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Board diversity and corporate investment oversight☆

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ABSTRACT

Drawn from theories in group diversity and group performance, this study examines the association between board diversity, measured in both relation-oriented dimension (i.e., gender, race, and age) and task-oriented dimension (i.e., tenure and expertise), and board performance in corporate investment oversight. We assess suboptimal investment by measuring how much firms deviate from the expected level of capital expenditures, R &D expenses, and acquisition spending within their industry. Using a sample of 15,125 firm-year across 1898 firms from 1998 to 2014, we find that task-oriented diversity attributes, such as tenure and expertise, are negatively associated with suboptimal investment, suggesting that diverse boards in terms of firm specific experience and functional expertise are more effective in overseeing corporate investment activities than homogeneous boards. Our results shed light on the recent regulatory requirements on board diversity and recommend greater task-oriented diversity in corporate boardrooms.

1. Introduction

Research on corporate boards has studied board composition, such as the presence of independent directors serving on corporate boards, and suggested that independent directors enhance monitoring function. However, an important but mostly overlooked factor that affects a board's ability to perform its monitoring and advisory roles is the heterogeneity (diversity) of directors. In recent years, investors and regulators worldwide have called for a more diverse board composition. On December 16, 2009, the U.S. Securities and Exchange Commission (SEC) approved a set of rules requiring public companies to disclose in proxy statements whether and how they consider diversity in evaluating director candidates (Securities and Exchange Commission (SEC), 2009). Under these rules, companies are allowed to define diversity in ways they consider appropriate,[1] with some companies emphasize *functional* attributes, such as tenure and expertise, and others focus on *surface-level* attributes, such as race, gender and age.

While diversity has been widely recognized as a desirable board characteristic, research findings on the effects of board diversity on firm performance are inconclusive because of the differences in how diversity is measured and conceptualized.[2] Some researchers turned to examine the impact of board diversity on boards' advising and monitoring functions (e.g., Adams & Ferreira, 2002, 2009, Farrell & Hersch, 2005). However, most studies on board diversity have a narrow focus on single attribute, such as gender, race, or expertise and results from these studies are difficult to generalize without taking other dimensions of diversity into account (Rhode & Packel, 2010). In this study, we examine the impact of board diversity on board performance in overseeing corporate investment activities. Unlike other studies examining only one diversity attribute, we measure diversity in both relation-oriented dimension, which consists of “surface-level” differences such as gender, race, and age, and task-oriented dimension, which consists of “deep-level” or job-related differences such as tenure and expertise.

Corporate investment oversight provides an interesting setting to examine board performance and effectiveness. While firms have to take risky investments to run business, both over-investment (i.e., excessive risk taking) and under-investment (i.e., excessive risk avoidance) could damage firm value and endanger their survival. In the wake of the major financial crisis in the late 2000s, regulators and the investing public have broadened boards' role to include risk oversight (e.g.,

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[1] This is a marked contrast with the quotas implemented at the national level for women directors on public company boards in several European countries, including Norway, France, Italy, Spain, and the Netherlands. For example, since 2008 Norway has required public companies to include at least 40% of the minority gender on their boards by the year 2020, with noncompliance leading to delisting from the exchange and dissolution.

[2] See Carter, Simkins, and Simpson (2003), Adam and Ferreira (2009), Carter, D'Souza, Simkins, and Simpson (2010), Farrell and Hersch (2005), and Kim and Lim (2010).

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COSO, 2009). Board responsibilities for overseeing corporate risk taking activities, including corporate investments, come from state law fiduciary duties, federal law and regulations, stock exchange listing requirements, and general best practices (Brancato, Tonello, Hexter, & Newman, 2006; Lipton et al., 2011). In general, board responsibilities include reviewing the company's investment guideline, strategy, and performance, and overseeing the company's investment-related risks. Boards of large public companies could establish an investment committee or a finance committee to assist in performing these highly specialized and complex tasks.[3] Despite the increased significance of boards' role in investment oversight, corporate governance research has not provided much guidance on what board characteristics are associated with board performance in overseeing corporate investment.

Drawn from theories in group diversity and group performance, especially social categorization (Turner, 1987), similarity/attraction (Berscheid & Walster, 1978), intergroup contract (Allport, 1954), and cognitive diversity theories, this study examines the association between board diversity and board investment oversight. The expectations model of diversity (McGrath, Berdahl, & Arrow, 1995) offers the mechanisms through which the social categorization process in a diverse team results in differential impacts of relation-oriented dimension (i.e., gender, race, and age) and task-oriented dimension (i.e., tenure and expertise) on board monitoring performance.

We measure suboptimal investment (i.e., under- and over-investment) by each firm's deviation from its expected level of investment, estimated using the firm's growth opportunities within the industry in each year. We find that task-oriented board diversity attributes, such as tenure and expertise, are negatively associated with suboptimal investment. Results suggest that diverse boards in terms of firm specific experience and functional expertise are more effective in monitoring corporate investment activities than homogeneous boards. We did not find an association between board relation-oriented diversity measured by gender, race, and age, and board performance in investment oversight.

Understanding the effect of board diversity on corporate investment activities is important for shareholders, corporate executives, and board nominating and governance committees in forming the best practices for board composition. It is also essential in evaluating the outcome of recent legal and disclosure requirements to increase board diversity in the U.S. and several European countries, such as Sweden, Norway, and Spain. For example, the Chairman of the SEC indicated that board diversity is a priority of the agency in 2016, and that the agency is likely to require publicly traded companies to provide more detailed disclosure on board diversity.[4] This study can inform such discussions on board diversity through discovering whether and which type of diversity influence investment and risk governance.

2. Theories and hypothesis development

Corporate boards are workgroups with complex monitoring and advising tasks that involve information processing and decision-making. Diversity in workgroups has been viewed as a "double-edged" sword (Milliken & Martins, 1996; Webber & Donahue, 2001), leading to more creative solutions to the group tasks, as well as less cohesion that hinders group decision making process. On the one hand, the cognitive resource perspective proposes that diversity could enhance group performance (Webber & Donahue, 2001) because members on a diverse team bring a greater pool of perspectives, knowledge, skills, and abilities to identify solutions and solve problems. People in diverse groups also have access to information outside their work group (e.g., Gruenfeld, Mannix, Williams, & Neale, 1996; Wittenbaum & Stasser, 1996). Broader information networks, along with greater cognitive resources, increase the ability of individuals in diverse teams to engage in more complex problem solving.

On the other hand, social categorization theory and similarity/attraction paradigm predict detrimental impacts of diversity on group process and performance (Williams & O'Reilly, 1998). Social categorization theory (Turner, 1987) describes the process under which people will classify themselves and others into social categories using salient characteristics such as age and gender. This process allows people to form a social identity and build self-esteem by identifying themselves as members of a particular group and by comparing themselves to members of other groups (Tajfel & Turner, 1986). Categorizing people into groups could create in-group/out-group bias and other cognitive biases. In a work unit, people are likely to favor in-group members and perceive out-group members as less trustworthy, dishonest, and less cooperative than in-group members (Brewer, 1979; Tajfel, 1982). The similarity/attraction theory (e.g., Berscheid & Walster, 1978; Byrne, 1971; Byrne, Clore, & Worchel, 1966) suggests that people are more attracted to those who are similar to themselves along various attributes such as demographic characteristics, attitudes, and values. Like social categorization theory, similarity/attraction paradigm predicts that diversity could harm group process and performance through negative attitudes toward dissimilar individuals and infrequent communication among members of a diverse team (e.g., Jehn, 1997; O'Reilly, Snyder, & Boothe, 1993; Riordan & Shore, 1997).

Pelled (1996) classified workgroup diversity attributes based on the degree to which the attributes capture perspectives, experiences, and skills relevant to the work being performed. Attributes such as functional, education, or industry background are considered more relevant (i.e., highly job-related), while demographic attributes such as age, gender, and race are considered less pertinent (i.e., less job-related) to the task on hand. Joshi and Roh (2009) conducted a meta-analysis of team diversity research and found that combining all types of diversity attributes would lead to a nonsignificant relationship between diversity and performance. Following extant studies (Jackson, May, & Whitney, 1995; Pelled, 1996; Webber & Donahue, 2001), we classify board diversity attributes into relation-oriented (less job-related) categories, such as gender, race, and age, and task-related (highly job-related) categories, such as tenure and expertise.

2.1. Relation-oriented diversity attributes and investment oversight

The expectations model of diversity explains how relation-oriented and task-oriented diversity attributes affect group cohesion and performance (McGrath et al., 1995). Social categorization theory (Turner, 1987) is the underlying theory for the expectations model (Webber & Donahue, 2001). The model suggests that, in a workgroup, one uses the other members' characteristics to place them into different social categories and use these categories to infer their underlying attributes (e.g., knowledge base, skills, abilities, values, and beliefs) and form expectations about the other members' behavior. For example, one may conclude that other members from his/her gender group will share the same values and beliefs, and therefore, are perceived as more cooperative and open to one's ideas.

Social categorization of group members into in-group and out-group categories based on relation-oriented attributes will enhance perceived similarities and differences between groups in terms of these surface-level attributes (Pelled, Eisenhardt, & Xin, 1999; Webber & Donahue, 2001). Based on the similarity/attraction theory, the perception of similarity in values, beliefs, and attitudes with members from the same social categories could result in in-group favoritism and out-group

[3] For example, Coca Cola's finance committee "helps the Board fulfill its responsibilities relating to oversight of the Company's financial affairs, including reviewing and recommending to the Board dividend policy, capital expenditures, debt and other financings, major strategic investments and other transactions." It "also oversees the Company's policies and procedures on hedging, swaps, risk management and other derivative transactions" (http://www.coca-colacompany.com/investors/committee-charters).

[4] A full transcript of her speech can be found at http://www.sec.gov/news/speech/chair-white-icgn-speech.html