“Cultural diversity in German boards”

AUTHORS	Udo Braendle https://orcid.org/0000-0001-6877-8466 Markus Stiglbauer
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Udo Braendle (United Arab Emirates), **Markus Stiglbauer** (Germany)

CULTURAL DIVERSITY IN GERMAN BOARDS

Abstract

The rise of MNCs, the expansion of the EU and several M&As have exposed German boards to a variety of cultures. But does diversity in the boardrooms improve performance? Based on an empirical study on German publicly listed companies, this unique research into cultural diversity answers the question if the level of cultural variety and cultural distance on boards of directors have an influence on firm performance in Germany. The results, which show a negative, linear influence of both cultural variety and cultural distance on operating performance measures, show empirical support for the importance of contextual factors in the relationship between diversity and performance. The authors ask for careful consideration before implementing regulations on board diversity.

Keywords board of directors, cultural diversity, firm performance

JEL Classification G28, G34

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Udo Braendle, Dr., LL.M., Associate Professor, American University in Dubai, United Arab Emirates.

Markus Stiglbauer, Privatdozent, Dr., Professor, University of Nuremberg-Erlangen, Germany.

INTRODUCTION

Recently, the concept of diversity has gained in popularity in Germany, and has simultaneously remained a topic of public discourse ever since: Germany pursued a controversial debate about the introduction of fixed quotas for women on corporations' supervisory boards (Bschorr & Lorenz, 2013), an attempt to increase diversity among the gender. This focus on gender diversity was also subject to legal regulation in 2015 which enforces listed companies to have a minimum of 30 percent females among their supervisory board members. Further, current European megatrends such as migration and the anticipated shortage of skilled labor in Germany both cause attempts to recruit skilled foreign employees (Mayer, 2017). Last but not least, the expansion of the European Union, numerous joint ventures and mergers and acquisitions, and the rise of multinational companies (MNCs) with global customer bases have exposed top management to a variety of cultures (Shin et al., 2016).

From a corporate governance perspective, of course, the topic of cultural diversity is especially interesting with regard to boards. In Germany, the corporate governance system is statutorily based on a dual board system (two-tier system) which is characterized by a strict separation of management and control. Unquestionably, it is of relevance for a supervisory board to be acquainted with the knowledge of how to best appoint the board of directors in regards to cultural diversity. Despite this obvious relevance, the effect that cultural board diversity exerts on firm performance has mostly been considered in empirical studies from the international research arena (e.g., Nielsen & Nielsen, 2013). Rarely have researchers included Germany in their analyses. With growing levels of international activities of German firms and in view of the fact that the German labor market is characterized by increasing internationalization as well, reliable scientific knowledge for the case of Germany is yet urgently required.

1. DIVERSITY ANGST?

Academic research has to a vast extent dealt with the board diversity – firm performance relationship. Stimulated primarily by Pfeffer (1983), the organizational demography approach argued for the use of demographic variables, such as age, sex, educational level, length of service in residence, race, and so forth when operationalizing board diversity and investigating its impact on firm performance. The results showed largely inconsistent findings. When it comes to cultural diversity, repeated calls for the consideration of cultural and psychologically underlying attributes have widely been ignored (Kirkman & Shapiro, 2005). Whereas the U.S.-based literature has mainly focused on racial diversity, the few European-based studies concerned national or ethnic diversity as substitutes for truly cultural diversity.

Richard (2000) explored the relationship between cultural diversity and firm performance as measured by productivity, return on equity, and an individual performance measure. Using a sample of U.S. firms, he found a significant positive influence of cultural diversity on firm performance. Carpenter (2002) tested the effect of cultural diversity in the sense of internationality – which can be regarded as a proxy for cultural variety – in a U.S.-based study of several diversity dimensions and likewise reported a positive relationship between diversity levels and firm performance. Oxelheim and Randoy (2003) investigated the influence of board internationality in Norway and Sweden by studying the effect on firm value as measured by Tobin's q and found a highly significant positive relationship. Nielsen and Nielsen (2013) in a recent study investigated the impact of top management's national diversity on firm performance using a large sample of Swiss firms and report a positive relationship. Summarizing, it is remarkable that most studies that conceptualized diversity in the form of internationality found a positive effect on firm performance.

2. THE ANSATZ

While many studies have presumed linear relationships between diversity and performance, this research differentiated between cultural variety and cultural distance. This is to follow Harrison and Klein (2007), who suggested a diversity typology, which distinguishes between diversity as variety and separation. Cultural variety is minimized if all board members come from the same culture. Diversity as separation will be minimized if all board members score equally on that specific dimension (along the values for Hofstede and GLOBE).

The sample used in this study comprised firms listed in the German selective indices DAX, TecDAX, MDAX, and SDAX and their respective boards of directors. In total, the four indices included 160 firms. DAX comprises the 30 largest and highest-grossing firms, while TecDAX contains the 30 largest and most liquid firms from the technology sectors. MDAX and SDAX include 50 firms from classic sectors each. After all adjustments (divergent fiscal year, board composition changes, etc.), the sample comprised 98 firms.

Every native German individual in the sample was regarded as belonging to the German culture. Every non-German individual serving on a German board of directors was allocated to that culture in which he or she spent at least the majority of his or her formative years. A unique feature of the study was its explicit differentiation between cultural variety and cultural distance. Therefore, a cultural variety index was built to measure the existence of various cultures on the board. Second, a cultural distance index was composed to measure the extent to which the cultures present on a board differ from each other.

Four variables were used to gauge firm performance: two measures of operating performance (return on investment, return on equity), one capital market-based measure (total shareholder return), and one hybrid performance measure (Tobin's q). Board size and Board age diversity were used as control variables. As for the firm level characteristics, firm size, past organizational performance, R&D intensity, debt/equity ratio, volatility, ownership structure, and industry membership were used.

Results of the hypotheses tested suggested a negative, linear influence of both cultural variety and cultural distance on operating performance measures (return on investment and return on equity). Further, no influence of cultural variety or of cultural distance on total shareholder return and Tobin's q was found. The assumed moderating influence of a firm's level of international activities on cultural diversity was not at all empirically confirmed. The additional analyses concerning the influence of a firm's industry membership on the level of cultural diversity further suggest differences in cultural distance between industries, but not in cultural variety.

3. ÜBER-DIVERSITY?

The existence of a significant relationship between cultural diversity and firm performance found in this study reinforces the fundamental assertion that executives' cultural values shape their mind sets and orientations, and thus influence their decision-making. But why does increased diversity in board rooms does not yield conclusively positive results for German corporations?

The theoretical foundation for hypothesizing a positive relationship between top executives' nationality (cultural variety) and firm performance had argued that culturally diverse boards bring diverse knowledge, different viewpoints, and a multifaceted experience to the decision-making table, and that the arising task conflict leads to positive decision-making outcomes. Moreover, the process of social categorization and its negative effects such as ethnocentrism and prejudice were expected to be minimized because it was assumed that social in-group/out-group identities based on diverging cultural values are minimized. Surprisingly, this does finally not seem to hold true. Instead, it seems likely that boards with high levels of cultural variety, i.e., with board members evenly diffused over all culture 'categories', experience higher social categorization effects based on their individuals' culture membership than boards with lower levels. It seems that boards with high levels of cultural variety may be more strongly affected by the negative effects of social categorization such as ethnocentrism and prejudice. These processes might consequently cause increased relationship conflict among board members and hence lead to effects such as lower commitment to the group, lower trust, and lower information processing capabilities. The negative effects might thus prevent culturally diverse boards from high performance. In a similar vein, high cultural variety may be expected to hinder effective self-verification attempts and thus to constitute an 'ego threat' to stable, positive self-views.

It is another interesting finding that the level of cultural variety has no influence on total shareholder return. There are several possible explanations: First, the topic of cultural diversity and its implications largely suffer from backlog in public perception. Both its relevance and its potential effects are argued to be not properly understood. For example, public attention in Germany has mainly been paid to gender and age diversity, so that other diversity attributes such as culture have passed unheeded. Second, diversity management to date has oftentimes been approached superficially. For example, practices to evaluate diversity have typically been restricted to awards, rankings, and audits, which however often do not precisely investigate diversity's true effects and have thus been criticized for their superficiality. Consequently, concern was raised that diversity (including cultural diversity) might only be implemented pro forma, because the public cherishes certain expectations which firms wish to answer. It might therefore be likely that investors are aware of these circumstances and leave out a board's level of cultural diversity when making investment decisions.

As for cultural distance, the negative influence on operational firm performance supports the assertion that increasing cultural distance among board members results in negative intragroup conflict and thus leads to negative firm performance. Although the meeting of distant cultures may imply the emergence of different insights, multiple perspectives, and miscellaneous knowledge, these positive effects seem to be overridden to a considerable extent by negative intragroup conflict. It seems to be valid that the existence of maximized dissimilarity of board members' values leads to the salience of culturally based social identities, which let to emerge mentally opposing cultural sub-units on the board. Hence, effective decision-making seems to be hampered.

It further appears to be true that higher cultural distance involves difficulties in successful self-verification, which is argued to lead to relationship conflict among board members. In this sense, Hofstede's devastating statement that culture is more often a cause of conflict than a synergy is not far from what the study reveals. Admittedly, however, although the results point out, such social processes can only be presumed from the investigations of this study and not be inferred from the data directly.

CONCLUSION

If there is mixed evidence that diversity on boards improves performance, this begs the question why policy makers push for regulations in this area. Across the globe, and in Germany specifically, the idea of introducing/tightening quotas in the area of diversity is high on the policy agenda.

Based on the study and without a deeper understanding of the processes and dynamics within corporate boardrooms, we do not think this is the right time to regulate board diversity. On the other hand, however, this article should lead corporate decision makers and researcher with a tough decision of what to finally conclude. The study cannot unambiguously answer the question of whether cultural distance differs between industries. It however sheds new light on a seemingly straightforward topic.

Researchers need to continue their efforts to give decisive answers for Germany's industries. Those conducting further research on industry-specific differences in the level and effects of cultural diversity may wish to more closely investigate the topic, for example by including the industries' moderating effect on the board diversity-firm performance relation ship. The present study has made an important first step into that direction.

Summarising, the results for German companies manifest that diversity is a "double-edged sword", that should as well consider the complex constructs of work psychology. The political debate on diversity often revolving around standard economic arguments or stereotypes is therefore missing the point and has to be seen critical.

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