How does board diversity impact a company's financial performance?

A preliminary literature review

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ABSTRACT

Countries' policy changes on improvement of female representation in board is in the spotlight of many researchers. In this paper studies current literature in board diversity, not specifically in gender but also ethnic, educational and cultural diversities, has been examined through their methodologies and findings. This study provides a summary of empirical findings of necessary papers in this field and try to assist researchers who are interested in this issue during their preliminary research.

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Introduction

The Board of Directors is a decision-making and executive body of a firm which is chosen by shareholders and representing a firm at the highest level. The main purpose of the board of directors is to maximize the firm's market value and therefore, the wealth of the shareholders. Board is responsible for the company's financial performance through its decisions. Therefore, directors of the board play an important role for the company. The structure of the board, diversity among them in terms of gender, nationality, educational background, age etc. shall be considered in-depth. Diversity in board level is expected to contribute to a firm through generating different perspectives before a strategic decision is made.

Board of directors, in particular the structure of the board of directors, constitutes an important part of corporate governance. The fact that the board of directors is considered as the mechanism of corporate governance and is based on agency theory. Agency theory attributes to the board of directors a duty to minimize conflict of interest between shareholders and managers. It is important to achieve this goal through an independent board structure. The nature of the board structure has been discussed and the relationship between board diversity and financial performance has been searched in many studies.

In recent years policies at the state level also supports the emergence of board diversity in terms of gender diversity via imposing some quotas. Most of the regulations on gender diversity are set in order to maintain gender equality in board level.

How these policies in various countries have an impact on companies' performances? How shall be the board structured for maximizing the value of the firm? Is board member's diversification necessary? These research questions are drawing the attention of many researchers academically as well.

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This study aims to analyze the recent literature on impact of board diversity on company's financial performance. By doing so, findings and methodologies will be handled separately in order to generate a preliminary literature review in this field.

In the following sections, theories supporting the idea of board diversity, major studies in the literature on board diversity impact on the company's financial performance have been discussed. State level and industry level implications have been mentioned in last section and in conclusion part an overview of the studies along with suggestions has been briefly presented.

Literature review

Theoretical background

Agency theory

Agency theory examines the problems that arise when people with different interests cooperate to achieve certain outcomes. Principal receives the agent's assistance in order to reach some specific goals, on the other hand agent takes action in order to achieve desired goals requested by principle.

However, agency theory, emphasizes on failure of the management and loss in financial performance by separation of ownership and management in three ways: one is lack of attempt of agents to satisfy the needs of the principals, second is misuse of the assets by the agents and third is agents' risk taking levels are different from principals (Jensen M.C. and Meckling W. H., 1976).

Therefore, a board of directors is necessary which generates top-level decision-making body in a company and places in a critical position between managerial team and shareholders. This position of the board is supported the Agency Theory's assumption of the need of monitoring for agent. Through monitoring function which is attributed to board of directors, conflict between agent and principle can be solved (Pechersky, A., 2016). In this case, risk of agency monitoring cost may arise. Therefore, in order to reduce this cost, performance of the board which can be captured through financial figures of the company matters. How the structure of the board of directors shall be in order to contribute to the financial performance of the company in a best way while executing the monitoring function?

Signaling Theory

Board diversity strategy of a company has been linked to signaling theory that a company utilized from board diversity in terms of gender, culture and nationality in order to place in a good position in society's minds and to provide reputation in the society. On the other hand, diversity in board of directors is suggested to signal loyalty to social laws as well as values and it disseminates positive information about firm which at the end have a positive impact on firm's financial performance (Miller T. et al., 2009). Especially female representation in the board provides diverse aspects of communication while decreasing the asymmetric information between stakeholders. Asymmetric information level has an impact on value of the firm on stock markets (Abad D. et al., 2017).

Therefore, gender diversity signals for a reliable monitoring mechanism, transparency between members and stakeholders and a quality of corporate governance of the firm (Brammer et al, 2009).

Stakeholder Theory

Responding to the needs of stakeholders and keep interactions with them to increase the value of the company while considering stakeholders' interest is the main responsibility of owner of the shareholders which are represented through board of directors (Freeman et al. 2004). Diversity in board of directors is considered as having a large capability of analyzing the needs of the stakeholders in many aspects. Corporate Social Responsibility programs allow companies to build close relationship with stakeholders and companies are valued with their CSR performances. Board of directors which is represented by diverse members in terms of gender, nationality, culture etc. involves in different CSR projects covering many segments of society (Harjoto M. et al., 2014).

Practical Background

Impact of board diversity on firm's financial performance has been handled mostly via different diversity indicators such as gender, race, age, educational background and culture. Although the question of interest is the same in many papers, findings are differentiated with each other empirically. In some studies, it is found that the more women's participation in board the better company's financial performance will be (Campbell C. et al., 2007; Francoeur C. et al., 2008; Conyon & He, 2017; Vafaei A. et al., 2015; Yilmaz et al., 2021). In addition to females' positive contribution to firm's financial returns, it is shown that this positive relationship increases as shareholders protects the board more (Post C. et al, 2014). There are some studies in which there is no relationship between gender diversity and financial performance (Rose C. 2007; Chapple L. et al., 2014; Carter D. et al., 2010; Pletzer J.L. et al., 2015). In Danish case, there is a small delegation of women in board and the finding does not support the previous findings dealing with U.S. or U.K. data samples in the literature (Rose C. 2007).

Women impact to performance of the company has been found positive industry specifically but overall there is no relation with the gender diversity and financial performance of the company found (Chapple L. et al., 2014; Carter D. et al., 2010; Pletzer J.L. et al., 2015).

Additional to women participation in board, diversity in terms of educational background, age and independence levels are studied. In short term it has been found that these four constructs have a significant impact on performance(Mahadeo J.D. et al., 2012). Another study shows that board diversity in terms of educational background, nationality and ethnicity positively affects firm performance(Ujunwa, A., 2012). On the other hand, ethnic minority's impact on financial performance of a company has been studied as well. A significant positive relationship has been found(Erhardt N. L. et al.,2003;Carter D. A. et al., 2003). A different approach has been taken and ethnic minority and gender variety in board have been handled in terms of functional structure of the boards. It has been found that board appointments by diversified genders has a positive impact on financial performance via their auditing function. Board appointments with ethnic diversity affect performance positively during auditing, executive compensating and director nominating functions(Carter D. A. et al., 2007). Relationship between board diversity and company's financial performance has been studied via mediators such as company's reputation and innovation. It has been found that relationship between diversity of board in terms of race and performance has been partially mediated by reputation and innovation(Miller T. et al., 2009).

There are other studies which have, in contrast, negative relationship between gender diversity and firm performance. In addition to that the study shows that national differences do not have any significant relationship with performance(Darmadi S., 2011). Board diversity has been addressed at the cultural level as well and it has been found that cultural diversity in board has a negative impact on the firm's performance(Frijns B. et al, 2016).

Relationship between gender diversity and firm's financial performance has been measured according to their sample country and summarized as in the following section.

U.S. Case

One of the pioneering studies in this field has been worked on data sample in US. Board diversity has been measured through gender and ethnic diversities. return on asset and return on investment ratios have been calculated for the indicators of financial performance of the company. According to the correlation and regression analysis' results there is a positive and significant relationship between board diversity and firm's performance(Erhardt N. L. et al., 2003). Quantile regression methods have been used to search for the subjected relationship and according to this study there is a positive relationship between gender diversity and performance of the company. In addition to this finding, female representation has a larger impact on companies which have higher company performance(Conyon & He, 2017).

UK Case

With data sample in UK, cultural diversity impact on financial performance has been also examined. Cultural diversity has been measured through the average of cultural distances of board members based on Hofstede's culture model. Return on asset and Tobin's Q have given the measures for firm's performance. It is stated that there is a negative relationship between cultural diversity in board and firm's financial performance(Frijns B. et al, 2016).

Europe Case

Gender diversity has been measured through dummy variable for female representation, female ratio among the board members, Blau index and Shannon index. Firm's financial performance has been captured through Tobin's Q. In this study, Panel data results do not support significantly a relationship between gender diversity in board and performance of the company in Spain case. (Campbell C. et al., 2007). In Denmark case Tobin's Q measures the firm's financial performance. Board diversity has been analyzed in terms of educational background of board members and ratio of the foreigners on the board. Finding has been accounted for Danish data sample in which small number of female representations in boards (4 pct. in general). exist compared to United States and United Kingdom(Rose C., 2007).

Emerging Country Case

In Indonesian case, a negative relationship between gender diversity and firm performance has been measured. Firm performance has been captured through Tobin's Q and Return on Asset ratio. There is not any statistically significant relationship between national diversity and performance found (Darmadi S., 2011). In Turkish case blau index has been used to create the diversity indexes for foreigners, female, age and education. Firm's financial performance has been measured through return on equity and Tobin's Q. In case of ROE as the indicator of financial performance, significant relationship between performance and age diversity has been found(Ararat M. et al., 2015).

As it can be seen, the effect of diversity in board members on firm performance is sometimes positive, sometimes negative and sometimes not depending on the country, time and selected diversity criteria. Gender diversity will be analyzed more specifically in the next section as per industry and policy level.

The following Table 1 and Table 2 intend to show the impact of the empirical studies in selected journals.

Table 1: CiteScore of Journals (retrieved on 3rd of Jan. 2020 from Scopus).

Source Title	Coverage	2016 CiteScore	2017 CiteScore	2018 CiteScore	Source Type	Publisher's Name	Publisher's Country/Territory	Top level: Social Sciences
Academy of Management Journal	1989-ongoing, 1975-1987	8.41	7.44	10.36	Journal	Academy of Management	United States	Social Sciences
Journal of Management Studies	1964-ongoing	5.25	5.07	5.99	Journal	Blackwell Publishing Inc.	United Kingdom	Social Sciences
Journal of Business Ethics	1982-ongoing	2.23	2.91	4.46	Journal	Kluwer Academic Publishers	Netherlands	Social Sciences
Corporate Governance	1993-ongoing	3.17	2.77	3.91	Journal	Blackwell Publishing Inc.	United Kingdom	Social Sciences
PLoS ONE	2006-ongoing	3.11	3.01	3.02	Journal	Public Library of Science	United States	
Australian Accounting Review	2008-ongoing, 1991-1995	0.98	0.87	1.47	Journal	Blackwell Publishing Inc.	United Kingdom	Social Sciences
Financial Review	2011-ongoing, 2008, 1969-1995	1.43	0.90	0.96	Journal	Wiley-Blackwell	United States	Social Sciences

Source: Authors

Table 2: Citation numbers of Articles (retrieved on 3rd of Jan. 2020 from Google Scholar).

Title	Author	Source	Citation
Corporate Governance Board Diversity and Firm Value	Carter A. D. et al. (2003)	The Financial Review	2586
Board of Director Diversity and Firm Financial Performance	Erhardt, N. L. et al. (2003)	Corporate Governance: An International Review	1651
Gender Diversity in the Boardroom and Firm Financial Performance	Campbell K. et al. (2007)	Journal of Business Ethics	1370
The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance	Carter A. D. et al. (2010)	Corporate Governance: An International Review	1043
Does Female Board Representation Influence Firm Performance? The Danish Evidence	Rose, C.(2007)	Corporate Governance: An International Review	994
Demographic Diversity in the Boardroom: Mediators of the Board Diversity–Firm Performance Relationship	Miller T. et al.(2009)	Journal of Management Studie	765
Gender Diversity in Corporate Governance and Top Management	Francoeur C. et al. (2008)	Journal of Business Ethics	681
Women on Boards and Firm Financial Performance: A Meta Analysis	Post, C. et al. (2015)	Academy of Management Journal	561
Board Composition and Financial Performance: Uncovering the Effects of Diversity in an Emerging Economy	Mahadeo J. D. et al. (2011)	Springer	283
Board Characteristics and The Financial Performance of Nigerian Quoted Firms	Ujunwa, A. (2012)	Corporate Governance: The International Journal of Business in Society	215
Does Board Gender Diversity Have a Financial Impact? Evidence Using Stock Portfolio Performance	Chapple L. et al. (2013)	Springer	205
Board Diversity and Firm Performance: The Indonesian Evidence	Darmadi S. (2011)	SSRN	183
Does Gender Matter? Female Representation on Corporate Boards and Firm Financial Performance - A Meta Analysis	Pletzer, J. L. et al. (2015)	PLOS ONE	118
Impact of board diversity on boards' monitoring intensity and firm performance: Evidence from the Istanbul Stock Exchange	Ararat, M. et al (2015)	SSRN	103
The Diversity of Corporate Board Committees and Financial Performance	Carter A. D. et al.(2007)	SSRN	83
Firm Performance and Boardroom Gender Diversity: A Quantile Regression Approach	Conyon J. M et al.(2017)	SSRN	79
The Impact of Cultural Diversity in Corporate Boards on Firm Performance	Frinjs B. et al. (2016)	SSRN	74
Board Diversity and Financial Performance in the Top 500 Australian Firms	Vafaei, A. et al. (2015)	Australian Accounting Review	53

Source: Author

Impact of policies and industries on gender diversity

While board diversity issue is studied in academic level, at state level new policies on female representation in workplaces as well as board of directors are discussed. For example, in France female board participation ratio was required to be 20pct in 2014 and it has been increased to 40 pct. in 2017. In Italy this ratio has been set for 33 pct. by 2015 and in case companies do not meet this threshold, they will be punished with one million Euro. By 2010 in Finland regulators have been agreed on the number of the women in board shall be one at a minimum level(Chapple L. et al., 2014).

Figure 1: Proportion of women directors on the board in 2013 (Europe); *Source:* Heidrick and Struggles, 2014.

Figure 1 illustrates the proportion of women directors in board for several European countries in 2013. More recent study has been made in 2019 for the ratio of new board appointment by women in Europe. Figure 2 shows these ratios for several European countries including an overall Europe ratio.

Figure 2: Proportion of new director seats filled by women in 2018, by country (Europe); *Source:* Heidrick and Struggles, 2019.

Policies in Europe on female representation requirement will have an impact on some industries more. Since each industry have different gender diversity ratio, it is important to increase female attractiveness in industries with low female representation.

Figure 3 contains some figures highlighting this issue for some countries in Europe.

Figure 3: Proportion of seats field by women in each industry in 2018; *Source:* Heidrick and Struggles, 2019.

In the literature industry level studies are important since each industry has its own specific women participation figures in board. For industries with low levels of female representation in board may result incorrect interpretations of the findings (Chapple L. et al., 2014). This is the case also for data samples form larger companies and smaller companies. The impact can be bigger after removal of the female representation in board in bigger countries than in smaller countries where female contribution is lack (Rose C. 2007). Therefore, it will be necessary to control the firm size and industry (Carter et al., 2003).

Conclusion

Many papers have been conducted in board diversity impact on financial performance of company. As it can be deduced from the information above there is not a unique impact in board diversity to company's financial performance. Although methodologies are common in many papers, reasons for different findings can be attributed mainly to sample size, type of the industries and difference in board diversity policies among countries as well as companies. Since these regulations became effective recently, it is hard to find a control group not surrendered to the legislation. It is important to study with the sample countries in which rules for gender quotas in board are not effective.

Generally, studies have been subjected to gender diversity while analyzing the board diversity impact. Diversity in board may be studied more in terms of nationality, culture, age etc. According to the theory and its assumptions the theory surrounded, studies may vary by the factors as well as moderating and mediating effects. Since mediating effect has been measured in a small number of studies, the number of such studies should be increased.

In country-based studies it has been noticed that this topic has not been handled so much in emerging countries. Studies are analyzing the data mostly from U.S. and European countries. Therefore, board composition in emerging countries shall be more studies' the question of interest as well.

More diversified boards in terms of gender, nationality, age, education will improve tolerance to each other and provide social harmony from top down to bottom up. Therefore, in the literature studies in board diversity which covers a sociocultural phenomenon, shall be improved by its content.

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