The Business Case for Commitment to Diversity

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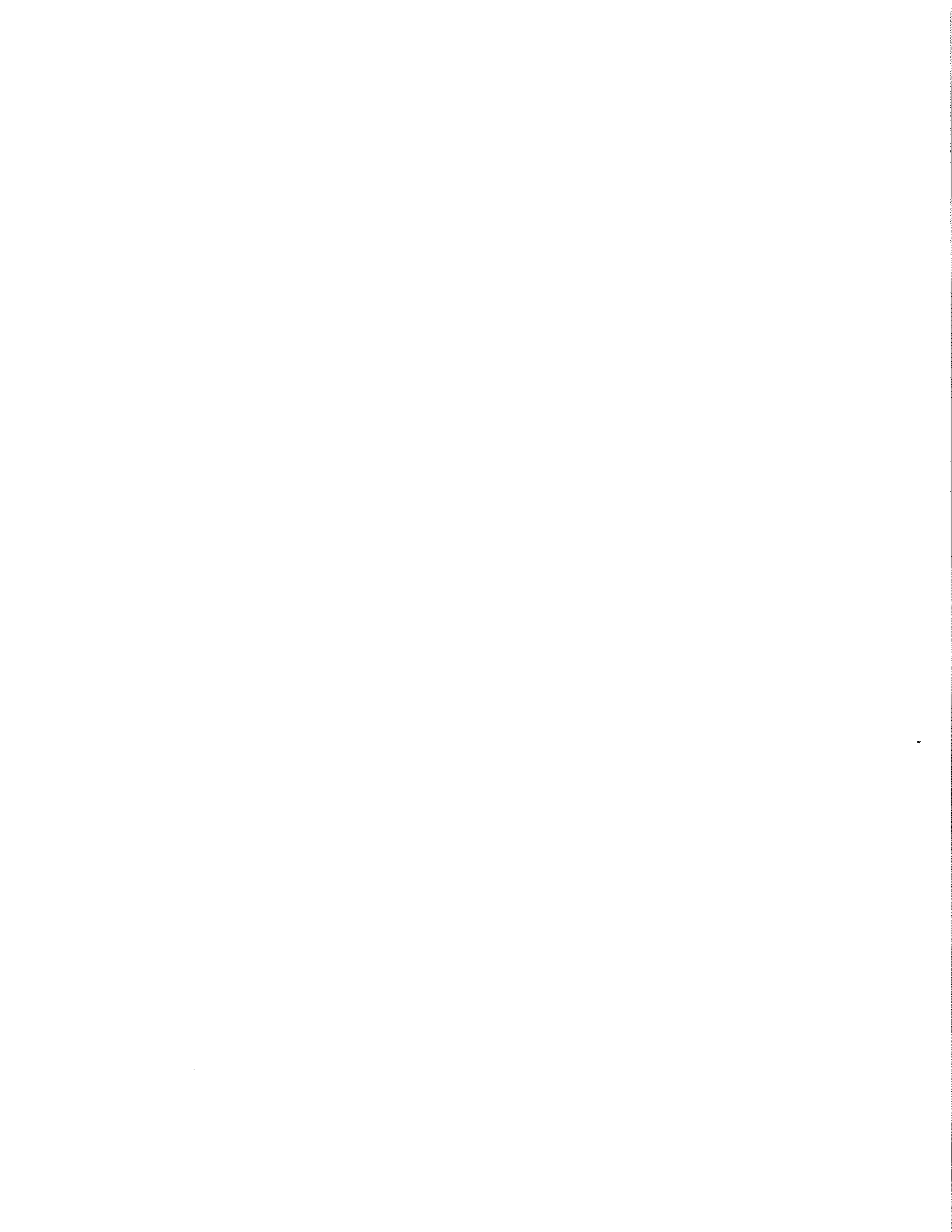

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Abstract

Does an organization's commitment to diversity — as reflected by CEO commitment, human capital, corporate communications (internal and external), and supplier diversity — result in competitive advantage and superior financial performance? Diversity can bring new voices and perspectives into the strategy dialogue, help managers understand and address the needs of a demographically diverse customer base, and stimulate a wider range of creative decision alternatives. However, the anticipated benefits of corporate diversity efforts may also be accompanied by costs that can affect shareholder wealth. We assess whether the benefits of having a diverse workforce outweigh the costs and have a positive effect on firm performance. We offer suggestions for how a firm can most effectively manage a diverse group of employees and suppliers.

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Abstract

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> Our consumers, customers and suppliers become more and more diverse every day, so our success depends on our ability to understand diverse consumers' needs and to work effectively with customers and suppliers around the world. Diversity is the uniqueness that everyone — from suppliers to employees to corporate officers — brings to fulfill P&G's Purpose, Values and Principles.
>
> A.G. Lafley
> Chairman & CEO
> Procter & Gamble

In recent years, customers, employees, suppliers, community groups, governments and shareholders have encouraged firms to undertake additional investments in diversity as a means to achieve competitive advantage. However, whether a commitment to diversity contributes to achievement of competitive advantage remains an open question. We review the arguments, pro and con, and describe a study that sheds additional light on this critical issue. We conclude by providing some recommendations for how a firm should manage its investment in diversity.

THE IMPORTANCE OF STRATEGIC HUMAN RESOURCE MANAGEMENT

A firm has sustainable competitive advantage when it employs a value-enhancing strategy that is not being implemented by other firms and cannot be duplicated by its rivals. Jay Barney, in his 1991 article, argues that the resources of the firm are a powerful source of competitive advantage. Firm resources include the assets, capabilities, organizational processes, firm attributes, information and knowledge that the firm can draw on to improve its efficiency and effectiveness. In our consideration of diversity as a competitively valuable resource, we focus on human capital and the human resource management system (Wright, McMahon and McWilliams, 1994).

Human capital refers to the stock of experience, judgment, intelligence, relationships and insights of individual managers and workers that exist within a firm at a given point in time. Human resource management systems include multiple practices directed at managing the pool of human capital and ensuring it is employed toward fulfilling organizational objectives.

Human capital is a source of competitive advantage when employees either possess more competitively valuable skills or when they are better matched to the strategic needs of the firm (Wright, Dunford, and Snell 2001). Human capital builds value when the firm has different jobs that require different skills, and there is variation in individual worker types and skill levels (Wright et al., 1994). This means that firm value increases when workers with the best skills and abilities are selected for jobs that require these skills. As the skill levels of individuals in the labor force should be normally distributed, higher quality human resources should be increasingly rare (Steffy and Maurer, 1988).

Human resources can provide a source of sustained competitive advantage only if they are imperfectly imitable. There are three primary conditions under which a resource is imperfectly imitable (Barney 1991): 1) a unique historical position has endowed the firm with resources that are not controlled by competitors and are not easily appropriable, 2) the link between firm resources and competitive advantage is not well understood so that competitors do not know which resources to imitate, and 3) the resources are socially complex, as is the case with culture, relationships, or systems. Both the firm's human capital pool and its human resource management system may meet some, or all, of these requirements (Wright et al., 1994).

The final requirement for a resource to provide sustained competitive advantage is that the resource has no viable substitutes. Wright, McMahon and McWilliams, in their 1994 article, argue that, of all of the resources of the firm, the human resource is the least substitutable in the long-run. Any substitution of capital or technology by one firm which enables it to leapfrog another firm that uses human resources as a source of competitive advantage will find its strategic advantage short lived. The firm with higher-skilled workers will obtain additional technology or capital and combine these resources with its higher-skilled workers to regain its

competitive advantage. Thus, experienced, knowledgeable, highly skilled and trained individual managers and workers meet the criteria for creating sustained competitive advantage.

Of course, not all firms have a workforce that provides a source of competitive advantage, but firms where human capital is a source of competitive advantage typically hire employees from the upper tail of a normal distribution of the population of skilled workers. As we noted, the upper tail of the distribution must be differentiated if competitive advantage is to be achieved. Since the tail is, by definition, different from the norm, it is likely to be differentiated as well as culturally diverse.

In their seminal 1994 article, Lado and Wilson describe the contribution of human resource management practices to the creation of sustainable competitive advantage, and explain how these practices can be unique, causally ambiguous and synergistic, and therefore very difficult to imitate. Human resource management systems include development of an HR strategy, staffing, work design, training, motivation and communication. Effective systems evolve and maintain interdependencies among components that competitors cannot easily imitate. These systems are the means through which the firm sustains an advantage as employees come and go and critical behaviors evolve due to environmental and strategic change (Wright et al., 2001). HR systems facilitate the development of human resources as a source of competitive advantage through the development of a high quality pool of human capital (Wright et al., 1994). Boxall (1996) argued that human resource advantage is based on the ability to both recruit and retain a stock of exceptional human capital to create a talented and committed workforce.

FROM DIVERSITY TO COMPETITIVE ADVANTAGE

There are numerous reasons posited for how workplace diversity can be a source of competitive advantage. Hamel (1998) argues that strategy innovation is the result of: 1) bringing a diverse set of voices into the strategy dialogue (see also Simons, Pelled and Smith 1999), 2) creating opportunities for conversations about opportunities in unserved markets, 3) focusing on passions that lie outside of the normal firm repertoire, 4) developing new perspectives on both capabilities and customer needs, and 5) launching low risk market experiments. None of these inspirations for strategy innovation is likely to be found among traditional managers or employees.

Opinions of a culturally diverse workforce can lead to higher quality decisions (Cox, 1994; McLeod, Lobel and Cox, 1996). Diverse teams can boost performance because they are more likely to have access to the breadth of information necessary to solve complex problems (Leonard, Levine and Joshi, 2004). In groups with high levels of cultural heterogeneity, casual social contacts and communication are more likely to involve members of different racial/gender groups (Richard, Barnett, Dwyer and Chadwick 2004). The broader range of perspectives and more creative analysis of issues associated with diverse groups (Jackson, 1992) can lead to better decisions. Thus, problem solving, creativity and innovation are enhanced when all human resources, including a multicultural workforce, are employed (Cox, 1994).

Taking a market-level perspective, the central proposition of Resource Dependence Theory (Pfeffer and Salancik 1978) is that organizational survival is dependent on the ability to procure critical resources from the external environment (e.g., labor markets, suppliers, customers). To reduce uncertainty in the flow of needed resources, organizations may form coalitions with resource providers, socialize members of the constraining organization, or

exchange other valuable goods, such as status, friendship or information. Agle, Mitchell, and Sonnenfeld (1999) argue that managers pay increased attention to stakeholders who they perceive as having three attributes – power, legitimacy, and urgency. Increasingly, members of different racial, ethnic, age, and gender groups are perceived to possess these attributes.

Diversity-related issues can easily damage corporate reputation, a key foundation upon which market value is built. Multiple stakeholders increasingly demand that firms be held accountable. As a result, corporate reputation strategy must embrace the needs and perceptions of multiple stakeholder groups. We therefore argue that the growing integration of strategy, reputation management and influence of stakeholder groups elevates diversity from being a minimal commitment or some social 'add-on' to becoming a strategic necessity (Werther and Chandler 2005).

Familiarity—a level of comfort with similar people—and the preference to associate with those one considers to be in the reference group should lead to an inclination for doing business with members of the same group. In addition to satisfying customer preferences, a close match between employee and customer demographics may improve performance by reducing communication costs among people from the same racial, ethnic, gender or age group (Leonard et al. 2004). Employees who are demographically similar to customers are likely to have an easier time understanding customer preferences and how they change over time. Employees may also attract customers through their connections within the community. Thus, in many cases, employees' social ties may help to attract and retain customers (Leonard et al. 2004).

THE OTHER SIDE OF THE COIN

There are, of course, costs associated with diversity. Within culturally homogeneous groups, members will tend to communicate with one another more often and in a greater variety

of ways, perhaps because they share similar worldviews and a unified culture resulting from in-group attachments and shared perceptions. Cultural homogeneity in management groups may increase satisfaction and cooperation and decrease conflict. Since homogeneous groups do not have significant cultural barriers to social intercourse, positive social associations and in-group social contacts are fostered (Richard et al., 2004). Thus, diversity can increase the costs of communication within the workforce, decrease group cohesiveness, result in higher employee turnover, and reduce incentives for cooperation (Leonard et al., 2004).

Not surprisingly, most studies of workplace diversity have found a weak, or no, relationship between diversity and performance. Richard (2000) surveyed banks in California, Kentucky and North Carolina to obtain data on the racial composition of the workforce and attitudes regarding diversity. He combined these data with financial information, including ROE and a "perceptual measure of market performance." He found no evidence of a direct positive relationship between cultural diversity and performance. He did, however, find that business strategy moderates the diversity – performance relationship.

Richard et al. (2004) found a curvilinear relationship between cultural diversity in management and firm performance in specific strategic contexts. More specifically, in firms with highly innovative strategic postures, both low and high management group heterogeneity were associated with higher productivity than was moderate heterogeneity. This effect was strongest for racial diversity. In firms characterized by high levels of risk taking, they observed that firms with moderately diverse management groups performed better than firms with either homogeneous or highly diverse management groups. Thus, their results suggest that totally homogeneous groups may not thrive in an environment requiring speedy decisions or aggressive

competitive behavior. As management group diversity approaches a moderate level, however, its positive effects may yield performance advantages in a high-risk strategic context.

In a related area, McWilliams and Siegel (2000) studied the relationship between corporate social responsibility (CSR) and performance. Socially responsible firms are considered to be reliable and ethical, and provide high quality products. Awareness of these attributes should favorably predispose consumers towards them. Thus, commitment to CSR should be valuable and rare, and thus a source of competitive advantage. However, after controlling for investment in R&D, no relationship between CSR and performance was found.

Reasons for No Results

Kochan et al. (2003) summarized many reasons why, despite supportive theory, little support for a diversity – performance relationship has been found.

- The empirical literature does not support the simple notion that more diverse groups, teams, or business units necessarily perform better, feel more committed to their organizations, or experience higher levels of satisfaction (Jackson et al., 1995; Millikin and Martins,1996; Williams and O'Reilly, 1998).
- Diversity may simultaneously produce more conflict and employee turnover as well as more creativity and innovation (Jehn et al., 1999; cf. Williams and O'Reilly, 1998).
- Diversity has been associated with higher rates of turnover among top management team members (Jackson et al., 1991).
- Business strategy may moderate the diversity – performance relationship (Richard 2000; Richard et al. 2004).

A DIFFERENT PERSPECTIVE

Much of the research on the diversity – performance relationship has been conducted based on one dimension of diversity (e.g., age, gender, race) and at the employee level (e.g., top management team, supervisory, front-line employee). We propose this understates the contribution of an **overall commitment to diversity**, in which diversity is fostered as part of an organization's culture, as opposed to being a "program". Culture is the pattern of shared values, beliefs, assumptions, and symbols that help individuals understand what is important to an organization and provide them with norms for behavior. Culture defines who are relevant employees, customers and suppliers (Barney 1986). Certain organizational cultures are able to do things for specific stakeholder groups that firms with different cultures could not do as well. Thus, our position is that a strong organizational commitment to diversity is an element of organizational culture that is valuable, difficult to imitate, and therefore a source of competitive advantage.

We investigate the potential financial benefits of diversity by comparing the performance (net profit margin, return on assets, and return on equity) of The 2004 DiversityInc Top 50 Companies for Diversity and a set of matching firms. The DiversityInc Top 50 list is derived exclusively from corporate survey submissions. The survey has more than 200 questions, and is sent to over 700 companies and promoted on DiversityInc.com and in *DiversityInc* magazine. Questions are organized in four areas: CEO Commitment, Human Capital, Corporate Communications (internal and external) and Supplier Diversity.

Respondents provide information on work-force demographics by race/ethnicity and gender, on race/ethnicity and gender for managers at different levels, and on retention rates by gender and race/ethnicity. Information is also provided about supplier diversity, including

whether companies include all small businesses in defining diverse suppliers, and if companies offer loans or other financial assistance to minority- and women-owned suppliers. The identity of a representative set of the Diversity 50 and matching firms is shown in Table 1. Because *DiversityInc* magazine ranks firms numerically and allows for ties, the 2004 Diversity 50 list actually contains 53 firms.

Insert Table 1 About Here

The matching firms are selected by identifying all firms listed in the Compustat database with the same 4-digit SIC codes as each firm listed on the respective lists. We selected the firm whose market capitalization is closest to that of the matching Diversity 50 company as the matching firm (market capitalization data is obtained from the Center for Research in Security Prices (CRSP) database). If no firm in the same 4-digit SIC class is found with a market capitalization at least half that of a diversity-sample firm, we repeat the above procedure using a 3-digit SIC match. If a matching firm is still not identified, we match based on 2-digit SIC code and market capitalization and/or book value of assets. This procedure yielded 44 matches from the *DiversityInc* list. For additional information on this process, contact the first author.

We focus on the 5-year period (1998-2002) preceding the year in which the firms completed the *DiversityInc* survey instrument, as it is likely firms were incurring costs and reaping the benefits of their diversity initiatives during these years. Studying the prior 5-year period also avoids any possible contamination that might exist between firms' accounting and financial reporting practices and attempts to achieve recognition by participating in the surveys. By focusing on 1998-2002 we can also observe the year-by-year behavior of the firms in both strong and weak economic conditions. All accounting data are obtained from Compustat. The

median values for net profit margin, return on assets, and return on equity for the diversity and matching firms are compared using a nonparametric Wilcoxon matched-pairs signed ranks test. Results are shown in Table 2.

Insert Table 2 About Here

The median net profit margin (NPM) of the Diversity 50 firms is higher in all 5 years, and significantly so in 4 out of 5 years. The difference in median NPM is also economically significant, between 2-4% from 1998-2002. The median return on assets (ROA) of the Diversity 50 firms is consistently larger than the matching firms, although this difference is only significant in 3 of the 5 years. A similar pattern emerges for return on equity (ROE). The Diversity 50 firms have higher median ROE than their matching counterparts in 3 out of 5 years.

These findings are consistent with the proposition that developing a diverse workforce and cultivating relationships with a diverse set of stakeholders provides firms with a competitive advantage.

WHAT SHOULD MANAGEMENT DO?

Diversity is a source of competitive advantage only when it represents a deep commitment as represented by the values, beliefs and behavioral norms of the organization. In fact, the costs of diversity are likely to outweigh its benefits when there is only superficial commitment to diversity. The following steps are likely to increase organization-wide commitment (Jayne and Dipboye 2004):

- For meaningful commitment to occur in an organization, employees must understand and embrace the business case for diversity. It is not sufficient for top management to enumerate generic benefits of diversity. While each may be plausible, for a business case

to resonate with employees, it must be tailored to the unique business challenges facing the organization. Demonstrating how diversity ties directly to the organization's business strategy provides a foundation for linking the diversity initiative to organizational success.

- Visible, active, and ongoing senior management involvement and commitment are critical to the diversity effort. Success also requires that line management, instead of the human resources function, owns the diversity strategy.
- Evaluate the effectiveness of diversity initiatives. Metrics allow the organization to track progress and identify and address issues as they emerge. Metrics also ensure that scarce resources are devoted to areas that will benefit most, and early identification of issues can avoid costly outcomes.
- Emphasize team-building and group process training. Once a diverse group of employees that has a variety of skills and perspectives is recruited and hired, a process is needed to ensure that these skills and perspectives are actually used to improve task performance. Capitalizing on the strengths that individual members bring to the team requires knowledge and understanding of the unique contribution that each member can make to the group.
- Emphasizing the fairness of a diversity program is crucial to building support and mitigating the potential negative reactions from both majority and minority groups. Backlash from majority group members and the stigmatization of women and people of color may occur. Fairness requires that people are hired, promoted, and otherwise rewarded commensurate with their relative contributions. Emphasizing the business rationale for diversity, as well as the intent of diversity initiatives to embrace all

employees, will demonstrate fairness and equity and mitigate potential negative perceptions on the part of employees.

GET IT RIGHT OR SUFFER THE CONSEQUENCES!

Diversity may be a source of competitive advantage when it brings new information and voices into the strategy dialogue, produces creative decisions, links the firm with its customers, enables the firm to attract and retain talented employees, and/or enhances the firm's reputation. However, diversity has many potential costs, including difficulty of communication between groups in the workforce, lower group cohesion, higher employee turnover, low levels of cooperation, and resentment among groups. The costs of diversity are more likely to outweigh its benefits when it is seen as a program rather than as an organizational commitment that will produce superior business results. Thus, it is incumbent on senior management to take the types of steps that we have outlined so that commitment to diversity is a deeply ingrained value in the organization's culture that produces the appropriate norms for constructive and productive behavior by all employees. Then, and only then, will the benefits of diversity live up to their promise.

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Table 1: Representative Diversity50 & Matching Firms

Diversity 50	Matching Firms
Abbott Labs	Wyeth
Altria Group	Reynolds American
American Express	Citigroup
Anheuser-Bush	Coors
Avon Products	Estee Lauder
Bank of America	J.P. Morgan Chase
Bristol Myers Squibb	Schering-Plough
Cardinal Health	McKesson Corp
Coca-Cola Co	Heinz
Daimler Chrysler	John Deere
Dell Computers	Apple
Delta Airlines	AMR Corp
Disney	Viacom
Exxon Mobil	Chevron-Texaco
Fannie Mae	Freddie Mac
General Electric	Tyco International
IBM	EDS
Intel	Texas Instruments
Johnson & Johnson	Merck
McDonalds	Starbucks
Microsoft	Oracle
Office Depot	Staples
Pfizer	Eli Lilly
Pitney Bowes	Ingersoll Rand
Procter & Gamble	Colgate Palmolive
Raytheon	United Technologies
Sears	J. C. Penney
Time Warner	Pixar
Unisys	Lucent
United Parcel Service	FedEx
Verizon	BCE
Wachovia	MBNA
Wal-Mart	Target
Wells Fargo	U.S. Bancorp
Xerox	Lexmark

Table 2

Net Profit Margin (Median)

	1998	1999	2000	2001	2002
Diversity 50	9.30	10.13	9.90	7.34	8.66
Matching Firms	6.34	7.00	7.35	5.84	4.58
Wilcoxon signed-ranks test	3.36**	3.42**	0.80	2.77**	5.89**

Return on Assets (Median)

	1998	1999	2000	2001	2002
Diversity 50	7.37	7.96	8.00	4.79	5.01
Matching Firms	5.99	5.91	6.77	4.23	3.58
Wilcoxon signed-ranks test	2.44*	5.47**	1.67	1.19	4.73**

Return on Equity (Median)

	1998	1999	2000	2001	2002
Diversity 50	23.01	26.01	24.54	13.98	18.76
Matching Firms	20.49	17.78	20.27	13.35	14.14
Wilcoxon signed-ranks test	2.05*	2.77**	1.13	1.55	2.02*

*, ** Significant at the 0.05 and 0.01 levels, respectively.