Effect of board diversity on firms performance

Business, Company

One of the most significant governance issues currently facing the managers, directors, and shareholders of the modern corporation is the gender, racial, and cultural composition of the board of directors. The issue has taken on a high public profile as a result of reports in the popular press, shareholder proposals from advocacy groups, and policy statements from major institutional investors. This is simply stated as Board of diversity which means different things to different people.

Among the types of diversity commonly described are: gender, national origin, race, sexual orientation and viewpoint. In my report I have selected three companies and have focused on “ The Impact of board of diversity on the company performance’. In my report I have mostly concentrated on gender, educational and age diversity of the board of directors. Board of directors is a body of elected or appointed members who jointly oversee the activities of a company or organization. It is the most important decision-making body in a corporation.

It has very defined roles and responsibilities within the business organization. Essentially it is the role of the board of directors to assess the overall direction and strategy of the business. It is solely responsible for approving major strategic and financial decisions, such as mergers and acquisitions and changes in capital structure, and also for the most important task of all, which is to hire and fire top executives. Effective boards build capabilities within themselves and their organizations that allow them to do both protect existing assets (compliance role).

A board is a group of diverse individuals who have different biases and prejudices and whose behavior is affected by social constraints and power

relations. This perspective suggests that director heterogeneity plays a key role in how boards function. In contrast, most researchers in economics consider the board as a single entity. The only heterogeneity considered is whether directors are independent from managers. All other director characteristics are usually deemed unimportant unless they are somehow related to (formal or real) independence.

The surprising fact is that, substantial research focuses on the workings of corporate boards. But researchers focus on various aspects of boards. The board of directors is the internal governance mechanisms intended to ensure that the interests of shareholders and managers are closely aligned, and to discipline or remove ineffective management teams. This internal corporate governance mechanism is highly important in emerging markets Bangladesh, because due to weak institutional structure, emerging market firms depend highly on internal governance mechanisms.

Diversity can be a source of market insight, creativity and innovation, and improved problem solving. These diverse resources can provide a firm with a competitive advantage if they are valuable, rare, inimitable, and non-substitutable. However, the value of these resources varies in firms across markets and so does their ability to provide competitive advantage. This study examines the influence of corporate board composition in the form of representation of outside independent directors on firm economic performance in Bangladesh.

Two hypotheses are developed to examine the relationship among composition of board memberships including independent directors and firm performance. The focus of this report is the ways in which board diversity

can contribute to a higher financial performance of firms and a more independent board. It examines ways in which firms can gain a competitive advantage by providing insights on how a board should be structured to improve firm performance. Literature Review Theoretical literature

Stakeholder Theory recognizing the fact that firms does not operate in an isolation but within an environment made of different interest groups aside the immediate owners, stakeholder theory expanded interested parties spectrum as it argued the need to take into consideration the interests of other constituents in corporate decision making since they are likely to affect or be affected by firms' strategic choices. Under this theory, the purpose of firm shifts from pursuing shareholder value maximization to that which encompasses other stakeholders' expectations.

Therefore, maintaining harmonious corporate relationship with each group is of high strategic importance to the firm and its ability to add value as well as the delivery of success in the marketplace. In order to actualized board effectiveness and performance derive, the stakeholder theory advocated for large and well diversified corporate board size that accommodate and facilitate the alignment of the interest of each constituent especially those that create value to the firm.

Agency theory has undoubtedly dominated other theories as the most preferred approach to corporate governance studies. Agency relationship is defined as " a contract under which one or more persons engage another person (the agent) to perform some services on their behalf which involves delegating some decision-making authority to the agent. " According to agency model, the separation of ownership and control creates an inherent

conflict of interest between the shareholders (Principal) and the management (Agent).

Therefore, managers must be controlled to avoid “ moral hazard” using some risk-bearing and monitoring mechanisms that checkmate their deviant behaviors. In order to effectively address the agency problem, the theorists acknowledged the crucial role of board as an instrument of owners in subduing the opportunistic behavior of managers. Agency theory advocated for a clear separation between decision management and control.

The need for greater representation of outside independent non-executive directors as well as dual leadership structure and larger board size that makes management manipulation difficult are all some of the internal mechanisms recommended to address the presumed conflict of interest In economics, theoretical analyses of corporate boards usually abstract from the process of how board members reach an agreement. Whenever directors are treated as heterogeneous, this typically occurs because of their status as corporate insiders or outsiders.

Accordingly, most of the existing empirical research in economics disproportionately focuses on the distinction between independent and no independent directors as the main source of director heterogeneity. Consequently, some view board composition as the outcome of choices made by executives in their attempt to reduce the effectiveness of monitoring by boards. This is also known as the managerial power view of boards. What both the economic approach and the managerial approach have in common is the idea that firms choose directors for their characteristics.

Different board compositions provide diverse connections with the outside environment (competitors, suppliers, investors, politicians, the media, and others). Director characteristics could affect directors' competence and incentives to monitor and advise managers, and thus could be chosen either to maximize shareholder value or to protect the interests of executives. The stewardship theory took an opposite view of management.

While agency theory hypothesized that managers are self-interested, the stewardship theory advanced that indeed managers can be trustworthy and thus not enticed by the extrinsic value but rather intrinsically motivated by desire for accomplishment, acknowledgment, self-actualization, self fulfillment, power, and affiliation. The theory recommends unification of the position of CEO and board chair to reduce agency costs and promote unity of command doctrine. One of the most viable paths to achieving board effectiveness and performance variation is conditioned on degree of board dependency with greater executive directors' involvement.

The stewardship theory also stresses the need for smaller board size in line with organizational behaviorists/psychologists argument that small teams promote group cohesiveness and bonding that propel high performance. It should be noted here that, the board responsibility under the stewardship theory is more of strategic formulation rather than that of monitoring and control. The resource dependency theory appreciates the strategic importance of other stakeholders beside the immediate shareholders in guaranteeing firms' access to resource through affiliation with various constituencies.

The role of board of directors under resource dependency model is that of “ Boundary –Spanners” who use their individual external network of contacts to attract all kinds of indispensable resource the firm needs to operate competitively and advance superior performance. In line with the above, the resource dependency theorists presumed that an ideal board should consist of individuals with varieties of external linkages such as business experts, support specialists and community influential that bring within the firm’s reach access to requisite resources.

Resources dependency hypothesis was based on the fact that board members serve not only as director in a single firm but may likely be board member in other complimentary firms and can influence decision in the favor of firm for which they are affiliated. Thus, resource dependency theorists assumed that a well diversified board with appropriate representation of outside independent members is likely to lead to improved corporate performance especially in the face of environmental volatility when the degree firm dependency. Empirical Review

“ The relationship between board diversity and firm performance: the Italian evidence”. (Paola Schwizer, Maria-Gaia Soana, Doriana Cucinelli.) This paper examines the relationship between board diversity, financial performance and risk. Board diversity is intended as the presence of female and foreign directors on corporate boards. They analyze a sample of Italian listed companies during the period 2006-2008. The results show no statistically significant relationship between the number of female directors on boards and firm performance.

The same results emerge with regard to the link between gender diversity and firm risk. When they consider the presence of foreign directors, a negative relationship emerges between this variable and firm risk. " Corporate Governance, Board Diversity and Firm Value". (David A. Carter, Betty J. Simkins, W. Gary Simpson). This study examines the relationship between board diversity and firm value for Fortune 1000 firms. Board diversity is defined as the percentage of women, African Americans, Asians, and Hispanics on the board of directors.

This research is important because it presents the first empirical evidence examining whether board diversity is associated with improved financial value. After controlling for size, industry, and other corporate governance measures, the study find significant positive relationships between the fraction of women or minorities on the board and firm value. It also find that the proportion of women and minorities on boards increases with firm size and board size, but decreases as the number of insiders' increases.

" Is Board Diversity Important for Firm Performance and Board Independence? - An exploratory study of Singapore Listed Companies. (Pei Sai Fan). This research examines whether there is empirical evidence to support the positive relationship between board diversity and both firm performance and board independence. The research has an Asian focus and uses data from firms listed in Singapore. Evidence is found to support the positive relationship between board diversity and financial performance and board independence.

The research found diversity in gender, ethnicity and discipline of study of board members showing a positive association with TOBIN Q, a market-

based measure of firm performance. It also found diversity in tenure of directorship and the discipline of study of board members had a positive association with board independence. “ The impact of board diversity on corporate performance” - An empirical analysis for the German two-tier system”- (Eulerich, M. / Velte, P. / van Uum, C).

Recently, the composition of boards is increasingly considered as a significant mechanism of good corporate governance. Thus, the question arises whether a heterogeneously or rather a homogenously composed board contributes to the efficiency of a company’s management and monitoring. Therefore, the economic impact of board size and board diversity aspects needs to be investigated empirically. This study examines the relation between board diversity and corporate performance for the German two-tier system by a comprehensive literature analysis as well as an empirical analysis.

Hence, board diversity is characterized by the attributes gender, age, nationality and in-/outsiders. A comparable analysis including multiple dimensions for German companies has not been performed, yet. Due to the diverging results presented in our literature review, we ought to consider our results within the empirical evidence impartial and open-minded. Surprisingly, we mostly find negative effects of various board diversity characteristics on corporate performance figures, especially regarding age and national diversity attributes.

However, our findings should not be generalized as prior research on diversity characteristics is twofold. “ Boardroom diversity: Why it matters”- (Lawrence J. Trautman). What exactly is board diversity and why does it

matter? How does diversity fit in an attempt to build the best board for an organization? What attributes and skills are required by law and what mix of experiences and talents provide the best corporate governance? Even though most companies say they are looking for diversity, why has there been such little progress?

Are required director attributes, which are a must for all boards, consistent with future diversity gains and aligned with achieving high performance and optimal board composition? How might women and people of color best cultivate the skills necessary to make themselves attractive and productive board directors? The goal in this paper is to provide answers to these questions, and to discuss how a nominating committee and board can define their needs, explore their options, and provoke radical thinking about how corporate governance may be improved by reexamining fundamental assumptions about diversity.

Hopefully, constructive thinking about diversity and board composition, and a productive dialogue among all in the corporate governance community will result. " The Influence of gender diversity on corporate performance"-(Alvez, Sanchez, Dominguez). This work focuses on the effect of gender diversity on corporate performance. The current work, an extension of previous studies, focuses on the presence and effect of female stockholders, directors and top managers by analyzing their impact on various accounting ratios, market value and technical efficiency.

With a view to testing these hypotheses, we selected Spanish corporations that were listed on the Madrid Stock Exchange over the period 2004-2006 as an objective population. Corporate governance information on these

companies is available from the CNMV database. Our findings show that companies with higher levels of gender diversity do not obviously outperform other companies with lower levels, in terms of several market and accounting measures. Therefore, gender diversity may not influence corporate performance. “ Board Composition and Firm Performance: Evidence from Bangladesh” -(A. Rashid, A. De Zoysa, S. Lodh, K. Rudkin).

This study examines the influence of corporate board composition in the form of representation of outside independent directors on firm economic performance in Bangladesh. Two hypotheses are developed to examine the relationship among composition of board memberships including independent directors and firm performance. An observation of 274 Bangladeshi firm-years is used in the study. A linear regression analysis is used to test the hypotheses. Results reveal that the outside (independent) directors cannot add potential value to the firm’s economic performance in Bangladesh.

The idea of the introduction of independent directors may have benefits for greater transparency, but the non-consideration of the underlying institutional and cultural differences in an emerging economy such as Bangladesh may not result in economic value addition to the firm. The findings provide an insight to the regulators in their quest for harmonization of international corporate governance practices. “ A Nordic Perspective on Corporate Board Diversity” -(Trond Randoy, Steen Thomsen and Lars Oxelheim). In this report they analyze board diversity and its impact on corporate performance.

They investigate the 500 largest companies from Denmark, Norway, and Sweden and find no significant diversity effect of gender, age, and nationality on stock market performance or on ROA. The study concludes that if increased diversity along these lines is attractive, per se, or as a matter of political preference, it can be achieved without shareholder value destruction. However, if board size increases due to the recruitment of more director diversity there will be an indirect cost in terms of value destruction.