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RELATIONSHIP BETWEEN BOARD DIVERSITY, CORPORATE SUSTAINABILITY PRACTICES AND FINANCIAL PERFORMANCE OF FIRMS

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Abstract
Research on board diversity (BD) has grown in the last two decades, but it is observed that the association between BD and financial performance (FP) of a firm is inconclusive to date. As the findings of the link between BD and FP are mixed, researchers suggest that the concerned parties might benefit from examining the critical effects of any third intervening variable on that relationship. Corporate sustainability practices (CSP) are an extensive management idea that assures long-term financial success and survival of a firm. However, the success of CSP is likely to increase when the board of directors (BOD) consists of diversified people who represent multiple stakeholders' interests. Therefore, BD is likely to influence CSP, which, in turn, affects the FP of the firms. Accordingly, this paper proposes CSP as a mediator in the relationship between BD and FP of firms based on Stakeholder Theory. The key purposes of this article are to review the previous literature on BD, CSP, and FP, propose a research framework, and offers suggestions for future empirical research.

Keywords. *Board diversity; corporate sustainability practices; financial performance; stakeholder theory; mediator*
JEL Codes. *G32; M41; Q56.*

Introduction

Corporate governance (CG) is a catchword all over the world due to financial scandals and crises (Bhaskar & Flower, 2019). It is defined as a system by which an organization is guided and controlled successfully (Cadbury, 1992). It is considered a serious issue in corporate sectors, particularly after the financial crises which were responsible for the economic recession. Researchers found that financial crises and failure of giant corporations like Adelphia, Enron, and WorldCom are mainly attributed to poor CG practices (Hassan, Marimuthu, & Johl, 2015). The regulatory bodies are trying to concentrate on the issues of CG in corporations to reduce corporate scandals and corruptions (Mees & Smith, 2019; Reguera-Alvarado, de Fuentes, & Laffarga, 2017).

Among the different CG mechanisms, the performance of the board is treated as a vital factor to ensure effective CG (García-Sánchez, Hussain, & Martínez-Ferrero, 2019). The board is also considered the essential tool for assuring proper CG practices and responsible for enhancing shareholders' wealth by effectively monitoring and overseeing the activities of the upper management teams (MCCG, 2016). Given the different aspects of the board role, the diversity of the board has been found to increase the effectiveness of the board to improve the performance of firms (Kılıç & Kuzey, 2016; MCCG, 2016). Diversified board means the varied characteristics of board members (Gordini & Rancati, 2017). Presently, all corporations in the world are encouraged to diversify their board because the decisions of the board of directors (BOD) and the BOD's lack of diversity are considered to be responsible for corporate scandals of Dynegy, Glitnir and Lehman Brothers in the USA (Terjesen, Couto, & Francisco, 2016).

Research related to board diversity (BD) has matured in the last couple of years because firms are advised to diversify their BOD regarding gender, ethnicity, and other attributes of the board members to represent the interest of all stakeholders of the organization (Guest, 2019). Agency Theory also postulates that BD increases the heterogeneity of BOD that is more independent from its management (Jensen & Meckling, 1976). BD leads to the improvement of the intensity of BOD, and it helps make appropriate decisions that could reduce agency costs and enhance the financial performance of firms in the long run (Ramly, Chan, Mustapha, & Sapiei, 2017).

Financial performance (FP) of firms is extensively recognized as an indicator of management performance. It is used as a measurement to reflect the effectiveness and efficiency of management in resource allocations (Cui, Zhang, Guo, Hu, & Meng, 2019). Nonetheless, previous studies found that lower FP is responsible for the weak performance of CG in firms (Van Vu, Tran, Van Nguyen, & Lim, 2018). Current studies revealed that the link between BD and FP of firms is either positive or negative; however, some results were found to be inconclusive, suggesting that it is difficult to understand why and how BD influences FP (Abdullah, 2014; Adams, Haan, Terjesen, & Ees, 2015). Also, it is unclear from previous studies concerning the BD and FP relationship (Hassan et al., 2015; Molla, Ibrahim, & Ishak, 2019). Thus, it is plausible to carry out further research on the relation between BD and FP more holistically (Hassan et al., 2015). As the association between BD and FP is found mixed, Umans (2013) and Roberson, Holmes IV, and Perry (2017) suggest that the concerned parties could benefit from examining the critical effects of any third intervening variable on that relationship.

Like board diversity, corporate sustainability practices (CSP) are a widespread management idea that assures long-term financial success and survival of a firm (Ameer & Othman, 2012; Lopatta, Buchholz, & Kaspereit, 2016; Margolis, Elfenbein, & Walsh, 2007; Molla, Ibrahim, & Ishak, 2019; Wang, Dou, & Jia, 2016; Zahid & Ghazali, 2015). However, the success of CSP can be increased when diversified people that represent multiple stakeholders' interests sit on the BOD (Harjoto, Laksmana, & Lee, 2015). According to Stakeholder Theory (Freeman, 1984), a diversified board improves the ability of firms to fulfill the desires of their large number of stakeholders. Therefore, it is speculated that BD is likely to influence CSP, which in turn affects the FP of the firm.

Based on Baron and Kenny's (1986) work and Stakeholder Theory (Freeman, 1984), this paper proposes CSP as a mediator in the relationship between BD and FP of firms. To the best of the authors' knowledge, researchers have not given much attention to the mediating role of CSP in the association between BD and FP. Therefore, this paper attempts to fill the research gap. Finally, some propositions connected with BD, CSP and FP of firms are presented to empirically justify future research.

Research Approach
This article broadly reviewed past literature related to BD, CSP, and FP of firms. Toward this end, relevant journals, international conference papers, and book chapters published mainly by different globally recognized publishers like Springer, Elsevier, Taylor & Francis, Emerald, Wiley Online Library, Sage, etc. had been selected.

Literature Review
Financial Performance
The stakeholders of a firm are habitually interested in FP for each period of that firm. These stakeholders are not only the shareholders but also employees, suppliers, management, and the government. Most of the firms are serious about their FP as it acts as a necessary performance measure of their long-term survival (Odalo, Achoki, & Njuguna, 2016). Carton and Hofer (2006) define financial performance as the measurement of the change of the financial condition of an organization, or the financial outcomes that result from management decisions and the execution of those decisions by the members of the organization.

There is no real consensus for measuring the financial performance of a firm (Maqbool & Zameer, 2018). Generally speaking, the FP of firms is calculated by two broad categories of measurement. The first is the accounting-based methods like return on equity (ROE), return on asset (ROA), economic value added (EVA), etc. The second is the market-based methods like Tobin's Q, market capitalization, MVA, etc. (Tayeh, Al-Jarrah, & Tarhini, 2015). Usually, the accounting-based measures reflect a firm's profitability and ability to use its assets to generate income, and it shows previous and short-term FP. On the other hand, the market-based measures expose the market value of an asset or security, which represents the perceptions of outside stakeholders and long-term FP of the firm (Post & Byron, 2015).

Board Diversity (BD)
At present, the notions of diversity, heterogeneity, and cognitive and demographic diversity are well known and matured in the corporate world. The concepts have also received significant attention among practitioners and in the academic literature (Erdur & Kara, 2015; Rao & Tilt, 2016). Diversity in the board is purported to enhance the FP of firms (Hassan et al., 2015). Board diversity means heterogeneity in the characteristics or different attributes of the board members in terms of age, nationality, ethnicity, religious background, functional background, task skills, relational skills, political preference, etc. (Van Knippenberg, De Dreu, & Homan, 2004). It can also be defined as tangible or imperceptible differences of the board members regarding gender, age, race, ethnicity, physical and mental ability, work and family status, religion, weight and appearance, language, and other identity-based characteristics that affect their interactions and relationships with other people in society (Piekkari, Oxelheim, & Randøy, 2015). Concerning corporate governance, BD refers to the different compositions like attributes, characteristics, and expertise of individual board members in a company (Walt & Ingley, 2003). In practice, however, research on BD has mainly focused on gender, age, race/ethnicity, tenure, educational background, and functional background of the BOD (Williams & O'Reilly, 1998).

Corporate Sustainability Practices (CSP)
Corporate sustainability practices (CSP) are the latest term used to denote corporate social responsibility (CSR) or sustainable development (Christofi, Christofi, & Sisaye, 2012). Before the 1990s, business people typically used the word 'sustainability' to refer to the ability of a firm to increase its income gradually. The concept has become a widespread management idea after the definition given by Gro Harlem Brundtland, the ex-prime minister of Norway, was published in a UN report in 1987. Brundtland defines sustainable development as "meeting the

needs of the present without compromising the ability of future generations to meet their own needs" (UN Report, 1987, p.2, as cited in Adams, Thornton, & Sepehri, 2012). CSP also refers to producing goods and services in such a way that meet and incorporate present economic, environmental, and social needs without destroying the required resources of the next generation (Ong, Soh, Teh, & Ng, 2016). Presently, the term CSP incorporates three dimensions of business atmosphere: economic, environmental and social sustainability of a firm (Adams et al., 2012).

Board Diversity (BD) and Financial Performance (FP)

The link between BD and FP of firms is not conclusive yet (Roberson et al., 2017). Several researchers have examined the association between the two variables and found mixed results (Post & Byron, 2015). Several reasons have been identified to explain the varied results. They include the variation of time (Campbell & Mínguez-Vera, 2008), the different scopes of study (Sabatier, 2015), the failure to consider an appropriate number of control variables (Terjesen, Aguilera, & Lorenz, 2015), and a lack of appropriate techniques of measurement (Terjesen et al., 2015). BD helps make strategic decisions, build strong networks with different organizations and stakeholders, bring diversified knowledgeable personnel and expertise in the board to assist in increasing productivity and FP of the firms (Ali, Ng, & Kulik, 2014). Although the influence of board diversity on financial performance has shown mixed results, many researchers found a positive relationship between the two (Hassan & Marimuthu, 2014; Hassan, Marimuthu, & Johl, 2016; Kılıç & Kuzey, 2016). On the contrary, researchers also revealed either a negative or non-significant correlation between BD and FP of firms (Adams & Ferreira, 2009; Miller & del Carmen Triana, 2009).

From the previous literature, it is observed that the correlation between BD and FP of firms is ambiguous and mixed (Hassan et al., 2015; Roberson et al., 2017). However, several researchers suggest a positive association between them. So, this article proposes the following:

Proposition 1: Board diversity is positively related to the financial performance of a firm.

Board Diversity and Corporate Sustainability Practices

Several studies have been conducted on the connection between BD and CSP around the globe. For instance, Chen and Jaggi (2001) conducted a study on the listed firms of Hong Kong and found a positive connection between the independence of the board and CSP. On the other hand, Eng and Mak (2003) revealed a negative relationship between the outside directors of the board and CSP in the case of Singaporean firms. In contrast, Matolcsy, Tyler, and Wells (2012) found no relationship between BD and CSP of listed firms in Australia. Others observed a positive association between gender diversity and CSR activities of firms (Adams, Licht, & Sagiv, 2011; Zhang, Zhu, & Ding, 2013). Haniffa and Cooke (2002) examined board diversity of Malaysian listed firms and found a significant positive relationship between ethnicity and multi directorship of board members and corporate social disclosure.

Rao and Tilt (2016) reviewed previous literature on BD and CSP of firms. They showed that diverse boards are positively related to higher sustainability performance. Post, Rahman, and Rubow (2011) inspected the relationship between BD and environmental CSR and found that to a higher percentage of outside directors, female directors, directors aged 50 years old and above, and Western European directors are positively related to CSR.

Despite the mixed result of the relationship between BD and CSP, several studies reveal a positive association between the two. So, the present paper proposes the following:

> *Proposition 2: Board diversity is positively related to corporate sustainability practices of a firm.*

Corporate Sustainability Practices and Financial Performance

It is essential for a firm to earn profit to survive in a competitive business market. Implementing corporate sustainability in a business needs a huge amount of expenditure that may reduce the profitability of a firm. Several studies in the field of corporate sustainability practices (CSP) tried to find the answer to the question of whether sustainability practices increase or decrease the profitability of a firm (Goyal & Rahman, 2014). However, mixed results are reported (Rivera, Muñoz, & Moneva, 2017). For example, Raza, Ilyas, Rauf, and Qamar (2012) reviewed the relationship between CSP and financial performance using content analysis of studies from 1972 to 2012. Out of 76 studies, they reported that 48 studies had found a positive link, eight studies found a negative association, four studies reported mixed results, and 16 studies showed no relationship between the two.

Hou (2019) found that CSP and FP are positively correlated. Jacobs, Singhal, and Subramanian (2010) also demonstrated a positive association between CSP and the stock returns of firms. Klassen and McLaughlin (1996) found that a higher level of CSP reduces the cost of production, increases sales volume, and increases profitability. Similarly, Potoski and Prakash (2005) observed that higher CSP firms are considered less risky, and the regulators occasionally come to inspect the company. In this way, a firm can reduce the cost of the inspection, which will reduce the aggregate cost and increase its profitability. Several studies also support the positive association between CSP and FP of firms (Margolis et al., 2007; Wang et al., 2016). However, some researchers concede that not all items of CSP in every aspect can enhance the FP of a firm (Barnett & Salomon, 2012). Moreover, Yusoff, Lehman, and Nasir (2006) found no significant association between CSP and FP of a firm. They argued that CSP is linked with social welfare rather than profitability.

Even though the relationship between CSP and FP is mixed and inconclusive, the literature appears to suggest a positive association between them. Consequently, this article undertakes the following proposition:

> *Proposition 3: Corporate sustainability practices are positively related to the financial performance of a firm.*

CSP as a Mediator

The Stakeholder Theory and Resource Dependence Theory suggest that firms should consider the benefits of stakeholders before achieving financial performance. Giving priority to society and the environment could enhance the competitive advantage of a firm, which ultimately can increase the financial performance of the firm (Donaldson & Preston, 1995). The previous literature indicates that, in most cases, the association between BD and FP of firms is positive. However, the results are distinctly mixed and inconclusive of a direct relationship between the two variables (Galbreath, 2016). As the link between BD and FP is not clear, other ways of investigation are required (Roberson et al., 2017). It is argued that female board members can increase the FP of a firm by ‘soft’ improvements, which cannot be measured directly in monetary terms. For example, women directors can enhance the social and ethical matters of the BOD that are essential to build and maintain a good relationship with the stakeholders of the firm (Rao & Tilt, 2016).

According to Stakeholder Theory, when a firm maintains a good relationship and considers the interests of its stakeholders, its FP could increase in the long run (Freeman, 2004; Jensen, 2001). Accordingly, BD can improve the FP of a firm by improving its CSP engagement. However, whether CSP mediates the relationship between BD and FP or not needs an empirical inquiry. Thus, the following proposition is offered:

Proposition 4: CSP positively mediates the relationship between BD and FP of a firm.

Proposed Research Framework

Figure 1 shows a research framework proposed based on the literature that BD could influence the FP of firms in two ways. Firstly, BD directly influences the FP of firms based on Agency Theory and Resource Dependence Theory and past empirical evidence. Secondly, BD is indirectly related to a firm's FP through CSP based on Stakeholder Theory (Freeman, 1984), which states that companies have responsibilities to their stakeholders apart from earning a profit. The theory also postulates that if a firm manages its relationship with its stakeholders properly, the firm can improve its financial performance over time (Donaldson & Preston, 1995; Freeman, 1984). Thus, it is expected that through CSP, the diversified board will enhance the financial performance of a firm.

Figure 1: Proposed Research Framework

Conclusion

In recent years, board diversity in organizations has received considerable attention among practitioners and in the academic literature because of the corporate scandals. In the last decade, research in BD has exponentially increased as companies are recommended to increase the heterogeneity of their board. Even though several researchers have investigated the association between BD and firms' FP, the results are not conclusive to date. Little is known about why and when board diversity would influence firm performance. Thus, this article explores the connection between board diversity and financial performance further. Moreover, as the relationship between BD and firms' FP is not conclusive, CSP is proposed to mediate the relationship between BD and FP. Accordingly, four propositions are offered to be investigated by future researchers.

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