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The relationship between Board Diversity and Financial Reporting Quality of Companies Listed at the Nairobi Securities Exchange in Kenya

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Abstract

The goal of the paper was to establish the relationship between board diversity and the financial reporting quality of the companies listed at the Nairobi Securities Exchange (NSE) in Kenya. The target population consisted of the 61 firms that had complete data and had continually and actively traded at NSE between January 2014 and December 2018. Secondary data was used and analyzed using fixed effects regression model as the *Hausman test found it consistent. The paper found that financial reporting quality was significantly predicted by the average age of directors, board gender, and board independence but insignificantly predicted by the foreign board members and board qualification. In addition, board independence negatively relates to financial reporting quality. The paper recommends the need for NSE-listed firms to consider more age and gender diversity while limiting the number of independent board members when constituting boards to improve the quality of financial reports and avert possible collapse.*

Keywords: Board Diversity, Financial Reporting Quality, Nairobi Securities Exchange Listed Companies.

Introduction

The involvement of corporations like Enron, Worldcom, Marconi, Parmalat, and others in accounting frauds has eroded investors' trust in financial reporting integrity. To avoid financial disclosure failure, strong governance frameworks must be established to reinforce manager control and improve the quality of financial reporting (Akeju & Babatunde, 2017). The regulatory response to financial scandals has been to take measures to protect information transparency, mitigate conflicts of interest and ensure the independence of auditors, in order to protect the investors' interests and increase the confidence in capital markets (Leuz, Nanda & Wysocki, 2003). A weak corporate governance structure may provide an opportunity for managers to engage in behavior that would eventually result in a lower quality of financial

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reports, which is a strong indication of a serious decay in business ethics (Jesus & Emma, 2013). To enhance corporate governance structure, authorities push for board diversity to promote quality of financial reports. This is based on the assumption that varied groups are more likely to self-regulate. Board diversity gives boards access to a wider range of talents, perspectives, and experiences, which improves board's ability to oversee financial reporting and overall company management (Firoozi, Magnan & Fortin, 2016).

Board diversity research has been guided by a variety of theoretical perspectives from four domains law, economics, psychology, and sociology. While rules and regulations dictate board functions, agency theory suggests that board oversight of management increases the quality of financial data and reporting systems (Bedard & Gendron, 2010). The expertise paradigm, a psychological view, and upper echelons theory, have confirmed the link between board diversity and financial reporting quality (Hambrick & Mason, 1984). According to Carter, D'Souza, Simkins, and Simpson (2010), the board of directors uses their wide and diverse sets of skills and abilities to improve the company's performance including financial reporting quality. Consistent with the upper echelon's theory, company outcomes replicate its board and senior administration attributes (Finkelstein, Hambrick, & Cannella, 2008; Hambrick & Mason, 1984; Ge & McVay, 2005). Board's experience, expertise, and skills have influenced the quality of corporate financial records (Kent, Davidson, & Goodwin-Stewart, 2005). Bianco, Ciavarella, and Signoretti (2011) claim board diversity improves the firms' Financial Reporting Quality (FRQ) as evidenced by resource dependency theory. Resource dependency theory is centered on the roles of the board in providing access to resources for the organization. As resource providers, their characteristics tend to be of paramount importance (Abdullah & Valentine, 2009; Ezelibe, Nwosu, & Orazulike, 2017). Some of their features are size, independence, gender, age, nationality, and so on. These features of the board are assumed to improve the quality of financial reports in an organization, which will, in turn, improve the confidence of the stakeholders of the organization.

The composition of the board in terms of age, education, gender, ethnicity, experience, lifestyle, culture, nationality, religion, and other characteristics that distinguish people is referred to as board diversity (Jhunjhunwala & Mishra, 2012). Boards of directors are responsible for the governance of their companies and are frequently credited with four primary responsibilities monitoring and managing management; providing information and advice to managers; monitoring compliance with applicable laws and regulations; and connecting the organization to the external environment (Mallin 2004; Monks & Minow

2004). The responsibility of the shareholders in governance is to appoint the directors and auditors, as well as to ensure that a suitable governance framework is in place (Cadbury Committee, 1992).

Board diversity is important for improving corporate governance procedures in a firm because diversity in the boardroom stimulates better decision-making and innovation (Wang, 2015). Gender, age, educational and functional background, industry experience or exposure, and nationality are all characteristics of a diverse board (Wang, 2015). According to Sirnidhi, Gul, and Tsai (2011), the best board is a combination of people with varied talents, experience, and information power who are willing to contribute their time professionally. It is worth noting that the expense of a diversified board is fairly significant, since this may restrict the organization's performance (Wang, 2015), and may also impair the quality of its financial reporting.

The FRQ has remained a prominent concern among practitioners, regulators, and other users of financial information as it is the primary means of conveying financial performance to stakeholders. However, researchers, practitioners, and regulators are not in agreement on a precise definition of FRQ (Pomeroy & Thomton, 2008). Martinez-Ferrero (2014) defines FRQ as the faithfulness of the information as reflected in the financial reporting process. The International Accounting Standards Board (IASB) (2008) in its conceptual framework defines FRQ as that which meets the objectives and qualitative characteristics of financial reporting.

Financial reports' accuracy in conveying information about the company's business in compliance with accounting standards, or even to the extent that accurately presented financial statements reflect the reporting company's core operations and financial position, is called the quality of financial reporting (Biddle, Hillary & Verdi, 2009; Nasser & Nuseibeh, 2003; Robinson & Munter, 2004).

The International Financial Reporting Standards (IFRS) compliance, earnings persistence, quality of disclosure, audit fees charged, auditor type, earnings management, qualitative characteristics, timeliness, and value relevance have all been used to evaluate the quality of financial reporting. Though accrual-based measures use only financial information that excludes non-financial details (Biddle et al., 2009; Van Tendeloo & Vanstraelen, 2005), the studies reviewed mainly applied accrual-based measures resulting in

inconclusive findings. The current paper applied IFRS Disclosure (IFRSD), qualitative characteristics, and auditor type to validate FRQ findings in NSE-listed firms.

The NSE was established in 1954 as Kenya's sole primary stock exchange, providing an online platform for the listing and trading of various securities. Based on the nature of their activities and operations, the firms listed at NSE are divided into distinct sectors including agricultural, commercial and services, banking, insurance, investment and manufacturing, construction, and allied sector among others. The NSE is governed by the Capital Markets Authority (CMA) and is authorized to manage the affairs of its associated firms. As of January 31, 2014, NSE had 66 listed companies, and a listed firm’s securities may be suspended or delisted according to NSE listing rules 2014 if the rules and procedures are not followed. The use of NSE is justified because it serves as the country's economic barometer and adheres to minimal corporate governance rules (CMA, 2015; NSE, 2016).

Research Problem

Financial statements are important tools that users need to make sound economic decisions. As a result, it is crucial that the information provided is double-checked and is meaningfully efficient, realistic, and reliable. Nonetheless, regulators, investors, market participants, and academics have expressed concerns about the quality of corporate financial reporting following the failures of companies such as WorldCom and Enron in the United States; Parmalat in Italy; Lernout and Hauspie in Belgium; and Cadbury, NAMPAK, and Afribank in Nigeria (Adeyemi, Okpala & Dabor, 2012). The collapse of Eurobank in 2004 and the discovery of hidden offshore bank accounts used by some directors to steal company funds at The Cooper Motor Corporation (CMC), as well as the manipulation of books of accounts at Uchumi Supermarkets, are just a few examples of corporate scandals in Kenya (Iraya, Mwangi, & Muchoki, 2015; Herbling, 2016). As a result, some have questioned the board's ability to oversee financial reporting and overall company management.

According to Ogoye (2002), incompetence, fraud, and abuse of office by agents controlling the corporations have resulted in an increasing number of corporate failures and financial crises. As a result, authorities have consistently spelled out principles and regulations to ensure that corporations have prudential management. In reaction to scandals, authorities push for board diversity to promote board oversight over financial reporting and management control. This is founded on the premise that heterogeneous groups are likely to

self-check each other. A board ensures credible financial reporting by complying with IFRS, ensuring strict adherence to internal controls, minimizing fraud, and improving the quality of earnings reported (Xie, Davidson & DaDalt, 2003).

Several studies on board diversity and FRQ have been undertaken internationally including Srinidhi, Gul, and Tsui (2011) who found gender diversity to have a positive impact on FRQ, in Korea. Kim and Yang (2014) revealed a negative link between tenure of directors on FRQ as measured by the discretionary accruals and Oba (2014) documented that board tenure, board independence, gender diversity, and directors' shareholding were essential predictors of Nigeria's reputation in financial reporting. Locally, Ogoro and Simiyu (2015) investigated the efficacy of audit committees in reducing financial restatements in state corporations. From the findings, multiple directorship and tenure significantly reduced the number of financial statement restatements

Empirical studies have also concluded that various relationships exist between board diversity and FRQ. Makhlouf, Al-Surf, and Almubaideen (2018), Ho, Li, Tam, and Zhang (2015), Klai and Omori (2011), Barua, Davidson, Rama, and Thiruvadi (2010), and Yunos (2011) all found significant influence among board diversity and FRQ. A significant and negative link among board diversity and FRQ was identified in other research (Labelle, Gargouri, & Francoeur, 2010; Dobbin & Jung, 2010). However, according to another line of research, board diversity has nothing to do with the quality of financial reporting (Firoozi, Magnan, & Fortin, 2016; Muhammad, Ayoib & Noor, 2016).

The inconclusiveness of research on diversity and corporate financial reporting quality is due to methodology adopted, country's economic environment, type of companies, and diversity measures adopted (Rhode & Packel, 2014). Previous research looked into certain specific board elements that could improve FRQ. This paper examined the influence of various board diversity features on multiple sectors of the economy to determine both their overall and individual impact on FRQ. As a result, this paper aims to fill in the gaps by addressing the following research question: how is the relationship between board diversity and FRQ of NSE-listed firms in Kenya?

In order to answer the aforementioned research question, the paper employed the following null hypothesis:

H_0: The relationship between board diversity and FRQ of NSE-listed firms is not significant.

Literature Review

Different theories have been applied to corporate board diversity, including agency theory (Jensen & Mackling, 1976), stakeholder theory (Freeman, 1984), upper echelons theory (Hambrick & Mason, 1984), and resource dependency theory (Pfeffer and Salancik, 1978). The Resource dependency theory was used in this paper to explain the association between board diversity and FRQ of listed firms at NSE. The theory focuses on the board's function in providing the organization with access to resources such as information and expertise through linkages to external organizations theory (Pfeffer & Salancik, 1978). Board of directors' traits tend to be of paramount importance as resource suppliers (Abdullah & Valentine, 2009; Ezelibe et al., 2017). Size, independence, expertise, gender, nationality, and age are just a few of their attributes. These board attributes are thought to improve the quality of financial reports in a company, which will, in turn, improve the stakeholders' trust in the organization.

The research conducted by Firoozi et al. (2016) explored how Canadian companies' consistency of financial reporting related to two dimensions of board diversity (gender and geography). Between 2008 to 2012, the study comprised Canadian companies in Compustat. The study used descriptive and inferential statistics (multivariate analysis). From their results, the consistency of financial reporting, as calculated by the number of abnormal accruals and re-statements, was lower for companies with geographically dispersed independent directors than for companies with less geographically representative boards.

Wahid (2018) conducted an empirical study to explore the effect of gender diversity on financial misconduct using financial manipulation as evidence. The author used a simple linear regression model to establish the hypothesized relationship. Firms with gender-diverse boards reported less financial misconduct and fraud from the findings.

This paper adopted the conceptual framework as shown in Figure 1 below and the independent variable was board diversity whereas the dependent variable was FRQ.

Figure 1 Conceptual Model

Research Methodology

The paper was driven by the positivist research philosophy and a deductive research approach using a multi-method quantitative research design. Descriptive and inferential statistics were employed to summarize the data and to draw inferences from the population studied. The paper employed fixed effects regression model in testing the hypothesis stated. Although there are 64 currently quoted companies at NSE, the target population consisted of the 61 companies that had continuously and actively traded at NSE between January 2014 and December 2018. The paper adopted a census study approach due to the small population.

The paper used secondary quantitative data to analyze the relationship between board diversity and FRQ. The secondary data was sourced from NSE-listed firms' annual reports, financial statements, pamphlets, CMA, and NSE websites. The data for each study variable was collected using data capture forms and the data covered 2014 to 2018. The data was collected included the total number of directors, age, the composition of female directors, independent directors, foreign directors, directors with finance expertise, and IFRS disclosure while financial data included total assets and net revenue.

Results and Discussions

The objective of this paper was to examine the relationship between board diversity and FRQ of NSE-listed firms in Kenya. The data were obtained from the published audited financial statements and annual reports of the respective NSE-listed firms from 2014 to 2018. The data collected was analyzed using panel regression analysis to test the influence of board diversity indicators and FRQ of NSE-listed companies. The regression results were interpreted based on the Pearson correlation, R-squared, and p-values. Linear regression equation was modeled as $FRQ = \beta_0 + \beta_1 BQ_{it} + \beta_2 Age_{it} + \beta_3 BG_{it} + \beta_4 IND_{it} + \beta_{5F} FBM_{it} + \varepsilon_{it}$ where

FRQ was Financial Reporting Quality (computed as a composite index of IFRSD, qualitative characteristics, and auditor type), whereas board diversity indicators included BQ as qualification of the board members; age as average age of board members; BG as gender of board members; BIND as board independence; and FBM as nationality of board members (foreign board members).

The research employed descriptive statistics comprising of mean, median, standard deviation, minimum and maximum to analyze and summarize the study variables. The data covered 61 NSE-listed companies from 2014 to 2018. Table 1 below shows the descriptive statistics.

Table 1: Descriptive Statistics for Board Diversity Indicators

Board Diversity	Sample Size	Minimum	Maximum	Mean	Standard Deviation	Coefficient of Variation	Skewness	Kurtosis
Age	305	45.92	74.00	59.44	4.39	0.07	.07	3.63
BQ	305	.10	.92	.53	.15	0.29	.15	2.92
BG	305	.00	.71	.23	.15	0.62	.62	3.56
BIND	305	.11	.93	.58	.18	0.31	-.16	2.60
FBM	305	.00	1.00	.32	.20	0.65	.69	3.21

From Table 1 above, average age of board members was about 59 years, indicating that the majority of board members were between the ages of 59 and 74, with a minimum and maximum age of 46 and 74 years, respectively, spread of 4 years, skewed to the right (skewness = 0.07) and was peaked (kurtosis = 3.63). On average, 53 percent of board members held a higher degree, such as a master's or doctorate in accounting/finance or a Certified Public Accountant (CPA) certificate, with a lowest and highest of 10 and 92 percent, correspondingly, and a standard deviation of 15 percent. Dataset for board qualification was skewed to the right (skewness = 0.15) and was peaked (kurtosis = 2.92).

On gender diversity, the results indicated that most of the boards had at least 23 percent representation made of women on average, implying that the majority are men. However, it was established that certain companies did not have any female representation throughout the period. This meant that most firms had not adhered to the two-third gender rule required by the Kenyan constitution. Similarly, the findings indicated that independent directors were 58 percent on average, with a minimum and maximum of 11 and

93 percent, respectively, and a standard deviation of 18 percent. Board independence data was negatively skewed (- 0.16) and was peaked as indicated by a kurtosis of 2.60.

The last board diversity indicator was foreign board members with 32 percent representation on average. Foreign board members represented 100 percent in some firms, forming the maximum number of board members in those firms. The FBM data had a standard deviation of 20 percent and was skewed to the right (skewness = 0.69) and was peaked (kurtosis = 3.21). Like gender diversity, some firms did not have any foreign board members, which meant that they were solely owned by Kenya nationals. Regarding the riskiness of board diversity indicators, FBM was the riskiest (coefficient of variation = 0.65), and least risky indicator was age (coefficient of variation = 0.07).

The strength of the association between FRQ and board diversity (age, foreign board membership, board qualification, board independence, and board gender was determined using Pearson product-moment correlation. The FRQ and board qualifications as well as foreign board members had a statistically significant positive connection (r = 0.117, p-value < 0.05 and r = 0.104, p-value < 0.05, respectively), as shown in Table 2 below. This means that both board qualifications and foreign board members improve FRQ of Kenya's NSE-listed companies. According to the research results, the other board diversity indicators were not significant.

Table 2 Correlations Between Board Diversity and Financial Reporting Quality

Variables	FRQ	Age	BQ	BG	BIND	FBM
FRQ	1					
Age	.080	1				
BQ	.117*	-.026	1			
BG	.111	-.076	.354**	1		
BIND	-.028	-.084	.410**	.160**	1	
FBM	0.104*	.195**	.260**	.260**	.221**	1

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

The paper's goal was to look into the relationship between board diversity and FRQ of Kenyan NSE-listed companies. Board diversity indicators comprised of gender diversity, age, educational level, board independence, and board nationality, while FRQ was computed as a composite index of IFRSD, qualitative

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characteristics, and auditor type. The data for the indicators came from each company's publicly available audited financial statements and annual reports. However, before testing the hypothesis that board diversity had no significant influence on FRQ of Kenyan NSE-listed companies, the Hausman test was done to establish if fixed or random effects should be utilized, with the null hypothesis being that random effects should be preferred over fixed effects (Greene, 2008). The p-value for the Hausman test was less than 0.05, indicating that the fixed-effects model should be used.

The paper examined the effect of board diversity measured by Board Gender (BG), Average Age of Directors (Age), Board Nationality (FBM), Board Independence (BIND), and Board Qualifications (BQ) on FRQ of NSE-listed firms in Kenya. As Table 3 below shows that the explanatory power was low (R-squared = 0.110), implying that board diversity indicators accounted for 11 percent of the variance in FRQ (dependent variable), whereas 89 percent was explained by other variables.

Table 3: Fixed Effects (Within) Regression Results of Board Diversity and Financial Reporting Quality

Financial Reporting Quality	Coefficient	P-value
Age	0.855*	0.026
FBM	0.395	0.366
BQ	0.870	0.113
BG	1.241*	0.018
BIND	-1.692*	0.001
Constant	-2.076	0.477
Model Summary		
R-squared	0.110	
F(5,238)	5.86	
Prob > F	0.0000	
Observations	305	
Number of FIRM_ID	61	

The overall model was statistically significant since p-value (0.0000) was less than 0.05, hence the null hypothesis was rejected. The findings below show that the average age of directors (Age) had a statistically significant influence on FRQ (p-value = 0.026, which was less than 0.05) of Kenyan NSE-listed companies (see Table 3 below). Similarly, board gender (BG) was significant (p-value = 0.018) as well as BIND (p-value = 0.001) and thus had a significant influence on FRQ. At the same time, board nationality and board qualifications were insignificant predictors of FRQ. The predictive equation was, therefore, FRQ_{it} =

0.855Age + 1.141BG – 1.692BIND. This meant that board independence was the single most important predictor variable followed by board gender and the age of directors, in that order. In other words, if board independence was enhanced, financial reporting quality, would, on average go down by 1.692 points. Similarly, if there was a marginal increase in gender balance, and age, financial reporting quality would, on average go up by 1.141 and 0.855 units, respectively.

The objective of this paper was to investigate the impact of board diversity on FRQ of firms listed at NSE in Kenya and proxies were used to measure the independent variable (board diversity- gender, age, independence, educational level, and nationality) and the dependent variable (FRQ proxied by IFRS disclosure, qualitative characteristics, and auditor type). A preliminary analysis which included descriptive statistics and correlational analysis was done. The paper employed panel regression analysis to test the hypothesis stated. From the paper analysis, the overall model was statistically significant, which implied that board diversity predicts FRQ. This further indicates that by selecting directors with diverse backgrounds and different characteristics, a firm is able to benefit from better access to different resources and therefore should have stronger firm performance including FRQ (Hillman, Cannella, & Paetzold, 2000). These findings are consistent with those of other studies that have investigated the relationship between board diversity and FRQ, including Klai and Omori (2011); Barua et al. (2010); Ho et al. (2015); Makhlouf et al. (2018); Pulungan and Sadat (2014); and Yunos (2011) who found that board diversity significantly correlates with FRQ. Nevertheless, according to another line of research, board diversity has no impact on FRQ (Firoozi, Magnan, & Fortin, 2016; Muhammad, Ayoib & Noor, 2016).

Conclusion and Recommendations

This paper's objective was to look at the association between board diversity and FRQ of Kenyan NSE-listed companies. According to the findings, the null hypothesis was rejected, implying that age, board gender, and board independence were the three factors that significantly influence FRQ of NSE-listed firms, that is, increased board age and gender would result in better financial reporting quality, whereas increased board independence would result in a less financial reporting quality. However, the explanatory power was low implying that other variables explained the changes in financial reporting quality.

From the findings, the paper recommends the need for effective corporate governance practices in terms of board diversity of listed companies in Kenya to contribute to quality financial reporting and hence

consequently avert the possible collapse of the listed organizations in Kenya.

Researchers in the accounting profession have looked for means of improving and restoring lost confidence in the profession due to large corporate scandals. Various recommendations have been made on how to improve the quality of financial reports including application of corporate governance mechanisms, ethical compliance, and even religion. Additionally, this paper based on its findings, recommends independent directors in the boardroom should be reduced so as to reduce management costs; regulatory authorities should look into the ratio of males to females in the boardroom since gender diversity in the boardroom could affect FRQ in the long run;and accountants with professional and educational qualifications should still go for further rigorous accounting training in other emerging areas in accounting, such as forensic accounting, human resource accounting, sustainability accounting, and integrated reporting.

The findings would be very useful to financial reporting regulators, for instance, the Institute of Certified Public Accountants in Kenya (ICPAK), in their supervisory efforts to ensure proper disclosures in yearly audited financial reports. Financial reporting measures may be included in the Auditor General's audit goals. The Auditor-General may make value-adding suggestions to strengthen FRQ in Kenyan organizations.

The current paper is subject to some limitations, for instance, the paper did not consider unlisted firms. Thus, any generalization of the results of this paper cannot be made without that caution. However, to improve on this paper, future research needs to be conducted to include both listed and unlisted firms for effective generalization. Also, future research may need to include the period before 2014 and after 2018 to ascertain the long-run influence of board diversity indicators on FRQ.

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