

October 2010

## Regnan Research Report

### Independent directors and board diversity broaden skills and enhance governance

#### Key points

- Companies will soon be required to address and report on board diversity.
- Companies are also strongly advised to structure boards and board committees with a preponderance of independent directors – that is, directors who do not hold management positions with the company or relationships that may interfere with the independent exercise of their judgement.
- Independent directors are presumed to add value to a board in a variety of ways.
- Overseas and Australian research suggests that companies with women directors enjoy substantial ‘bottom-line’ and other performance advantages over companies with all-male boards. In particular, the former group appear to enjoy governance advantages over the latter group.
- However, for women to operate effectively as directors, it is generally necessary – but not sufficient – that there be a ‘critical mass’ of women on a board. The other vital requirements for effective board participation of women – indeed, minorities generally – is that they be included in the same social interaction as the majority, and that they be given comprehensive information.
- The empirical evidence on the bottom-line value of board independence and diversity more generally is more equivocal.
- However, it appears that neither board diversity nor independence has any adverse effect on company performance. There is therefore no evidentiary basis for arguing against either diversity or independence on financial performance grounds, especially given the prevailing corporate and government climate favouring – and in some cases mandating – diversity and independence.
- In any case, board diversity is likely to bring a range of longer term benefits to a company, ranging from better understanding of the market to a wider pool of job applicants.
- The commitment of Australia’s larger companies to board diversity is indifferent. Women occupy at most 10 per cent of board positions in these companies. A substantial minority of directors are drawn from an extremely narrow gender, occupational and industry background.

#### Introduction and context

A 30 June 2010 amendment to the Australian Securities Exchange Corporate Governance Council (ASXCGC)’s principles will require companies from 1 January 2011 to establish and disclose a policy for board diversity. A primary focus is on establishing measurable objectives for achieving gender diversity and an assessment of the board’s progress in achieving them. Amended ASXCGC recommendation 3.4 requires companies to disclose in their annual reports the proportion of women on the board, in senior executive positions and in the whole organisation. Amended ASXCGC recommendation 3.2 covers

diversity more broadly, and includes suggestions for the content that companies should include in their diversity policy, among them:

- promotion of ‘an environment conducive to the appointment of well-qualified employees, senior management and board candidates so that there is appropriate diversity to maximise the achievement of corporate goals’
- promotion of ‘a corporate culture [that] embraces diversity when determining the composition of employees, senior management and the board, including recruitment of employees and directors from a diverse pool of qualified candidates’
- ‘identification of factors that should be taken into account in the selection processes and whether professional intermediaries should be used to identify or assess candidates’
- ‘articulation of a corporate culture [that] not only supports workplace diversity but also recognises that employees at all levels of the company may have domestic responsibilities’
- ‘transparency of board processes, review and appointments’.

Principle 2 says companies should structure their boards to add value; they should have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties. Foremost of the salient recommendations is that a majority of the board should be independent directors (2.1), and that the chair should be an independent director (2.2). An independent director is, in the words of Britain’s 1992 Cadbury report, ‘a non-executive director who is not a member of management and who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgment, apart from their fees and shareholding’.

The Australian Institute of Company Directors agrees that non-executive directors add value to a board by:

- assisting the board in appointing, encouraging and, if necessary, replacing the CEO
- bringing an external, alternative perspective
- representing shareholder interests
- questioning, encouraging and monitoring management
- ensuring proper corporate governance process is followed with integrity, including financial reporting and disclosure, and compliance with the law and other requirements (such as stock exchange listing rules)
- approving overall strategy, budgets and large financial decisions such as capital expenditure.

The ASX, in common with many other exchanges, requires that a company either ensure that a majority of its board members are independent or advise in its annual report its failure to so ensure – which could affect investor confidence in the company.

It is, however, left to the board to decide whether individuals meet the definition of independence. (Certain categories of people who do not meet the definition are specified.) The ASX, again in common

with exchanges overseas, also recommends that audit, nomination and remuneration committees be established, and that they wholly or largely comprise independent directors.

### **Does diversity matter?**

There are three (potentially complementary) grounds on which diversity could be advocated as company policy: the normative (companies or governments and authorities determine that it's the right thing to do); it enhances 'bottom-line' shareholder value; and it improves company performance in other ways. It is important to note here that the first ground is a sufficient reason to introduce diversity policies and commitments in the absence of the second or third grounds, provided that it can be shown that diversity does not harm value and performance.

Since, as noted above, governments and authorities – and many companies – have already determined that diversity is important, this paper focuses on the second and third grounds. It first examines the evidence relating to diversity and independence, on the one hand, and company value and performance, on the other. It then examines the data relating to the board composition of major Australian companies.

### **What the research tell us**

Empirical research from Australia and overseas lends support to the hypothesis that board independence and diversity – especially gender diversity – translate into better business performance.

Carol Stephenson of the University of Ontario, in the September-October 2004 issue of *Ivey Business Journal*, details North American research on the value of women board members to businesses:

- Among 353 companies examined over four of the five years 1996 to 2000, the group with the highest representation of women in senior management had a 35 per cent higher return on equity and a 34 per cent higher total return to shareholders than those with the lowest such representation.
- Of 215 Fortune 500 companies tracked between 1980 and 1998, the 25 companies that had the best record for promoting women to board and other senior positions recorded 18 per cent higher returns and 69 per cent higher returns on investment than the Fortune 500 median for their industry.
- The Conference Board of Canada (CBC) found in 2002 that Canadian companies with two or more women board members 'were far more likely to be industry leaders in revenues and profits six years later'.

The CBC also identified substantial leadership benefits enjoyed by boards with three or more women members relative to all-male boards:

- The former 'surpass all-male boards in their attention to audit and risk oversight and control'.

- They are much more likely to ‘identify criteria for measuring strategy’ (74 per cent versus 45 per cent); to ‘ensure conflict of interest guidelines (94 per cent versus 68 per cent); and to ‘ensure a code of conduct for the organisation (86 per cent versus 66 per cent).

In a forthcoming article, *Women and influence in corporate boards: the case of Norway*, Beate Elstad of Oslo University College and Gro Ladegård of the Norwegian Institute of Life Sciences proceed from the assumption – based on research findings similar to the above – that women with influence in the boardroom will enhance company value and performance, and ask under what circumstances women directors will hold such influence.

The Norwegian government legislated in 2005 to require boards of public limited liability companies – which are typically the largest companies – to comprise no more than 60 per cent of either gender. The authors were interested ‘to understand the relationship between the proportion of women and their influence on corporate boards’.

Based on their examination of a sample of 346 directors in Norway, representing boards with female proportions ranging from 11 per cent to 100 per cent, Elstad and Ladegård conclude that ‘increasing the female ratio in a board is a necessary but not sufficient condition for increased influence for women’. It is necessary in part because gender ratios of 85:15 or worse result in the majority group ‘becom[ing] aware of their commonalities and their difference from [the minority group]’; to ‘preserve their commonalities, they keep the [minority group] outside and isolate them from the rest of the group’; furthermore, the minority group ‘will often be exposed to stereotype prejudices – for example, what is “suitable behaviour” for a woman’.

They continue: ‘It is often the case that in-group members (the majority) develop a coherence and confidence that reinforces their own self-esteem and self-perception’, and ‘will thus be more positive to communicating with each other than to communicating with other out-groups’.

‘Research has indicated that the minority problems decrease as a function of the number of women’, they say. But there are two caveats.

First, it is not unusual for board meetings to be substantially *pro forma* in character, ‘with the real business taking place outside of the meeting’ such as during breaks in proceedings or in pre-meeting telephone hook-ups. The minority group, however numerous, will be substantially excluded from influence if they are not included in the social interaction that facilitates or even constitutes these informal processes.

Second, ‘a considerable amount of research has shown that those involved [in a board decision-making process] often do not receive complete information during such a process’. Information can be filtered, embellished or withheld by the in-group, which substantially precludes the out-group from ‘understanding the matters under discussion’ or ‘submitting well-informed proposals’.

The evidence is more equivocal regarding independence and diversity more broadly. Yi Wang of the University of Tasmania, Albie Brooks of Melbourne University and Judy Oliver of Swinburne University of Technology say in a paper, 'Antecedents and performance outcomes of board independence: the Australian evidence', presented to the 2008 AFAANZ/IAAER conference that 'for Australian listed companies, there is no strong relationship between board independence and past or subsequent firm performance'. Yang *et al* focus only on financial performance – they argue that adopting a broader definition of performance that included such measures as executive turnover and remuneration, making or defending against takeover bids, and shareholder litigation, would be methodologically fraught: firms with majority-independent boards could perform better against some criteria and worse against others, making it all but impossible to reach a definitive overall finding on a possible link.

They identify six other Australian studies from 1998 to 2004 that have examined this question. Of the seven studies (their own included), four (including their own) find an insignificant relationship between independence and performance; two find a negative and one a positive relationship. However, they caution against discarding the hypothesis that there is such a link, for two reasons.

First, most of the studies are based on small sample sizes, lack controls for board or firm size, or adopt only short timeframes. Second, 'appointing outside directors to the board might merely represent firms' attempts to comply with institutional pressures, and therefore might not be necessarily linked to firm performance'; alternatively, they might be 'copying other reputable organisations, even without knowing the direct benefits of doing so, [as] a low-cost strategy to gain legitimacy'.

The authors call for more empirical testing of the hypothesis of such a link, and for 'more attention on the actual roles played by independent directors in public companies'. In particular, they are interested to learn whether executives or independent directors are more risk-averse, especially given the evidence 'that managers may not be as risk-averse as believed by some agency theorists'.

Yang and Bob Clift, also of the University of Tasmania, in 'Is there a "business case" for board diversity?' (*Pacific Accounting Review*, volume 21, issue 2, 2009), find that board diversity in Australia, as represented by the proportion of female, minority, or female and minority, directors, has no adverse effect on firm performance. As noted previously, this finding suffices to make the case for promoting board diversity as 'the right thing to do'.

Wang and Clift also identify several potential benefits beyond short-term financial performance that a diverse board membership can bring:

- It can promote a better understanding of an increasingly diverse market.
- It may increase creativity and innovation.
- It may produce more effective problem-solving by introducing a wider variety of perspectives and encouraging evaluation of more alternatives.
- It could enhance the effectiveness of corporate leadership through a better understanding of the environment and more astute decisions.

- It may promote more effective global relationships through greater cultural sensitivity.
- It could serve as a positive signal to potential job applicants, and increase competition for internal positions.
- It can enhance the company's reputation.

The August 2010 Reibey Institute preliminary research note, *ASX500 women leaders*, finds that ASX500 companies with women directors delivered an average return on investment 10.7 per cent higher over three years, and 11.1 per cent higher over five years, than those without women directors. Companies with women directors outperformed those without women directors in this respect in eight of 10 industry sectors. They note, however, that these findings 'do not suggest a causal relationship'.

According to the research note, women fill 7.1 per cent of ASX500 board positions, with higher female representation generally found in larger companies. (Other reports suggest the figure may be somewhat higher at 8.4 per cent for the ASX200, according to the Equal Opportunity for Women in the Workplace Agency's *2010 Australian Census of Women in Leadership*, or 10.1 per cent according to the Australian Institute of Company Directors – see [www.smh.com.au/executive-style/executive-women/women-still-locked-out-of-management-roles-at-work-20101005-166dj.html](http://www.smh.com.au/executive-style/executive-women/women-still-locked-out-of-management-roles-at-work-20101005-166dj.html).)

#### **Directors' backgrounds**

A Regnan study identified 795 independent directors of 176 S&P/ASX200 companies as at 31 December 2009.

A further 218 non-executive directors were not considered independent for a variety of reasons:

- former executives of the listed entity (3)
- familial relationship with the listed entity (3)
- long-serving – on the board for more than 15 years (26)
- disclosed as not independent (3)
- material related party transactions that may impair independence (36)
- substantial shareholder relationship: ownership exceeds 5 per cent (115).

An occupational background was assigned to each of the 795 independent directors, based on information provided in annual reports, on company websites and obtained through internet searches. Information obtained varied from full biographical details to a list of current and former directorships. In addition, an industry background was assigned to the 560 independent directors whose occupational backgrounds were former or current CEOs or executives.

Backgrounds could not be obtained for only a handful of directors.

Table 1: Occupational backgrounds of independent directors

<i>Occupational background</i>	<i>Number</i>	<i>Per cent of total</i>
Former executive	434	54.6
Former CEO	98	12.3
Accountant – ‘Big Four’	67	8.4
Lawyer	60	7.5
Current executive	22	2.8
Public service	15	1.9
Funds management	13	1.6
Management consultant	10	1.3
Accountant – second tier	9	1.1
Academia	8	1.0
Former politician	8	1.0
Agribusiness	6	0.8
Corporate advisory	6	0.8
Current CEO	6	0.8
Medical	6	0.8
Private company	3	0.4
Accountant – small firm	2	0.3
Private equity	2	0.3
Secondary education	2	0.3
Diplomatic service	1	0.1
Economist	1	0.1
Investment	1	0.1
Military	1	0.1
Regulator	1	0.1
Small business	1	0.1
Insufficient information	12	1.5
<i>Total</i>	<i>795</i>	<i>100.0</i>

Table 2: Industry backgrounds of independent directors who are current or former CEOs or executives

<i>Industry background</i>	<i>Current CEOs</i>	<i>Current executives</i>	<i>Former CEOs</i>	<i>Former executives</i>	<i>Total</i>	<i>Share of total (%)</i>
Banking, finance and financial services	0	11	23	185	219	39.1
Resources	3	3	23	91	120	21.4
Property, construction and materials	0	5	8	27	40	7.1
Consumer goods	0	0	11	27	38	6.8
Engineering	0	0	3	20	23	4.1
Manufacturing	1	0	12	10	23	4.1
IT	0	0	0	20	20	3.6
Sales and marketing	0	0	2	12	14	2.5
Healthcare	1	0	4	7	12	2.1

Transport and distribut	0	2	3	5	10	1.8
Telecommunications	0	1	3	5	9	1.6
Insurance	0	0	0	5	5	0.9
Logistics and distributio	0	0	0	4	4	0.7
Media	0	0	2	2	4	0.7
Retail	0	0	2	1	3	0.5
Agribusiness	0	0	0	2	2	0.4
Human resources	0	0	0	2	2	0.4
Law	0	0	0	2	2	0.4
Management consulting	0	0	0	2	2	0.4
Tourism and leisure	1	0	1	0	2	0.4
Actuarial services	0	0	1	0	1	0.2
Change management	0	0	0	1	1	0.2
Insufficient information	0	0	0	4	4	0.7
<i>Total</i>	<i>6</i>	<i>22</i>	<i>98</i>	<i>434</i>	<i>560</i>	<i>100.0</i>

This data suggests that non-executive independent directors of major Australian companies are drawn predominantly from narrow occupational and industry backgrounds. Over 70 per cent of the sample are current or former CEOs or directors, and of these, over 60 per cent are drawn from just two industry groupings: banking, finance and financial services; and resources.

The low proportions drawn from engineering and manufacturing should be of particular concern given the national imperative to promote innovation in order for Australian industry to remain globally competitive.

When combined with the Reibey Institute finding that women hold barely 7 per cent of directorships, this points to an at best lukewarm corporate commitment to board diversity in Australia, with around 40 per cent of directors sharing a homogeneous gender, occupation and industry background.

## Conclusion

This report examines the evidence regarding independent directors and diversity of board membership and their relationship to company performance. The evidence suggests that, at worst, neither independence nor diversity has an adverse impact on performance; at best, they are likely to bring substantial benefits. (The evidence on diversity appears stronger in this regard than that on independence.)

A succession of global and regional financial crises have ushered in requirements in many countries, including Australia, in relation to board independence. There are those, such as Bond University's Thomas Ritchie ('Independent directors: magic bullet or band-aid?', 2007, downloadable at <http://epublications.bond.edu.au/cgej/5>), who counsel against saddling boards with a *majority* of independent directors on the grounds that they are likely to 'lack relevant experience and will tend to manage the company more conservatively' because they do not have the 'more immediate sense of loyalty to the company and an incentive to take commercial risks' of non-independent directors.

However, in the absence of robust evidence that independent board majorities do indeed hamper company performance in this regard, there is a solid case for compliance with a strong government and public sentiment favouring closer attention to corporate governance through more independent board oversight.

Large Australian companies have a poor record with regard to board diversity, with close to half of directors drawn from a remarkably narrow gender, occupation and industry pool. Companies are thus forgoing a range of financial and performance advantages that diverse boards are likely to bring. They may also be unwittingly bringing forward the time when board diversity is more strongly mandated than at present.

Thanks are owed to New Zealand librarian Denny Boothe, who located key resources for this report.