

# Diversity Washing

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WFA

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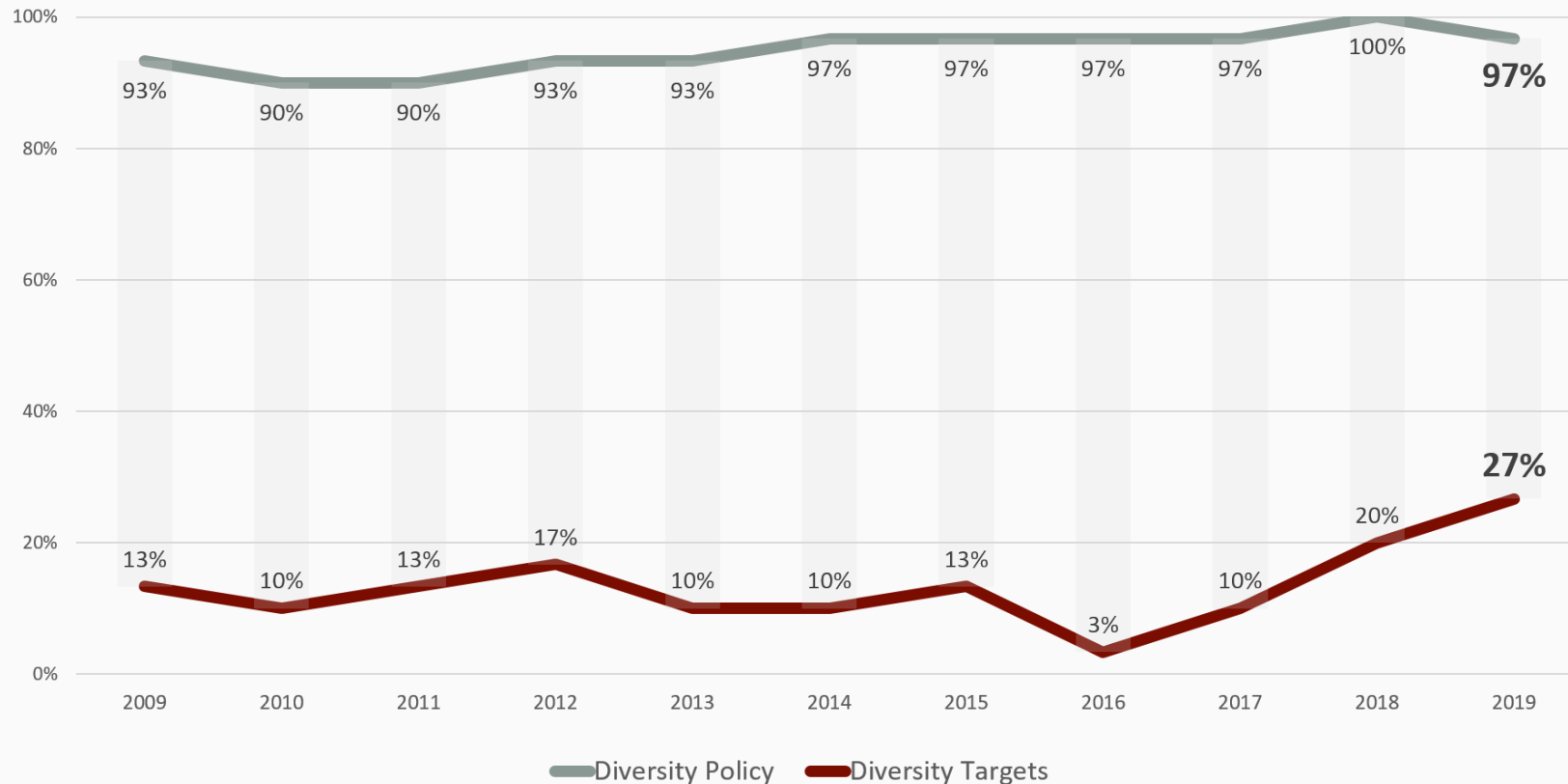
# Research Question

## **Do firms truthfully disclose their commitments to Diversity, Equity, and Inclusion (DEI) in their financial statements?**

- Are there market implications for talking more about diversity than is reflected in underlying actions?
- We focus on diversity in this paper given:
  - Prior literature.
  - Recent investor attention and public commentary.
  - Data availability.

# Motivation: Diversity "Policies" and "Targets"

- Disconnect between share of firms with policies and those with actual concrete targets.
  - What do we draw from this?



# Motivation: Legal and Regulatory Action

- SEC very interested in standardizing ESG disclosures.
- Around 40 lawsuits filed since 2020 related to diversity washing.
- Many of these suits have centered on public commitments in financial documents.

March 2, 2022, 10:46 AM

## Cisco Beats Board Diversity Shareholder Derivative Suit, for Now

Jennifer Bennett  
Legal Reporter

Risk Management

## Diversity suit filed against The Gap dismissed

Judy Greenwald  
April 29, 2021

WESTLAW NEWS MARCH 22, 2021 / 4:18 PM / UPDATED 2 YEARS AGO

## Facebook directors get diversity failure lawsuit tossed

4 minute read · July 2, 2021 4:31 PM CDT · Last Updated 2 years ago

## AMD directors dodge shareholder derivative suit over board diversity

By Jody Godoy

May 24, 2021, 2:53 PM

## Oracle Wins Dismissal of Shareholders' Board Diversity Suit

## NortonLifeLock Beats Investor Suit Over Board Diversity

By Dean Seal · 2021-08-31 19:50:32 -0400

## Tractor Supply Gets Lift from Court with Diversity Suit Dismissal

Thursday, June 9, 2022

## Board Diversity Lawsuit Against Danaher Directors Dismissed

By Kevin LaCroix on July 1, 2021

Posted in Shareholders Derivative Litigation

# Diversity Washing

- **DEI disclosures are relatively new.**
  - Little to no regulation or standardization.
  - Impossible or costly verification.
  - **Potential benefits to diversity washing:**
    - Enhanced reputation among stakeholders.
    - Capital flow with rise of ESG investing.
  - **Potential Costs:**
    - Litigation (has historically been very rare).
    - Diversity audits (only 8 proposals passed in 2022.)

# Our Contribution

**We construct measures of underlying firm-level diversity, which we can compare with discussion of diversity in financial disclosures.**

- **Advantages of our approach:**

- Allows us to peak "under the hood" at a non-self-disclosed measure of actual diversity.
- Breadth: we can measure diversity along cross-section and time-series.

- **Real-world relevance:**

- Firms have been accused of diversity washing, but evidence so far consists of anecdotes.
- Can provide evidence on the implications of diversity washing for firms and fund flow.

# Data

- Sample: **All Firms in Compustat-CRSP File** from **2008 to 2021**.
- Variety of data sources:
  - **Revelio Labs**: Firm-year level diversity measures.
  - **EDGAR Filings (WRDS SEC Analytics Suits)**: Raw text of 10Ks, DEF 14As, 8Ks.
  - Additional Data Sources: Compustat, CRSP (securities prices and mutual fund holdings), Sustainalytics, Thompson Reuters (13-F holdings and Refinitiv), Goodjobsfirst, Twitter, Corporate Register.

# Revelio Labs: Diversity Data

- Aggregates measures of firm diversity at firm-year level.
  - Compiles data from hundreds of millions of online public profiles and resumes.
  - Prediction-based algorithm to assign gender and race/ethnicity from name and location.
    - Trained on Census and voter registration data.
- Caveats:
  - Data is imperfect. But
    - Firm has done analyses to validate its accuracy.
    - Sample may be biased towards professionals.
  - 90% correlation for females when compared to sample of disclosing firms (Liang et al. 2022, WP)



# DEI Related Disclosures

- Difficult to observe all possible disclosure channels.
- Focus on EDGAR documents:
  - **Coverage:** All publicly traded firms have to file.
  - **Increasingly essential avenue** for firm communication about ESG-related activities and commitments.
  - **Firms have recently come under scrutiny for false or misleading commitments** to diversity in their financial disclosures.
  - **SEC currently has proposals for ESG disclosures under review.**
  - **Representative** of external stance on DEI.

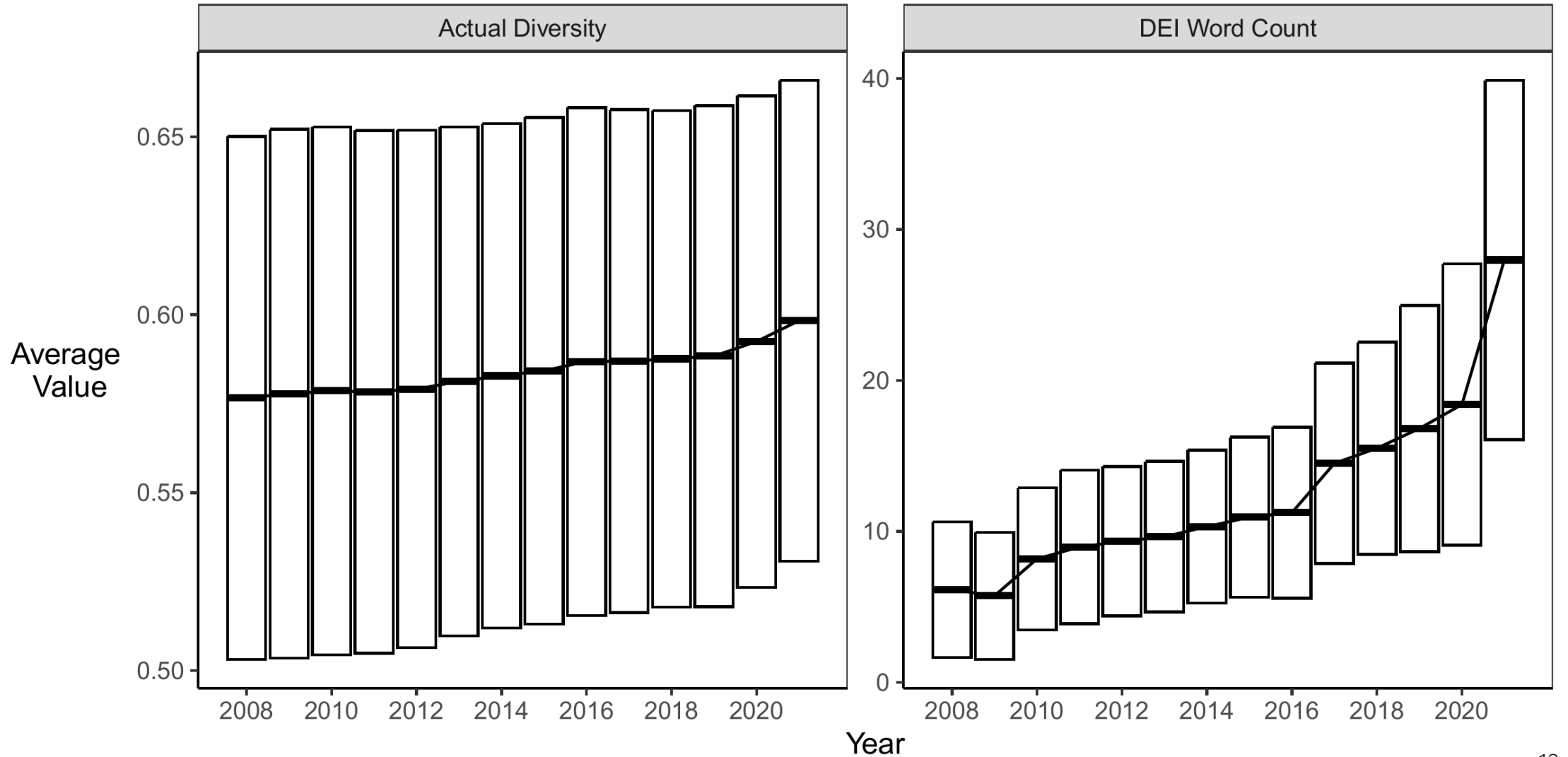
# Dictionary Based Approach

- Build upon dictionary-based approaches commonly used in finance.
- **Steps:**
  - Assemble a dictionary of key DEI-related words from online DEI dictionaries.
    - e.g. "Equal Pay", "Affirmative Action", "Sexual Orientation"
  - Remove terms that have alternative meanings in financial documents (e.g., equity)
    - replace with bigrams where possible (e.g. "pay equity")
  - Count DEI terms across SEC filings.
- **Summary:** Measure the extent of DEI discussions in financial statements.

# How Do Firms Talk about DEI (in progress)

- Extract the sentences with DEI words.
- Use `word2vec` and `kmeans` to identify topics.
- Have RAs label topics and classify them into categories:
  - Community engagement, governance, employee characteristics, legal concerns, etc.
- Measure the tone of the sentences with DEI words and correlate it with our washing measure.

# Underlying Diversity vs. DEI Discussions

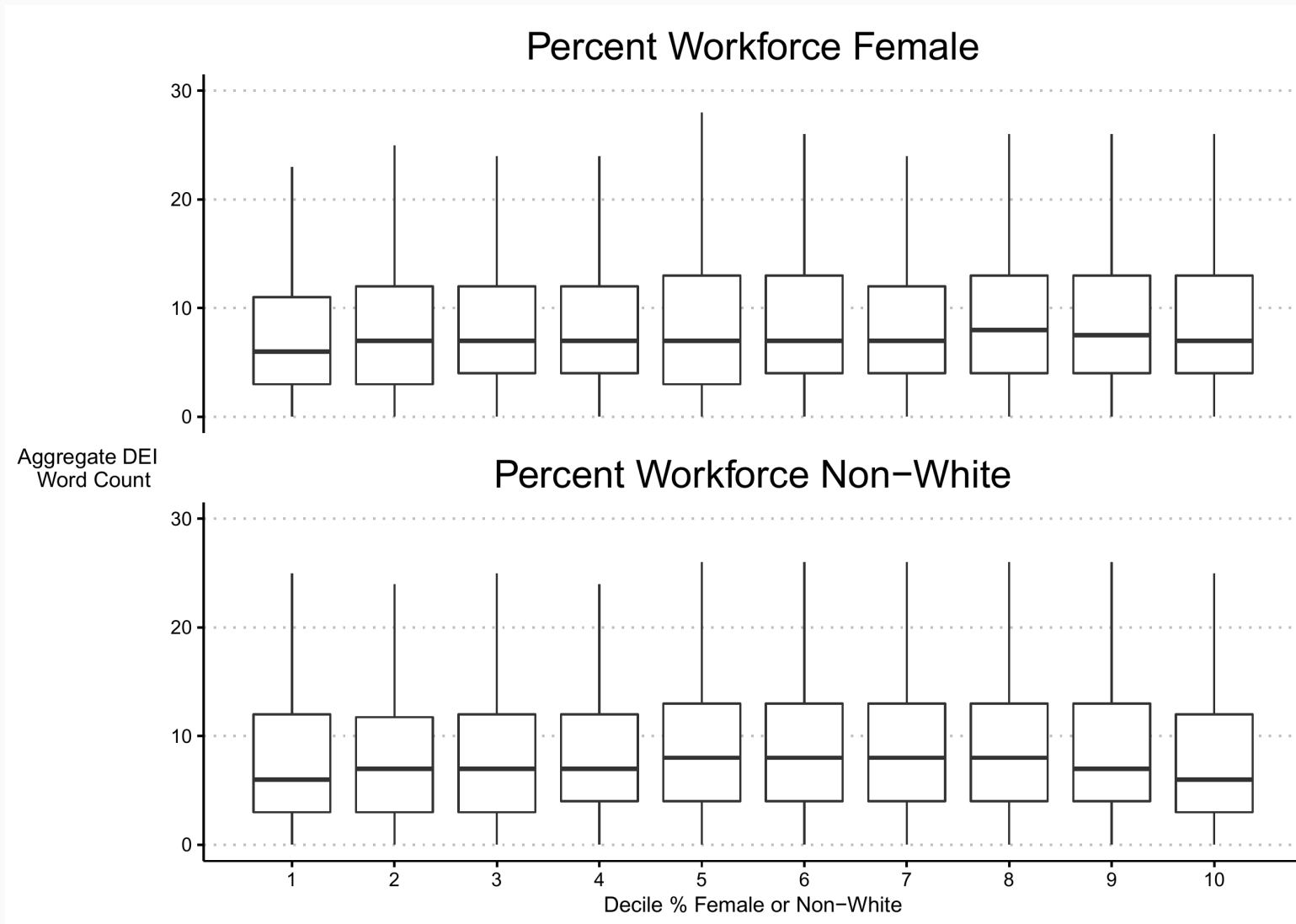


# DEI Disclosures and Diversity

- We document a **positive but weak** relationship in aggregate between DEI disclosures and underlying diversity.
  - Consistent with prior work.
  - Results slightly stronger without FEs, but remain economically very small
  - Incremental  $R^2$  only on order of 0.1-0.7%.

Panel B: With Industry and year FEs				
	DEI Words <sup>Agg.</sup> (1)	DEI Words <sup>10-K</sup> (2)	DEI Words <sup>DEF14A</sup> (3)	DEI Words <sup>8-K</sup> (4)
% Female	0.157** (2.083)	0.296*** (3.075)	0.104 (1.095)	0.074 (0.660)
% Non-White	0.435*** (6.134)	0.563*** (6.505)	0.449*** (4.975)	0.131 (1.102)
Year fixed effects	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
Pseudo R <sup>2</sup>	0.186	0.124	0.215	0.029
Observations	46,384	46,371	46,384	46,384

# DEI Disclosures and Diversity



# Empirical Measure of Diversity Washing

1) **Diversity Washing Level** =  $\eta_{DEI} - \eta_{Diversity}$

2) **Diversity Washers** =  $1(\eta_{DEI} > \eta_{Diversity})$

- Disparity between DEI word count and underlying diversity.
  - Assumption being that these measures should be correlated.
- Similar rationale to prior studies using **abnormal textual measures** (e.g. Teoh et al. 2014, Bushee et al. 2017)

# Descriptive Analysis

1) **Diversity Washing Level** =  $\eta_{DEI} - \eta_{Diversity}$

2) **Diversity Washers** =  $1(\eta_{DEI} > \eta_{Diversity})$

	Diversity-Washing Level		Diversity Washers	
	(1)	(2)	(3)	(4)
Constant	-37.590*** (-19.872)		0.089*** (4.215)	
log(Market Cap.)	5.969*** (22.882)	5.053*** (20.308)	0.065*** (23.113)	0.056*** (19.376)
Asset Growth	-2.983*** (-5.396)	-0.860* (-1.646)	-0.030*** (-4.311)	-0.007 (-1.085)
log(Book-Market)	5.379*** (11.168)	5.070*** (10.735)	0.059*** (10.802)	0.058*** (10.295)
Return on Assets	-3.371* (-1.808)	-10.012*** (-5.302)	-0.040* (-1.919)	-0.109*** (-5.042)
Ann. Return	-1.820*** (-4.980)	-1.025*** (-2.672)	-0.020*** (-4.232)	-0.011** (-2.196)
Ann. Volatility	6.438*** (5.736)	1.606 (1.479)	0.073*** (5.580)	0.018 (1.363)
Industry fixed effects	No	Yes	No	Yes
Year fixed effects	No	Yes	No	Yes
R <sup>2</sup>	0.078	0.238	0.058	0.164
Observations	43,721	43,721	43,721	43,721



# Descriptive Analysis

## Diversity Washers are conditionally larger

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# Descriptive Analysis

**Diversity Washers are conditionally less profitable and have lower growth**

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# Descriptive Analysis

## Diversity Washers have conditionally lower returns and higher volatility

	Diversity-Washing Level		Diversity Washers	
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Observations	43,721	43,721	43,721	43,721

# Diversity Washing and Employment Violations

**Diversity Washers have more employment and discrimination-related penalties (number and dollar amount)**

	Employment Penalty		Discrimination Penalty	
	(1)	(2)	(3)	(4)
Diversity-Washing Level	0.003*** (2.690)		0.005** (2.187)	
Diversity Washers		0.129 (1.631)		0.263* (1.825)
Controls	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
Pseudo R <sup>2</sup>	0.150	0.149	0.187	0.187
Observations	15,979	15,979	14,899	14,899

Panel B: Total dollar amounts of penalties

	log(1 + \$ Penalties)		log(1 + \$ Penalties <sup>Discrimination</sup> )	
	(1)	(2)	(3)	(4)
Diversity-Washing Level	0.004*** (3.311)		0.002*** (3.222)	
Diversity Washers		0.245*** (2.708)		0.132*** (3.077)
Controls	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.117	0.117	0.065	0.065
Observations	16,067	16,067	16,067	16,067

# Diversity Washing and Questionable ESG Policies

**Diversity Washers have more *questionable ESG policies*:**

**Lack quantifiable targets**

**Table 6**

Diversity washing and questionable ESG policies: “Policies” vs. “Targets”

Panel A: Diversity and energy

	Questionable Diversity Policy		Questionable Energy Policy	
	(1)	(2)	(3)	(4)
Diversity Washing Level	0.002*** (2.671)		0.003*** (2.741)	
Diversity Washers		0.083 (1.393)		0.153** (2.460)
Controls	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
Pseudo R <sup>2</sup>	0.060	0.059	0.127	0.127
Observations	19,268	19,268	19,127	19,127

# Diversity Washing and ESG Ratings

- ESG rating agencies rely heavily on firm disclosures.
  - "... a default value of 0 is assigned... when no relevant data is found in the public disclosure of companies." - Refinitiv Methodology guide.
- Diversity washers have 2-13% *higher ESG ratings* than other firms.

**Tables 9, Panel A: Refinitiv**

	ESG Score <sup>Refinitiv</sup>		Social Score <sup>Refinitiv</sup>	
	(1)	(2)	(3)	(4)
Diversity-Washing Level	0.001*** (10.339)		0.001*** (8.853)	
Diversity Washers		0.050*** (8.720)		0.042*** (7.177)
Controls	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.555	0.552	0.512	0.508
Observations	19,053	19,053	19,053	19,053

# Diversity Washing and ESG Ownership

- Firms might use opportunistic DEI disclosures to attract investors.
  - Socially-responsible capital could be misallocated as a result.
  - The SEC is very concerned with this question.
- Diversity washers have approximately *10% Higher ESG fund ownership* than could be expected.

**Tables 10, Panel A: ESG Investor Ownership, identified by US SIF**

	(1)	ESG Ownership <sup>US SIF</sup> (bps) (2)	(3)	(4)
Diversity-Washing Level	0.098*** (4.740)	0.080*** (4.048)		
Diversity Washers			6.652*** (4.598)	5.272*** (3.761)
Controls	Yes	Yes	Yes	Yes
Year fixed effects	No	Yes	No	Yes
Industry fixed effects	No	Yes	No	Yes
R <sup>2</sup>	0.064	0.087	0.063	0.087
Observations	43,721	43,721	43,721	43,721

# Diversity Washing as an Aspiration

- Could DEI disclosure channel signal aspiration to become more diverse?
  - **No evidence of future increases in diversity hiring.**
  - **Similar results focusing on senior employees.**

Table 7, Panel B: Changes in diversity						
	% $\Delta$ Diversity <sub>t+1</sub>		% $\Delta$ Diversity <sub>t+2</sub>		% $\Delta$ Diversity <sub>t+3</sub>	
	(1)	(2)	(3)	(4)	(5)	(6)
Diversity Washing Level	-0.006** (-2.143)		-0.001 (-0.221)		-0.004 (-1.445)	
Diversity Washers		-0.397** (-2.197)		-0.054 (-0.293)		-0.104 (-0.558)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
R <sup>2</sup>	0.121	0.121	0.067	0.067	0.039	0.038
Observations	38,977	38,977	33,932	33,932	29,296	29,296



# Conclusion

- We provide large-sample evidence consistent with:
  - Weak correlation between discussion of DEI and actual underlying diversity.
  - Aggregate correlation masks large underlying disparity between disclosed commitments to DEI and hiring practices.
  - This disparity is correlated with ESG ratings and fund flows, similar to worries about misallocated capital with unverifiable disclosures.