Board Diversity and Firm Value

By Carl R. Chen and Jeffrey Zhang
Department of Economics & Finance, University of Dayton

It has been hotly debated on whether a diverse board is beneficial to the firm. Some argue that the benefits of a diverse board include better performance, reducing workplace discrimination, improving recruiting and retention, reflecting societal diversity expectations, access to resources and connections (financial and political), and "diversity leads to more innovation, more outside-the-box thinking and better governance; when directors are too alike, the thinking goes, they look at problem and solutions the same way". However, diversity is not without cost. *Wall Street Journal* reports examples of costs associated with diverse board which include "when directors are appointed because their views or backgrounds are different, they often are isolated and ignored," "the newcomers run the risk of being saddled with all sort of stereotypes," and "existing directors may unite in defensive reaction to the new members and become more entrenched in groupthink." The debate is not confined to the U.S. For example, U.K.'s Department for Business Innovation and Skills recently commissioned a report on board diversity. The report sets a voluntary quota to encourage FTSE 100 employers to boost the number of women on boards to 25% by 2015. The report argues that companies should make a push to diversify their boards because "corporate boards perform better when they include the best people who come from a range of perspectives and backgrounds."

Recently, SEC requires that all public companies disclose enhanced proxy statement which includes board diversity beginning February 28, 2010. As a result, for example, in its 2013 Proxy Statement, Google has the following statement: "When considering a potential non-incumbent candidate, the Nominating and Corporate Governance Committee will factor into its determination the following qualities, among others: integrity, professional reputation and strength of character, educational background, knowledge of our business, diversity of professional experience, ... Additionally, due to the global and complex nature of our business, our board of directors believes it is important to consider diversity of race, ethnicity, gender, age, education, cultural background, and professional experiences in evaluating board candidates, although our policy does not prescribe specific standards for diversity." The SEC regulation and the compliance of the companies thus make this research topic more interesting than ever.

To shed lights on this ongoing debate, we construct a board diversity index and analyze the relationship between board diversity and firm value. Our sample is the most comprehensive to date covering seven years of data (2001-2007) for a total of 179,399 director-firm-year observations. The board diversity index is constructed from six sub-indexes including demographic diversity, educational diversity, professional diversity, director experience diversity, managerial traits diversity, and cultural diversity. We show that firm performance measured by the industry-adjusted Tobin's Q increases in board diversity index. However, at higher level of diversity, the effect of board diversity on Q levels off suggesting that while some diversity is good for the firm, too much diversity does not help. Bulks of the positive effect, however, come from demographic diversity, educational diversity, and professional diversity. Surprisingly, board experience diversity negatively impacts firm value, while both managerial trait diversity and cultural diversity have no impact on firm value.