



## Gender and ethnic diversity on boards and corporate information environment



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### ABSTRACT

Prior studies argue that demographic diversity on a firm's board impacts its information environment, yet there is limited empirical evidence regarding the relation between board diversity and corporate opacity. We extend this line of research by examining whether gender and ethnic diversity of directors impacts corporate opacity. Using a Herfindahl Index based on directors' gender and ethnicities to measure board diversity, and an opacity index based on analyst following, analyst forecast error, bid–ask spread, and share turnover to measure corporate opacity, we find that board diversity is negatively associated with corporate opacity. Our results are robust to alternative measures of board diversity and the various tests we employ to address potential endogeneity concerns.

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### 1. Introduction

Diversity on boards has drawn a considerable amount of interest from academic researchers, business leaders, investors, and policymakers over the last two decades. Proponents of board reform worldwide have called for increasing the number of women directors on boards by arguing that gender diversity enhances board effectiveness (Higgs, 2003). Several European countries such as Norway, Spain, and Sweden have passed laws mandating firms to add more women directors on boards. In the U.S., regulators, shareholder advocacy groups, and large institutional investors also push for an increase in diversity on boards. For example, some of the largest institutional investors, such as CalPERS and TIAA-CREF, have included in their principles of corporate governance a policy statement that requires the composition of the board of directors to include diverse experiences, genders, races, and ages. Also, the Interfaith Center on Corporate Responsibility (ICCR) has sponsored a large number of shareholder proposals that would require major corporations to increase and report board diversity (Carter, Simkins, & Simpson, 2003). Additionally, effective 2010, SEC requires public companies to disclose whether or not they consider the issue of diversity in their director recruitment decisions.

Increased demand for director diversity has led researchers to examine its impact on boardroom behaviors. Specifically, existing literature finds that diverse boards have broader discussions, higher quality deliberations, and more effective communication (Huse & Solberg, 2006; Joy,

2008; McNerney-Lacombe, Billimoria, & Salipante, 2008). Anderson, Reeb, Upadhyay, and Zhao (2011) argue that diversity of directors brings a variety of skills and heuristics to the boardroom which improves the monitoring of management. Other studies have found that, diverse boards allocate more efforts to monitoring and are likely to hold CEOs accountable for poor stock price performance (Adams & Ferreira, 2009; Hillman, Shropshire, Albert, & Cannella, 2007).

In this study, we examine whether diversity impacts corporate information environment. Diversity could cause communication problems and divisiveness among directors, leading to poor interactions between the board and external stakeholders such as analysts, bankers, large investors, and regulators. Alternatively, higher quality of board deliberations and more effective communication associated with diverse boards could allow financial analysts to collect, develop, and disseminate more accurate information to investors. In addition, greater monitoring, oversight, and control of managers' actions and reports by diverse boards could effectively discourage managers from disclosing limited or distorted information.

To measure board diversity, we begin by constructing a Herfindahl Index based on directors' gender and ethnicities. Greater values of the Herfindahl Index indicate lower social diversity. Prior studies on board diversity focus mostly on gender diversity and use either an indicator variable for the presence of women directors or a ratio of women directors to board size (e.g. Adams & Ferreira, 2009; Carter et al., 2003). The Herfindahl Index provides a better measure of board diversity because it accounts for both gender and ethnic diversity instead of capturing the concentration of either attribute. For example, based on this index, a board with a greater proportion of ethnic or women directors is actually a less diverse group, however, the same board would be considered highly diverse if measured using only the proportion of ethnic or

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women directors. To make interpretation of the diversity measure more intuitive, we follow the literature on ethnic diversity (e.g., [Gijbbergs, Meer, & Dagevos, 2011](#)) and subtract the Herfindahl index from one to yield our primary measure of board diversity.

To examine the relationship between board diversity and corporate information environment, we develop an opacity index based on four individual proxies (analyst following, analyst forecast error, bid–ask spread, and share turnover) for corporate information environment and rank the relative opacity/transparency of each firm using this index ([Anderson, Duru, & Reeb, 2009](#)). The index provides a comprehensive measure of the corporation information environment by capturing three categories of corporate opacity: information quantity; information accuracy and precision; and information uncertainty and asymmetry among investors. Using this index, we find that after controlling for various firm characteristics board diversity is negatively associated with corporate opacity.

However, one needs to be cautious in interpreting these associations because of the potential endogeneity concerns arising out of omitted variables or causality issues. On the one hand, omitted unobservable variables could affect both the selection of women and ethnic minority directors and corporate information environment, leading to spurious correlations between board diversity and corporate opacity. On the other hand, the presence of women and ethnic minority directors on boards might not be a random event. For example, firms with certain characteristics may not be able to compete for women and ethnic minority directors, or these directors may be attracted to more transparent firms. We mitigate these endogeneity concerns in several ways. First, we include firm fixed effects in our estimation to address omitted variable problems caused by the omission of time-invariant firm characteristics. Second, we employ an instrumental variable (IV) approach to address potential endogeneity due to causality concerns. We use board connectedness of white male directors as an instrument for board diversity. Third, we account for possible selection bias using propensity score matching method and Heckman's selection model. We continue to find a negative association between board diversity and corporate opacity.

Our findings contribute to the existing literature in several ways. First, we show that it is not just the presence of outsiders on a board, but the variety of viewpoints in decision-making that is important. Prior studies (e.g., [Kim & Lim, 2010](#)) examine the impact of board diversity on firm performance without investigating the channels through which it impacts shareholder value. We examine one such channel, namely corporate information environment. By impacting a firm's information environment, board diversity allows shareholders to monitor managers more closely and, if necessary, to put more effective safeguards in place. Thus, this work is in line with recent studies that focus on the association between corporate governance structures and media through which external stakeholders evaluate a firm's operations.

Our study extends the findings of [Gul, Srinidhi, and Ng \(2011\)](#) who document a positive effect of gender diversity on the informativeness of stock prices. [Gul et al. \(2011\)](#) use a transformed idiosyncratic volatility measure for stock price informativeness, which has a correlation coefficient of  $-0.683$  with the opacity index in our study. We add to [Gul et al. \(2011\)](#) in several ways. For example, we expand the definition of board diversity by adding ethnicity of directors. Second, we also complement [Gul et al. \(2011\)](#) by examining how specialized consumers of firm-specific information perceive its quality. We find that board diversity not only impacts the quality of firm-specific information generated by managers but also impacts the information collection and dissemination process by important information intermediaries such as analysts.

The remainder of this paper is organized as follows. [Literature review and hypothesis development](#) section discusses the existing literature and develops a testable hypothesis. [Data and sample](#) section discusses the sample and reports univariate statistics. In [Multivariate results](#) section, we present results from the multivariate analysis and discuss the implications of the results. [Conclusion](#) section concludes.

## 2. Literature review and hypothesis development

A principle fiduciary duty of the board is to monitor a firm's management. Given the monitoring by the board, potentially entrenched CEOs like to have people they personally know and are comfortable with to serve on boards. Consistent with this notion, [Westphal and Milton \(2000\)](#) find that CEOs and board members prefer to recruit new directors who are demographically similar.

Studies on group behavior have shown that socially homogeneous groups have greater transparency among members as the communication barriers are low. Consistent with these findings, [Lang \(1986\)](#) demonstrates that ethnic and gender diversity impedes communication among group members. Therefore, a socially homogeneous board is more likely to have better communication among the directors, which could lead to greater transparency internally.

Nevertheless, socially homogeneous groups are more likely to have the problems associated with groupthink. As argued by [Kandel and Lazear \(1992\)](#), directors of socially homogeneous boards face peer pressure to conform to groupthink, which favors setting a lower monitoring norm because the benefits of a greater level of monitoring are to be shared by people outside that group. Also, such boards are less likely to be effective in communicating with a diverse set of external stakeholders such as bankers, regulators, analysts, and suppliers who could be as important as employees or shareholders ([Brickley & Zimmerman, 2010](#)).

[Upadhyay, Bhargava, and Faircloth \(in press\)](#), [Klein \(2002\)](#), [Carcello and Neal \(2000\)](#), and [Dechow, Sloan, and Sweeney \(1996\)](#) examine the importance of board monitoring as it relates to the information production process and they document an association between board structure and the quality of information. [Adams and Ferreira \(2009\)](#) find that diverse boards are effective monitors because gender diversity on boards reduces attendance problems of directors. [Anderson et al. \(2011\)](#) argue that director diversity could benefit firms by bringing multiple heuristics, greater problem-solving capabilities, and improved mutual monitoring among directors. If diversity on corporate boards improves monitoring effectiveness and establishes good communication with external stakeholders, one would expect a more credible and transparent corporate information environment to be associated with such boards. Thus, our hypothesis is:

**Hypothesis.** Social diversity on board is negatively associated with corporate opacity.

## 3. Data and sample

We collect data on S&P 1500 firms from the years 2000 through 2003. Utilities and financial firms are excluded because factors that determine these firms' capital and governance structures may be different. We restrict our sample to those firm years that have accounting data in Compustat industrial and segment files, equity-return data in CRSP, board characteristics data in IRRC databases, analyst coverage data in I/B/E/S, and bid–ask spread data in TAQ database. The above selection criteria yield a final sample of 961 firms with 3018 firm-year observations. We winsorize all continuous variables at the 1% and 99% levels to minimize the effect of outliers.

We use analyst coverage data to construct analyst following and analyst forecast error. We use CRSP files and Compustat data to construct share turnover and firm-specific control variables, respectively. We use board characteristics data to construct board size and board independence. Following prior studies ([Adams & Ferreira, 2009](#); [Anderson et al., 2011](#)), we draw data on director gender and ethnicity from IRRC. In approximately 30% of cases, the director ethnicity is not identified by IRRC. For those directors who do not have ethnicity classifications in IRRC, we hand collect the data from proxy statements and other sources such as LexisNexis, The Dun and Bradstreet Reference Book of Corporate Management, Who's Who in Finance

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