Diversity, Corporate Governance and Implication on Firm Financial Performance

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Abstract
Recent research in corporate governance has focused primarily upon minimization of agency costs in the shareholder-management relationship. Particularly, a number of studies in developed countries have carried out to investigate the effect of corporate governance on firm performance. Board characteristics play an important role in organizations to improve their corporate governance and firm performance. This paper will investigate a complimentary perspective, which is a diversity dimension at top-level management based upon upper echelon theory. Diversity comprises on demographic and cognitive dimensions. The objective of this paper is to theoretically examine and explain the effect of diversity on board of directors with regard to firm financial performance. The upper echelon theory contended that demographic and cognitive diversity dimensions at Top Level Management may impact on firm financial performance. This study contributes to potential investors, shareholders, top managements and stakeholders. It provides clear information about how to measure a firm performance. In fact, it also contributes to top managements and helps in reducing the principal-agent problem by considerate the effect of diversity in terms of BODs on firm performance. Based on this study, shareholders, stakeholders, managements and potential investors will know more how the significant roles of diversity are playing in the measurement of firm value.

Keywords: Diversity; Corporate Governance; Performance; BODs (Board of Directors)

1. INTRODUCTION

The concept of corporate governance is playing an important role in business world. Corporate governance has become the most critical issue all around the world, specially, after global financial crisis that teetered many economies into recession. Corporate governance has received too much concentration due to Adelphia, Enron, WorldCom, and other related high profile scandals. Now days, policy makers are concentrating the issues of corporate governance (Co-operation & Development, 2004). The concept of diversity, demographic diversity and cognitive diversity in business have emerged and matured over the years. Specially, diversity in Board of Directors (BODs) is playing an important role in firm financial performance. Businesses are facing risk and uncertainty, it is hard to forecast and control the intangible or tangible factors which are influencing firm performance

(Kuratko & Morris, 2003). Customers are well aware and more demanding for quality of services and delivery. In this dynamic business environment, boards are becoming very important for proper functioning of organizations. Boards are expected to perform variety of activities like monitoring management to mitigate agency cost provide resources, hiring and firing of management grooming CEO and provided that strategic direction for the firm (Wong, Chan, Hee, Lee, & Yeoh, 2011).

In the case of Malaysia, the financial crisis of 1997 has affected Malaysia economy badly and many of major corporations have shut down. Poor corporate governance was the result of corporate failure of financial crisis. After this failure, Malaysian regulators have taken effective steps to improve corporate governance. The regulators are the Malaysia Institute of Corporate Governance (MICG), Malaysia Accounting Standards Board (MASB), Bursa Securities Malaysia (BM), Companies Commission of Malaysia (CCM) and Securities Commission (SC) (Wong et al., 2011).

By practicing good corporate governance, it is able to reduce principal-agent problems and preclude corporate scandals, frauds, civil and criminal liability of the organization. In addition, it can improve the image and reputation of the organization to attract more stakeholders involvement in the organization. Therefore, better firm performance is the result of better corporate governance, which good-governed firms should perform better than bad-governed firms (Lipman & Lipman, 2006). In a risky business environment, BODs are playing significant role in smoothing companies operations. Boards consist of different individual teams, who put in their experience, knowledge and skills towards governing function (Brown & Caylor, 2005). Shareholders are company owners and they select directors of the company to manage company on behalf of them. However, BODs owes duty to act in the best interest of the organization and shareholders. BODs play an important role in firm’s strategic decision making, control the internal mechanism of governance and monitoring of company management. A board will help the firm to achieve better performance with good corporate governance practices (Kemp, 2006).The key factors of success are transparency, ownership, diversity and active participation in strategic decision making (Bathula, 2008).

Managers at strategic level are concerned with major roles of company, the primary duty and responsibility of boards of directors to ensure the corporation performance. The literature always discusses the roles of boards of directors with two main theories, which are agency and stewardship theory. The stewardship explains the positive relationship on manager’s participation in organization. Stewardship theory explains that the stewards put the value of the firm higher than their individual interest. The behavior of stewards assumed collective since their goal is mainly the success of organizations reflected through, for example, a high profitability and sales growth, which leads to the satisfactions of principals due to an enhanced wealth. In this theory there is a form of trust-based corporate governance system where the BOD acts primarily as an adviser to top management teams (Grundei, 2008). However, since this relationship is based on trust, goal alignment, and cooperation, the unity of the relationship might be so strong that it prevents justified criticism of managerial behavior by the BOD (Argote, McEvily, & Reagans, 2003).

Agency theory explains the relationship between agent and principal, which may cause conflict among company owner and company agents ahead corporate goals. The board members consider as the most important tool for ensuring effective corporate governance (Coles, McWilliams, & Sen, 2001) and have liability to enhancing shareholders wealth through an effectual monitoring or control system over top management teams. The resource dependency theory argues that boards of directors considered as a mechanism for handling external dependencies and reducing external uncertainty. Stakeholder theory explains that the organization is an important part of social system and organization may impacts on, or impacted by other social group of society (Deegan, 2002). The specific groups within society – called 'stakeholder groups'- they will have different views about organization how its operation should be conducted .They also have power to push the organization to comply with their expectations. (Nordberg, 2008) (1998 cited in Nordberg 2008) also states that boards should manage the business for the benefit of all stakeholders. A firm's diversified board would be in a better position to understand societal needs and thereby create a positive image about the firm which could help enhance the wealth of stakeholders and stimulate a firm's awareness of social responsibility to the community in which it operates (Nordberg, 2008). Gender diversity on firm boards becomes relevant from the perspective of the stakeholder theory as well. Top-level management consists of top manager and board of directors (BODs). It observed that boards are key discussion in corporate world and found quite interesting when its link with firm performance (Kroll, Walters, & Le, 2007). Certainly, women and multi ethnic groups are becoming part of labor force and part of top management level including BODs. There is a need to investigate the board characteristics with firm performance (Burke & Nelson, 2002).

2. DEMOGRAPHIC, COGNITIVE BOARD DIVERSITY AND FIRM PERFORMANCE

It is a proven fact that boards of directors are the key players of corporate performance (Hermalin & Weisbach, 2003). Gender is a status, which constructed through social, cultural, and psychological means; it based on personal traits. The general perception that there are differences between men and women have somewhat been diminished by (Chaganti, 1986). He claims that there is no significant difference between men and women when it comes to needs such as leadership, achievements, self-confidence, aggression, goal orientation, persistency, independence, non-conformity, autonomy, and locus for control. Boards should take advantage from a diverse mix of knowledge, background and expertise among their members. To perform better and for good governance, companies need women and men directors who possess the right competences i.e. knowledge, skills and experience, to contribute to board decision making. As per Malaysian code on Corporate Governance (MCCG) in 2012, by assessing the board members competences to ensure that directors have right skills, attributes, traits and right character to handle specific situations (Commission, 2011).

Numerous studies have conducted on gender diversity, which can concluded that gender diversity is a positive thing. One case in favor of gender diversity is that a gender diverse board has more alternatives to base its decisions on (Singh & Vinnicombe, 2004). It may also improve the image of the firm, which can affect the customers' view of the firm in a positive way, leading to better performance results. Furthermore, a board with more gender diverse members may lead towards quality decision-making (Smith, Smith, & Verner, 2006). Heterogeneity in the gender leads to more constructive processes in a group (Kochan et al., 2003). According to Adler (2001), claimed that more female oriented firms affect the performance positively. According Carter, Simkins, and Simpson (2003) supported these findings; their results show that there is a positive relationship between gender diversity and firms value. A Danish study of 2500 Danish firms shows that there is a positive effect of women in the CEO position and firm performance, but when it comes to BODs the results are ambiguous and insignificant (Smith et al., 2006). First, greater gender diversity that leads to more differing opinions and critical questions can be time consuming which inhibits the firm, especially if the firm is competing in a business environment that is turbulent and requires fast and rapid decisions (Smith et al., 2006). There is also a greater risk for conflicts which also slows down the decision making process (Hambrick, Cho, & Chen, 1996). According to Hambrick et al. (1996) have conducted a study of the 200 largest firms in the US and the outcome of that study does not show any positive relationship between gender diversity in BODs and firm performance. A similar study by Kochan et al. (2003) supports this outcome, showing no positive relationship between gender diversity and performance.

Women are playing a good role to achieve good governance in organizations. They argued that females have skills in accounting, finance and good decision-makers. Human resource directors should train women for leading and top positions and make sure more women available in top management teams. In board meetings, women are said to be cooperative, polite, sympathetic, and empathetic qualities because they always listen more openly to the speakers, to put forward respect, kindness and to help the board to recognize equally acceptable compromises to solve fragile problems (Konrad, Kramer, & Erkut, 2008). According to "agency" and "resource dependency theory", claim that women directors on board show different behavior from their male adjacent male board members and in presence of females that change the overall behavior of all board members and they considered as they can provide better monitoring and advisory services (Ismail, Abdullah, & Nachum, 2013). Having greater number of women on boards may increase the reputation of the organization (Lückerath-Rovers & De Bos, 2011). There is a positive and significant relationship between the presence of women at board and firms' performance as measured by return on asset-ROA (Ismail et al., 2013). Lückerath-Rovers and De Bos (2011) found that women's have distinctive managerial styles and firms with women on board have better performance in relation to return on equity (ROE) than firms having no women on their boards in Netherlands. However, in Malaysia researchers found no significant relationship between the female gender and firm financial performance. This could be due to differences in country and corporate cultures of organizations (Mohamad, Abdullah, Mokhtar, & Kamil, 2010; Ramli & Esa, 2012; Shukeri, Shin, & Shaari, 2012). A study from Pakistan, the result of this study found that there is no significant relationship between board gender diversity and firm performance measured by (EVA) economic value added (Yasser, 2012).

Malaysia has diversity by religious beliefs, customs, rituals and languages. Malaysia has three main ethnic groups: Malay, Chinese and Indian, which draw a line of diverse nation. This diversity could translate into diversity on corporate boards. Having an ethnically diverse board could enhance firm value because diversity forces directors to explain their ideas with logically, which cause better decision making. Diverse corporate boards have ability to do things in more creative or innovative way and always give benefit to its stakeholders (Marimuthu & Kolandaisamy, 2009). According to Yusoff (2010) corporate board diversity improves decision making, policies, procedures and business networking. In Malaysia, some studies have found a positive and significant relationship between board ethnicity and firm performance (Marimuthu & Kolandaisamy, 2009; Shukeri et al., 2012; Zainal, Zulkifli, & Saleh) and some studies have found no significant relationship between ethnic diversity and firm financial performance in context of Malaysia (Bolbol, 2012; Ismail et al., 2013). In case of Malaysia, women are not encouraging to as a board member and the average is one woman as director for every two firms. According to Minority Shareholder's Watchdog Group – Corporate Governance (MSWG - CG) report only 8.4 % women appointed as a board member in listed companies and more than 56 % listed firms did not have single woman on board (Johl & Kaur, 2013). In the context of cognitive diversity, board members selected on basis of experience, and making good decisions require experience. Most board directors in Malaysia have less than nine years board experience (Commission, 2011). According to Poon, Yap, and Lee (2013) stated that there is a relationship between firm performance and directors seniority.

The above inconsistent and conflicting arguments on ethnic, gender and experience diversity towards the firm performance, the possible research questions of this study can be: Does demographic diversity among board members has a positive impact on financial performance? Does cognitive diversity among board members have a positive impact on financial performance? Does gender diversity among board members have a positive impact on financial performance? Does ethnic diversity among board members have a positive impact on firm performance? Does experience diversity among the board members have positive impact on firm financial performance?

3. FOCUS OF THE STUDY

Diversity and corporate governance has a strong relationship in the context of top-level management. Boards of directors are the strategic leaders in the organization as they make strategic decisions and set its strategic directions. Through organizational performance, we can measure board effectiveness. Cognitive and demographic diversity require for boards operate effectively. Diversity includes gender diversity, so board of directors can best carry out their roles and tasks (Marimuthu & Kolandaisamy, 2009). According to Prihatiningtias (2012) the board is an important part of the overall corporate governance mechanism within a firm. BODs are essentially driving the overall performance of company. Board characteristics and board composition that includes, the number of independent boards, the tenure of boards, the size of the board, as well as board diversity in terms of gender, age, ethnicity, nationality, educational background, industrial experience and organizational membership, may influence firm performance (Talke, Salomo, & Rost, 2010).

Demographic diversity dimensions are race, gender, age while cognitive diversity dimensions are knowledge, education, values beliefs and perception. This paper investigates on demographic diversity (gender, ethnicity) & cognitive diversity (experience) among board members (BODs) and its impact on firm financial performance (Marimuthu & Kolandaisamy, 2009).

4. THEORETICAL JUSTIFICATION & GAP

Research reveals that diversity has a positive or negative effect depends on organizational strategies, culture context and HR (Human resource) practices & polices. Diversity is helpful for organization in certain conditions (Pugh, Dietz, Brief, & Wiley, 2008). Previously research shows that relationship between diversity and firm performance can be positive or negative. Some researches shows inconclusive results. Diversity among board members perceived as high profitably and better return on equity in context of firm performance (Allen, Dawson, Wheatley, & White, 2007).

Researchers have studied on demographic diversity (gender, ethnic) among TMTs (Top management teams) and BODs (Board of directors) and its impact on financial performance of organization. Findings have indicated that diversity in board of directors (BODs) has a significant impact on financial performance but diversity in top management teams (TMTs) does not have any significant impact on financial performance of organizations. Greater diversity brings greater creativity, innovation and quality decisions. Researcher emphasized that companies should prefer heterogeneity factor in BODs (Marimuthu & Kolandaisamy, 2009). Demographic diversity among board members directly associated with upper echelon theory because this theory explains the real relationship between firm performance and board characteristics (Nishii, Gotte, & Raver,

2007).There are many studies have been carried out on board diversity but very few studies focused on demographic and cognitive diversity in the context of top level management. Many researchers perceived gender diversity dimension as an important argument in the context of corporations. However, the results of the current studies seem to be ambiguous and inconclusive when dealing with the top level management with regard to the aspects of diversity and firm performance, and hence, more contemporary studies may be required to justify this (Van der Walt, Ingley, Shergill, & Townsend, 2006).
Furthermore, some studies have focused on other forms of diversity in BODs with regards to financial performance of the companies (Carson, Mosley, & Boyar, 2004; Wang & Clift, 2009). There seem to be very limited studies done by integrating both demographic and cognitive diversity in measuring firm financial performance in the context of top-level management. In view of this, there is a need to investigate the effect of demographic and cognitive diversity in top-level management on firm performance in a more comprehensive manner. However, the term diversity usually includes two main variables and they are ethnicity and gender. In most commonly, the focus is always on the demographic factors and a little emphasis is given on cognitive components (Marimuthu & Kolandaisamy, 2009). Hence, more studies that are comprehensive are required in this area.

5. THEORETICAL FRAMEWORK

The theoretical framework showing the relationship between demographic, cognitive diversity and impact on financial performance of firm is proposed in Figure 1. Here, independent variables are demographic and cognitive diversity. Demographic diversity includes (gender, ethnicity) and cognitive diversity includes (experience). The dependent variable of this study is firm performance which can be measured through ROA (Return on Asset) and ROE (Return on Equity). The control variables of this study are firm, firm size and board size. This study will show the actual relationship between diversity and firm performance.

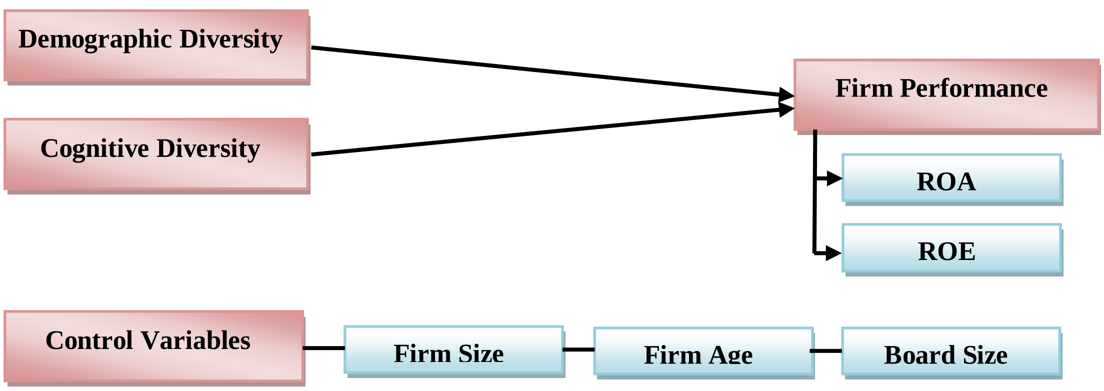

Figure 1: Relationship between Demographic, Cognitive Diversity and Firm Performance

6. HYPOTHESES

The **Upper Echelon Theory** explains board characteristics (top level management) and its impact on firm performance (Hambrick & Mason, 1984). Demographic diversity includes fourteen dimensions and cognitive diversity includes six dimensions that can view in context of board of directors (BODs). Consequently, under the discussion of previous studies, it allow us to make a set of hypotheses that shows the actual relationship between demographic & cognitive diversity among board members and its impact on firm financial perforce. The proposed hypotheses for this study are as below:

H1: Demographic diversity among the board members (BODs) has a positive impact on firm financial performance.
H2: Cognitive diversity among the board members (BODs) has a positive impact on firm financial performance.

7. METHODS AND MEASURES

This study will analyze public listed companies in Bursa, Malaysia. The companies will be select based on top market capitalization from Non- Financial sector listed in Bursa Malaysia. The annual reports will be use in gathering the information on demographic and cognitive diversity. The selection will be base on non-probability sampling or judgmental approach. The research design is cross sectional and time series. For data collection, companies' annual reports will be use.
The independent variables are demographic & cognitive diversity while dependent variable is firm financial performance. The control variables (Cv) are board size, firm age and firm size.

Firm Performance (Y) = α + βDiversity + ΣβCv + ε
ROA= α + βDemographic + ΣβCv + ε
ROA= α + βCognitive + ΣβCv + ε
ROE= α + βDemographic + ΣβCv + ε
ROE= α + βCognitive + ΣβCv + ε

To measure the independent variables, demographic & cognitive diversity will use ratio scale. The dependent variables (ROA, ROE) will be determined as firm financial performance (Certo, Lester, Dalton, & Dalton, 2006).

"Return on assets (ROA)" = $\boxed{\text{"Net Income/Total Assets"}}$

"Return on equity (ROE)" = $\boxed{\text{"Net Income / Equity} \times 100\%\text{"}}$

The control variables; "firm age" refers to total number of years since incorporation, "board size" refers to total number of directors on the board, "firm size" refers to company log of total asset. For the data analysis, techniques such as cross sectional and time series data, panel/pooled data analysis method, correlation tests will consider for analysis.

8. CONCLUSIONS

One of the contributions of this study will be that it investigates on demographic & cognitive diversity among board members and its impact on firm financial performance. The study's second contribution will be through concrete findings. Based on the findings it will draw a conclusive statement in context of diversity and its impact on firm financial performance. Most likely there is a need to be carried more research on different sample size and different sampling techniques to use for further verification. The results from this study will provide a big picture of relationship between diversity and firm performance. Therefore, organizations may gain the strategic edge from result of this study. The outcome of this study will give the potential benefit to businesses, policy makers, professional bodies, and the wider community.

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