The Presence of Diversity on the Modern Board of Directors (BODs) and its Subsequent Effect on the Financial Performance of the Firm

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Abstract

This research is conducted to study the presence of diversity on the modern board of directors and the effect the diversity will have on the financial performance of the firm. For this research diversity in age, gender and race are covered and their subsequent effects are studied. This research theoretically examines the relation between the diversity in age, gender and race in board of directors and the financial performance. Initially the concept of diversity is studied and then their relations with the financial performance are studied. The research shows that the three factors have positive impact on the financial performance. The factors result in growth of return on investment and return on assets. This research was conducted using the survey method. The research also focuses on the increase in women directors in an organization. The decision-making capabilities and strategic planning of an organization have been improved with the help of diversity in the three factors.

Keywords: Board of Director, Diversity, Race, Age, Financial Performance

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An organization pillars on the board of directors that is elected to act as the shareholders agents. Being an important entity in the decision making body of an organization the board of directors is expected to formulate the operational and the financial strategy of the organization. The board of directors is responsible for monitoring the effectiveness of the practices being followed in the organizations. The diversity of board of directors can be defined in many perspectives. One perspective states the diversity in age, race and gender of the board of directors' members and other perspective can be diversity in professional qualification, experience and personal attitudes of the directors. In this paper the prior one is considered and the main focus is to find out the subsequent effect the diversity of Board of Directors will have on the financial performance of the Firm. There is need to research about the need of diversity in the organization and also about the impact this diversity will have on the financial performance of an organization. The diversity will benefit the effective decision making by the help of group thinking of directors, belonging to different psychological behavior. Since the competition level is high in the marketplace so there is a need to understand the stakeholders' point of views in all perspectives. This is possible with the election of diversified board of directors. The diversity in board of directors is going to help organization with better decision making capability and also maintains a healthy relationship with the stakeholders and all this implies an improved and efficient financial performance of the organization (Erhardt, Werbel, & Shrader, 2003).

Hypothesis

Diversity in age, gender and race in board of directors has positive impact on an organization's financial performance.

Method

This study is conducted with implementing survey method. The data of companies were gathered and analyzed to find out the effect this diversity has on its financial performance. The sample size taken comprised 45 companies. The companies are studied to find out the work environment for the minorities and women. It was also analyzed about the diversity the organizations have in its board of directors. The survey was about the financial performance before the implementation of diversity in the board of directors and after the implementation of diversity in board of directors. The study focused on the ways the diversity has affected the performance of an organization. Some literature reviews are also conducted to get the precise data about the concepts and analyze through historical researches on the concepts.

Literature review

An organization's performance is the result of the dedication and fulfillment of responsibilities by the workforce of the organization. Currently, the workforce of the organization is very diverse in nature, as a number of women that were once regarded as minorities are becoming large in numbers as compared to the white males. This diversity will have its impact on the resource pool to select the members for the board of directors. This diversity will help the organization to elect the potential candidates to ensure the higher performance of the organization. The various researches show that this diversity among the board of directors will have a positive impact on the decision making capabilities of the organization. To understand the concept of relation between the diversity of board of directors and firms' financial performance firstly, there is a need to understand the concept of diversity and then relating the same to the financial performance of the organization (Ness, Miesing, & Kang, 2010).

Based on research in diversity categorization, basically there are two categories of diversity. One is observable diversity and the other is non-observable diversity. This research will consider only the observable diversity that includes race, gender and age. The increase in number of women, Hispanic, Black and Asian Americans are the major diversification in the workforce of an organization. The diversifying workforces are mainly contributing to the broader perspective as the organization will have to deal with the different view of the stakeholders. The diversity affects the group performance of an organization. Various research suggest that the affect diversity have on the group performance are divided into two categories. The first one states that the diversity ensures the high quality of creativity, innovation and greater knowledge base. This makes an organizations gain competitive advantages and ensures healthy relation with the stakeholders. This gains the trust of the stakeholders and the decision-making is benefited and hence the financial performance of an organization improves.

In another research, it is stated that the non-observable diversity (educational qualification, experience) affects the organizations' return on investment negatively. This negative impact is due to the informal communication within the board of directors. The demographic diversity promotes to a better integration and communication among the board of directors' members of an organization. This ensures the healthy understanding and hence eases the process of decision- making in an organization. The better decision-making capability of an organization ensures the efficient strategic decision-making. The research also shows that the board of directors with diversity demonstrates better decision-making as compared to a board of directors with less diversity. This is because the diversity also includes creativity, diversified perspective to view an issue and innovative ideas, with itself. These strong factors help in better decision-making in an organization. The better the decision making capability is the better strategic planning will be possible. This ensures that an organization will reflect financial improvement and assure better return on investments and return on assets. The broader the range of opinion will be the more parameters will be considered while decision-making. An organization hence will be considering all the factors internal as well as external that will have an impact while making any decision.

The diversity present in the organizations also ensures that the referencing factors are diminishing from the industries. An organization will gain a broader perspective to deal with an issue and operational management. The CEO's impact on the board of directors is also a very crucial factor in determining the functioning of an organization. The controlling and monitoring of an organization's performance will be at ease if independence is provided in decision-making process in an organization. Initially, CEOs had a tendency to appoint a familiar person from their social circle as a member to the board of directors. This is done with an intention to have greater command on the decision-making process. However, such controlling had negative impact on the organization's performance. There was a need to have the wider perspective for taking any decision in an organization. Consideration of wider perspective in decision-making increases the satisfaction level of the employees in an organization and also helps to gain confidence of the stakeholders.

The research showed that Enron's Board of directors lacks diversity, additionally there was only one woman included in the board. This creates the lack of conflicts and hence a lack of broader perspective in decision making, which was the main reason for the failure of the board. One needs to consider the broader perspective to consider all the risk factors. The decision made after considering all the risk factors proves to be more successful. The involvement of a larger number of senior women in the board ensures that the women in the workforce get motivation and inspiration to contribute more creatively in order to improve the financial performance. Niclas, James & Charles (2003) also stated in their research that the dependency solely on the CEO's of an organization has no more benefits for the board of directors. It is also stated that involvement of women in the board increases the diversity in the labor force and customer pool. This diversity will help to improve an organization's performance. The talent pool of an organization must be expanded to ensure a wider diversity of the workforce and hence improved performance of an organization. According to the research it is concluded that in the near future there is a need to do a research to develop a theoretical model that defines how oversight functions can be improved by the diversified board of directors (Alvarado, Briones, & Ruiz, 2011).

The people are less critical about the views of people from the similar race and gender. This lacks the conflicts and hence all the perspectives are not studied. Also, this makes a CEO to ignore the board of directors' oversight when they all are from the same race, gender and age. The diversity also enables the board of directors to have a broader base of information.

Ness, Miesing, & Kang (2010) stated that the outsider directors have better understanding of the expectation of the stakeholders. The better understanding of the stakeholder's view results in better returns to the shareholders. So, it can be concluded that stakeholder's relation with an organization's directors is directly related to the financial performance of an organization. This is the reason that the number of outsiders in the workforce tends to increase after the poor financial performance and returns of an organization. The directors' performance degrades with the interference of the insiders. The outsider directors restructure an organization and hence results in improved performance. In a research conducted by Beasley, it is found that after investigating a total of 150 firms it is found that the firm that comprises more insiders have higher amount of financial fraudulent cases as compared to the firms with a greater number of outsider directors. This implies that diversity among the board of directors have a direct impact on the financial performance of an organization. The outsider director looks at the point in a broader way without any partiality. This tendency helps the outsider director to get a better perspective about the matter and hence results in better decision-making for an organization. The better decision-making results in better strategic-planning of an organization. The better strategy involves more customers and stakeholders and ultimately results in improved financial performance with satisfied figures of return on investments and return on assets (Marimuthu & Kolandaisamy, 2009).

The directors from different races to increase the size of a firm are more likely to tie executive compensation to the market performance rather than switching to corporate acquisition. The research also reflects that the directors from the different races are better at managing the financial performance. The directors from different races have a tendency to continually monitor the market condition and diminish any factor that may be a risk for an organization. In other case, the directors from the same race or insiders may put the organizations at risk for their personal benefits. In the same research it is also stated that the diversity in the board of directors ensures the wider resource stream. The directors of different race, gender and age have a wider source of resources as they have huge experience and creativity, are innovative in nature, possess professional contacts and knowledge. This wide resource stream will ensure a better decision-making and better strategic planning for the organization and hence results in better financial performance. The increase in a number of women in the workforce began after 1990. The women and minority are directly related to the financial performance and increase in count of women and the minority workforce reflects an increase in return on investment. This direct relation is due to the broader perspective that the women workforce brings with it. The women directors have a better understanding of the employees' expectation and also have a capability to maintain a better relation with the stakeholders. The diversity among the board of directors establishes a better communication and has better integration among them. From the study it is found that although sizes of board of directors have been decreased, there is an increase in the number of women in the boards of directors. The women Director have a perfect balance between the social and an organization's workflow. The research also concluded that diversity among the age of the directors also have significant impacts on the organizational performance. In a survey conducted by Fortune in 1999 it is found that majority of the directors was in his or her mid-50s. The research also revealed that opposite to the belief it is observed that young directors are more readily accepting the challenging managing task as compared to more experienced directors. The young directors are dynamic in nature and are also eager to learn new things. The average age of directors in a board are highly influencing the type of risk factors they are considering while decision-making process. The financial performance of an organization is highly affected by the risk factors considered during the decision-making process. The young directors are more prone to take risks in their decision-making for the sake of innovation in the strategy of the organization, and their decisions are amended very quickly as well. The research also includes that the young generations are not as much experienced but they have the technical knowledge and they implement the recent technology in their decision-making process. Since the young directors have recent educational qualification, they are well familiar with the recent trends in technology and are comfortable in implementing the recent technology in the practical use. The technological knowledge also helps the young directors to get many innovative ideas to deal with an issue using various available software and applications as well as dealing with an organization's oversight issues. This technological knowledge is the advantage young directors have over the experience of old directors. The directors old in age are lacking the technological knowledge. Therefore, a board that has directors of different age enjoy an advantage of combining the experience with the technological knowledge and hence have the best decision-making skills as their resource (Marimuthu & Kolandaisamy, 2009).

The research also reveals that longer tenure of the directors in an organization is directly related to the positive growth in the financial performance. The longer tenure gains the social independence to the directors and hence better decision making process can be conducted. The study also concluded that directors having experience equal to the longer tenure are also similarly capable of taking efficient decision. The huge experience gains them sufficient social freedom to take decisions. As the different age groups of the directors have positive impact similarly the differences in tenures also have positive impact on the financial growth of an organization. The average of tenures is finding by adding the tenures of directors being a member of board and average is calculated. The research also reflects the negative impact the board size has on the financial performance. The larger the number of directives a board will have the more the dysfunctional capabilities will be present in the board. A large size of board may help in decision-making process by having a broader perspective of the topic but then arouse an issue of consensus. The directors may not agree to each another's perspective and hence conflicts may lead to dissatisfactions. The heterogeneity in the experiences the directors will have also affects the financial performance positively. The broader the experience of the director will be the broader the director will be able to think about the perspective and hence more balancing decision can be taken in an organization. Also, in decision-making process considering various factors will lead to the success of the decision (Marimuthu and Kolandaisamy, 2009).

Alvarado, Briones & Ruiz (2011) focused on the impact the gender diversity in board of directors will have on the financial performance. The study reflects that involvement of women among the directors helps to provide broader base of knowledge, creativity and huge innovation. This involvement will result in better decision making and problem solving techniques in an organization. The research also states that diversity in board is good to gain the broader perspective but this also inculcates the conflicts that results in delay in decision making process. This delay may cause an organization to lose its competitive advantage. The research resulted that the women involvement is not reflecting any major impact on the financial performance of an organization. So, the research states that gender diversity in the board of directors has neutral impact on the financial performance of an organization. It is stated that inclusion of women in the board is merely to increase the size of the board and to manage the large size organization's functioning (Alvarado, Briones, & Ruiz, 2011).

Discussion

The purpose of this study is to find the positive, negative or neutral effects of race, gender and age diversity present on a board of directors will have on the financial performance of the organization. From the literature review it can be concluded that the diversity in three factors i.e. race, gender and age will have a positive effect on the financial performance of an organization (Adams & Ferreira, 2009).

The Race diversity implies there are directors from outside of the particular culture or country. The race diversity ensures that the director will have a broader perspective of the problems of an organization. The director will be aimed to gain more for the organization without thinking about the personal benefits. Organizations having more directors from outside show better financial performance as compared to the firms with a larger number of internal directors. The reason for this difference is that the outsiders tend to gain profit without putting an organization in risk. The outsiders maintain a healthy communication with the stakeholders and put their efforts into increasing the share of stakeholders. This communication with the stakeholders leads an organization to gaining a better knowledge about the stakeholder's view-point. This facilitates better decision-making process. The decision-making process ensures the better strategic-planning of the organization. The better strategy will define smooth financial flow in an organization and hence ensures better return on investment and better return on assets (Vania & Supatmi, 2014).

The gender diversity is considered as main research area to find its impact on the financial performance of an organization. The research also reveals that with time, the size of the board has decreased but with an increase in a number of women directors in the board. The women directors are more capable to balance the decision-making with the social environments of an organization. The women are also capable of understanding the perspective of stakeholders and also serve as a motivation to their workforce. This facilitates the better decision-making and hence ensures better return on investment (Galia & Zenou, 2013).

The age diversity has two perspectives: firstly, the young age directors are technically very advanced and hence are more capable of making better decision-making with the implementation of various technical tools. The aged directors are experienced and hence there is a need to merge the capabilities of both age groups to get the balanced board of director decision-making skills. Secondly, the tenure of experience of directors also has a positive impact on the financial performance. The more the tenure of the directors will be the more social freedom is gained to conduct interference free decision-making in an organization (Adams & Ferreira, 2009).

The various theories of the research have been argued and also certain disagreements are found that directors' broader perspective may lead to conflicts among the board of directors. This broader perspective are beneficial at first thought that all the risk factors will be considered but at the second thought it is observed that it may lead to another issue of consensus that leads to dissatisfaction among the directors (Marimuthu & Kolandaisamy, 2009).

Conclusion

This research is about the diversity on the board of directors in terms of age, gender and race. The board of directors forms the pillar for any type of an organization. They also act as an agent of the stakeholders. It is expected from directors to realize the perspective of the stakeholders and based on that various decisions regarding the operational management of an organization are taken. So, this is very crucial to appoint the right person to the board. Earlier it used to be only the close friends of CEO in the board but that causes the fall of the board so there is a need to redefine the resources on the board. The inclusion of diversity among the directors proves to be very beneficial. The diversity helps the board to have broader perspective of expectations, risk factors and other various factors. The broader view of factors assists the directors in conducting better decision-making process of an organization. The decision-making process serves as a basis for strategic planning. The financial performances of an organization are positively affected by the three factors race, age and gender diversity in board of directors.

The study shows that the directors' diversity in race is the important factor that affects the financial performance of an organization as the return on investment and return on assets shows a very positive growth. The outsider never forces for firms acquisitions for the expansion of business rather believes in increasing the share value in the market. The research said that the fraudulent cases are more in firms having a large number of insider directors. The outsider also creates a good communication with the workforce, stakeholders and clients. The age difference is a bit conflicting. The younger representatives have technological knowledge whereas the older ones gained more experience. The age is also considered in terms of tenure of directors. The average of tenure of directors is calculated and concluded that higher average of tenure of directors also represent higher returns on investment and higher returns on assets.

The number of women is gradually and constantly increasing in the boards. A larger number of women means the broader perspectives of stakeholders are considered in decision-making process of an organization.

The diversity of the factors discussed in this research in the board of directors has a positive impact but there are still various other factors and their effects may vary. There are certain contradictions about the inclusion of women to the board of directors, yet it does have a neutral impact on the performance of the organization. The women are merely involved in the board to increase the size of the board for larger organizations.

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