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Board Diversity – 14 November 2011

ESG Analyst - Paul Rogers

1 Executive Summary

The boards of Australian companies are predominantly made up of directors who share the same gender, similar age, culture and professional backgrounds. Despite increasing evidence of a correlation between forms of diversity (including gender) and company performance, Australian companies have so far been slow to increase the diversity of their boards. This paper contends that this slowness to act means companies are failing to fully benefit from their existing and potential human capital and consequently constraining financial performance, which should be of concern for all investors. The paper calls on public companies to take strategic, concrete steps to increase board diversity, beginning at a minimum with implementing the recommendations on diversity outlined in the ASX Corporate Governance Council's (ASXCGC) Principles and Recommendations. However, the paper warns that the real challenge will be to overcome unexamined assumptions about what constitutes a good leader. This will require a commitment to more rigorous consideration of this question in the director search and selection process, strong leadership, and concrete actions to remove barriers to women and other under-represented groups. Companies which take a tokenistic approach are likely to improve superficial diversity without gaining the business benefits of a genuinely diverse board.

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3 Board diversity is about more than gender

In recent years there has been increasing awareness in Australia and other countries of the lack of diversity on company boards. Although gender is one important dimension of diversity, it is not the only one. In Australia, boards are predominantly made up of directors who share similar age, culture, professional background and gender. Research undertaken by Regnan shows, that the vast majority of the 795 independent directors on S&P/ASX200 company boards at 31 December 2009 came from a narrow band of occupational and industry backgrounds. Around 70 percent were current or former executives, including CEOs, and of these more than 60 percent had a background in just two industry groupings: banking, finance and financial services; and resources. Despite the significance of the service sector, just two of the current and former executives had a background in human resources. It is also noteworthy that despite the current resources boom, only 4.1 percent of independent board directors who were former or current executives had engineering backgrounds.

Of concern for investors is how limited diversity prevents companies from fully benefiting from their available and potential human capital, a view expressed by the Productivity Commission in its 2009 inquiry into executive remuneration.[1] This can manifest in a number of ways. For example, the age of directors' technical expertise may limit a board's fluency with complex or innovative products, markets, trends or operational risks – with consequences for the effectiveness of their contribution to reviewing strategy, monitoring management and overseeing risks. Examples where this could be relevant include complex financial instruments, competition from ecommerce, audience fragmentation in the media sector or reliance on critical IT in banking.

One study in the United States found that companies with a high representation of diverse board members, as measured by gender, race and skills, exceeded average returns on both the Dow Jones and NASDAQ over a five year period.[2] As the Corporations and Markets Advisory Committee suggests, diversity may in such cases be the by-product of a genuinely talent-focussed approach to board composition with better overall talent translating to better performance.[3] It is also possible that diversity could have more direct benefits, such as better understanding of a diverse market, increasing innovation and creativity, and promoting more effective problem-solving and reducing groupthink tendencies by introducing a wider variety of perspectives.[4] Recognition of these benefits is behind the United States Securities and Exchange Commission's (SEC) new disclosure rules for governance and executive remuneration, which from 2010 require boards to disclose whether diversity is a factor in considering candidates for nomination to the board of directors, and how the

[1] Productivity Commission, 2010, Executive Remuneration in Australia Inquiry Report, 4 January
[2] Virtcom Consulting, 2009, 'Board Diversification Strategy: Realizing Competitive Advantage and Shareowner Value'. White Paper
[3] Australian Government, Corporations and Markets Advisory Committee, 2009, 'Diversity on boards of directors', March
[4] See Yang and Clift, B., 2009, *Pacific Accounting Review*, 21 (2)

company assesses the effectiveness of policies.[5] The Australian Institute of Company Directors (AICD) also supports a broader approach to diversity.[6]

4 Board diversity – opportunities lost

The case of gender is a particularly visible example of the lack of board diversity given that women make up around 51 percent of the population. In 2009, only around five percent of new appointees to the boards of S&P/ASX200 listed companies were women. Although this increased to 27 percent in 2010 (following new disclosure requirements under the ASX 'Corporate Governance Principles and Recommendations') women still represent only around 12-13 percent of S&P/ASX200 company directors.[7] A mere 2.5 percent of those chairing S&P/ASX200 companies were women in 2010 – only a 0.5 percent increase from 2008.[8] Compare this with proportion of Vice Chancellors of Australian Universities who are women (17.9 percent) or women on Government boards (33.4 percent). The figures are equally disappointing in the case of women at senior management levels. In 2010, for example, only 8 percent of senior executives in S&P/ASX200 companies were women.[9] We believe this is an important contributor to the shortage of women directors, given the prevalence of former executives in director ranks. If women are represented poorly in these senior positions this may flow through to their representation on company boards.

The research shows that in failing to appoint women, both at director and senior management levels, companies are depriving themselves of a valuable untapped resource and may be foregoing financial benefits. A study by McKinsey in 2007 showed financial outperformance in companies with a higher proportion of women on their senior management committees.[10]

Research on companies with female directors shows similar outperformance. A 2002 study by The Conference Board of Canada (CBC) found that Canadian companies with two or more female board members were "far more likely to be industry leaders in revenues and profits six years later". A 2007 study of Fortune 500 companies by Catalyst showed that companies with more women directors outperformed companies with the least women directors by 53 percent on ROE and other financial performance measures.[11] In a study of S&P/ASX500 companies by The Reibey Institute in 2010, it was found that companies with women directors had an average ROE of 10.7 percent higher over three years than companies with no women directors; over five years this increased to 11.1 percent.[12]

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[5] The SEC's interpretation of diversity is wider than simply gender and it suggests companies may want to consider diversity in terms of race, background, experience, skill and other factors
[6] AICD, 2009, 'AICD takes action on board diversity', 24 November
[7] This is 'real time' data as at 9 August 2011. See http://www.companydirectors.com.au/Director-Resource-Centre/Governance-and-Director-Issues/Board-Diversity/Statistics, accessed 16 August 2011
[8] Australian Government, Equal Opportunity for Women in the Workplace Agency, 2010, 'EOWA 2010 Census Key Findings Report'
[9] Ibid
[10] McKinsey & Company, 2007, 'Women Matter: Gender Diversity, a Corporate Performance Driver'
[11] Catalyst, 2007, 'The Bottom Line: Corporate Performance and Women's Representation on Boards'
[12] Reibey Institute, 2010, 'ASX500 Women Leaders: Preliminary Research Note', August

The reasons for this outperformance are not entirely clear. The CBC study hypothesised that the multiple women on boards give those companies substantial leadership benefits, for example in terms of greater attention to audit and risk oversight and control or because such boards are more likely to identify criteria for measuring strategy. Another view posits that an "active and open" approach to board composition and renewal is likely to drive long term corporate performance, and that this approach is also likely to be more inclusive of non-traditional candidates, including women.[13] Irrespective of the cause, the correlation between board diversity and company performance is well documented. Regnan believes the evidence of poor diversity on the boards of Australian companies, represents a lost opportunity for companies and for shareholders.

5 Why has progress been so slow?

One popular explanation for slow progress in increasing women's representation on boards is that women face gender-specific barriers to career progression into the senior positions from which directors are commonly recruited - barriers associated with their traditional role in society as primary carers within families.

One of the main barriers identified has been termed the "double burden syndrome"; women's work and family / household responsibilities prevent them from living up to the "anytime, anywhere" expectation that is a part of corporate culture.[14] It is commonly supposed in the business world that effective leadership requires unfailing availability, regardless of time or place.[15] There is also a belief that the path to leadership positions is linear, uninterrupted by career breaks such as those taken by many women to care for children. If women do not adhere to these conventions, it is interpreted as lack of commitment and ambition. This may explain research showing that a large pool of talented, educated women does exist in Australia but that they do not appear to be given the same opportunities to climb the corporate ladder as their male counterparts.[16] Assumptions about their commitment to their jobs and their choices when they have children mean they are less likely to be chosen for accelerated development programs. A survey by the Financial Services Institute of Australasia (FINSIA) of women in the financial services sector found that 85 percent believed that there was a "gender divide" in that sector and most felt that it was almost impossible to overcome.[17]

Rarely examined however, are suppositions about what constitutes effective leadership and how gender stereotypes interact with these suppositions to hinder women's progress. For example, a persistent myth in the business world is that women are not tough negotiators or aggressive enough in business.[18] This has led to an unconscious (and occasionally conscious) bias against appointing women to senior positions, a bias which serves to reinforce stereotypes about what traits constitute

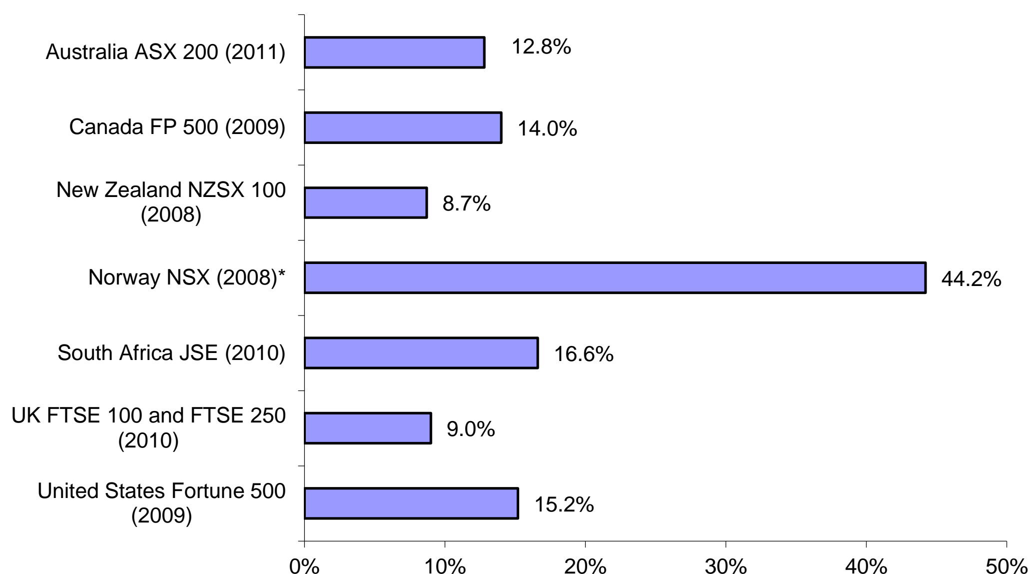
[13] Australian Government, Corporations and Markets Advisory Committee, 2009, 'Diversity on Boards of Directors', March
[14] McKinsey & Company, 2010, 'Women Matter 2010, Women at the Top of Corporations: Making it Happen'
[15] McKinsey & Company, 2007, 'Women Matter: Gender Diversity, a Corporate Performance Driver'
[16] Fox, C, 2010, 'Mythbusters – Seven Myths about Women and Work', Financial Services Institute of Australia, October
[17] Ibid
[18] Ibid

effective leadership.[19] Moreover when women do demonstrate qualities more often seen as masculine, they are often judged unfavourably, due to different social norms for male and female behaviour. This situation has hallmarks of a "Catch-22" for women and a stalemate for the business community, and has consequently invited regulatory interest around the world.

Lack of gender diversity is an issue widespread in English-speaking economies. Figure 1 shows the proportions of women on boards in a number of countries. Norway's significantly higher numbers reflect mandatory quotas introduced in 2004.[20]

Figure 1.

Percentage of Board Directors who are Women



Source: AICD (2011), EOWA (2010), European Professional Women's Network (2008)

Australia has taken an "if not why not" approach and from 1 January 2011, the ASX Corporate Governance Council (ASXCGC) 'Corporate Governance Principles and Recommendations' has required all ASX listed companies to address diversity – including through establishing measurable objectives for greater diversity and reporting against these- or to report why they have elected not to do so.[21]

[19] Ibid
[20] Ibid
[21] Amended recommendation 3.2 covers diversity more broadly (not simply gender diversity) and requires companies to establish and disclose a diversity policy. The principles provide suggestions for the content of a policy, for example the inclusion of "statement of commitment to diversity and articulation of the corporate benefits arising from employee and board diversity and the importance of benefiting from all available talent". Recommendation 3.3 requires companies to set and report

The amended ASXCGC Principles suggest that diversity policies could outline programs that help develop a broader pool of skilled and experienced board candidates, such as executive mentoring programs and preparatory programs for senior management and board positions. It notes that diversity policies could articulate a corporate culture that recognises many employees have outside responsibilities.

While commending companies that are taking action on this issue, Regnan is concerned that the board diversity problem should not be narrowly framed as a lack of committed and suitably qualified women. Women's greater prevalence in leadership roles in other institutions, including universities and in government agencies, belies this diagnosis of the issue – and should challenge corporate Australia to distinguish those characteristics that are genuinely important for a given position from those that are conventionally associated with leadership, but which are not, on inspection, necessarily essential. Education, mentoring and flexible work provisions will only address part of the problem if women (and other under-represented groups) continue to be judged against the conventional templates.

What is needed is a more systematic investigation by corporations on what formal and informal barriers prevent meritorious but unconventional talent from being retained, recognised, cultivated, and progressed. An authentic and visible commitment from the CEO and leadership team is essential if we are to break down the informal barriers to advancement of the diversity agenda.

At board level, there is some evidence that many Australian directors are recruited through informal social networks and that this, coupled with a lack of transparency surrounding board appointment processes and decisions, has been a significant barrier to increasing the proportion of women and other under-represented groups on company boards.[22] One UK study found that almost half of the directors interviewed in a survey claimed they had been recruited through personal friendships and connections.[23] This would naturally result in the director pool being replenished in a manner that maintained homogeneity. Greater transparency in director selection processes has the potential to encourage greater diversity in all its forms, including gender, professional background, age, skills and culture.

6 Call to action

Regnan represents institutions who invest for the long term and fiduciary duty requires them to rigorously scrutinise the performance of the companies in their portfolios. These investors therefore have an interest in ensuring the companies in which they invest engage appropriately with the challenges and the opportunities presented by increased board diversity.

on progress towards meeting gender diversity targets. Finally, recommendation 3.4 requires companies to report on the proportion of women at various levels of the company, including on the board. ASX Corporate Governance Council, 2010, 'Corporate Governance Principles and Recommendations', 2nd Edition with 2010 Amendments

[22] See for example *The Age*, 2009, 'Old boys' network rules the boardroom', 13 August. See also Government, Corporations and Markets Advisory Committee, 2009, 'Diversity on Boards of Directors', March.

[23] Tyson, L, 2003, 'The Tyson Report on the Recruitment and Development of Non-Executive Directors, London School of Economics, June

Regnan does not favour quotas, believing that a more reflective and resourceful approach to securing director and executive talent is likely to result in improved diversity as well as improved performance. However we note that a rate of progress out of step with community expectations can leave companies vulnerable to politically motivated regulation.

Regnan expects S&P/ASX200 companies to evidence efforts to improve board and executive diversity, within the context of the company's particular business needs by:

- Having and disclosing a policy on the manner in which board composition is adequately informed by considerations of diversity. The contents of the policy could be based on the suggestions within the 2010 version of the ASXCGC 'Principles and Recommendations'. It could also include setting and publicly reporting progress in achieving any diversity objectives.

- Adopting a more transparent approach to the director appointment process, especially through disclosure of the rationale for appointing a particular director. This could entail clearly articulating the skills and competencies required by the board in the context of the company's business strategy and market position, and discussing how a particular appointment fits within this strategy.

- Developing and disclosing strategies for sourcing those skills and competencies within populations not already well represented on the board – focusing not only on gender, but also other aspects of diversity (e.g. age, cultural or professional background etc.) which might add value on a given board. Regnan particularly encourages the identification of key business risk areas that may benefit from improved oversight if board skills in that field were bolstered.

- Assigning clear responsibility for the company's diversity objectives, for example assigning responsibility to the nomination or similar committee and/or at executive management level.

- Having the CEO take a leadership role in advancing the diversity agenda at the executive level, and leading by example (for instance in recognising and accommodating outside responsibilities). An explicit acknowledgement by the CEO of issues such as unconscious bias could prompt recognition within the rest of the company of such dynamics where they occur.

- Taking steps to identify and address informal barriers to meritocratic progression, for instance by investigating reasons for failure to recruit, retain, or promote women (and other under-represented groups) in numbers roughly proportionate to their presence within a population.