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The Impact of Racial Diversity of Executive Managers on Financial Performance of South African State-Owned Companies

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Abstract: Globally, companies are increasingly embracing both gender and racial diversity and are beginning to witness the impact of this diversity on performance. Several studies suggest that with increased diversity, companies can gain access to unique networks, information and human capital, which ultimately improves financial performance. In this paper, we investigate whether racial diversity at executive management level bears financial benefits. The study is set in the South African context where, since the advent of democracy in 1994, regulations such as the Employment Equity Act of 1998 require companies to racially diversify their workforce. This study examines data from 21 state-owned companies (SOCs), covering the period of 2010 to 2014. Correlation and regression analysis was used to examine the relationship between the racial composition of executive managers (Black, White, Indian or Coloured) and the companies' financial performance (i.e. profit margin, return on assets and fruitless and wasteful expenditure as a percentage of revenue). The results indicate that there is slow progress made by the South African government on including non-whites in their executive management teams in SOCs. However, no correlation was found between the racial diversity of the management teams and the financial performance of these SOCs. These findings are significant, particularly for South African regulators and policy makers, as they provide justification for increased efforts to racially diversify the South African executive management teams in SOCs. This is important since numerous studies have demonstrated that such diversity is financially beneficial, particularly in the private sector.

Keywords: Financial performance, State-owned companies, Racial diversity, Workforce

1. Introduction

Over the past few decades, the number of women and ethnic minorities has increased in the boardrooms of companies around the world (Hillman, Cannella & Harris, 2002). The justification behind such increases has been to address gender and racial imbalances in the corporate environment. However, apart from simply rectifying inequalities in the boardroom, some companies have begun realising significant increases in workforce productivity and performance. A growing body of literature argues that a diverse workforce, that includes more women and racial minorities, drives economic growth (Burns, Barton & Kirby, 2012). It has also been suggested that with increased diversity, governance is also improved, leading to better financial performance (Carter, D'Souza, Simkins & Simpson, 2010).

Most studies examining the impact of board and management diversity have traditionally focused on developed countries (Shleifer & Vishny, 1997; Vafeas & Theodorou, 1998). It is only recently that a growing number of research publications have emerged on developing countries (see for instance Abidin, Kamal & Jusoff, 2009; Baek, Kang & Park, 2004; Haniffa & Hudaib, 2006). However, only a handful of studies have investigated this subject in the South African context (Ho & Williams, 2003; Mangena & Chamisa, 2008; Okeahalam, 2004).

Research on the impact of racial diversity is particularly important in a country such as South Africa, which has a long history of racial discrimination. Over the last twenty years, various policies and legislation have been introduced to rectify these inequalities, notably, the Employment Equity Act of 1998 (EEA) and the affirmative action (AA) programmes. These laws were implemented in order to drive transformation in South Africa's corporate environment (including SOCs) and redress the racial imbalances of the past. Consequently, the progress, as well as the impact of these anti-racism laws and policies, has drawn the interest of researchers.

According to Sebola (2009), AA policies simply focused on balancing corporate demographics, however, this often leads to the appointment of poorly qualified and incompetent employees. Such a problem stems from two perspectives, namely, political nepotism and the lack of suitable candidates from the designated groups. These two problems do not take into account the need for serving the public efficiently and effectively, particularly in the public sector. Bullard (2007:3) states that in principle, there is nothing wrong with AA policies and addressing past inequalities, but it is equally important for these programmes to serve the economic needs of the country and ensure the delivery of efficient public services. He moreover contends that AA programmes are an 'insult' to qualified black employees as it is sometimes perceived that black applicants are unable to compete as equals against white applicants. In this study, we focus on the impact of racial diversity (a component of affirmative action) on the financial performance of all major SOCs. The study examines the implementation of the EEA in SOCs in terms of racial diversity and seeks to determine whether racial diversity has affected the SOCs' financial performance. The article therefore seeks to establish whether there is a business case supporting racial diversity in SOCs.

The next section reviews literature on racial diversity in South Africa's corporate environment, the role and performance of SOCs as well as the link between the racial diversity of management and the financial performance of companies.

2. Literature Review

2.1 The Role of State-Owned Companies and their Performance

After the Second World War, many countries worldwide established SOCs. These enterprises were established in order to redress market failures created by the war and to provide essential services such as telecommunications, aviation, nuclear energy and electricity to the public. Since such services were too expensive to be deployed by the private sector, SOCs were established to deliver these services and yield both a financial and social return for the capital invested in them by the government (Heath & Norman, 2004).

According to the Organisation for Economic Co-operation and Development's (OECD) 2004 comparative report on the corporate governance of SOCs, some of the governments in OECD countries still own a majority of the businesses in essential sectors such as energy, transport and telecommunications. In developing countries, SOCs plays a much more important role as they are also expected to promote economic development and equity (Kaldor, 1980). Balassa (1993) specifies that the role of SOCs is to provide economic and social infrastructure, promote science and technology for development and ensure better distribution of wealth and opportunities for society.

In South Africa during the apartheid era, SOCs were given an economic development mandate. These entities assumed a dominant role in key infrastructure areas such as rail, air and sea transport, telecommunications, water, coal-based synthetic fuels and nuclear energy. The government also viewed these industries as being important for industrialisation, employment creation and economic development. Unfortunately, during this period, there was racial segregation and white South Africans were the only beneficiaries. Thus, post-apartheid, the stance of the South African democratic government was to transform these SOCs (Thabethe, 2010) by employing blacks, women and physically disadvantaged people. McGregor (2014) reveals that today in South Africa, SOCs play a crucial role in providing economic infrastructure. They serve the needs of capital-intensive industry, assist with sustainable job creation, promote Black Economic Empowerment and help governments to implement employment equity by eliminating previous apartheid discrimination practices.

The financial measurement and monitoring of these SOCs is therefore important. According to a 2004 OECD report on SOCs, these enterprises are required to publish their annual financial statements, which are subjected to examination and review by stakeholders. In South Africa, the Public Finance Management Act (PFMA) of 1999 was adopted to make financial management in the public sector more efficient. The Act was intended to reduce fraud, corruption and wasteful expenditure. The PFMA established clear lines of accountability and broad frameworks of best practice that managers were required to adopt. Any executive manager underspending or underperforming would be transgressing the Act and would be open to the specified sanctions. Transgressions include unauthorised, irregular, fruitless or wasteful expenditure. Fruitless or wasteful expenditure is expenditure made in vain, which could have been avoided had reasonable care been exercised.

Worldwide, the performance of most SOCs has been disappointing (Kim & Chung, 2007). Over the years, the majority of SOCs has lacked budgetary discipline and governments have found it financially strenuous to keep on injecting capital into these enterprises as there were other competing programmes that needed funding. During the 1980s, the financial burden of these SOCs in most countries had grown so onerous, that it contributed to increasing public deficits, rising interest rates and growing inflation (OECD, 2004). The poor performance of SOCs can be attributed to their structure and governance, which makes them susceptible to weak accountability by management. In the private sector, should an entity underperform, the shareholders withdraw from the business regardless of the social implications (Heath & Norman 2004). In the public sector, however, governments (who are the shareholders) constantly bail out SOCs when these face financial difficulties. Governments very rarely let an SOC become bankrupt. These regular bailouts lead to the management of SOCs not being as financially efficient as management in the private sector (Heath & Norman 2004).

In Ghana, SOCs have been criticised for being overstaffed and inefficient, which resulted in considerable strain on government finances and inflation (Odainkey & Simpson, 2013). South Africa has also had its share of criticism relating to the performance of SOCs. The majority of these SOCs are failing to deliver on a number of key objectives, namely, efficient public service delivery, failure to meet the transformation needs of society, lack of skills transfer and job creation and failure to play a catalyst role in broader industrial development and economic growth (Gumede, 2012).

In South Africa, the majority of SOCs are currently in serious financial distress (McGregor, 2014). McGregor (2014) points to a poor selection system of board of directors, constant turn-over of executive managers as well as inadequate structures and systems as some of the key reasons leading to the failure of these SOCs (McGregor, 2014). It is worth mentioning that these SOC corporate failures are happening following the adoption of EEA and AA programmes (i.e. post 1998).

2.2 Racial Diversity in the South African Corporate Environment

South Africa has had a long history of racial discrimination that was created by the apartheid regime. Following the advent of democracy in 1994, various pieces of legislation have been introduced to drive transformation in South African companies. In 1998, the EEA was adopted. This Act was intended to end racial, gender and ethnic discrimination in the workplace, giving birth to AA policies and programmes (Tladi, 2001). The main objective of the AA was to correct the misrepresentation of the overall demographics of the South African workplace. These programmes sought to ensure that companies gave preferential treatment to previously disadvantaged racial groups (i.e. Blacks, Indians and Coloureds) as well as women, who were also discriminated against during the apartheid era. The AA policies also required companies to develop the skills of these previously disadvantaged groups, and finally, to promote employment opportunities which were equal for all (Burger & Jafta, 2010; Tladi, 2001).

The 2014-2015 Commission for Employment Equity (Department of Labour, 2015) reported on the employment distribution of the various population groups in terms of their representation at the top management levels of organisations. The representation of white people decreased by 2.6%, dropping from 72.6% in 2012 to 70% in 2014. Black representation increased slightly by 1.3%, rising from 12.3% in 2012 to 13.6% in 2014. The representation of Coloureds remained the same at 4.7%, while the representation of Indians increased by 1.3%, rising from 7.3% in 2012 to 8.6% in 2014. Notwithstanding the fact that there is a steady but slow decline in the representation of whites, their dominance remains as they maintain more than a two-thirds majority in terms of representation at management level in organisations. This is of major concern since more than 80% of South Africans are black.

A 2005 study by von Holdt & Webster revealed that, in South Africa the old racial colour bar that was created by apartheid laws in the working environment remained unchanged. The authors further state that even in rare cases where black people occupy senior positions, they usually earn less, have fewer benefits and less responsibility compared to their white counterparts. Booysen & Nkomo (2006), Selby & Sutherland (2006) and Thomas (2004) support this statement, maintaining that increasingly, black applicants are required to have higher qualifications for jobs once done by less-qualified white people.

From the discussion above, it is evident that there could be barriers in South Africa's corporate environment that are hindering black employees from progressing in the workplace. Ngambi (2002) and Thomas (2004) identify organisational culture issues such as the exclusionary 'old white boys clubs' as creating barriers which make it challenging to retain black employees and women at management level.

Selby and Sutherland (2006) and Thomas (2004) state that even though South African anti-discrimination legislation is fundamental in addressing unfair workplace discrimination, legislation on its own is not sufficient. It is important to change organisational culture. These researchers are of the view that the implementation of the EEA needs to be supported by comprehensive employment practices that focus on human capital development and promote organisational culture change.

2.3 The Relationship Between Racial Diversity and Financial Performance

Advocates of diversity in corporate boardrooms usually base their arguments on agency, resource dependence and stakeholder theories (Goodstein, Gautam & Boeker, 1994; Carter, Simkins & Simpson, 2003). Firstly, agency theory suggests that both executives and non-executives from diverse backgrounds, rather than homogenous, elite groups with similar socio-economic backgrounds, increase board independence and improve executive monitoring (Van der Walt & Ingley, 2003). Secondly, a diverse board of directors carries with it diverse ideas, experience and business knowledge (Baranchuk & Dybvig, 2009). The diverse composition of boards also leads to increased creativity and innovation due to diversity in cognitive abilities, which can facilitate effective decision-making (Carter *et al.,* 2003). Thirdly, resource dependence theory suggests that companies which embrace diversity in their leadership are better able to attract critical resources, including skills, business contacts, prestige and legitimacy (Goodstein *et al.,* 1994). Fourthly, Rose (2007) argues that companies with a diverse leadership convey a positive signal to potential female and ethnic minorities that they are not excluded from the highest positions in these companies.

Drawing closer to home, Swartz & Firer (2005) investigated JSE listed companies and reported a statistically significant and positive association between the average number of blacks (i.e. Blacks, Indians and Coloureds) and financial performance. These results were consistent with those of Ntim (2013) who assessed 291 companies listed on the JSE over a five-year period and found a positive and statistically significant relationship between board diversity and the stock market valuation of the firm. Another South African study by Yortt (2009), which examined the top 40 listed companies, revealed that only 32.5% of the directors in the top 40 companies were Black, and only two of these companies employed at least 50% Black executive directors. She also found a positive correlation between ethnic diversity and company performance which was measured in terms of both return on assets (ROA) and return on equity (ROE).

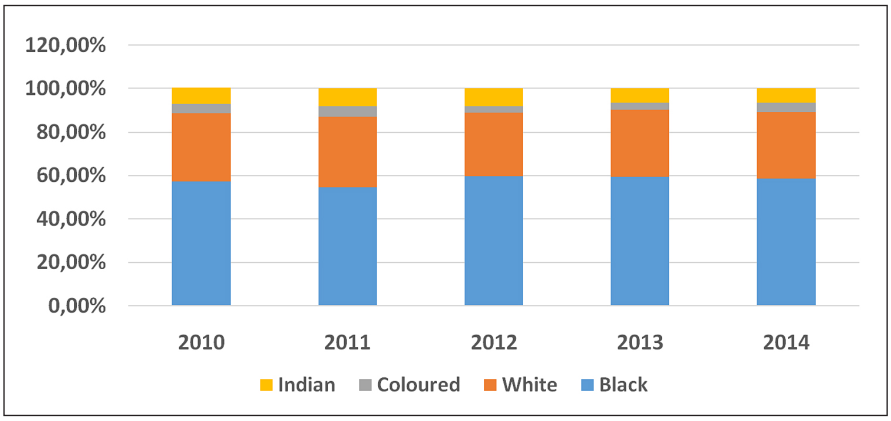
It is evident from the literature reviewed that there are financial benefits that come with the inclusion of Black members on the board of directors and in management positions. However, these studies have only tested JSE listed companies. The 1998 EEA, AA programmes as well as the introduction of the King Report (i.e. King Code of Corporate Governance reports) require companies (particularly JSE listed companies and SOCs) to set targets on the composition of executive and non-executive management in terms of their race and gender. These companies are also required to conduct regular reviews of these targets and to report on them in their annual financial statements. It is also worth noting that the majority of studies on the impact of race on performance have been conducted on JSE listed companies. The current study is unique as it focuses on SOCs and therefore brings additional empirical evidence on the topic of diversity and performance. Furthermore, the study provides insights on how government has implemented its own AA policies in SOCs and the impact of these on performance.

3. Methods and Materials

3.1 Data Collection Process

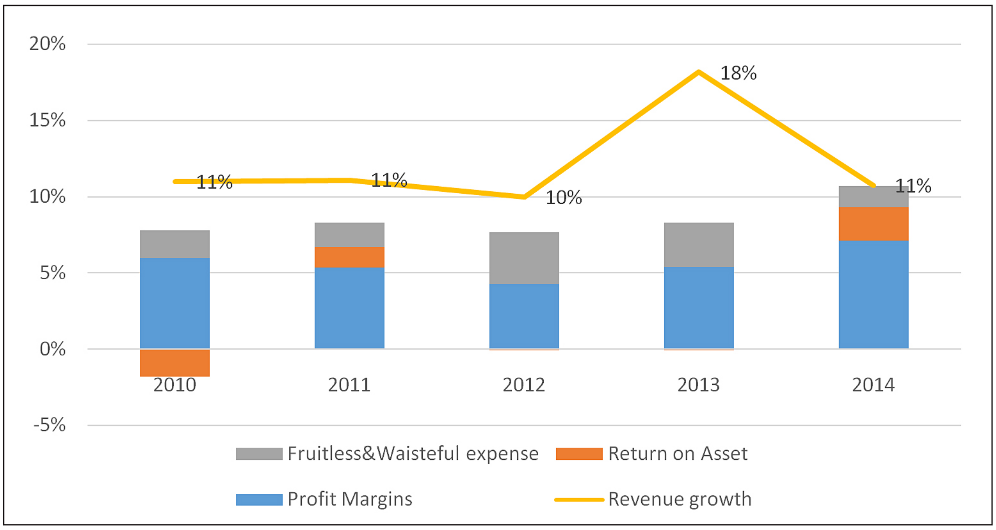
The PFMA requires all SOCs to publish their annual reports. These annual reports include both financial and non-financial information. In this study, all 21 entities that are classified as major public entities according to Schedule 2 of the PFMA were included in the population and sampled. Each entity's annual report was obtained from its website for the five-year review period (2010 to 2014). Calculations of the profit margin, ROA and fruitless and wasteful expenditure as a percentage of revenue were then derived from the financial statements. Information

Figure 1: Analysis of Racial Diversity of SOCs



Source: Author

Figure 2: Analysis of Financial Performance of SOCs



Source: Author

on the racial demographics of the executives was also extracted from the annual reports. In most cases, pictures of the executive management team were also included, which enhanced our investigation on the race of the executives.

Measures

It was important to identify and measure the two variables, namely, racial diversity and financial performance, and to establish the nature of the relationship between these two variables. The independent variable in the study was the race (i.e. Black, White, Indian and Coloured) of the executive management while the dependent variable was financial performance (i.e. profit margin, return on assets (ROA) and fruitless and wasteful expenditure). This study investigated whether the dependent variables (profit margin, ROA, etc.) changed when the management team was more racially diverse.

3.2 Data Analysis

In this study, SPSS was used to determine the association between the diversity of executives' management and the financial performance of the SOCs. First, the study conducted a descriptive analysis of the two variables (i.e. race and financial performance). The results from this descriptive analysis are displayed in graphical format (Figures 1 and 2 above), showing the percentage of Black, Indian, Coloured and White managers over the five-year review period. Figure 1 displays the gradual improvement made by government to racially transform SOCs over the review period. In addition, the same descriptive analysis was conducted on the financial performance measures. The results are displayed Figure 2 that shows how the financial performance of these entities had improved over the five-year period. Finally, correlation and regression analyses were conducted to demonstrate the specific effects of the independent variables (i.e. executives' race) on the dependent variables (i.e. profit margins, ROA etc.). This analysis revealed how the SOCs' financial performance tended to change or vary with changes in executive managers' racial composition.

4. Results and Discussion

The statistical results of this study demonstrate the racial diversity of executive managers in SOCs and how this racial diversity influences the companies' financial performance. Figures 1 and 2 illustrate the racial diversity and the financial performance on the SOCs over the review period, demonstrating the improvement or regression in racial diversity as well as in the financial performance. The figures are followed by Tables 1 to 3 which describe the correlation between racial diversity and financial performance.

4.1 Racial Diversity in SOCs

The statistics in Figure 1 indicate that the majority of executives in SOCs are non-white (approximately 69% in 2014). This translates to 58% Blacks, 7% Indians and 4% Coloureds. The statistics further indicate that there are approximately 31% White executives in these SOCs. The graph also demonstrates an insignificant growth in the racial demographics of the executive management teams over the five-year review period. However, it is worth mentioning that the racial diversity statistics in Figure 1 differ considerably from the current composition of South Africa's racial population. According to the 2014 mid-year statistical information reported by Statistics SA, South Africa's population had a representation of 80% Blacks, 8.8% Coloureds, 8.4% Whites and 2.8% Indians. Therefore, even though the majority of the executives in these SOCs are non-white, their representation is not consistent with the racial demographics of South Africa. The results suggest that the South African government, as the owner of the SOCs, has not effectively implemented the EEA and greater efforts still need to be made to racially transform these SOCs.

4.2 Financial Performance of SOCs

Similarly, a descriptive analysis was conducted on the financial performance of the SOCs. The results showed a total average 16.8% increase in revenue over the five-year review period. This increase stems from government's implementation of the New Economic Growth Plan (NDP Plan). During this period the South African government was investing funds into SOCs so they could implement the NDP plans. The implementation of the NDP plan resulted in an increase in profit margins as well as an increase in ROA. Also worth mentioning is that during this period, the ratio of fruitless and wasteful expenditure to revenue declined over the review period. This is an indication that during the review period, there was an increase in revenue and the fruitless and wasteful expenditures that was reported was at a minimal level.

4.3 The Relationship Between Racial Diversity and Financial Performance

Both correlation and regression analyses were performed to determine the relationship between the demographic makeup of executives and the financial performance of the SOC. The outcomes of these analyses are summarised in Tables 1 to 3.

The results indicate that all the racial groups had an insignificant relation to profit margin. The analysis between profit margin and Indians showed an insignificant relationship of -0.19. Based on these results it was concluded that the demographic composition of SOC executives had very little impact on profit margin.

Table 2 shows no significant correlation between ROA and SOC executives who are Black, Coloured or Indian. This correlation analysis was followed by a regression analysis. The regression analysis also indicated no correlation between ROA and all racial groups.

Table 3 shows a positive correlation of 0.247 between fruitless and wasteful expenditure and Coloured executives. However, additional analysis was performed and after the third iteration of the Cochrane-Orcutt estimation method, there was no correlation found between fruitless and wasteful expenditure and Coloured executives. When interpreting fruitless and wasteful expenditure as a percentage of revenue, one should bear in mind that during the period under review, revenue was on the increase (due to investments made towards the NDP), which therefore diminished this particular ratio. Furthermore, it should be noted that the sample size in this study is relatively small (21 companies), which may have had an impact on determining of the correlation.

Table 1: Pearson Correlations - Profit Margin vs Racial Demographic Variables

		Black	Coloured	Indian
Pearson Correlation	Profit Margin	-0.02	0.00	-0.19
Sig. (1-tailed)	Profit Margin	0.44	0.50	0.03
N	Profit margin	99.00	99.00	99.00

Source: Author

Table 2: Pearson Correlation - Return on Asset vs Demographic Variables

		Black	Coloured	Indian
Pearson Correlation	Return on Assets	-0.094	0.086	-0.084
Sig. (1-tailed)	Return on Assets	0.177	0.200	0.203
N	Return on Assets	99	99	99

Source: Author

Table 3: Pearson Correlation - Fruitless and Wasteful Expenditure vs Demographic Variables

		Black	Coloured	Indian
Pearson Correlation	Fruitless & Wasteful Expenditure	-0.133	0.247	0.056
Sig. (1-tailed)	Fruitless & Wasteful Expenditure	0.095	0.007	0.292
N	Fruitless & Wasteful Expenditure	99.00	99.00	99.00

Source: Author

Consequently, in most cases, the correlation and regression analyses showed an insignificant or no relationship at all.

The results of this study indicate that there has been limited racial transformation in SOCs at executive level. This is of concern, especially considering the fact that South Africa's government (who is the owner of these SOCs) implemented the EEA two decades ago. The correlation and regression analyses indicate that there is no significant relationship between the racial diversity of management and the financial performance of the SOCs. These results correspond with those of Zahra & Stanton (1988), who conducted a correlation analysis on a sample of American companies, examining the relationship between women and ethnic minorities and found no relationship between the percentage of females and ethnic minorities on the board of directors and ROA and profit margin.

5. Conclusion and Recommendations

The results from the study point to a clear need for more rigorous regulatory enforcement in the area of transformation such as a legislative quota similar to that applied in Sweden, where companies are obliged to have a certain percentage of women in their top corporate positions (Adams & Ferreira, 2009). In the South African context, quotas would be based on the inclusion of non-white employees. It is also important to mention that the South African government, as the author of the EEA, should take the lead when it comes to transformation. It should ensure that government-owned companies, namely, SOCs, fairly represent the racial demographics of the country. If the South African government were to lead by example, the private sector would follow in its transformation of the South African workplace. Transformation in South Africa is not only intended to correct the inequality of former apartheid laws; it has been proven that transformation in South African JSE listed companies can also be financially beneficial.

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