Impact of Board Diversity on Firms' Economic Sustainability in Sri Lanka

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Introduction

Sustainability is one of the most recent trends, which has become an integral part of the developing business world. Every type of business regardless of its size should apply sustainability for its success. Economic sustainability is measured in terms of financial performance of a firm. Therefore, sustainable development affects financial performance of the business firm. To increase the financial performance of a firm, it is important to have a diversified board which generates effective decisions for the company. As such, this will set the background for supportive working conditions, thereby enabling economic growth of the company. Variety inherent in boards' composition referred to as board diversity, can be measured via a number of dimensions, such as gender, ethnicity, nationality, educational background, industrial experience and organizational membership (Kevin Campbell, 2008).

Evidence on board diversity in the recent literature is that it is comparatively low in Sri Lanka (Nirosha Hewa Wellalage, 2013). Increased emphasis on sustainability by firms could have a positive influence on the board diversity in Sri Lanka. Therefore, this study aims to measure the impact of board diversity on firms' financial performance in Sri Lankan listed companies in 2018. This study draws on agency theory and human capital theory which have been identified from the literature on board diversity. Agency theory discuss the conflicts between the interests of owners and managers. Human capital theory focuses on the experience of board members. It is concerned about how directors' experience affects firm performance. Furthermore, agency theory and resource dependency theory posit a positive effect of board diversity on firm performance. Agency conflict occurs due to the separation of decision making and risk bearing of a company, and agency problem occurs at any point where the managers have an intention to pursue their own interests (Eugene F. Fama, 1983). Resource dependency theory provides an explanation for a board's function of providing critical resources to the firm. Moreover, there is a positive linear relationship between board demographic diversity and firms' financial performance. This means that board of directors were in a position to provide better resources to the knowledge intensive firms (Muneza Kagzi, 2017).

Objectives

The first objective of this study is to identify the reasons behind low board diversity in Sri Lanka and the second objective is to measure the impact of board diversity on firm financial performance.

Methodology

The data collection methods differed according to the objectives of this research where semi structured interview method was adopted to collect data on reasons behind board diversity status in Sri Lanka. Since the population of the directors and academics were not directly quantifiable, a sample of senior professionals holding directorships in top profile blue chip companies in Sri Lanka and also senior academics specialized in relevant fields were chosen to conduct interviews. Due to time constraints and busy schedules of directors, sample was limited to 10 directors and academics and the respondents were chosen using the snowball method. The sample consisted of 70 % males. They represented different industries including Bank, Finance and Insurance, Hotels and Travels and Diversified Holdings.

The operational definition used was the following: "Board diversity may be defined as the variety inherent in a board composition. This variety can be measured on a number of dimensions such as gender, age, ethnicity, nationality, educational background, industrial experience and organizational membership" (Kevin Campbell, 2008). This study uses six variables to measure board diversity. These variables include, gender, ethnicity, nationality, educational qualifications, industrial experience, and organizational membership. According to the literature, most of the researches focused on diversity factors such as, age, gender, educational qualifications and ethnicity. However, this study focuses on more diversity factors such as, industrial experience and organizational membership compared to other studies.

Table 1: Measurement of variables

Variable	Measurement
Gender	Proportion of male directors to the total
	Proportion of female directors to the total
Ethnicity	Proportion of Sinhalese directors to the total
	Proportion of Tamil directors to the total
	Proportion of Muslims directors to the total
	Proportion of other ethnic directors to the total
Education - Academic	Proportion of Bachelor’s Degree Holders to the total directors
	Proportion of Master’s Degree Holders to the total
	Proportion of PhD Holders to the total
	Proportion of directors who don’t have Higher Educational Qualifications
Education – Professional	Proportion of FCA Members to the total directors
	Proportion of FCMA Members to the total directors
	Proportion of directors who don’t have professional qualifications
Industrial Experience (Area)	Proportion of directors with Management experience to the total
	Proportion of directors with Finance experience to the total
	Proportion of directors with IT experience to the total directors
	Proportion of directors with Law experience to the total
	Proportion of directors with Engineering experience to the total
Organizational Membership	Proportion of Executive directors to the total
	Proportion of Non-Executive directors to the total

This study uses Blau Index which is widely used to measure of board diversity (Kevin Campbell, 2008). It calculates the proportion of board members (p) of each category.

$$\text{Blau Index} = 1 - \sum_{i=1}^{n} p_i^2$$

Where i is no. of firms, p is the proportion of number of directors to the total and n is the total no of board members

Furthermore, different diversified category results cannot be compared due to the differences in diversity categories. Therefore, this study uses adjusted blau index by using $1 - 1/\mathrm{k}$ where k is the number of categories used to measure each variable (Alan Agresti, 1978). Economic sustainability is measured in terms of financial performance in a firm. Hence this study uses two proxies to measure the firm's financial performance. First proxy is ROA. It can be defined as how profitable a company is relative to its total assets (Nirosha Hewa Wellalage, 2013). Tobin's Q (total market value of firm divided by its total assets) is the second proxy of this study. It can be measured by the total market value of the firm divided by the total assets of the firm. In addition to that, this study used control variables such as firm size and leverage which have not been used in past research (Nirosha Hewa Wellalage, 2013). Firm Size is the natural logarithm of total assets and leverage is measured by total debts divided by total assets of each and every firm. Two regression models are used to identify the impacts of different variables on ROA and Tobin's Q.

Results and Discussion

The industry experts and academics who were interviewed commonly stated that they believe the board diversity in Sri Lanka is low. The analysis of the semi structured interviews provides five key factors driving low board diversity in Sri Lanka. The reasons include, appointing family members to the board, inviting allies to perform as board members, male dominant culture in Sri Lanka, glass ceiling for working women and weak corporate governance provisions. Firms which have started as family businesses and later expanded as public listed companies show a tendency to appoint family members to their boards of directors. Reasons behind that could be to protect confidentiality of company information and to keep ownership control within a certain family. Another reason is, the Nomination Committee may have a tendency to invite people who are close affiliates of those already in the board and whom they can trust. As such there is a tendency away from factors that can enrich a board and improve firm performance such as gender, education qualifications and experience etc. The main reasons for low gender diversity in Sri Lanka can be surmised to stem from the male-dominant culture influencing the organizational culture, along with a general tendency for the females to prefer not to take higher responsibilities since they would have to compromise their family responsibilities. Moreover, according to a corporate governance expert who was interviewed, Sri Lanka does not have a proper and well diversified corporate governance code in place. As shown in Table 1 this study used six variables to measure board diversity. The Blau Index was used to measure the independent variable while ROA and Tobin's q were used to measure firms' financial performance. Firm Size and Leverage are used as the control variables. Regression analysis was carried out to measure the impact of board diversity on firms' financial performance.

Table 2: Board diversity and firms' financial performance

	ROA			Tobin's Q		
Variable	b	T	Sign.	B	t	Sign.
(constant)	-0.085	-0.97	0.331	1.391	5.439	0.000
Gender	-0.031	-0.71	0.479	0.046	0.355	0.723
Ethnicity	0.054	0.984	0.327	-0.268	-1.675	0.096***
Aca_Q	0.036	0.478	0.633	-0.037	-0.166	0.869
Pro_Q	0.023	0.452	0.652	-0.159	-1.054	0.294
Nationality	-0.013	-0.30	0.764	0.473	3.634	0.000**
Ind_Exp	0.002	0.027	0.978	-0.495	-2.739	0.007***
Org_Mem	0.001	0.014	0.989	0.092	0.686	0.494
Leverage	-0.051	-1.76	0.08***	0.092	1.077	0.283
LN_FZ	0.005	1.747	0.083***	-0.036	-4.003	0.000**
R^2		0.050			0.225	
Adjusted R^2		-0.01			0.173	

Notes: ***Significance at 10% level; **Significance at 5% level.

Aca_Q: Academic Qualification, Pro_Q: professional qualification, Ind_Exp: industry experience, Org_Mem: organizational membership, LN_ FZ: natural logarithm of firm size.

Results of the regression analysis are summarized in the Table 2. According to the results, diversity variables do not have significant impact on firms' ROA. However, ethnic and industrial experience variables are positively and statistically significant at 10% level for Tobin's Q. In addition to that, Nationality has a positive and significant impact on firms Tobin's Q.

Conclusion

The measurement of the impact of board diversity on financial performance in Sri Lanka by a regression analysis shows that diversity variables do not have a significant impact on firms' ROA and ethnic diversity. And industrial experience diversity variables are positively and statistically significant for Tobin's Q. Moreover, National diversity has a positive and significant impact on firms Tobin's Q. So the most important thing is a firm's economic sustainability is measured by the Financial Performance of the firm and financial performance shows how sustainable a firm is in its economic world. As such, there is no doubt that sustainability development transformed the business world effectively.

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