



INFLUENCE OF ETHNIC DIVERSITY OF THE BOARD OF DIRECTORS ON FIRM'S CAPITAL STRUCTURE AMONG LISTED FIRMS IN NAIROBI SECURITIES EXCHANGE, KENYA

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Abstract:

Capital structure decisions are important because they influence the performance of firms. Researchers posit that the new diverse boards are critical in exercising strategic control, tougher monitoring and financial decision making. The specific objective of the study is to examine the effect of the ethnic diversity of the board of directors on a firm's capital structure. The study adopted a longitudinal design. The study utilized a census technique for 34 firms that are listed on the Nairobi Securities Exchange (NSE) consistently for an 8-year period, 2004–2012, hence giving 272 years of observations. This study utilized secondary data. A documentary guide was used to collect data. Data was analyzed using both descriptive statistical methods, which included mean, standard deviation and inferential statistics to test the linear relationship between variables and multiple regression to test the hypothesis. The study found that ethnic diversity ($\beta_3 = -0.188, p < 0.05$) of board directors negatively affects capital structure. The study concluded that board diversity was an important determinant of capital structure. Therefore, there was a need to diversify the board of directors in terms of ethnicity and nationality so as to effectively monitor management from adopting excessive leverage. In order to add valuable and diverse expertise that domestic members do not possess, there was a need to enhance national diversity.

Keywords: capital structure, board diversity, ethnic diversity, corporate governance, securities exchange

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1. Background of the Study

According to Tarus and Ayabei (2014), the board of directors have different characteristics, such as board diversity, which contribute to firms' corporate governance mechanism, with some characteristics providing more controlling mechanisms than others. Therefore, it is crucial to examine whether having a diverse board would enhance or reduce the leverage of firms. Researchers agree that diverse boards are critical in exercising strategic control, tougher monitoring and financial decision making such as capital structure in firms (Gulamhussen and Santa, 2011). From an agency perspective, boards monitor the management, particularly in decision making, and critical managerial decisions that require constant monitoring are capital structure decisions. It is argued that diversity is better for decision making, particularly from a resource dependency perspective (Hillman *et al.*, 2007). The successful selection and use of capital is one of the key elements of the firms' financial strategy (Velnampy & Aloy Nireesh, 2012). The existence of a well-developed board diversity assists in the management of debt (Kajananthan, 2013).

Diversity has also been a topic of conversation in the public discourse for decades in industrial countries. Over time, laws have been changed to include diversity, and many firms have also adjusted their policies to include this subject (Dagsson, 2011). Adams and Ferreira (2009) argue that having a diverse board may appear legitimate in the views of the public, the media, and the government. However, there are potential costs of board diversity, such as a lack of communication, pursuing distinct personal agendas, and conflicts of interest among directors (Ferreira, 2010). Excessive diversity has been found to be negatively related to capital structure because of conflicts and communication breakdowns (Murphy and McIntyre, 2007). Board diversity may cause lenders to have faith in internal governance mechanisms and thus reduce borrowing costs.

Carter *et al.* (2002) argued that board diversity contributes to creating shareholder value, promotes better understanding of the marketplace, leads to the evaluation of more alternatives and more careful exploration of the consequences of these alternatives. Diversity also promotes more effective global relationships. Fields *et al.*, (2010) asserted that firms with more diverse boards are less likely to have collateral requirements on their loans and those that also have greater board diversity and better director compensation are less likely to have financial ratio restrictions, even after adjusting for the influences of firm size and the financial characteristics of the borrower.

Previous studies suggested a link between board diversity and improved firm valuations; an extension would suggest a similar link to bank loans (Erhardt *et al.*, 2003; Carter *et al.*, 2003). However, Booth *et al.* (2001) and Bas *et al.* (2008) argued that knowledge about capital structure has mostly been derived from data in developed economies that have many institutional similarities. There are differences in social and cultural issues and in the levels of economic development, thus the need to examine differently the board diversity and capital structure for firms in developing economies.

According to Bulent *et al.* (2013), most studies have given attention to the developed countries, such as the United States, leaving a gap in the existing literature on the board diversity and capital structure in emerging economies such as Kenya. As such, this study attempted to determine the effect of board diversity on capital structure.

2. Statement of the Problem

The decisions on structuring the mix of financing are largely a management responsibility; however, with increasing cases of agency problems (Bebchuk, 2004), boards of directors act as monitors in such decisions. Indeed, the board of directors approve and ratifies management decisions, which include capital structure decisions (Gulamhussen and Santa, 2011), and so the role of the board in the decision of the capital structure cannot be ignored. Corporate failure among companies in Kenya has often been associated with the financing behavior of the firms. Momentous efforts to revive the ailing and liquidating companies have focused on financial restructuring. A great dilemma for management and investors alike is whether there exists an optimal capital structure and how various capital structure decisions, both short-term and long-term, influence business performance (Mwangi, Makau and Kosimbei, 2014).

Corporate governance literature has placed a lot of emphasis on the value of board diversity in corporate decision-making. Some scholars, such as Carter *et al.* (2003), Carter *et al.* (2002), Adams and Ferreira (2009) and Hillman *et al.* (2007), argued that diverse boards bring in a wealth of skills and experience as well as networks in decision making. Empirical evidence by Boone *et al.* (2007), Coles *et al.* (2008), and Linck *et al.* (2008) finds that board structure and capital structure are related. Over the last decade, many authors have investigated the relationship between board composition and firm performance (Kiel and Nicholson, 2003; Van Ees *et al.*, 2003, Uadiale, 2010), but the effect of diverse boards on capital structure is barely considered. In addition, recent diversity studies have focused on board diversity with interesting but mixed results (Dagsson, 2011). In Kenya, for example, scant literature can be found on the relationship between gender diversity and firm performance, with the exception of Barako & Brown (2008). Barako & Brown (2008) established that board diversity in Kenya's banking industry leads to improved corporate social reporting. This study, however, focused on the relationship between gender diversity and capital structure in Kenya.

But with the new constitution in place in Kenya, the majority of women are likely to participate actively in various activities, including business management. This study may have been timely to establish what effect board diversity has on capital structure, with a specific focus on the listed firms. Based on the above discussion, the current study assessed the effect of board diversity (age diversity, gender diversity, ethnic diversity and national diversity).

3. Literature Review

3.1 Board of Directors' Ethnic Diversity on Capital Structure

Prat (2002) measured the causal effect of ethnic diversity on the capital structure of corporate boards using a randomized field experiment. Board ethnic diversity has become increasingly important in capital structure decision-making bodies. This is the case in many sorts of organizations, varying from judges in collegial courts or academic researchers to business start-ups (Hamilton *et al.*, 2003).

Carter *et al.* (2003) investigated the relationship between board diversity and defined it as the percentage of women and ethnic minorities and firm value. After controlling for several external factors, they found a significant positive relationship between the two variables. The analysis used 638 firms from the Fortune 1000 and found that approximately half had no minority director on the board. When controlling for external factors, it became apparent that larger and more successful firms tend to have more minority directors. This raises the issue of endogeneity due to the possibility that not only can diversity affect performance, but firm performance may also affect diversity. This can commonly be understood as reverse causality by a firm which exceeds the norm for divergence, which may be the kind of firm which also exceeds the performance norm, the active variable being the firm's progressiveness, with performance and diversity both being dependent variables. Even when controlling for endogeneity, there was still a significantly positive relationship between the presence of both women and ethnic minority directors and firm value, and a positive correlation between the existence of one and the other.

One of the most salient dimensions of board heterogeneity is ethnicity (Alesina and La Ferrara, 2005). It is commonly measured based on the country of birth of the individual or of his/her parents. Ethnic diversity implies heterogeneity in (mother) languages, religions, and cultures (Alesina and La Ferrara, 2005). It also coincides with a variety of norms, information sets, knowledge and ability levels (Lazear, 1999; Morgan and Vardy, 2009). This variety affects the formation of boards, capital structure acquisition and performance. Ethnic diversity would benefit better capital structure and team performance due to a more diverse pool of skills and knowledge that leads to complementarities and mutual learning. For example, due to complementarities and learning opportunities, ethnically diverse teams are associated with more creativity and innovation (Alesina and La Ferrara, 2005; Lee and Nathan, 2011, Ozgen *et al.*, 2011b). On the other hand, the costs associated with more ethnic diversity would be related to more difficult communication and coordination (Lazear, 1999; Morgan and Vardy, 2009). All in all, ethnic diversity is a major source of heterogeneity.

Empirical research presented contradictory findings on the value of ethnic diversity. Watson *et al.* (1993) reported that a homogeneous board is better in the short term, while a heterogeneous board is better in the long term in achieving corporate goals. However, Pelled *et al.* (1999) find that a heterogeneous board resulted in emotional conflict that ultimately affects a firm's capital structure. Stronger board management of

capital structure has been positively associated with the provision of advice and counsel, the provision of firm legitimacy and reputation, the provision of channels of communication and the acquisition of resources elements outside the firm, and a source of effective performance.

4. Research Methodology

4.1 Research Design

Research design is the arrangement of conditions for the collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy as procedure (Kothari, 2008). This study adopted a longitudinal design. The researcher did not visit individual firms under study to administer any questionnaire, but instead used secondary data from the Nairobi Securities Exchange handbook, published financial statements for the firms under study. A longitudinal study is an observational research method in which data is gathered for the same subjects repeatedly over a period of time. Longitudinal research projects can extend over years or even decades. In a longitudinal cohort study, the same individuals are observed over the study period. The design was best for ascertaining the effects of board diversity on capital structure among listed firms at the Nairobi Securities Exchange in Kenya, and it allowed for the use of secondary data through documentary guide analysis to facilitate data collection in the listed firms.

4.2 Target Population

The target population of this study was the published financial statements of the listed firms in Kenya; there are 34 listed firms in the NSE being firms which have shown consistency in the market during the period 2004-2012 giving a total of 272 firm year observations therefore the target population above was chosen since it provided research information in respect to the study.

4.3 Sampling Size and Procedure

The study sampled all firms that have been listed on the Nairobi Securities Exchange (NSE) during the eight-year period, 2004–2012. Thirty-four firms qualified to be included in the study sample. The sample was selected from the firms which had been listed consistently for 8 years.

4.4 Data Collection

This study utilized secondary data, which was obtained through handbooks, magazine articles, sales analysis summaries and investor annual reports, for the researcher to get systematic information. It used a designed documentary analysis guide. This guide was used to find out the information concerning board diversity, ethnic and national.

4.5 Measurement of Variables

4.5.1 Dependent Variable

Capital structure was measured as the ratio of debt to equity (Rafique, 2010). In the prior studies, for example, in (Al Shammari *et al.*, 2007; Ali *et al.*, 2004), capital structure has been tested using Debt to Assets or Debt to Equity; for this research, the ratio of Debt to Equity was utilized in measuring capital structure.

4.5.2 Independent Variable

Ethnic diversity is the percentage of minority directors on the board. This was calculated as the number of minority directors divided by the total number of board directors (Locke and Scrimgeour, 2011).

4.6 Data Analysis

The study utilized a quantitative technique to analyze data; quantitative data was analyzed using descriptive statistical methods, and statistical tools such as frequency distribution, measures of central tendency and dispersal, such as mean and standard deviation, were used.

The data collected was analyzed using multiple regressions and correlation analysis, the significance of each independent variable was tested at a confidence level of 95%. The regression equation of the form below was applied.

4.7 Ethical considerations

The study was undertaken bearing in mind all the ethical concerns, and it attempted to uphold them. Permission to carry out the research was sought from the relevant authorities and from the participants who were involved in the study. The nature and purpose of the study were explained to the listed firms. During the course of the study, the listed firms were assured of confidentiality, anonymity, and the researcher's responsibility (Mugenda and Mugenda 1999). The information was based on the selected listed firms, which marked an informed decision on whether or not to participate in the study. The study maintained the confidentiality of all data collected from the listed firms as it related to the operations of the organization that was used to gain a competitive advantage.

5. Data Presentation, Analysis and Interpretation

5.1 Descriptive Statistics

The findings in Table 4.1 present capital structure in all the sectors. The results in Table 4.1 revealed that all sectors had an average of 53 years of operation. Gender diversity mean ratio was 12.2045, ethnic diversity (mean = 26.0389) and national diversity was evidenced by a mean ratio of 35.8739. The average board size for firms in NSE is 9 members, with 54% of them being independent directors (mean = 0.5412). The average

ratio for firm size among all listed firms in NSE was 6.5566, and CEO tenure was 2 years (mean = 2.7108) with 14% CEO duality.

Table 4.1: Descriptive Statistics for all Sectors

	Mean	Std. Deviation	Skewness	Kurtosis	Minimum	Maximum
Age	53.997	6.27248	-0.067	-0.497	40.18	69.27
Gender	12.2045	12.0455	0.926	0.26	0	48.2
Ethnic	26.0389	17.04075	0.215	-0.345	0	81
National	35.8739	30.23173	0.382	-0.883	0	128.33
Board Size	9.2587	2.8598	-0.102	-0.582	3	16
CEO Duality	0.1439	0.35156	2.04	2.178	0	1
Firm Size	6.5566	1.25838	-1.426	4.17	0	8.89
CEO Tenure	2.7108	0.93681	0.221	0.987	1	6
Board Independence	0.5412	0.55379	1.494	3.685	0	2.8
Capital Structure	1.7331	4.86528	3.715	12.696	0	26.91

5.1.1 Correlation Results

Correlation analysis is a technique of assessing the relationship between all variables: age, gender, ethnicity, national diversity, industry, board size, CEO duality, firm size, CEO tenure and capital structure. Thus, the study analyzed the relationships that are inherent among the independent and dependent variables. The results were summarized and presented in Table 4.2.

From the results, Ethnic diversity was negatively correlated to capital structure as indicated by the correlation coefficient value of -0.140, indicating that ethnic diversity was a significant factor contributing to a 14% negative relationship with capital structure. Further, national diversity was also negatively correlated to capital structure as evidenced by the correlation coefficient value of -0.184 (significant at $\alpha = 0.01$), an indication of an 18.4% negative relationship with capital structure. Industry type was also shown to be negatively correlated to capital structure, as shown with a correlation coefficient value of -0.139, which indicates that the industry type accounts for a 13.9% negative change in the capital structure (significant at $\alpha = 0.05$). Firm size was also negatively correlated to capital structure, as shown by the correlation coefficient value of -0.136. Thus, there is a 13.6% negative relationship with capital structure (significant at $\alpha = 0.05$).

Table 4.2: Correlation Results

	CS	AG	GRD	ETH	NTL	BS	CD	FZ	CT	BI	I
CS	1										
AG	.310**	1									
GRD	.472**	-.154*	1								
ETH	-.140*	-0.028	-0.007	1							
NTL	-.184**	0.056	-.169**	-0.093	1						
BS	-0.098	0.067	0.032	0.061	-.201**	1					
CD	-0.105	0.017	-.187**	-0.046	0.04	-.399**	1				
FZ	-.136*	-0.063	-0.038	0.036	-0.004	.121*	-0.054	1			
CT	.391**	.173**	.140*	-0.073	-0.076	0.008	-0.033	-0.003	1		
BI	-0.034	0.048	-0.097	.174**	.283**	-.250**	0.063	0.018	0.019	1	
I	-.139*	-.146*	-.163**	-0.045	-.158**	.301**	-.148*	0.097	-0.022	-.131*	1
** Correlation is significant at the 0.01 level (2-tailed).											
* Correlation is significant at the 0.05 level (2-tailed).											

Key:

CS	=	Capital structure
AG	=	Age
GRD	=	Gender
ETH	=	Ethnic
NTL	=	National
BS	=	Board size
CD	=	CEO duality
FZ	=	Firm size
CT	=	CEO tenure
BI	=	Board independence
I	=	Industry

5.2 Hypothesis Testing

The study showed that ethnic diversity had a significant and negative effect on capital structure ($\beta_3 = -0.188$, $q < 0.05$). Therefore, the study rejected the hypothesis. This indicates that there is a negative change in capital structure by 0.188 units with an increase in ethnicity. In addition, the effect of ethnicity is stated by the t-value = -4.069, which implies that the effect contributed by the estimated parameter is less than the standard error.

6. Summary of Findings, Conclusion and Recommendations

6.1 Summary of Findings

The study was carried out to determine the effect of Board Diversity on Capital Structure among Listed firms in the Nairobi Securities Exchange, Kenya. The study adopted an explanatory design.

The findings provided evidence to suggest that the ethnic diversity of board directors negatively affects capital structure ($\beta_3 = -0.188$, $q < 0.05$). Previous investigation

by Carter *et al.* (2003) revealed a significant positive effect between ethnic diversity and a firm's capital structure. Consequently, the presence of both women and ethnic minority directors is an added advantage to a firm and in the long run, it enhances capital structure. Similarly, ethnic diversity improved capital structure in that it offers a broad range of skills and knowledge that leads to complementarities and mutual learning, leading to enhanced creativity and innovation (Alesina and La Ferrara, 2005; Lee and Nathan, 2011; Ozgen *et al.*, 2011b). Nonetheless, costs associated with more ethnic diversity would be related to more difficult communication and coordination (Lazear, 1999; Morgan and Vardy, 2009). Contrary to the results, Watson, Kumar and Michealson (1993) reported that a homogeneous board is better in the short term, while a heterogeneous board is better in the long term in achieving corporate goals. Even so, to Pelled, Eisenhardt and Xin (1999), a heterogeneous board resulted in emotional conflict that ultimately hindered a firm's capital structure. From the foregoing, the ethnic diversity of board directors not only affected performance, but firm performance may also affect diversity. Further, previous research has established that ethnic diversity can both be advantageous and disadvantageous to a firm's capital infrastructure. Specifically, it is of benefit to capital structure since it offers a wide array of skills and experience to the board and disadvantageous since it is associated with emotional conflict and difficulty in communication and coordination.

7. Conclusion

The study showed that the ethnic diversity of the board of directors has a significant effect on firm's capital structure. The results showed that larger and more successful firms tend to have more minority directors. Precisely, ethnic diversity positively influences capital structure and team performance due to a more diverse pool of skills and knowledge that leads to complementariness and mutual learning. Furthermore, an ethnically diverse board of directors is associated with more creativity and innovation.

8. Recommendations

The study results showed that the ethnic diversity of the board of directors is advantageous because it enhances capital structure. Ethnic diversity is likely to increase leverage because of networks, particularly among the ethnically diverse boards, causing directors to become risk-averse because high capital structures have a lot of risks. Thus, more networking through ethnic diversity in the board may help to build trust across ethnic divides and bring subgroups together behind a common goal under the right circumstances. Furthermore, firms should put effective measures in place to counter emotional conflict and difficulty in communication and coordination that comes with ethnic diversity. With these considerations, firms will be able to effectively manage their financing.

8.1 Further Research Recommendations

This study recommends that other studies be done to augment findings in this study; it therefore recommends that a study be done on a larger number of firms rather than including only firms in the NSE for the sake of generalizing the results of the study. Moreover, including moderator factors can also be made in the research models of the new research by other scholars in future.

This study included only four factors; there could be some other relevant factors that may be perceived as important but were excluded from this study. Future researches, therefore, may consider more factors, like non-executive directors, audit committee, independent directors and other variables which can influence capital structure.

Conflict of Interest Statement

The authors declare no conflicts of interest.

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