Does Cultural diversity of Board of Directors and Audit Committee Dynamics Affects Firm Performance? Evidence from Firms in Karachi Meezan Index

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Abstract

In this study we have investigated that how cultural diversity of the board and audit dynamics affect firm performance. The data have been collected from Karachi Meezan index (KMI) for the period 2008 to 2016 all companies included in are Shariah compliance. The board's cultural diversity has been measured after analyzing a grand sum of 2161 board members belonging to 26 countries. The regression analysis is used to estimate the econometric model. The study reports positive and significant relationship between cultural diversity of the board and board's independence with firm's performance. Additionally, the study also establishes that audit fee, audit committee size and independence also have a significant relationship with firm's performance. The study has useful implications for the mangers and investors, especially those who operate in international settings. It recommends that in future the idea should be tested in other Islamic and conventional indices as well as for different cultures.

Keywords: Cultural diversity of BoD; board's independence, audit committee's independence, Shariah compliance.

1 Introduction and background of study

When corporate scandals like Enron, WorldCom and many other of the similar type started to take place, people began to voice their concerns and started giving importance to corporate governance. The major goal of corporate governance is to protect the interest of all stakeholders of any firms. Over the last few years, there have been numerous factors affecting the corporate governance mechanism. These factors include growth of world economy, intense competition between capital markets, strict regulatory frame work and globalization phenomena (Denis and McConnell, 2003; Claessens., 2006).

Kurniati (2008) observed that companies use modern corporate governance mechanisms that are in line with the principles of Islam. It is because Islam put emphasis on "transparency"; "accountability"; "compliance"; "independence" and "fairness". Modern corporations use corporate boards; audit committees and other such practices that are directly or indirectly aligned with the principles of Islam. Hafeez (2013) also established that the best practices of corporate

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governance are closer to the Islamic system of governance, which promotes ethical standards that help companies to achieve superior performance.

One major gap in the broader area of research on corporate governance is less or an altogether no exploration of the cultural aspects. Although its importance has been recognized, but the area is still under-searched with respect to corporate governance and firms' performance. However, Frijns et al., (2016) pitched board's cultural diversity in a different manner. They measured it by introducing a new proxy. Significance of their study can be highlighted through the exploration of board's cultural diversity through cultural distance.

In this study, similar proxy has been used for the first time specifically in Pakistan's settings. In previous studies, diversity was measured by other proxies such as tenure, gender, language and religion (Anderson et al., 2011; Ferreira, 2010), and most of the evidence is from conventional markets. Secondly, major contribution of this study is that it also establishes empirical evidence for board and audit dynamics. Numerous corporate governance mechanisms are used to achieve better firm performance. Despite a lot of research, there is a mixed evidence regarding number of corporate governance mechanisms in relation to firm performance i.e. board size, diversity, Chairman/CEO duality, audit committee, audit quality, ownership concentration, corporate social responsibility etc. So, with the passage of time corporate governance practices must be re-examined so that changing effects can be captured (Braiotta, 2000; Lam ,2000; Dehkordi and Makarem ,2011; Aggarwal et al.,2007). Lastly, this is the first study which considers the impact of board's cultural diversity on firm performance of *Shariah* compliance companies.

2 Literature Review:

2.1 Board's independence and Size, and Firm's Performance:

There are two important factors in boards' composition, one is board size and the other is the board independence. Hidalgo et al; (2011) indicated that to promote corporate governance board plays a very pivotal role. Larger as well as smaller boards have their own advantages and disadvantages. Larger boards have more advantages as compared to smaller boards because the former have vast range of expertise and resources which enhance the decision making process. Similarly, Adam and Mehran (2005) found positive association between board size and companies performance. Linck et al. (2008) pitched that the board size and the firm size have a positive correlation, whereas few growth opportunities are a bit compromised. Fama and Jensen (1983) contended that executive and non-executive boards of directors have different approaches while making decisions; executive directors are more inclined towards company while making decisions, whereas non-executive directors are unbiased and impartial. They are also helpful in solving various conflict situations.

Berghe and Baelden (2005) studied the role of independent directors, and found that non executive directors are necessary for efficient working. Likewise, Dahya and McConnell (2007) scrutinized the relationship between board's independence and firm's performance. They realized that independent directors are necessary for board's better performance; apart from the fact that independent directors are more useful for the firm in general. Fallatah (2015) also observed a strong and positive correlation of board's independence and firm performance. Independent board of directors can improve the board's decision making capacity. Non-

executive directors bring valuable inputs, which leads to better governance and performance (Yeh et al., 2011). Hence, we hypothesize as below:

H1: There is a positive relationship between board's independence and firm's performance

H2: There is a positive association between the board's size and the firm's performance

Audit Committee Independence and Firm's performance:

There are several tools of corporate governance through which the company's corporate governance and the firms' performance can be enhanced. One of such important tools is the audit committee of the Board. The number of independent directors in the audit committee is directly proportional to the quality of auditing; it also brings improvement in reporting as well as in other functions of the company. According to Corp Law Blog (2014), it is the basic right of every stakeholder to have a clear picture of the firm. This particular goal can be achieved with the help of the audit committee and auditors.

Some companies use different techniques to manage and influence the financial facts and figures. This phenomenon is known as "financial engineering" or "earnings management" (Dye, Glover, and Sunder, 2014). To address this particular issue, the role of the independent audit committee and independent auditors is of utmost importance, as the level of independence of both, the audit committee and the auditors improves the corporate governance practices and, as a result, the firm's performance as a whole gets improved. In turn, that leads to reliability and accuracy of accounts and hence provides the stakeholders with a clear and more reliable picture of the firm (Leungetal., 2014). Likewise, Beasley (1996) asserted that almost all the standards of corporate governance put emphasis on the transparency of the audit committee. To achieve this goal, the inclusion of a larger number of independent members in the audit committee is necessary. As a result, the chances of manipulation decrease significantly. This was also endorsed by Bukit and Iskandar (2009) who argued that in the audit committee, the greater number of independent members will make a significant decrease in the "Window Dressing", leading to improvement in financial reporting quality and in turn increase in the firm's performance (Arslan et al. 2014; Bouaziz and Triki, 2012). Sharma *et al*. (2009) emphasized that larger the size of audit committee, better and reliable the expertise and the independence. They also found positive association between audit committee independence and firm performance. We, thus, we hypothesize as below:

H3: There is a positive relationship between audit committee independence and the firm's performance.

H4: There is positive relationship between audit committee size and the firm's performance

H5: There is positive relationship between audit quality and the firm's performance

Culture Diversity and Firm's Performance:

Hopt and Leyens (2004) have indicated that corporate governance practices have evolved in accordance to the changes in the culture persisting in the market. The previous research on this topic highlighted the boardroom changes such as chairman and CEO duality, composition in terms of executive/non-executive directors and other corporate practices. Hence the corporate

governance practices indicate that these practices have failed to find definitive financial performance effects (e.g., Dalton, Daily, Johnson & Ellstrand, 1999). Culture is an important element for researchers in corporate governance. Various traditional determinants of corporate governance have been used in the research but culture is a less explored dimension of corporate governance, especially in the corporate boards. Many researchers have indicated that different practices of corporate governance have been influenced from culture (Bebchuk and Roe 1999; Buck and Shahrim, 2005; Clarke and Rama, 2006; Aguilera and Jackson, 2010).

The behavior and attitude of the society impacts culture vividly. They are directly proportional to each other, as behavior changes, so do the culture and vice versa. Different societies have different cultures and their corporate governance practices vary accordingly. Similarly, the firms' performance is affected by legal contexts and the national culture. Some aspects are positive and some others are negative. To understand the national level performance of any company, we have to first understand the national cultural settings because cost and the benefits of a company are dependent on the national culture. (Heugens, van Essen & van Oosterhout, 2009; Peng& Jiang, 2010).

Cultural diversity in the board is studied by Frijns et al., (2016) and tested in United Kingdom. Diversity on board has advantages and disadvantages of its own. On the advantageous side, diversity brings skills, expertise and different opinions, which makes a board more efficient. Hence, the hypothesis:

H6: Cultural diversity on board has positive association with firm's performance.

Control variables:

Four control variables are included in this study namely, firm size, debt to equity ratio, assets turnover ratio, and the current ratio. Firm size (total assets) affects firm's performance; the companies with larger size are on advantageous side as compared to small size companies. (Ahmed & Hamdan, 2015). Log of total assets has been used as a proxy. Debt to equity ratio is another variable that is being used as a control variable. All companies in the Index are Shariah compliant, so they have an advantage on this particular ratio up to a certain level. Tax and other benefits might be taken by the firms (Hillier, Clacher, Ross, Westerfield & Jordan, 2011). The assets turnover ratio indicates that how much company's assets are contributing towards revenue generation. Increasing turnover ratio is good indication of effective usage of assets. For sustainability and smooth running of a business a persistent current ratio is necessary because the companies can easily meet their short term obligations. Working capital requirement for small firms are different as compared to firms with larger size (Gill and Shah 2012).

3 Methodology:

The sample of this study is comprised of 30 companies for the period July 2008 to June 2016. All companies are listed at KMI-30. Due to lack of access to the prestigious databases like data stream, Thomson Reuters World scope and other such databases, data were obtained from annual reports, companies' web and from Internet sources. Nationalities of directors are necessary for measurement of cultural diversity of board. So data regarding origin of directors were obtained from annual reports, companies' web and from Bloomberg and LinkedIn. These sources have also been used previously, e.g. by Frijns et al., (2016). All companies are fulfilling the basic thresholds for Shariah compliance because for the inclusion in index, compliance is obligatory. The shariah thresholds are: one, core business must be halal; second, the debt to equity ratio must

not be more than 37%; the ratio of non-compliant investment must be less than 33%. Fourth non compliant income must not exceed more than 5%; the illiquid assets to total assets ratio should be more than 25%; and lastly, market price per share should be greater than the net liquid assets.

To measure cultural diversity of board, first the cultural distances of directors are calculated. This was done by taking scores of individual dimension of the country of the nationality for each director (Kogut and Singh, 1988 ; Frijns et al., 2016)

$$CD_{ij} = \sqrt{\sum_{k=1}^{4} \{(I_{ki} - I_{kj})^2 / V_k\}} \quad \forall\, i \neq j\,, \tag{1}$$

CD_{ij} is the cultural distance between each two directors (i, j), I_{ki} is the culture score on dimension k for a director i, I_{kj} is the cultural score on dimension k for a director j, and V_k is the in-sample variance of the score for the specific cultural dimension. This study considers Hofstede's first four cultural dimensions to compute CD. These dimensions include (individualism-collectivism, masculinity-femininity, power distance, and uncertainty avoidance).The scores of each dimension are available at Hofstede's web and on published index.

$$CD\ BOARD_{nt} = \frac{\sum_{i,j} CD_{ij,nt}}{m(m-1)/2} \quad \forall \quad i < j\,, \tag{2}$$

"CD $BOARD_{nt}$ is the measure of cultural diversity of the board of firm n in year t, while m is the number of board members. The measure of cultural diversity is scaled by the number of pairs of board members, so that the measure is normalized for the size of the board." The CD is computed by formula (1) as explained above. The "m" is number of board of directors; their data is taken from annual reports, respectively.
The other variables of this study are:

Variables	Type	Measure	reference
Return On Assets	D.V	ROA = Net Profit /Average Total Assets	Al-Matari et al. (2012); Swamy (2011).
Cultural Diversity	I.V	Cultural Distances	Kogut and Singh (1988); Frijns et al., (2016)
Board Size	I.V	Number of board of directors	(Gill, Biger et al. 2012); Ahmed Haji (2014)
Board Independence	I.V	Number of independent board members	Gill, Biger et al. (2012); Dalton et al. (1999)
Audit Committee Size	I.V	Number of Audit Committee members	Anderson et al. (2004)
Audit Committee Independence	I.V	Number of Independent Audit Committee members	(Gill, Biger et al. 2012).
Audit Quality	I.V	Big five Auditors	Charles et al. (2010)
Audit Fee	I.V	Fee paid to external auditor	Lee and Ryu (2011)
Debt Equity Ratio	C.V	Debt/Equity Ratio = Total Liabilities / Shareholders'	Yaseer (2011); shah et al, 2011), Degryse and Ongena,

		Equity	(2001)
Current Ratio	C.V	Current Ratio = Current Assets / Current Liabilities	Soenen (1993)
Asset Turnover	C.V	Asset Turnover = Sales / Average Total Assets	Fleming et al. (2005)
Firm Size	C.V	Log of Total Assets	Elyasiani & Jia, (2010); Ahmed & Hamdan, 2015)

Econometric Model:

$$ROA_{i,t} = \beta_{0i,t} + \beta_1 CD_{i,t} + \beta_2 BS_{i,t} + \beta_3 IND\ B_{i,t} + \beta_4\ Audit\ C\ S_{i,t} + \beta_5 Non\ Ex\ Audit\ C_{i,t} + \beta_6 Audit\ Q_{\ i,t} + \beta_7 Audit\ Fee_{\ i,t} + \beta_8 DE_{i,t} + \beta_9 CR_{i,t} + \beta_{10} AT_{i,t} + \beta_{11} FS_{i,t} + \varepsilon_{i,t}$$

The stationarity of data has been tested through unit root test, and all have been found stationary. Heteroskedasticity is addressed by white test and weighted least square. Two auto regressive lag found significant so have been added in the model. Multicolinearity is analyzed by correlation matrix, no high correlations were found.

Results and Discussion:

Table 1

Descriptive statistics

	ROA	CD	B S	IND B	AUDIT C S	Non Ex AUDIT C	AUDIT Q	AUDIT FEE	DE	CR	AT	FS
Mean	10.12	2.01	9.67	1.78	4.13	2.62	0.50	14.13	0.54	1.80	1.17	10.36
Median	7.97	1.93	9.00	1.00	4.00	3.00	0.50	14.08	0.16	1.49	0.79	10.38
Maximum	53.85	10.09	16.00	9.00	7.00	6.00	1.00	16.92	13.04	8.74	6.32	13.29
Minimum	-17.29	0.00	7.00	0.00	3.00	0.00	0.00	11.92	-5.60	0.27	0.09	7.67
Std. Dev.	10.75	1.91	2.65	2.09	1.09	1.07	0.50	0.77	1.36	1.21	1.07	1.31
Skewness	0.69	1.54	0.62	2.23	0.78	0.56	0.00	0.25	5.00	1.75	2.40	0.24
Kurtosis	3.96	6.86	2.12	7.63	3.14	4.27	1.00	4.52	46.53	8.26	9.37	2.12

*Note: Table 1 shows a descriptive statistics of the study: Return on assets (ROA) ; Cultural diversity of board (CD); Board size (BS); Board Independence (IND B); Audit committee size (Audit C S); Non Executive Audit committee members (Non Ex audit c); Audit Quality (Audit Q); Audit fee; Debt to equity ratio (DE); Current ratio (CR); Asset Turnover (AT); Firm size (FS).

Table 1 shows descriptive statistics of the variables used in the study. The mean value of return on assets and maximum value are 10.12 and 53.85% respectively. The mean value of cultural diversity is 2.01, maximum value is 10.09 and standard deviation is 10.75 from the mean. Average size board is 9.67, while maximum is 16. Mean of board independence is 1.78, while maximum independent directors are 9. Mean value of Audit committee size is 4.13, while the maximum value is 7. Non-executive directors' presence enhances the working of audit committee; their mean value is 2.63, while maximum value is 6. Mean of audit fee is 14.13, while maximum is 16.92 respectively.

Table 2

Correlation matrix

	ROA	CD	BS	IND B	AUDIT C	NON EX AUDIT C	AUDIT Q	AUDIT FEE	DE	CR	AT	FS
ROA	1											
CD	-0.14	1										
B S	-0.29	0.08	1									
IND BOARD	0.24	-0.27	0.30	1								
AUDIT C	-0.17	0.01	0.49	0.24	1							
NON EX AUDIT C	-0.20	0.19	0.26	-0.20	0.43	1						
AUDIT Q	0.32	-0.18	-0.13	0.08	-0.30	0.08	1					
AUDIT FEE	0.13	0.15	0.12	0.15	0.12	0.07	-0.18	1				
DE	-0.17	-0.02	0.13	0.04	0.13	0.10	-0.21	0.19	1			
CR	0.52	-0.19	-0.22	0.46	0.00	-0.06	0.25	0.01	-0.23	1		
AT	-0.10	0.22	-0.12	-0.13	-0.28	-0.15	-0.21	0.18	-0.16	-0.13	1	
FS	0.01	0.06	0.12	0.08	0.00	-0.05	-0.07	-0.07	0.09	0.02	-0.10	1

The results of correlation analysis are reported in table 2. The correlation value between ROA and cultural diversity is -0.14. These results are in line with previous studies which conclude that due to cultural diversity, the board takes more time to make a decision, hence resulting in impediment of decision making process, which impacts the firm's performance negatively (Barsade et al. 2000). Similarly, firm's performance also has a negative correlation with the board size i.e. -0.29. This result is in accordance to the results presented by Cheng (2008).Whereas board independence is positively correlated with firm's performance. Brown and Caylor (2004) also endorsed that the greater board independence enhances the firm performance.

Audit committee size also has a negative correlation with ROA, its value is -0.17. Audit committee size and the presence of non-executive audit committee members are negatively correlated with firm's performance. Their values are -0.17 and -0.20 respectively. In large committees, a lot of time, efforts and energy are consumed in immaterial matters, which affect performance negatively and adversely (Eisenberg, Sundgreen and Wells, 1998; Vafeas 2005). On the contrary, the audit quality (0.32) and audit fee (0.31) have a positive correlation with performance. These results are in line with the results of Bouaziz (2012) who pitched that financial performance and audit quality of firm are directly related to each other. The firm size and current ratio are positively related with profitability. Shanley (1990) also reported similar results. However, debt to equity and asset turnover has a negative weak correlation with firm's performance.

Table 3

Regression Analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-52.710	20.674	-2.550	0.012
CD	0.480**	0.231	2.079	0.040
BS	4.636	7.860	0.590	0.557
IND_BOARD	1.583***	0.431	3.676	0.000
AUDIT_C_S	0.297**	0.117	2.546	0.012

NON EX AUDIT C	2.065***	0.546	3.784	0.000
AUDIT Q	2.029	1.356	1.496	0.138
AUDIT FEE	2.616***	0.494	5.294	0.000
DE	-1.080**	0.388	-2.811	0.006
CR	1.657 **	0.566	2.929	0.004
AT	1.566	1.681	0.932	0.354
FS	1.347	0.960	1.404	0.163
AR(2)	0.140	0.059	2.348	0.021

R-squared	0.880678
Adjusted R-squared	0.84129
S.E. of regression	5.861078
F-statistic	22.35908
Prob(F-statistic)	0.000000

***p< .001

**p< .05

**p< 0.1

The results of pooled regression are presented in tables 3. The Model has good explanatory power with Adjusted R^2 = 0.84. According to the theory, cultural diversity in the board brings expertise, resources and improved decision making. Results show that there is positive effect of cultural diversity of board on firm's performance (Nederveen Pieterse et al., 2013). P-value is .04 with t-value more than 1.96. Our results are aligned with the previous studies like that by Aguilera and Jackson (2010), Frijns et al., (2016). Islam also put emphasis on transparency and independence so that interests of all the stakeholders are protected. The analysis shows that firm's performance has no significant relationship with board size, but the independence of the board of directors' has significant effect on firm's performance. Results are also in line with the literature, i.e. Adam and Mehran (2005). Presence of independent directors induces better governance practices which ultimately results in achieving superior performance.

The study finds a positive and significant effect of Audit committee size and independence on firm's performance. P-value of audit committee size is .012, while the t-value is 2.56. The results are consistent with the study of Beasley (1996).The study found that audit quality does not have significant relationship with performance. Hence, it doesn't make any difference whether the company's accounts are audited by big five auditors or not,. The reason behind this particular phenomenon may be that these companies are shariah compliant, and already on the conservative side. The results are similar to the previous studies (Yasar, 2013; Ching, et al. 2015). The study finds a positive relationship with control variables. Debt to equity has negative significant relationship to performance. The results are aligned with the theory. Current ratio has a positive and significant relationship. Its t-value is 2.9, while p-value .000. Firm size has positive but not significant relationship.

Conclusion:

The study provides empirical evidence that corporate governance practices affect firm's performance. This is the first study that investigates the impact of cultural diversity of board

using hofstede index on shariah compliance companies. Cultural diversity can bring different opinions on board, which might improve decision making. The Board's cultural diversity has been measured by calculating the cultural distances of 2161 board members from 26 different nationalities for a time period of 8 consecutive years. The result of study shows positive and significant relationship with firm's performance (see table 3). So, it is established that better firm performance can be achieved if cultural diversity is considered, because it brings skills, expertise and different opinions, which could make a board more effective (Peng & Jiang, 2010 ; Aguilera and Jackson 2010).

The basic theme behind this study is that Islam put a lot of emphasis on governance, transparency and accountability; that's why such variables are hypothesized. Presence of independent directors can bring more transparency bringing better governance practices in the companies, which in turn protect the interests of all stakeholders. For effective accountability, the role of audit committee is important. It helps to reduce the agency conflicts as well. This study represents positive and significant relationship of audit variables with firm's performance. Audit committee size and independence have positive and significant impact on firm's performance. Islam also stressed upon accountability and for this particular reason modern organizations use audit committees. The present study only examines thirty companies from KMI index; in future, however, the study can be extended over the Pakistan stock exchange (PSX-100). Secondly, greater larger data set from developed and developing markets may also be used for testing the same thought as changes in the structures and governance patterns may impact the results of the study.

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Appendix 1

Number of board of directors in each year

Country	2008	2009	2010	2011	2012	2013	2014	2015	2016	Total
Pakistan	218	215	215	216	220	224	224	218	224	1759
India	2	3	3	3	2	2	2	1	1	16
South Africa	1	1	1	1	1	1	0	0	0	5
USA	1	2	3	3	1	1	1			9
US	7	8	8	8	7	6	6	6	8	56
Germany	3	3	3	3	3	3	3			18
Saudi Arabia	11	11	11	11	11	10	10	10	8	82
Japan	9	9	9	11	10	10	12	14	12	87
Australia	0	0	0	0	0	0	0	1	0	1
Canada	1	1	1	1	1		1	1	0	6
UK	4	5	5	5	4	3	4	5	3	33
Denmark	1	1	1	0	1	1	1	0	0	5
Netharland	1		1	1	1	1	1	2	2	9
UAE	3	2	2	2	4	3	3	3		20
Bangladesh	0	0	0	1	1	1	0	1	1	5
Italy	0	0	0	0	1	1	0	0	0	2
Kuwait	3	0	1	1	1		0	0	0	5
France	0	0	0	0	0	1	1	1	0	3
Turkey	1	1	0	0	0	0	0	0	0	2
Tunsia	0	0	1	1	1	1	0	0	0	3
Indonesia	0	0	0	0	0	0	0	0	1	1
Philippines	0	0	0	0	0	5	6	6	5	22
Singapore	1	1	1	1	0	0	0	1	0	4

Swedan	0	0	0	0	1	1	0	0	0	2
Switzerland	0	0	0	0	0	0	1	1	1	3
Finland	0	0	0	0	0	0	1	1	1	3