International Journal of Management and Commerce Innovations ISSN 2348-7585 (Online)
Vol. 4, Issue 2, pp: (141-150), Month: October 2016 - March 2017, Available at: www.researchpublish.com

Effect of Board Diversity on Capital Structure among Listed Firms in Nairobi Stock Exchange, Kenya

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Abstract: **Capital structure decision is a vital one since the profitability of an enterprise is directly affected by such board decision. The existence of a well-developed board diversity assist in the effectiveness of debt. It is therefore important to examine how board diversity affects capital structure. However, in developing economies including Kenya there is scanty of literature on relationship between board diversity and capital structure. The main aim of the study was be to determine the effect of Board Diversity on Capital Structure among Listed firms in Nairobi Stock Exchange, Kenya. To establish effect of age diversity of board of directors on firm's capital structure, effect of gender diversity of board of directors on firm's capital structure, effect of ethnic diversity of board of directors on firm's capital structure and national diversity of board of directors on firm's capital structure. The study was informed by Pecking Order Theory and Agency Cost Theory. This study will adopt explanatory design. The study sampled all firms that have been listed on the Nairobi Stock Exchange (NSE) for eight-year period, 2004–2012. Thirty four firms qualified to be included in the study sample. The sample was selected from the firm which has been listed consistently for 8 years. This study utilized secondary data. Documentary guide used to collect data. Data was analysed using descriptive statistical method. In additional, multiple regression and correlation will also be used. The findings were that gender and age had significant and positive effect on capital structure whereas ethnicity and national had negative relationship with capital structure.**

Keywords: **Capital Structure, Board Diversity, Listed firms, stock exchange, Age Ethnicity, Gender, National Diversity.**

1. INTRODUCTION

One of the important decisions made by board of directors is Capital structure. Capital structure has long been linked to the firm's profitability and performance (Abor, 2005; Arbiyan and Safari, 2009; Chakraborty, 2010). According to Tarus (2013) board of directors have different characteristics such as board diversity which contribute to firms' corporate governance mechanism, with some characteristics providing more controlling mechanism than others. Therefore it is crucial to examine whether having a diverse board would enhance or weaken or capital structure. Researchers in accounting, economics and management 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). In management, boards monitor from agency perspective and often diversity of skills are needed for effective management of companies. It is argued that diversity is better for decision making particularly from a resource dependency perspective (Hillman *et al.*, 2007). Capital structure decision is the vital one since the profitability of an enterprise is directly affected by such decision. The successful selection and use of capital is one of the key elements of the firms' financial strategy (Velnampy & AloyNiresh, 2012).The existence of a well-developed board diversity assist in the effectiveness of debt (Kajananthan, 2013).Excessive diversity has been found to be negatively related to performance because of conflicts and communication breakdowns (Murphy and McIntyre, 2007). Board diversity may cause banks to have greater faith in internal governance mechanisms and thus reduce borrowing costs. 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: e.g., lack of communication, pursuing distinct personal agendas, and conflicts of interests among directors (Ferreira (2010). Carter *et al.,* (2002) maintain that board diversity contributes to creating shareholder value: corporate diversity promotes better understanding of the market place; further more heterogeneity leads to the evaluation of more alternatives and more careful exploration of the consequences of these alternatives. Finally diversity promotes more effective global relationships. Fields *et al.,* (2010) asserts 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 suggest a link between board diversity and improved firm valuations; an extension would suggest a similar link to bank loans (Erhardt, Werbel, and Shrader (2003) and Carter, Simkins, and Simpson (2003). However, According to Booth *et al*., (2001) and Bas *et al.,* (2008) knowledge about capital structures 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 board diversity and capital structure for firms in developing economies. According to Bulent and Cuneyt and Arif (2013) most studies have given much attention on the developed countries, such as United States, leaving a death gap in the existing literature on the determinants of capital structure in emerging economies such as Kenya. As such this study will attempt to determine the effect of board diversity on capital structure.

2. RESEARCH OBJECTIVES

General Objective:

The general objective of the study is to determine the effect of Board Diversity on Capital Structure among listed firms in Nairobi Stock Exchange, Kenya

Specific Objective:

The specific objectives of this study were:

a. To establish effect of age diversity of board of directors on firm's capital structure

b. To establish effect of' gender diversity of board of directors on firm's capital structure

c. To determine effect of ethnic diversity of board of directors on firm's capital structure

d. To assess effect of nationality diversity of board of directors on firm's capital structure

Research questions:

This research was guided by the following hypotheses:-

a. $H_{o1:}$ Age diversity of board of directors has no significant effect on firm's capital structure

b. $H_{o2:}$ Gender diversity of board of directors has no significant effect on firm's capital structure

c. $H_{o3:}$ Ethnic diversity of board of directors has no significant effect on firm's capital structure

d. $H_{o4:}$ Nationality diversity of board of directors has no significant effect on firm's capital structure

3. JUSTIFICATION OF STUDY

The benefit of the study goes to the firms' management to use the outcome in improving on optimal capital structure through board diversity concept and provide information to firms operating in Kenyan business environment and investors on how board diversity operates thus enhancing capital structure decision which benefits shareholders value in the firm. The study also provides information to scholars pursuing research and students in this field showing the gaps for further studies in this area. From the study scholars will be able to evaluate the effect of board diversity on capital structure

4. LITERATURE REVIEW

This study is based on the following theories;

Static Trade-off Theory:

The static trade-off theory of capital structure states that optimal capital structure is obtained where the net tax advantage of debt financing balances leverage related costs such as bankruptcy. Um (2001) suggests that a high profit level gives rise to a higher debt capacity and accompanying tax shields. Hence, it is expected that a positive relationship should exist between profitability and financial leverage. Firms with high levels of tangible assets will be in a position to provide collateral for debts. If the company then defaults on the debt, the assets will be seized but the company may be in a position to avoid bankruptcy. It is expected, therefore, that companies with high levels of tangible assets are less likely to default and will take on relatively more debt resulting in a positive relationship between tangibility and financial leverage.

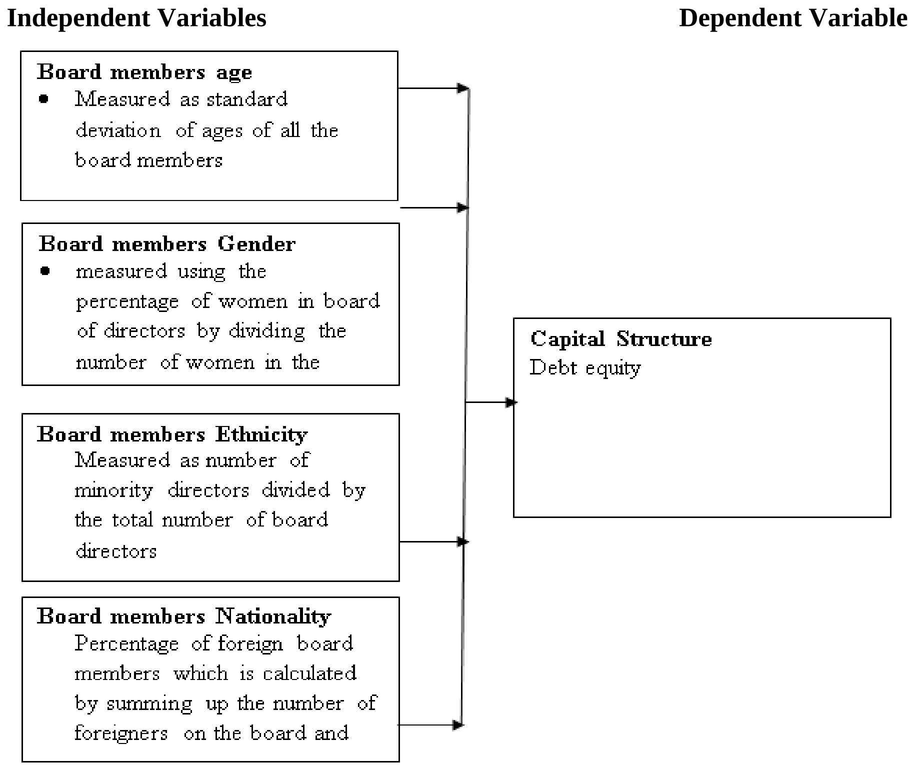
Information Asymmetry Theory (Pecking Order Theory):

The information asymmetry theory of capital structure assumes that firm managers or insiders possess private information about the characteristics of the firm's return stream or investment opportunities, which is not known to common investors. In an attempt to explain some financing behavior that is not consistent with the prediction of static trade-off theory (such as a negative relationship between profitability and leverage), Myers (1984) emphasizes that internal funds and external funds are used hierarchically. Myers (1984) refers to this as a 'pecking order theory' which states that firms prefer to finance new investment, first internally with retained earnings, then with debt, and finally with an issue of new equity. Bevan and Danbolt (2002) state that the more profitable firms should hold less debt, because high levels of profits provide a high level of internal funds. Consistent with the pecking order theory, work of Titman and Wessels (1988), Rajan and Zingales (1995), Antoniou et al, (2002) and Bevan and Danbolt (2002) in developed countries, Booth et al, (2001), Pandey (2001), Um (2001), Wiwattanakantang (1999), Chen (2004) and Al-Sakran (2001) in developing countries all find a negative relationship between leverage ratios and profitability.

Agency Cost Theory:

Debt agency costs arise due to a conflict of interest between debt providers on one side and shareholders and managers on the other side (Jensen and Meckling, 1976). Managers have the motivation to invest funds in risky business for shareholders' interest, because if the investment fails, the lenders are likely to bear the cost as the shareholders have limited liability. The use of short-term sources of debt, however, may mitigate the agency problems, as any attempt by shareholders to extract wealth from debt holders is likely to restrict the firms' access to short-term debt in the immediate future. Titman and Wessels (1988) point out that the costs associated with the agency relationship between shareholders and debt holders are likely to be higher for firms in growing industries hence a negative relationship between growth and financial leverage is likely. Consistent with these predictions, Titman and Wessels (1988), Chung (1993) and Rajan and Zingales (1995) find a negative relationship between growth and the level of leverage on data from developed countries. Jensen and Meckling (1976) argue that the use of secured debt might reduce the agency cost of debt. Um (2001), however, suggests that if a firm's level of tangible assets is low, the management for monitoring cost reasons may choose a high level of debt to mitigate equity agency costs.

CONCEPTUAL FRAMEWORK:



5. RESEARCH METHODOLOGY

RESEARCH DESIGN:

Research design is the arrangement of condition for collections and analysis of data in a manner that aims to combine relevance to the research purpose with economy as procedure (Kothari, 2008).This study will adopt explanatory design. This is because the research is a cause- effect relationship. The design is best for ascertaining the effects of board diversity on capital structure among listed firms at Nairobi Securities exchange in Kenya and it allowed the use of secondary data through documentary guide analysis to facilitate data collection in the listed firms.

TARGET POPULATION:

The target population of this study is 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 firms year observations therefore the target population above is chosen since it provided research information in respect to the study

SAMPLE SIZE AND SAMPLING TECHNIQUE:

The study sampled all firms that have been listed on the Nairobi Stock Exchange (NSE) during the ten-year period, 2004–2012. Thirty four firms qualified to be included in the study sample. The sample will be selected from the firms which had been listed consistently for 8 years**.** The sample size for this study will be obtained using (Mora & Kloet, 2010) formula for finite population as follows; $n = \frac{N}{\left(1 + Ne^2\right)}$

Where,

n = the sample size

N = the size of population

e= the error of 5 percentage points

$$n = \frac{272}{\left(1 + 272 \times 0.05^2\right)} = 162$$

DATA COLLECTION METHODS:

This study will utilize secondary data which is obtained through hand book, 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 is used to find out the information concerning board diversity age, gender, ethnicity and nationality.

PILOT TEST:

The instruments were subjected to content validity. The instruments population constituted all accounting, finance, and administrative staff at 10 firms at Nairobi securities exchange. The instruments were given to two experts in Finance at the Jomo Kenyatta University, to validate them. An early draft of the questionnaire was pre-tested in this stage. The aim of a pre-testing is to ensure that the questions brings out the responses required, discover vague wordings or errors before the survey is launched at large (Burns and Bush, 2002). Churchill (2002) reckons that pre-testing is necessary because it assures the researcher that the questionnaire designed will perform its diverse functions, and that the data collected will be relevant and corrected. Cronbach alpha test will be used to test reliability of questions. Cronbach’s alpha reliability coefficient normally ranges between 0 and 1. However, there is actually no lower limit to the coefficient. The closer Cronbach’s alpha coefficient is to 1.0 the greater the internal consistency of the items in the scale

6. CONCLUSION

From Table, the VIF for all the estimated parameters were found to be less than 4 indicating the absence of multi-collinearity and thus the variation contributed by each of the independent variables was significant and all the factors should be included in the regression model.

Multiple Regression Effect of National Diversity, Age, Gender Diversity and Ethnicity Diversity on Capital Structure

	Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
	B	Std. Error	Beta	t	Sig.	Tolerance	VIF
(Constant)	-9.214	2.658		-3.467	0.001		
age	0.284	0.036	0.362	7.781	0.000	0.862	1.16
gender	0.171	0.018	0.454	9.536	0.000	0.824	1.214
ethnicity	-0.059	0.015	-0.188	-4.069	0.000	0.877	1.14
national	-0.041	0.008	-0.246	-5.071	0.000	0.792	1.262
a Dependent Variable: capital structure							

The study recommends that;

There is enough proofing that age diversity of board of directors is positively associated with a firm's capital structure. Therefore, in order to improve the ability of a firm to solve tasks with high complexity, there is need for age diversity of board of directors to be enhanced. Further, so as to increase the knowledge on debt policy and equity ownership and offer a broad range of skills and experiences, there is need to enhance age diversity. There is evidence that gender diversity of board of directors' impacts positively on firm's capital structure. Thus, there is need to include women in the board so as to increase access to capital. Also, when women are included in the board they will acquire the required expertise to manage the firm. Also an increase in the number of female directors' increases board independence and better ways of financing a firm are availed since women tend to ask more questions than male do. Therefore, gender diversity makes it possible for firms to outperform competitors and promotes better understanding of the market. The study results have shown that ethnic diversity of board of directors is an added advantage to a firm since it enhances capital structure. Thus, firms should enhance ethnicity diversity so as to heighten the skills and experience of the board of directors. Furthermore, firms should put effective measures in place to counter emotional conflict and difficulty in communication and coordination that comes with ethnicity diversity. With these considerations, firms will be able to effectively manage their financing. National diversity of board of directors is also crucial if financing is to be improved. Therefore, firms should enhance nationality diversity so as to assure foreign minority investors that the firm aims at managing their best interests professionally. Also, in order to add valuable and diverse expertise that domestic members do not possess, there is need to enhance nationality diversity.

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