Composition and clarity of purpose

This section is focused on the first element of the effectiveness framework (shown in Figure 2). The composition of the board and clarity among directors about their roles is an obvious starting point — a properly focussed and functioning board. Directors need to have a strategic focus and recognise that the role of the board may vary over time in response to organisational requirements, management changes, and the external environment.

Directors need to be aligned on where the focus should be, whether it is more on future performance (right side of the Tricker model for a mature and highly developed organisation) or current issues (left side of the Tricker model for a newly formed or poorly resourced organisation in the NFP space).

There are times where board involvement in the organisation is needed more than other times (for example, during an organisational crisis). Board members need to agree about where and how they can add value to the management team, otherwise the board may struggle to perform well in all quadrants of the Tricker model, which may detract value from the performance of the organisation.

At the core of effectiveness are clarity and alignment about the skills needed on the board and how directors are able to function together.

Board composition

'Board composition' is a broad term to encompass issues such as who is on the board and their particular skills and experience, their personalities and style of interaction with other directors. Board effectiveness depends on obtaining the right mix of skills, experience and attitude.

In practice, there are many different ways that board composition is determined. The boards of new companies are often determined by the shareholders or financial backers, comprising people to whom they have ready access and without a great deal of careful and deliberate design. The initial boards of not-for-profit organisations are usually comprised of a selection of like-minded individuals who set up the organisation to meet a specific need or for a particular purpose. These initial boards are critical in establishing governance standards needed to enhance and protect the reputation of the organisation.

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Board composition varies significantly between organisations and is influenced by:

- legal requirements including the organisation's purpose, local legislation and other legal framework documents (for example, constitution, shareholder agreement, joint venture agreement);
- the minimum size and residency requirements for propriety limited and public companies under the *Corporations Act 2001* (Cth);
- board size — is the size appropriate such that the board discharges its workload effectively, has productive discussions, is able to plan for orderly succession and has a mix of skills, experience and backgrounds;
- the balance of executive and non-executive directors;
- individual director competencies — is the mix of skills, experience and backgrounds aligned with the company's overarching strategy;
- terms of office for directors;
- the structure of the shareholding or membership; and
- the role of committees.

Director competencies

The director competencies required on each board will vary, depending on the nature and type of the organisation and the laws and statutes applying to it.

Regardless of the entity, director competencies encompass two distinct areas: technical and behavioural.

Competencies consider experience, skills, attributes and capabilities

Technical competencies — refer to a director's technical knowledge, skills and experience (educational qualifications, what you know and can do) such as accounting, legal skills, engineering or marketing; industry knowledge; experience in strategic planning, fund raising or corporate governance and the ability to assimilate and synthesise complex information.

Behavioural competencies — refer to a director's capabilities and personal attributes (how you apply what you know and your personal and social skills) such as an ability to positively influence people and situations; commitment to the role; honesty and integrity; individual decision-making processes and biases and ethical standards. It is imperative that new directors appointed to the board are a good cultural fit for the board and the organisation.

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When boards consider director competencies, for instance, during a skills audit, desirable technical skills are usually listed first. Consideration may also be given to knowledge of, or experience in, the industry in which the organisation operates, the director's network of contacts, or the director's link to a key stakeholder or stakeholders.

Unfortunately, in some cases less attention is paid to essential director capabilities that are critical to board dynamics and may not be evident from their CV, such as:

- the ability to assimilate and synthesise complex information quickly;
- the ability to develop and deliver a cogent argument;
- imagination, curiosity and breadth of vision;
- an open mind, the ability to be innovative and think outside the square;
- the ability to understand issues at both the detailed and 'big picture' level; and
- self-awareness, respect for others, listening skills, energy, courage, resilience and intellectual capacity.

All directors need to have the ability to make points succinctly and effectively at board meetings

All directors, regardless of the entity they serve, should have a reputation for acting with integrity, honesty and high ethical standards. As directors are often ambassadors for their organisations, a real sense of commitment is also important. This applies equally, and sometimes more so, to unpaid directors on a not-for-profit board, where the lack of remuneration can risk clouding the responsibility of directors and the time commitment required to participate effectively on the board.

Unpaid directors should never feel, even subconsciously, that attendance at board meetings or any other function is optional because they are not remunerated. Not-for-profit boards have the same responsibilities and are increasingly moving towards higher standards of professionalism and governance and need directors who reflect these standards.

Prior to nominating, appointing or reappointing individuals as directors, the board should spend time developing a board skills matrix to prioritise the skills, competencies and behavioural attributes it seeks. A board skills matrix seeks to list all the skills, wisdom and experience the company needs on its board. Once prepared, this document should be considered in light of the company's strategic priorities to identify if the board has the requisite skills needed to drive the organisation's future performance.

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Boards should also consider how to delve beyond a CV and formal reference checking to uncover the critical aspects of character and attitude, which can influence the potential director's ability to integrate and perform with the board team. Due diligence on candidates is extremely important, even if a candidate is known to a director on the board and should include a careful selection process involving two or more candidates which is normally overseen by a governance or nominations committee.

Board size

The board of any organisation should be large enough to benefit from a range of diverse skills and experience, yet small enough to encourage contribution and informed debate. Board size will also be influenced by the ownership structure and any legal requirements such as the constitution of the organisation.

Board size has received attention in the US governance literature because of the correlation of poor performing companies and large size (15–20 members) of some US boards.[8]

Not-for-profit organisations and government instrumentalities often have larger boards, particularly when they represent different interests. However, the larger the board, the greater the potential to create factions, risking disharmony and difficulty in effective decision making. It is also much more difficult to run tight board meetings with larger boards and meetings can take much longer without any great gain in decision making capabilities.

> *A director on a board with too few members will experience isolation, limited input, interaction with a narrow field of vision, and pressure to reduce his or her independence. A director on a board with too many members will find it very difficult to participate in the full board's proceedings, confront the company's challenges and build solutions.*[9]

[8] Examples include D Yermack, 1996, "Higher Market Valuation of Companies with a Small Board of Directors", *Journal of Financial Economics*, Vol 40, No 2, pp 185–211; also J Huther, 1997, "An Empirical test of the Effect of Board Size on Firm Efficiency", in *Economic Letters*, Vol 54, No 3, pp 259–64.

[9] C J Crawford, 2007, *Compliance and Conviction: The Evolution of Enlightened Corporate Governance*, XCEO, Inc, Santa Clara.

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The 2012 Spencer Stuart US Financial Services Board Index showed that the Standard & Poors (S&P) 500 financial services firms have the largest boards of any industry sector (11.6 average in 2012, 11.8 in 2011). The S&P 500 average is 10.7 directors. A 2010 study showed the average board size for ASX300 companies was seven and for ASX50 companies was nine.[10]

A study by researchers at Bain found that after there are seven people in a decision-making group, each extra member reduces decision effectiveness by 10 per cent. At that point, personal and group performance is highest. With such limited numbers, who constitutes the board then becomes critical in terms of skill/ experience/ capability and other desired contributions.

In practice, boards tend to increase in size to remedy perceived weakness or to add necessary skills and experience, or to bring new knowledge or contacts. It is not often that there is a reduction in numbers. The commentary to recommendation 2.4 of the ASX's Listing Rules suggests that ultimately, a board should be of a size and composition that is conducive to making appropriate decisions.

In Australia, the ideal board size is considered to be around 8 to 10 members. Research in the UK suggests that when a board is composed of more than 12, a number of skills are compromised, namely attention span, ability to deal with complexity, ability to maintain effective inter-personal relationships and motivation.[11] Experienced company chair, John Schubert FAICD, has commenced on board size as follows:

> *The dynamics of the discussion at any meeting deteriorate with every addition above six or seven participants, but with a major company, you probably need a minimum of nine or 10 people to cover the skills and experience needed and to populate the various board committees. That means the dynamics are not ideal.*[12]

Boards must have a good understanding of the positives that they expect will be gained from an additional director before increasing the board size. Those positives should outweigh the negatives of less effective communication.

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[10] Korn/Ferry International, 2010, *Board of Directors Study Australia and New Zealand*, Korn/Ferry International and Egan Associates, Sydney.

[11] A McIntyre, 2011, *Tomorrow's Boards, Creating Balanced and Effective Boards*, Australian Institute of Company Directors, Sydney, referring to research by Tavistock Institute of Human Relations and Crelos Ltd in the report prepared by Sir David Walker on 16 July 2009, *Á review of corporate governance in UK banks and other financial industry entities.*

[12] A McIntyre, 2011, *Tomorrow's Boards, Creating Balanced and Effective Boards*, Australian Institute of Company Directors, Sydney, referring to D Stuart, *QA with John Schubert*, Company Director Magazine, May 2010.

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For boards other than those of the large publicly listed companies, some general observations can be made about board size. These are:

- Board size usually increases with company size.
- Not-for-profit organisations and government instrumentalities tend to have larger boards, particularly when they seek to include different interests (for example, boards with member and union representatives).
- The larger the board, the greater the potential to factionalise.
- The potential for political problems exists in member or representative type organisations when trying to reduce the size of the board.

Board diversity

There are four diversity of thinking enablers:

- Composition — a focus on specific aspects of group composition in terms of visible and invisible diversity.
- Conversation — disciplined debating and thinking processes instead of random brainstorming.
- Bias mitigation — mitigating biases that lead individuals and the group back to homogeneity and the status quo.
- Inclusive leadership — a mindset and set of behaviours that enable leaders to role model what it means to be, and create an environment that is, highly inclusive of diversity.[13]

Modules 1 and 2 covered the processes a board can use to think and debate (conversation), and the way to mitigate biases that lead towards maintenance of the status quo (bias mitigation). The role of the chair is discussed later in this module (inclusive leadership).

Current governance thinking emphasises choosing a diverse range of board members to capture the widest range of skills and experience. Age, nationality, gender, business experience, educational background and specialist industry experience are all criteria that may be considered.

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[13] J Bourke, 2016, *Which Two Heads Are Better Than One?*, Australian Institute of Company Directors, and Deloitte Sydney.

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The book, *Superforecasting*,[14] looked at what decisions by the most successful forecasting groups had in common and the key concluding line was "diversity trumps ability". A group of intelligent people with the same background underperformed in comparison to the group of people with lower intelligence that was 'externalised' by outliers. The characteristic that matters wasn't intelligence, but having a high level of open-mindedness, coupled with a culture of sharing.

Foster a board culture encouraging divergent views and robust discussion

Directors from a variety of backgrounds can provide substantial benefits to the board, if they possess the appropriate knowledge, skills and capabilities. Board member selection should focus on the ability of each individual to bring particular skills and experience and to contribute to the effectiveness of the board discussion and decision making, as discussed in Module 2.

The subject of board diversity in recent years has been largely focused on gender diversity, as multiple surveys and reports showed a very low proportion of women on Australian boards. As a consequence, Principle 1.5 of the ASX Corporate Governance Council's (ASXCGC) *Corporate Governance Principles and Recommendations* recognises the importance of gender balance in board diversity, recommending boards establish and then report on measurable objectives to achieve diversity:

> *It should be noted that while the focus of this recommendation is on gender diversity, diversity has a much broader dimension and includes matters of age, disability, ethnicity, marital or family status, religious or cultural background, sexual orientation and gender identity. To garner the full benefits of diversity, an entity should ensure that its recruitment and selection practices at all levels (from the board downwards) are appropriately structured so that a diverse range of candidates are considered and that there are no conscious or unconscious biases that might discriminate against certain candidates.*[15]

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[14] Philip E Tetlock and Dan Gardner, 2015, Superforecasting: The Art and Science of Prediction, Penguin Random House, New York. Quoted by C Slater, 2017, "Diverse Boards Made More Dollars and Sense", *Australian Financial Review*, 21 August.

[15] ASX Corporate Governance Council, 2014, *Corporate Governance Principles and Recommendations*, 3rd edn, Australian Securities Exchange, Sydney.

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INSEAD Professor of Corporate Governance Ludo Van der Heyden sat down with Marcel Mol, AICD General Manager of Education and International, to talk about education and governance. During that interview, he noted that boards are moving in the direction of diversity and understanding that gender diversity is just one element. However, his observations are that although directors are saying that, “I like diversity as a principle but when I taste it, I like it less”, so there is a tendency to group together with liked-minded people. He also noted that it is difficult for there to be diversity with one different person on a board as people tend to reject that person because there can be a suggestion that they do not understand the issues. With respect to gender diversity, Ludo Van der Heyden noted that in management research this is about equality, that is, women can do what men can do. However, the discussion from a governance point of view is that women are needed on boards because they are different and contribute to diversity.

Juliet Bourke in her book, *Which Two Heads are Better Than One?* concludes that the indirect value of racial and gender diversity, and the direct value of functional and educational diversity, to the overall diversity of a group’s thinking is a much richer albeit more complex message to communicate than supporting stereotypical views.[16] More importantly, it offers a more realistic view about how to create diversity of thinking and highlights the inherent risks and limits of visibly homogenous groups. Professor Page’s definition of diversity is supported:

> *Neither a person nor an apple can be diverse. Diversity is the property of a collection of people — a basket with many kinds of fruit.*[17]

Balance and independence

The term ‘balance’ usually refers to the proportion of executive to non-executive directors on the board, to independent and non-independent directors. Independent directors should bring independence of thought to enhance the board’s capacity to act in the best interests of the company. In some regulated industries, there is a legal requirement for boards to comprise a majority of independent directors, for example, superannuation funds under the *Superannuation Industry (Supervision) Act 1993* (Cth).

Independence of mind is more important than structural independence

[16] Bourke, 2016, op cit, p 84.

[17] Scott E Page, 2007, *The Difference: How the Power of Diversity Creates Better Groups, Firms Schools, and Societies*, Princeton University Press.

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The following are examples of characteristics that may render a director 'non-independent' as discussed in Module 1:

- being a current or former (within the past three years) auditor of the company;
- being a current or former (within the past three years) staff member or family member of an employee (hence all independent directors are non-executives but not all non-executives are independent);
- a major competitor, supplier or customer of the company;
- a shareholder with more than five per cent of the share capital of the company; and/ or
- a secured creditor.

Independence is believed to add objectivity to the board's decision making. The ASXCGC *Corporate Governance Principles and Recommendations*, Principle 2, recognises the majority of the board of a listed entity should be independent directors:

> *Having a majority of independent directors makes it harder for any individual or small group of individuals to dominate the board's decision making and maximises the likelihood that the decisions of the board will reflect the best interests of the entity and its security holders generally and not be biased towards the interests of management or any other person or group with whom a non-independent director may be associated. Non-executive directors should consider the benefits of conferring periodically without executive directors or other senior executives present.*[18]

Selection processes

Board selection processes are changing as boards seek members with specific skills and experience to contribute their wisdom and insights in a more complex business environment. There is a tendency towards appointing board members for a specific stage in a company's development, rather than a longer-term appointment. Getting the right combination of skills and experience is the starting point for ensuring an effective board. Board composition is a dynamic factor driving how well the board works and its effectiveness can be compromised if board membership and culture are out of step with the overall needs of the organisation.

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[18] ASXCGC, 2014, op cit.

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