge on diversity in TMT, thus board of directors could be viewed in the same context as TMT (Hofman, Lheureux and Lamond, 1997) and it should be noted that it is not organizational performance rather financial performance is being investigated here and ethnic diversity represents diversity (Roberson and Park, 2007).

Therefore, these concepts allow us to form a reliable proposition that explains the relationship between demographic diversity on boards of directors and financial performance, thus the following hypothesis is proposed: *Firm financial performance is positively impacted by ethnic diversity among board members.*

Methods

Data for the study were gathered from top 100 non-financial companies listed on the Main Board of the Bursa Malaysia over a period of 2000 to 2005. It involved a non-probability sampling (judgemental sampling) as there was a need to meet some specific criteria in selecting the 100 companies.

First, as there were over 600 companies listed on the Main Board, the companies were split into two; financial and non-financial companies. It seemed top 100 companies accounted for about 60 per cent of the total market capitalization as compared to about 80 per cent contributed by both groups in the top 100 list. Thus, non-financial companies were still making substantial contribution on the main board and as for this study, this is important to maintain the homogeneous characteristics of the companies selected. Then, the average market capitalization for each non-financial company was calculated over a period of 2000 to 2005. Then finally top 100 companies (refer to Supplement 1) are determined by ranking them based on their market capitalization.

Measures

As the main focus was to detect the effect of board diversity (by using ethnic diversity as a proxy) on firm financial performance and this was measured at two different points; 2000 and 2005 and these periods reflected the beginning of the post-crisis and the enhancement of the corporate governance in Malaysia (evidenced by the release of the Malaysian Code on Corporate governance by the committee in March 2000). The dependent variable was financial performance, independent variable was ethnic diversity and the control variables were board size, firm size and financial performance for year 2000 (used for the second period year 2005).

The dependent variable, ROA; Return on Asset (Net Income divided by Total Asset) was a measure used to measure firm financial performance (Certo et al., 2006; Erhardt et al., 2003), the independent variable, ethnic diversity (board diversity) was measured on a ratio scale (Non- Malay directors divided by the total directors), the control variables; board size was determined by the taking the number of directors sitting on the board, firm total asset was a measure for firm size (Roberson and Park, 2007; Jehn and Bezrukova, 2004).

Analyses and Findings

Two statistical techniques were adopted; correlation and regression analyses. The correlation result (Table 1) shows the relationships among the variables considered in the study and the regression analysis explains the effect of ethnic diversity (board diversity) on firm financial performance in the presence of the control variables.

The regression model first based on the OLS (ordinary least squares) estimators was however further corrected; first diagnostic testing done on the multicollinearity effect, and it was verified that the VIFs (Variance-inflating factor) for both control and independent variables were less than 5. Then the method of Weighted Least Squares (WLS) was adopted as a remedial measure of correcting heteroscedasticity and the findings were reported accordingly.

Table 1: Mean, standard deviation and bivariate correlation results

	Mean	Std D	1	2	3	4	5	6
1.Boardsize	8.28	2.27	-					
2.Ethnic diversity	0.53	0.26	-0.084	-				
3.Performance'2000	3.14	10.34	0.025	0.101	-			
4.Performance'2005	3.17	28.22	0.053	0.239*	0.074	-		
5.Firmsize'2000	4.00 ^a	6.63	0.124	-0.233*	-0.027	-0.018	-	
6.Firmsize'2005	5.13	8.46	0.193	-0.195	0.001	0.039	0.815**	-

a In billions

* p < 0.05

* p < 0.01

The mean, standard deviations and correlation are coefficients shown in Table 1. As for correlation analysis, ethnic diversity was significantly and positively related to performance'05 ($r = 0.239$, $p < 0.05$). However, there was a significant negative correlation between ethnic diversity and firmsize'05 ($r = -0.233$, $p < 0.05$). This indicates that the larger the company, the lower the ethnic diversity will be. Meantime, firmsize'05 and firmsize'00 were strongly correlated ($r = 0.815$, $p < 0.01$) and this reflects positive growth of the companies.

Table 2: Regression results for predicting performance

	Performance'2000			Performance'2005		
	Beta	R ²	F	Beta	R ²	F
Constant	-0.224	0.011	0.365	1.458 2.456*		0.097
Board size	0.156			0.101		
Firm size	-0.012			0.004		
Performance'2000	-			0.135*		
Ethnic Diversity	4.002			5.832*		

*p < 0.05

Table 2 shows two sets of regression models at different points in time; period 1: performance year 2000 and period 2: performance year 2005. However, based on the results obtained, there was no significant impact found though there was a positive relationship between ethnic diversity and performance in the presence of the control variable. Thus, the hypothesis is not supported.

On the other hand, firm performance was significantly impacted by ethnic diversity in 2005 in the presence of the control variables ($t = 2.194$; 0.030), and the model is significant (F-test = 2.456). This indicates that a one unit increase in ethnic diversity could result in an increase of about 6 units in performance while the model is reliable at 0.05 (F-test = 2.456). Meantime, it seemed performance in year 2005 was positively impacted by the performance in 2000.

Hence, this result supports the hypothesis indicating that increased ethnic diversity (board diversity) on boards of directors would lead to higher firm financial performance. Though Board size, Firm size positively influenced the level of performance, however, ethnic diversity was proven to be an effective tool that should be imposed on boards of directors for a greater performance.

Limitations

Some limitations or potential weaknesses in this study must be addressed. First, the sample involves non-financial sector which comprises of various industries thus, it is quite difficult to maintain homogeneous characteristics within the companies chosen as different industries tend to face different types of challenges.

Second, this study is constrained by the selection of variables where, only one independent variable (ethnic diversity) was used to measure board diversity and the operational definition of ethnic diversity (non-Malay ratio) is to some extent becomes arguable as there are possibilities where all the board members are non-Malays but of the same ethnic group which statistically gives a high score for diversity and this could be misleading. The dependent variable (performance measure) ROA may not be the most recommended measure from various parties' point of view though widely used in most research.

Third, the regression model in this study assumes there is a linear relationship between diversity and performance. There could be a curvilinear relationship. This means diversity may result in adverse results for a certain period, followed by indifferent results, then positive relationship with regard to performance.

Implications and Conclusions

It is clear the fact that generally, demographic diversity contributes positively towards organizational performance as well as firm financial performance. There are many studies carried out on demographic diversity (mainly on gender, age) and its implications on performance, but very few studies conducted with a special focus on ethnicity involving top management in general and boards of directors in particular. In the context of Malaysia, the 1997 financial crisis had sparked off many domestic policy weaknesses and admittedly, poor corporate governance was one of the contributing factors to the downfall of many listed companies Mitto (2002) and thus, it reflected the weaknesses of the boards of directors.

In view of this, since board of directors are directly involved in issuing, restructuring, takeover exercises, introducing measures to enhance regulatory, transparency, accountability and independence therefore, the current principles of good corporate governance should not ignore the relevance of heterogeneity in 'reshaping' board members' commitment in making sure that their companies are on the right track. This study also signifies a very important aspect in management whereby companies might have to face a dangerous practice- '**Grouphink**' in the presence of

homogeneity especially when the board members are of the same ethnic group and this in turn leads making wrong decisions at strategic level.

Despite the limitations, this paper reveals that ethnic diversity enhances firm financial performance. Hence, being a multi-racial country, Malaysian companies should make fullest use of this opportunity as increased ethnic diversity offers greater innovativeness, greater creativity, quality decision making and eventually greater financial performance. While the need to check on the various aspects of board members (in terms of ownership structure, board structure: size, CEO duality role, independent members, professionalism/qualifications; board activity: meeting and remuneration) remains intact, the parties concerned should also seriously consider the tangible benefits resulting from ethnic diversity.

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Supplement 1: Top 100 non-financial companies

No	Company	No	Company
1	Amsteel Corporation Bhd	51	Malaysian Pacific Ind Bhd
2	Amway (Malaysia) Hldgs Bhd	52	Malaysian Plantations Bhd
3	Asiatic Development Bhd	53	Marco Holdings Bhd
4	Batu Kawan Bhd	54	Matrix International Bhd
5	Berjaya Corporation Bhd	55	Measat Global Bhd
6	Berjaya Land Bhd	56	MISC Bhd
7	Berjaya Sports Toto Bhd	57	MMC Corporation Bhd
8	Boustead Holdings Bhd	58	Mulpha International Bhd
9	British American Tobacco (M)	59	Multi-Purpose Holdings Bhd
10	Cahaya Mata Sarawak Bhd	60	NCB Holdings Bhd
11	Camerlin Group Bhd	61	Nestle (Malaysia) Bhd
12	Carlsberg Brewery Malaysia Bhd	62	Oriental Holdings Bhd
13	Chemical Co of Malaysia Bhd	63	Pan Malaysia Corporation Bhd
14	Country Heights Holdings Bhd	64	Pan Malaysian Industries Bhd
15	DIGI.Com Bhd	65	Pantai Holdings Bhd
16	DRB-Hicom Bhd	66	Petaling Tin Bhd
17	E&O Property Development Bhd	67	Petronas Dagangan Bhd
18	Esso Malaysia Bhd	68	Petronas Gas Bhd
19	Fraser & Neave Holdings Bhd	69	POS Malaysia & Svcs Hldgs Bhd
20	Gamuda Bhd	70	PPB Group Bhd
21	Genting Bhd	71	PPB Oil Palms Bhd
22	Golden Hope Plantations Bhd	72	Proton Holdings Bhd
23	Guinness Anchor Bhd	73	PSC Industries Bhd
24	Hap Seng Consolidated Bhd	74	Puncak Niaga Holdings Bhd
25	Highlands and Lowlands Bhd	75	Ramatex Bhd
26	IGB Corporation Bhd	76	RB Land Holdings Bhd
27	IJM Corporation Bhd	77	Resorts World Bhd
28	Integrax Berhad	78	Road Builder (M) Hldgs Bhd

29	IOI Corporation Bhd	79	Sarawak Enterprise Corpn Bhd
30	IOI Properties Bhd	80	Shell Refining Co (FOM) Bhd
31	Island & Peninsular Bhd	81	Sime Darby Bhd
32	Jaya Tiasa Holdings Bhd	82	Sime UEP Properties Bhd
33	JT International Bhd	83	Star Publications
34	K & N Kenanga Holdings Bhd	84	Sunway Holdings Incorp Bhd
35	Karambunai Corporation Bhd	85	TA Enterprise Bhd
36	KFC Holdings (Malaysia) Bhd	86	Talam Corporation Bhd
37	Kuala Lumpur Kepong Bhd	87	Tan Chong Motor Holdings Bhd
38	KUB Malaysia Bhd	88	Tanjong Public Limited Company
39	Kumpulan Guthrie Bhd	89	Telekom Malaysia Bhd
40	Kumpulan Perangsang Selangor	90	Tenaga Nasional Bhd
41	Lafarge Malayan Cement Bhd	91	TH Group Bhd
42	Lingkar Transkota Hldgs Bhd	92	UEM World Bhd
43	Lingui Developments Bhd	93	UMW Holdings Bhd
44	Lion Corporation Bhd	94	Unisem (M) Bhd
45	Magnum 4D Berhad	95	United Malayan Land Bhd
46	Magnum Corporation Bhd	96	United Plantations Bhd
47	Malakoff Bhd	97	YTL Corporation Bhd
48	Malayan United Industries Bhd	98	YTL Power International Bhd
49	Malaysian Airline System Bhd	99	Hyundai-Sime Darby Bhd
50	Malaysian Oxygen Bhd	100	Integrated Rubber Corp Bhd