

# **Does Diversity in The Boardroom Add Value to a Firm?**

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*This study examines whether board diversity affects firm performance. We investigate this study using panel data of a sample of S&P 500 firms during a 12 year period. After controlling for industry, firm size, and other board composition variables, we find that all three board diversity variables of interest – gender, ethnicity, and age have a significant influence on firm performance. While ethnicity and age have a positive influence on firm performance, it was found that gender has a negative influence. Implications for future research are discussed.*

## **INTRODUCTION**

The progressive notion of adding diversity, gender and ethnic specifically, in most major corporate firms is undeniable, but the results of such integration remains unclear. Companies are seeking to hire a diversified boardroom cast for a plethora of reasons which include reputational advantages, diversity in thought, matching workforce and customer population, and of course to increase firm financial performance. Different organizations may have different motives for valuing diversity in the board but agency theory suggests that composition of a board can have a significant impact on firm performance. Of the several studies that focused on variables of board composition such as the effect of board independence, CEO duality, and board size on firm performance, only a few studies examined the role of diversified boards that can create value to the organizations. The idea of a diversified board is to take advantage of differences that come with individuals who can offer unique perspectives and add meaningful contributions to the issues an organization is facing in the form of inclusion. For example, theoretical arguments over an ethnically diverse board using their wide-ranging backgrounds and life experiences to positively influence idea generation continue to rage on with proponents supporting a changing culture within the corporate world and critics calling this an unjustifiable and often counterproductive measure.

Gender diversity on the board has been a particularly divisive issue as of late with frustration over the slow growth in women on major firms' boards. Women have earned over half of all bachelors and master's degrees in the United States (Catalyst, 2004), however, continue to be underrepresented in the

highest of executive positions. While some argue the integration will occur naturally as companies seek to employ the best possible candidate regardless of gender, ethnicity, or ideology, proponents of gender diversity claim firms should mindfully add a greater percentage of females to their boardrooms to not only to enhance firm performance but also to maintain ethical standards which by way of will keep a company's image positive and may ostensibly enhance performance.

This study examines gender, ethnicity, and age diversity in the board rooms and how they affected the financial performances of a sample of Standard and Poor's (S&P) 500 firms during 2001-2011. The results demonstrate that all three variables have a significant influence on firm performance. However, while ethnicity and age variables have a positive influence on performance, gender has a negative influence. The remainder of the paper is organized as follows. The next section provides literature review on the performance effects of gender and ethnicity. Section III explains the details of the data used and methodology applied to examine the relationships. Section IV describes the findings and analyses of the outcomes. The final section covers the conclusion and discussion.

## LITERATURE REVIEW

### Gender Diversity

Two major reasons in the literature over female inclusion in the board is the potential reputational advantages and financial performance. Reputational advantages stem from acts such as charitable causes. Some studies have suggested that women place increased attention on philanthropic and charitable causes which may increase the reputation of a firm (Stanwick, P. A., and Stanwick, S. D., 1998; Wang and Coffey, 1992; Williams, 2003). However, women often do not hold enough upper echelon decision making positions to have a say in changing a company's reputation, and since the signaling theory is derived from perception, women must be visible to the outside as having important roles in the boardroom for reputation to get a boost (Dalton et al., 2006; Kesner, 1988; Peterson and Philpot, 2007; Zelechowski and Bilimoria, 2004). Financial implications of increased women on boards are still largely ambiguous as women tend to be minorities on them. Successful firms hire more women as they accelerate their growth rather than placing women on the board to pursue growth (Smith et al., 2006). This creates confounding data as this phenomenon places the firm's success as the dependent variable and women on the board as the independent variable. Catalyst (2006) reported that approximately 15% of board size was occupied by women in the fortune 500 firms during 2005. However, only 76 firms had reported that they has three or more female directors on their board indicating that not all boards have a greater degree of gender diversity. The following studies clearly identify that the relationship between gender diversity and firm performance has been mixed.

A study by Siciliano (1996), one of the earlier studies on gender diversity, examined 240 YMCA organizations and found that gender diversity has a positive influence on social performance and a negative influence on the funds raised by the organizations. Shrader (1997) used data on women in management and board of directors published in the Wall Street Journal on 200 largest U.S. firms and found that higher percentage of women board members results in decreased firm performance. The results were the same for all financial indicators including return on sales, return on equity, return on investment, and return on assets. However, study conducted on 127 large U.S. companies by Erhardt et al. (2003) demonstrated that diversity in the board resulted in a positive return of assets and return on investments. Carter et al. (2003) examined 1997 data on 638 US Fortune 1000 firms to analyze the potential impact of more women on the board using financial indicators return on assets and Tobin's Q. The study found no conclusive evidence regarding return on investment, however, a positive link with the Tobin's Q was established.

Miller and Triana (2009) investigated mediator variables that could affect firm performance based on a set of US fortune 500 companies. The study identified that reputation and innovation partially mediates the relationship between the two variables. He and Huang (2011) analyzed US manufacturing firms between 2001 and 2007 using a gender diversity index (blau index) and found that the index has a negative influence on Return on Assets (ROA). Adams and Ferreira (2009) also found a negative link

between women on the board and ROA and Tobin's Q when analyzing nearly 2000 US firms. Boulouta (2013) studied S&P500 companies over a 5 year time period, 1999-2003, to analyze the relationship between boardroom gender diversity and corporate social performance. She finds that there is positive correlation between women on the board and the corporate social responsibility and the subsequent performance of the firm. Some studies have been done on the topic of gender diversity across the world as well. For example, Joecks et al. (2013) studied 151 German firms from 2000 to 2005 analyzing the impact of added women in the boardroom in terms of financial performance. The study finds that financial performance of firms significantly increase when there are three or more female board of directors compared to just one or two. However some other studies found completely opposite outcomes. For example a study by Bohren and Strom (2010) examined firms listed on Oslo stock exchange over a 14 year period and found that firm performance decreases by 3.5% for every one unit increase of gender diversity standard deviation. In summary, previous studies have been inconclusive in their findings of the effect of gender diversity on firm performance. However, majority of the studies found that boards have a low representation of women on the boards. As the role of women continues to grow and possible extremities such as social ostracization become less of a factor we may get a better gauge of the true impact of a more balanced board.

### **Ethnic Diversity**

By mirroring the makeup of the board to the company's workforce as a whole, firms enjoy a perceptual advantage (Certo, 2003; Pfeffer and Salancik, 1978). This credibility stemming from a more racially diverse board benefits the firm's reputation. Diversity in background aids in innovation by avoiding a phenomenon known as groupthink which hinders progress as a result of similar minded being in accordance without critical independent thinking (Cox, 1993). With globalization unifying cultures and connecting people from all paths, businesses find it necessary to diversify largely due to the outside environment derived from the customers of their particular company (Brammer et al., 2007). However, the variety in ideas often do not lead to superior performance, but there are stipulations likely preventing progress. For example, minorities who are placed through "tokenism" feel isolated causing their performance to decline which can be attributed to the fact they are placed on the board for inclusion purposes, and they feel obligated to be in cohesion with the majority of the board only to lower their performance as a result of their social ostracization (Kanter, 1977). Additionally, an ingroup bias (Gilbert et al., 1998) to lead people in power to either consciously or subconsciously prefer people with similar qualities making diversification a difficult process. Relative power of the board member is correlated to decision making opportunities. It is to be noted that an overwhelming percentage of minorities in boardroom position are in lower positions, and it is argued that due to social impact theory (where a person in higher power disproportionately influences decisions) it is difficult for minorities to really use their diverse backgrounds to deliver different viewpoints (Westphal and Milton, 2000) as a result of lower power.

Miller and Triana (2009) analyzed fortune 500 companies from 2002 to 2005 and found racial diversity is positively related to innovation and reputation of firms. Their study suggest that innovation and reputation mediates the relationship between racial diversity and firm performance. Hafsi and Turgut (2013) studied a sample of S&P500 firms to analyze the impact of board diversity on corporate social performance but found no relation between the variables. The study by Rhode and Packel (2014) does not yield any conclusive evidence either between ethnic diversity and firm performance. Carter et al. (2010) studied firms listed in the S&P500 from 1998 to 2002 and concluded that the inclusion of women and minority directors do no correlate to financial indicator, return on assets. Bantel (1993) assessed the impact of cultural diversity in the boardroom and found positive results in broad decision making derived tasks. Maznevski (1994) noted the importance of inclusion and proper conversation with the ethnically diverse groups and found improved performance. Similar to gender diversity, the results have been mixed when the relationship was analyzed between ethnicity and firm performance.

Ethnic diversity is rapidly being incorporated into the American executive boards as immigrants are making up a larger percent of founders and CEO's of S&P 500 firms, and the data is backing their

inclusion. While studies are not unanimous in their positive view of racial diversity, the majority are. Demographic diversity fosters independent thinking and avoids groupthink which is important to companies in idea delivery. Additionally, ethnic diversity often enables firms to reach a wider audience and align their practices closer to the customer population. Board members from different ethnic backgrounds have proven to be advantageous for firms in their pursuit of improved financial performance.

### **Age Diversity**

Although not very commonly studied, age diversity has become an interesting topic when discussing the relationship between board diversity and firm performance. While older directors may bring in a lot of experience to the table, it is argued that younger directors may bring in distinctive and innovative ideas. One of the seminal pieces of work related to age diversity by Vance (1983) suggests that age of board of directors does positively affect firm performance.

To summarize, literature lists improving firm value as the primary motivating factor to appoint female directors, directors from different ethnicities, and directors with experience. An advantage to this is that boards are able to receive diversified information which will not only enhance monitoring role but also make innovative decisions that can increase firm value. Based on the existing research and for economic and reputational reasons, we expect that board diversity increases firm performance. Furthermore, in the last few years companies have begun to not only embrace diversity but are recognizing the value of inclusion. The idea of inclusion is to not only recruit board members with differences but also firms making efforts to embrace those differences. Since this data was more current than many other previous studies, companies may very well be reaping the benefits of board diversity.

*H1: Board gender diversity positively affects firm performance.*

*H2: Board ethnicity diversity positively affects firm performance.*

*H3: Average age of board positively affects firm performance.*

## **DATA AND METHODOLOGY**

The sample for the panel data analysis includes S&P 500 firms between 2000 and 2011. If the data for any of the variables used in the study was not available during a particular year then the firm was not included for that particular year. The final sample resulted in 2020 firm-year observations. Both the financial data and board composition data for the firms were obtained from Compustat, database.

### **Dependent Variables**

Similar to many other studies, the dependent variable used to assess firm performance is Tobin's Q, defined as ratio of market value to book value (Carter et al., 2003; Rose, 2007; Bohren and Strom, 2005; Campbell and Minguez-Vera, 2008). Although many studies use Tobin's Q as a proxy for firm performance, some other studies use either ROA (Erhardt et al., 2003; Randoy et al., 2006) or ROE (Shrader et al., 1997; Haslam et al., 2010; Boulouta, 2013) to measure firms financial performance. To test whether explanatory variables of interest have significant influence on firm performance, this study used all three proxies of dependent variable to evaluate the relationships for robustness. Also, the other main reason to look at both Tobin's Q and accounting ratios was that while accounting ratios offer financial performance in the past, Tobin's Q reflects expectations of future firm performance.

### **Independent Variables**

The independent variables examined in this study include three board diversity variables – gender, ethnicity, and age. Gender Diversity is a measure of number of female directors divided by total board

size. Demographic Diversity is measured by board of directors from ethnicities other than US to total board size. Age Diversity of the board is simple average age of all board of directors in a given year.

### **Control Variables**

We controlled for several other variables that could affect firm performance as suggested by prior research. In addition to using industry and firm size as control variables, we also included other board composition variables such as board size (Yermack, 1996; Adams and Ferreira, 2009; Farrell and Hersch, 2005), board independence (Ramdani and van Witteloostuijn, 2010; Baysinger and Butler, 1985), and CEO Duality (Finkelstein and D'Aveni, 1994; Iyengar and Zampelli, 2009).

Board size is measured by total number of members on the board

Board independence is a measure of total outside directors on the board divided by board size.

CEO Duality is a binary variable: 1 indicates that CEO is also chairman of the board; 0 otherwise.

### **RESULTS**

The descriptive statistics which includes means, standard deviations, and correlations are provided in Table 1 below. The correlation analysis was conducted to evaluate the relationships among variables. Data in this study consists of a panel of observations of firm performance in multiple industries. Based on the Wooldridge test for serial correlation in panel data (Druckker, 2003) and a likelihood-ratio test for heteroskedasticity, the analysis showed an existence of AR(1) autocorrelation and heteroskedasticity across the panels in each panel regression model. To account for heteroskedasticity and cross-sectional correlation across panels and autocorrelation within each panel (Certo and Semadeni, 2006), we used the feasible generalized least squares-based statistical procedure (Stata xtgl) with heteroskedastic and correlated error structure. Autocorrelation would result from the correlation between dependent variable (firm performance) values in the previous and current periods, or from inter-industry differences in performance due to varying industry characteristics. On the other hand, heteroskedasticity could result from unexplained variability in the dependent variable.

**TABLE 1**  
**DESCRIPTIVE STATISTICS AND PAIRWISE CORRELATION MATRIX**

	Mean	S.D.	1	2	3	4	5	6	7	8	9	10
Tobin's-Q	1.55	1.57	1.00									
Return on Assets	0.06	0.10	0.39	1.00								
Return on Equity	0.12	0.52	0.06	0.38	1.00							
Ln (Employees)	2.88	1.50	-0.14	0.09	0.09	1.00						
CEO Duality	0.77	0.42	0.02	0.06	0.04	0.19	1.00					
Board Independence	0.77	0.15	-0.17	0.01	0.01	0.04	0.02	1.00				
Board Size	10.71	2.59	-0.24	-0.08	0.03	0.37	0.12	0.01	1.00			
Age Diversity	60.35	3.53	-0.20	0.07	0.02	0.06	0.10	0.18	0.14	1.00		
Gender Diversity	0.14	0.10	-0.17	0.01	0.05	0.28	0.07	0.19	0.23	-0.01	1.00	
Ethnicity Diversity	0.07	0.12	0.01	0.01	0.02	-0.01	-0.01	0.01	0.01	-0.02	-0.01	1.00

**TABLE 2**  
**RESULTS OF PANEL GLS ESTIMATION FOR FIRM PERFORMANCE**

Independent Variable	Dependent Variable	
	TQ (Model 1)	ROA (Model 2)
Industry Dummies	Included	Included
Ln (Employees)	-0.0818*** (0.0195)	0.0136*** (0.0011)
CEO Duality	0.0628*** (0.0220)	0.0005 (0.0017)
Board Independence	-0.2441*** (0.0715)	0.0197*** (0.0051)
Board Size	0.0071 (0.0048)	0.0003 (0.0003)
Age Diversity	0.0071* (0.0038)	0.0007*** (0.0003)
Gender Diversity	-0.3976*** (0.1094)	-0.0261*** (0.0082)
Ethnicity Diversity	0.1324*** (0.0441)	0.0091** (0.0038)
Wald $\chi^2$	2895.61***	4159.71***
		ROE (Model 3)
		Included
		0.0347*** (0.0027)
		0.0129*** (0.0040)
		-0.0122 (0.0118)
		-0.0055*** (0.0010)
		0.0042*** (0.0006)
		0.0734*** (0.0203)
		0.0305* (0.0181)
		3620.24***

Note: N = 2020; \* p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

As stated earlier, while several studies used Tobin's Q as a proxy for firm performance, some others used ROE or ROA. For robustness, our study used three models of regression with each model using a different proxy for firm performance. While model 1 used Tobin's Q as the dependent variable, models 2 and 3 used ROA and ROE respectively. Regression results for all three models are provided in Table 2 above. All three models demonstrate that the three diversity variables examined – gender, ethnicity, and age have a significant effect on firm performance. Under model 1 results, the co-efficient for board gender diversity is -0.4 and is significant at 1%. Although regression results shows that gender variable has a significant effect on firm performance, co-efficient is negative indicating that boards that have gender diversity decreases firm performance. While model 2 also has a negative co-efficient, model 3 where ROE is the dependent variable shows a positive co-efficient. Hypothesis 1 is confirmed under model 3 but not under model 1 or 2. For ethnic diversity, all three models demonstrate that higher the ethnicity diversity on the board, greater the firm performance. Hypothesis 2 is thus confirmed. Similarly all three models confirm that greater the average age of directors on the board, greater the firm performance. The results confirm hypothesis 3 as well. Depending on the model, control variables are significant as well. Firm size measured by logarithm of assets is significant in all regression models.

## CONCLUSION

In this study, we contribute to the literature by examining a sample of S&P 500 firms to assess the relationship between board diversity and firm performance. The premise of our study stemmed from both prior research and attention that the topic has been receiving in the last decade or so. Our results demonstrate that three dimensions of board diversity – gender, ethnicity, and age have a highly significant influence on firm performance.

Although gender diversity was found to positively influence firm performance when ROE was used as a proxy, a negative relationship was found when Tobin's Q or ROA were used as proxies. One major explanation as why gender diversity has a negative influence on firm performance could be that the percentage of women that sit on the board is still a small percentage. For example, Mattis (2000) suggests that although women are being appointed to the board, the changes are small. The study by Joecks et al. (2013) demonstrates that gender diversity has a negative effect on firm performance when less than 30% of board size is represented by women but performance significantly increases thereafter. For the sample examined in this study, female ratio is still smaller with an average of 0.14 suggesting that firms are still not recruiting a lot of women on their boards. As suggested by Carter et al. (2003), while women directors may add fresh perspective to the board but if they are a minority, they may be marginalized which may not result in effective board monitoring. One other reason could be that due to high demand for women directors, they may have the luxury of choosing best firms. It is also very important to understand that in the last five to ten years, boards are not only aiming to recruit diversified board members but are also implementing strategies to make the boards more inclusive. The results may vary once firms start to embrace inclusiveness in their boards. The positive influence of ethnicity on firm performance clearly indicates that firms that have board members from other ethnicities are well possessed with understanding of the diverse atmosphere that companies are facing in this global competitive world. Similarly age has a positive effect on firm performance indicating that experienced board of directors add a lot of value with their inputs to the board.

One of the limitations of this study is sample size. The sample size could be expanded to include more firms and also include more recent data to improve our understanding. Further, the results may alter if the focus of the study is on boards that are greatly diversified. It would be also interesting to see how diversity affects firm performance in other countries as this has been a topic of interest across the globe.

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