DIVERSIFYING THE BOARD – A STEP TOWARDS BETTER GOVERNANCE

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The responsibilities of the board of directors have been on the corporate agenda for years. Acting as the agents of shareholders, directors are expected collectively to devise operational and financial strategies for the organisation and to monitor the effectiveness of the company's practices.

The board of directors forms one of the pillars of a robust corporate governance framework. This is evidenced by the Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance stating that *'the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders'*. This, in turn, links to the fundamental concepts of corporate governance – namely, judgment, responsibility and accountability.

Recent academic literature suggests that one of the ways to enhance corporate governance, arguably, is to diversify the board, which is a new topic added to the Paper P1, *Governance, Risk and Ethics* syllabus in 2013. In the Paper P1 *Study Guide*, section A3i requires students to (i) explain the meaning of 'diversity' and (ii) critically evaluate issues of diversity on the board of directors. This article attempts to elaborate on this topic by first introducing the concept of board diversity and how it may benefit the organisation, which is followed by a discussion on the possible costs of board diversity. The article will then conclude with a comment on the current regulatory initiatives of board diversity.

DEFINITION OF BOARD DIVERSITY

Over the years, regulators have placed great emphasis on addressing different matters relating to the board of directors. Two prominent examples were: (i) stressing on the roles of non-executive directors as well as the importance of independence of the board in the Higgs Review in 2003; and (ii) emphasising the significance of balancing skills and experience of the board members as in the Walker Review in 2010. Until recently, there has been an urge for diversifying the board. Intuitively, diversity means having a range of many people that are different from each other. There is, however, no uniform definition of board diversity. Traditionally speaking, one can consider factors like age, race, gender, educational background and professional qualifications of the directors to make the board less homogenous. Some may interpret board diversity by taking into account such less tangible factors as life experience and personal attitudes.

In short, board diversity aims to cultivate a broad spectrum of demographic attributes and characteristics in the boardroom. A simple and common measure to promote heterogeneity in the boardroom – commonly known as gender diversity – is to include female representation on the board.

BENEFITS OF BOARD DIVERSITY

Diversifying the board is said broadly to have the following benefits:

- More effective decision making.
- Better utilisation of the talent pool.
- Enhancement of corporate reputation and investor relations by establishing the company as a responsible corporate citizen.

1. More effective decision making
It is believed that a diverse board is able to make decisions more effectively by reducing the risk of 'groupthink', paying more attention to managing and controlling risks as well as having a better understanding of the company's consumers. These benefits are further elaborated below.

Directors are responsible, as mentioned previously, for devising strategies through critical analysis and effective problem solving. One of the pitfalls behind the decision-making process in the boardroom is 'groupthink', which is described as a psychological behaviour of minimising conflicts and reaching a consensus decision without critically evaluating alternative ideas in a cohesive in-group environment. Combining contributions of a group of people with different skills, backgrounds and experiences is assumed to be able to approach problems from a greater range of perspectives, to raise challenging questions and to debate more vigorously within top management groups. Such a multiple-perspective analysis of problems can change the boardroom dynamics and is more likely to be of higher quality than decisions made under a 'groupthink' environment.

Diversified board members are more likely to possess different personal characteristics, which lead to dissimilar leadership, thinking, emotional styles and even risk preferences and behaviours. Not only may this foster creativity in delivering solutions to problems, but also provide a more comprehensive oversight to the operations of the organisation through a further enhancement of the company's sensitivity to a wider ranger of possible risks such as reputation and compliance risks. This may then support a greater supervision on the boards in its performance evaluation and in the decision-making process.

Further, companies are competing in a global environment nowadays. In order to achieve organisational goals and objectives, directors need to understand diverse stakeholders' claims – in particular the needs of customers – well. A balanced board will have more representatives of users and customers of its products in the boardroom to make informed judgment. This may be especially important for consumer-facing industries to have female directors and for multinational companies to include foreign nationals on the board. Dissimilar backgrounds, experience and social networks in the boardroom may therefore improve their understanding of the stakeholders, provide diverse connections with the external environment and help address stakeholders' claims in a more responsive manner.

2. Better utilisation of talent pool

Stakeholders are demanding more from directors, in particular from non-executive directors (NEDs). Having NEDs on the board has already been a common requirement across countries. NEDs are, however, often criticised for having insufficient devotion of time and effort in understanding the business and representing stakeholders to scrutinise executive directors in making appropriate decisions.

One of the problems of searching for suitable directors lies on the limited number of candidates – there is especially a tendency to search for board members with typical characteristics, such as male directors. If directors expand the pool of potential candidates by considering more diversified attributes, like women and ethnic minorities to be included in the boardroom, it will alleviate the problem of 'director shortage' and therefore better utilise the talent pool. It is therefore vital for companies to initiate tapping into the under-utilised pool of talent through board diversity.

3. Enhancement of reputation and investor relations by establishing the company as a responsible corporate citizen

Having a heterogeneous board can enhance corporate reputation through signalling positively to the internal and external stakeholders that the organisation emphasises diverse constituencies and does not discriminate against minorities in climbing the corporate ladder. This may somehow indicate an equal opportunity of employment and the management's eagerness in positioning the organisation as a socially responsible citizen.

It is also argued that board diversity reflects the diversity of the society and community served by the organisation. This reflection strengthens the social contract between a business and its stakeholders, which, in turn, improves its strategic fit that the business has with its environment. As a result, it is suggested that a diverse board can help a company build its reputation as a responsible corporate citizen that understands its community and deserves its trust.

Further, more institutional investors have taken into account board diversity as a factor for investment evaluation due to the reasons that: (i) a number of academic research papers indicated the positive correlation between firm value and board diversity; and (ii) institutional investors are placing greater emphasis on corporate social responsibility. Board diversity can, therefore, to a certain extent, improve its investor relations.

COSTS OF DIVERSIFYING THE BOARD

Diversifying the board is not without costs. Though a board is inherently subject to conflict as it is formed by individuals collectively, having a diverse board may potentially increase friction between members, especially when new directors with different backgrounds are stereotyped by existing members as atypical. This may split the board into subgroups, which reduces group cohesiveness and impairs trust among members, leading to reluctance to share information within the board.

Another danger of board diversity is sometimes referred to as tokenism. Theoretically, as mentioned in the previous section, the minorities in the boardroom are said to contribute to value creation of the organisation by their unique skills and experiences; however, in practice, they may feel that their presence is only to make up the numbers required by the external stakeholders. They may then tend to undervalue their own skills, achievements and experiences, which demeans their potential contribution to the organisation.

Further, the board may potentially ignore the underlying important attributes of successful directors as a sacrifice to meet the requirement of board diversity. The board needs to pay special attention to these costs when implementing measures to diversify the board.

REGULATORY INITIATIVES OF BOARD DIVERSITY

Board diversity can be promoted by a number of methods. Measures currently adopted by different regulatory bodies are generally classified into the following approaches: (i) through imposing quotas on the board; and (ii) enhancing disclosures using the 'comply or explain' approach.

Imposing quotas refers to mandatory requirement in appointing a minimum number of directors with different attributes on the board. This legislation enactment mainly deals with gender diversity to tackle the relative underrepresentation of women in the boardroom. For example, since 2008, each listed company in Norway has had to ensure that women fill at least 40% of directorship positions. Spain and France are implementing similar mandatory requirements for gender diversity. This approach increases the number of women on the board at a faster rate and forces companies to follow the legislation.

Another measure to enhance board diversity is through transparency and disclosure. Companies, under corporate governance codes, are required to disclose their diversity policy in appointing directors so that investors and stakeholders can make proper evaluation. Those who fail to implement such measures have to explain their non-compliance in the corporate governance report or equivalent. The Corporate Governance Code (2010) of the United Kingdom, for example, stipulates that companies are required to: (i) incorporate diversity as a consideration in making board appointments; and (ii) disclose in their annual reports describing the board’s policy on diversity, as well as its progress in achieving the objectives of that policy. Australia and Hong Kong are promoting diversity using a similar 'comply or explain' approach. Supporters of this approach believe that board appointments should be made on the basis of business needs, skills and ability instead of legislative requirements, which may sometimes be considered excessive in the market.

CONCLUSION

Board diversity is justified as a key to better corporate governance. The following extract from academic literature by Conger and Lawler (2001) serves as a good summary of board diversity:

'The best boards are composed of individuals with different skills, knowledge, information, power, and time to contribute. Given the diversity of expertise, information, and availability that is needed to understand and govern today’s complex businesses, it is unrealistic to expect an individual director to be knowledgeable and informed about all phases of business. It is also unrealistic to expect individual directors to be available at all times and to influence all decisions. Thus, in staffing most boards, it is best to think of individuals contributing different pieces to the total picture that it takes to create an effective board.'

In implementing policies on board diversity, both the company’s chairman and the nomination committee play a significant role.

The chairman, being the leader of the board, has to facilitate new members joining the team and to encourage open discussions and exchanges of information during formal and informal meetings. To create such a well-functioning team, the chairman further needs to commit and support mentoring, networking and adequate training to board members.

The nomination committee should give consideration to diversity and establish a formal recruitment policy concerning the diversity of board members with reference to the competencies required for the board, its business nature as well as its strategies. The committee members have to carefully analyse what the board lacks in skills and expertise and advertise board positions periodically. They are strongly encouraged not to seek candidates merely through personal contacts and networks in order to carry out a formal and transparent nomination process.

The most important ingredient to the success of board diversity, however, would most probably be the board members' changing their mindset to welcome a more heterogeneous board, as well as to place greater trust in one another and work together more effectively.

Eric YW Leung FCCA, lecturer, CUHK Business School, The Chinese University of Hong Kong

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