WHO SHOULD BE A DIRECTOR?

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INTERNATIONAL GOVERNANCE AND PERFORMANCE RESEARCH CENTRE

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WHO SHOULD BE A DIRECTOR?

PURPOSE

This paper undertakes exploratory analysis and provides conclusions regarding 'who should be a director?' The method employed involves consideration of some 'official' approaches existing within Australia and internationally.[1] The paper provides informed commentary for members of CPA Australia and others involved in boardroom activities and board member selection. Ideally, it will assist shareholders to understand the complexities involved in director selection as well as those considering directorships. While the 'official' approaches tend towards advising larger listed entities, discussion of who should be a director is equally relevant in relation to smaller entities.

[1] A related- question is 'who should NOT be a director'? This question will not be examined directly in this paper. The Corporations Act 2001 Cth, commentary by the Australian Securities & Investment Commission and aspects of the Bankruptcy Act 1966 Cth are of significant import in respect to this issue.

1. OVERVIEW

Boards of directors are focused on long-term organisational success – in all dimensions. As directors, they should not run day to day operations but set strategic targets, select key management, and overview management on an ongoing basis. Regardless of whether the organisation is listed or unlisted, private or public sector, for profit or not-for-profit, **boards of directors set the direction and influence all aspects of the organisation**. Boards have group responsibility. All board members must ensure that board decisions are those of the board and are not inappropriately directed by individual power or pressure. **Every individual board member must be equipped to contribute**. Where boards include executive managers, it is important to understand that these executives have a role on the board that is separate from, and complementary to, their role as an executive. This understanding is especially important in smaller entities where interactions between executives, owners and board members may be complex.[2]

Boards need to be productive as decision makers. They need to be informed, innovative and highly skilled in relation to strategy, value creation and a broad range of responsibilities. All board relationships and interactions – including those that occur with management, employees, shareholders and other stakeholders – are important.

Board renewal is a critical issue, as renewal processes provide opportunities to choose the 'right' new directors. The qualities of retiring directors will not necessarily be those sought in the right people for the future. The balance of the boardroom must change regularly, according to new circumstances and new competitive forces. At any time the 'correct balance' will include individuals with up-to-date skills and knowledge and whose decisions are based on foundations that encompass critical thinking, independence, industry knowledge, corporate knowledge and representative diversity. **Innovative, independent critical thinking** in the boardroom will better assure that corporations **create sustainable value** for shareholders, customers and other stakeholders. In short, **boardrooms need directors who bring new thinking and innovation, along with independence and pre-existing relevant knowledge**. Board decisions should, as far as possible, display good judgment relevant to constantly changing forces affecting the corporation.

So, 'who **should** be a director?' What combination of capabilities and characteristics will be required of the individuals who comprise the board so that this ambition for ongoing 'good judgment' is satisfied? These are questions that boards and their nomination committees must consider when proposing directors for election or re-election by shareholders. They are important questions to be considered by shareholders when exercising their voting power. And they are important questions for any person becoming, or thinking about becoming, a director. The position of director is one of profound responsibility – it is not a sinecure.

One matter that must not be ignored relates to **potential bias** and related **insufficient levels of independence** in decision making. It is a fine balance – while industry skills and corporate knowledge are very important sometimes boards are over-represented by individuals who are industry insiders; management of the corporation; self-interested large shareholders; or 'mates'. Where boards lack balanced independence, biased decision making with

[2] This paper does not explore further the complexities that surround smaller corporations' directors in respect to this issue.

flawed judgment can result. Where such bias exists, questions will be asked about whether the board demonstrates genuine leadership and is genuinely value oriented. Are 'biased' boards capable of objectively considering the current and future strategic needs of the corporation in relation to its internal and external environment and the needs of all shareholders and other stakeholders? The answer would seem inevitably to be an emphatic no.

1.1 The International Context: Organisation for Economic Co-operation and Development (OECD) Framework

The OECD's Principles of Corporate Governance 2004 reflect on the importance of boards of directors in relation both to strategic performance and to conformance responsibilities. The OECD refers to this combination of performance and conformance with the term 'corporate governance framework'. OECD 2004 Principle VI is focused on the responsibilities of boards of directors of all types of corporations across all international jurisdictions:

VI. The Responsibilities of the Board

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.

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
2. Monitoring the effectiveness of the company's governance practices and making changes as needed.
3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
5. Ensuring a formal and transparent board nomination and election process.
6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.
8. Overseeing the process of disclosure and communications.

E. The board should be able to exercise objective independent judgement on corporate affairs.

1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.
2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.
3. Board members should be able to commit themselves effectively to their responsibilities.

F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.[3]

This OECD international guidance reflects universal understandings of good corporate governance. It is apparent that a great deal is expected of boards. The many expectations to which they are subject can be met only by boards with members who have the requisite skills and who understand, and to some degree, reflect the norms and values of the communities in which corporations operate. Independent critical thinking is essential in order for boards to appropriately consider all stakeholders and to challenge thinking that is not independent. This is especially important where dominant individuals challenge independence within the boardroom. Such challenges can be common as senior management, large shareholders (including institutional shareholder pressures) and other powerful insiders seek to influence boards. It is not uncommon for boards also to need to resist pressure from 'special interest' groups in society, governments and others who commonly seek to influence board decisions. Highly capable directors who are also independent are essential to ensure skilled critical and unbiased judgments.

1.2 Australia's Corporate Governance Framework: ASX Corporate Governance Council Principles and Recommendations (ASXPR 2014)

The third edition of the Australian Security Exchange's (ASX) *Corporate Governance Principles and Recommendations* (ASXPR)[4] came into effect on 1 July 2014 and applies to all listed entities. It is developed from the original set of Principles and Recommendations first introduced by the ASX in 2003 and amended in 2007 and again in 2010. It is very similar in overall concept and approach to the United Kingdom Financial Reporting Council's *Corporate Governance Code* 2014 (UKCGC 2014).

Within ASXPR2014 there are a range of recommendations, within broadly stated principles. Further insight into these principles and recommendations is contained in more detailed comments to the principles and recommendations. ASXPR2014 contains eight principles and 29 more specific recommendations.

[3] http://www.oecd.org/corporate/oecdprinciplesofcorporategovernance.htm
[4] http://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf

Unlike the *Corporations Act 2001* legislation and related Australian Securities Investment Commission (ASIC) regulations and ASX Listing Rules, which provide detailed and clear mandatory requirements for legal compliance, the ASXPR2014 approach is more a 'framework' approach to corporate governance. Frameworks, unlike legislation, are less detailed and rely on professional judgment (or at least good judgment) for their correct operation. The ASXPR2014 framework approach generally[5] allows (the boards of) listed entities the flexibility to make judgments about the appropriate ASXPR2014 governance measures they see as being relevant to them and then complying with the specific ASXPR2014 recommendations. There is, however, a strict requirement (legally required under the ASX Listing Rules) that any listed entity's failure to comply with, or decision to depart from, these recommendations must be explained. The required explanation approach is called 'if not, why not' reporting. (It is essentially the same approach as used in UKCGC 2014 where the explanation process is termed 'comply or explain'.)

It is important to appreciate that ASXPR 2014 is written for listed entities – and discussion within this paper reflects this fact. However, effective corporate governance requirements are not relevant only to listed entities. The concepts and ideals discussed can – and are intended to be – translated to entities operating in other environments. The key conceptual issues arising are relevant to the two million plus private companies registered within Australia and also to the large number of not-for-profit and government enterprises. All entities can be expected to benefit from first rate corporate governance and its contribution to better performance. Indeed, given the media and public exposure that applies to 'large listed corporations' the principles and their application arguably are likely to be very important for smaller entities whether listed or not – and any entity that is not subject to broader scrutiny.

5 'Recommendations' not subject to the 'if not why not' rule are outside the framework approach in that in some circumstances they are mandatory. For example, a 'top 300' corporation in Australia must have an audit committee that must satisfy audit committee membership 'recommendations'. That is, the general 'if not why not' framework approach is replaced by a mandatory regulatory requirement that cannot be 'explained' in terms of its absence.

2. BOARD COMPOSITION

As previously discussed, the right balance in the boardroom and the complementary capabilities required of any new director are necessary to ensure that good judgment is exercised by the board. ASXPR2014 provides direction about how to create effective boards and, by implication, what new directors should contribute to board renewal. First, existing board composition must be fully understood both in terms of strengths and weaknesses. Second, there must be an understanding of the emerging internal and external strategic circumstances that will affect the entity and the type of desirable strategic direction that will be needed. Note that the existing board itself must be informed, highly skilled and also possessed of an independence-based understanding of what the entity will need of its future board. The existing board must validly assess what is needed in a reconstituted board. It should assess which directors need to be replaced and what the replacement director(s) needs to bring to the board. Any attempt by a board simply to replicate itself unchanged is unacceptable – future success cannot be achieved with a 'same old, same old' approach.

The most significant 'foundation rules' regarding 'who should be a director' arguably are seen in Principle 2, more precisely within Recommendations 2.2 and 2.4.

Principle 2 of ASXPR2014 states:

> ***Structure the Board to Add Value.***
> *A listed Entity should have a board of an appropriate size, composition, skills and commitment to enable it to discharge its duties effectively.*

Recommendation 2.2 of ASXPR2014 requires that:

> *A listed entity should have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve in its membership.*

Principle 2, in part, states and fully implies that the board of a listed entity should be the right size and should be made up of the right people. Directors should have the right skills and also the commitment and available time necessary to fulfil their duties.

Recommendation 2.2 is more specific. It requires that the entity 'should' disclose its overall 'skills matrix' AND its level of 'diversity'. Both of these concepts are discussed in this paper. ASXPR2014 'disclosure' refers to disclosure in the annual report or on the company website that a recommendation is followed – or explanation as to why it is NOT followed.[6] These disclosures are normally included within what many entities refer to as their 'Corporate Governance Statement'.

Board and individual director skills are highly important. Meeting the many expectations – including those identified and stated by the OECD – will not be easy. Therefore, it is suggested that an entity should make known both the current skills matrix of existing boards along with its ambitions in terms of its desired skills matrix. Beyond this, entities should consider identifying individual relevant strengths and perhaps even weaknesses – although this latter may be stated in respect of the whole board and not in relation to an individual. The ambition should be to identify information that provides a sound basis for shareholders' decisions when voting for the best new director in elections. Regardless of the

6 ASXPR2014, pp. 5, 6

way that Recommendation 2.2 is constructed or interpreted the concept that shareholders and other stakeholders should
be aware of current and desirable skills and skills gaps is of fundamental importance. One key feature of 'who should be a director' is that any new director should contribute, in an appropriately balanced way, to reducing skills and diversity gaps.

Recommendation 2.4 of ASXPR2014 requires that:

> *A majority of the board of a listed entity should be independent directors.*

This rule is simple yet important. The Commentary to Recommendation 2.4 explains that such a majority makes it harder for the board to "… be biased towards the interests of management or any other person or group with whom a non-independent person may be associated" (ASXPR2014)

This attribute of independence is required to ensure appropriate unbiased decision making. However, very importantly, as identified in Recommendation 2.2, the overall skills matrix must be assessed and therefore **every director, independent and otherwise, must contribute to the overall set of skills present in the boardroom**. There must be no place for a director who is independent but otherwise has no real contribution to make. Independence is important in the overall balance but it must exist in conjunction with other necessary attributes.

Concluding this introduction to the key foundations regarding who should be a director, the following words from the Commentary to Principle 2 are also highly relevant regarding the importance of independent directors as a balance in relation to executive directors and other executives who lack independence:

Commentary to Principle 2 of ASXPR2014

> *A high performing, effective board is essential for the proper governance of a listed entity. The board needs to have an appropriate number of independent non-executive directors who can challenge management and hold them to account, and also represent the best interests of the listed entity and its security holders as a whole rather than those of individual security holders or interest groups.*
>
> *The board should be of sufficient size so that the requirements of the business can be met and changes to the composition of the board and its committees can be managed without undue disruption. However, it should not be so large as to be unwieldy.*

In short, the board of a modern listed entity needs to have directors who collectively possess a range of skills and who individually bring the required standards of independence and diversity. Care must also be taken to ensure the board size does not become 'unwieldy'. 'Who should be a director?' is a question best answered by looking at what is best added at any one time and ensuring that individuals joining a board will fill an identified success-oriented 'gap'. Many factors need further analysis in identifying this 'success gap' – including cognitive diversity so that innovative alternative concepts are included as part of board decision making.

3. DIRECTOR CHARACTERISTICS, SKILLS AND ROLES

3.1 Director Characteristics

A board of directors is elected by shareholders to be both custodian and manager of a company's resources, which are owned by shareholders. In 1976, Jensen and Meckling[7] coined the term agency theory, which recognises that agents are acting on behalf of the principals – often with more power and knowledge than the principals (termed "information asymmetry"). In this situation agents may not always act in the best interests of the principals, but may act for themselves to a greater or lesser extent (the moral hazard issue). Boards (as agents of shareholders – the shareholders being principals) and indeed CEOs (as agent of the board – the board being the principal) may, or may not, act according to the wishes of the principals. Board members must understand their role and the benefits and risks that arise through agency[8] relationships and also the fact that a CEO is often both an agent of shareholders (as a director) and an agent of the board as CEO.

Each individual director has a role to play if the board is to be effective as 'agent' of the shareholders and therefore create sustainable shareholder value. It is self-evident that every company is different and that every board will have its own dynamics. The law and the requirements imposed on directors are complex and voluminous. New and potential directors must be willing to learn and to keep on learning. Indeed the ASXPR2014 Commentary to Recommendation 2.6 expressly states that entities should ensure formal educative induction programs and also ensure continuing professional development for their directors.

Legislative requirements as to 'who should be a director' are few, yet the duties are wide-ranging, and the obligations significant. Corporations Act 'guidance' is limited to the fact that a person appointed as director must be a natural person aged over 18[9] who has given consent to their appointment – and who is "not disqualified from managing a corporation". There is no maximum age limit for directors. This is similar to the United Kingdom – there, however, the minimum age is 16.[10] The implication of this is that as long as "disqualification from managing a corporation" statutory rules[11] do not currently affect a person adversely, any person can be appointed as a director.

Other circumstances under which a person may not be appointed a director (unless specific consent is obtained from relevant regulatory authorities) include where:

- a person is an undischarged bankrupt;
- a person is subject to an unresolved personal insolvency agreement or an unresolved arrangement under Part X of the Bankruptcy Act 1966;
- the concept of being "disqualified from managing a corporation" includes having been convicted of offences involving dishonesty (where certain jail sentences were possible), certain offences under company law (such as a breach of duties as a director or insolvent trading).

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7 Jensen, M.C., and W.H. Meckling. 1976. Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure. Journal of Financial Economics 3(4): 305–360

8 Agency theory is the most commonly considered theory and is therefore discussed here. Other relevant theories not discussed here include stakeholder theory, stewardship theory and resource dependency theory.

9 Corporations Act 2001, s. 201B

10 UK Companies Act 2006 s. 157

11 The Corporations Act provides for disqualification involving a notified disqualification (by the Courts or by ASIC) to a person; and certain criminal convictions or bankruptcy, with the latter effectively resulting in automatic disqualification.

It is also important to understand that under corporate law statute, and regulation generally, appointment as a director is not dependent on any particular qualification or skill of any kind. This means that as far as the regulatory process is concerned anybody can be a director. However. from a 'good corporate governance' perspective it is entirely unacceptable that just anybody should, in fact, become a director. It is also highly dangerous as the potential for personal and corporate liability is very high where boards act in an uninformed or negligent manner.

3.2 Director Skills

It is necessary to explain ASXPR2014 (p. 3) where it states the entity's board is "the body charged with the legal responsibility for managing its business with due care and diligence".[12] This means that the board is to be regarded as the overall 'manager and custodian' (or 'agent' for the shareholders). It does not mean that the board manages 'day to day' issues – rather board 'management' involves higher level activities by a body that must appreciate and be equipped for these higher level activities. Understanding this alternative use of the word 'management' in relation to high-level board activities is important.

Executive 'management' principally relates to the 'day-to-day' ('operational') decision-making and responsibilities of managers employed to act according to delegations given by authority of the board. Higher level board 'management' relates to the decision-making and responsibilities properly retained by the board (some of which cannot be delegated) including overall responsibility for strategy, policy and 'corporate governance' – included in the latter are a number of ongoing duties. Shareholders and other stakeholders need to be aware of the 'settings' that apply in each corporation as the relationship between the board (and its decision-making and responsibilities) and executive 'management' vary greatly.

Principle 1 of ASXPR2014 is very important in understanding the role of the board. The wording of this Principle implies the 'board' is the higher level strategic authority and management is the 'operational' authority – although the precise relationship between these authorities is to be determined by the board itself:

> ***Lay solid foundations for management and oversight:***
> *A listed entity should establish and disclose the respective roles and responsibilities of its board and management and how their performance is monitored and evaluated.*

Alone, these words provide little assistance in terms of answering 'who should be directors?' but obviously the skilled input of the board is required in determining the roles and responsibilities of the board management. We can therefore state that ***each director must understand the potential and actual roles and relationships of boards and also, very importantly, how it relates to operational management*** in order to be able to contribute to laying the foundations for overall management and oversight.

The Commentary to Principle 1 is extremely helpful. In stating the responsibilities of the board it effectively states a range of expected functions that directors must fulfil. **Each director should have the skills to be able to contribute meaningfully to many, or all, of the stated functions** (see below) so that collectively, the necessary skills are satisfied by the board as a whole. Indeed, this is a requirement implied in Recommendations 2.1(b) and clearly evident in Recommendation 2.2.

It is necessary that these skills are quickly built if lacking in any respect and then kept up-to-date according to Recommendation 2.6:

> ***Recommendation 2.1(b)***
> *[where a board does not have a nomination committee – 2.1(a) applies where there is a nomination committee but 2.1(a) is silent on board membership]*
>
> *If it does not have a nomination committee, disclose that fact and the processes it employs to address board succession issues and to ensure that the board has the appropriate balance of skills, knowledge, experience, independence and diversity to enable it to discharge its duties and responsibilities effectively.*
>
> ***Recommendation 2.2***
> *A listed entity should have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve in its membership.*
>
> ***Recommendation 2.6***
> *A listed entity should have a program for inducting new directors and provide appropriate professional development opportunities for directors to develop and maintain the skills and knowledge needed to perform their role as directors effectively.*

The reportable "skills matrix", referred to in Recommendation 2.2, should indicate to shareholders and other stakeholders the board's overall set of skills. Although there is no requirement to state each director's skills it is clear that each director should contribute to this overall skillset.[13] An appointed director who cannot, or does not, contribute to the skills matrix is unlikely to be desirable as a director.

The **Commentary to Principle 1** notes the functions of the board. It is highly reflective of the approaches suggested by the OECD, earlier stated. The bold emphasis indicates a range of attributes that a director must bring to the boardroom and which must be present in decision making – including leadership, understanding of strategy and financial knowledge. Personal skills in dealing with individuals who possess high degrees of power will also often be highly important.

> ***Commentary to Principle 1 ASXPR***
> *Usually the board of a listed entity will be responsible for:*
>
> - *providing leadership and setting the strategic objectives of the entity;*
> - *appointing the chair and, if the entity has one, the deputy chair and/or the 'senior independent director';*
> - *appointing, and when necessary replacing, the CEO;*
> - *approving the appointment, and when necessary replacement, of other senior executives;*
> - *overseeing management's implementation of the entity's strategic objectives and its performance generally;*
> - *approving operating budgets and major capital expenditure;*
> - *overseeing the integrity of the entity's accounting and corporate reporting systems, including the external audit;*
> - *overseeing the entity's process for making timely and balanced disclosure of all material information concerning the entity that a reasonable person would expect to*

[13] There is no expectation that any individual director will be identified to shareholders as being 'weak' or 'strong' in an area – although executive directors' skills and abilities are usually strongly identified. This raises an area for debate regarding any new director as it makes sense that the relative strengths of a new director should be made known to the electorate. Over time, therefore, individual strengths and weaknesses are broadcast. There seems no reason, therefore, why the skills matrix should not identify all individual directors' strengths and weaknesses.

have a material effect on the price or value of the entity's securities;

- *ensuring that the entity has in place an appropriate risk management framework and setting the risk appetite within which the board expects management to operate;*
- *approving the entity's remuneration a framework; and*
- *monitoring the effectiveness of the entity's governance practices.*

The Commentary to Principle 1 continues by describing the normal delegations given to management, who correctly will operate under the board's oversight including in relation to the strategic direction set (or approved by) the board:

> *Management will usually be responsible for implementing the strategic objectives and operating within the risk appetite set by the board and for all other aspects of the day-to-day running of the entity. It is also responsible for providing the board with accurate, timely and clear information to enable the board to perform its responsibilities.*

As is indicated above, boards are in fact the highest level of management at the most senior level of non-operational control in an entity. Board control and board management typically do not involve management at the day to day or operational level. Especially important board activities are the tasks of setting higher level strategies and policies including those relating to the entity's 'risk appetite'. Reviewing the implementation and appropriate disclosure of these strategies and policies is obviously essential. In recent years the role of the board in selecting and reviewing the ongoing activities of senior executives who 'operate and implement' strategies and policies has included a much stronger focus on ensuring appropriate executive remuneration, as well as on approaches to risk.

Directors must possess the necessary skills and knowledge in a technical sense. They must also have the strength of character to ensure that effective review of senior executives is achieved on an ongoing basis. This is especially significant as such scrutiny will commonly entail review of executive directors. It is very important that directors know their skills must extend to the task of reviewing the competence and innovative capabilities of their fellow board members – probably over time people who become friends. Given that CEOs are often titled 'managing directors' boardroom power and politics may be very difficult. It is all too possible – and very much likely to be hidden – that the CEO, along with other executive directors, may become dominant in the boardroom just as the CEO is very powerful in operations. This may even occur with the assistance of the 'independent' chair. NAB Chair, Michael Chaney has observed:[14]

> *The last thing you want is a chairman conveying, either directly or through their body language, that there is no need for questioning [by other directors in the boardroom] things that have already 'been decided upon'.*
>
> *I did see in some cases in the US where the CEO is almost seen as having God-like powers, and there is an unhealthy degree of deference to the CEO by the board. My view is that an atmosphere of open discussion works much better, both at a senior management and board level.*

[14] Leadership in Action, CEO Form Group – "From CEO to Chairman – Michael Chaney". Available at: http://www.ceoforum.com.au/article-detail.cfm?cid=10093&t=/Michael-Chaney/From-CEO-to-Chairman, accessed November 2014.

3.3 Director Roles

As we have seen, boards cannot be, and must not do, everything. The board can and does rely on the operational management headed by the CEO. Delineation between board activities and management activities will vary from entity to entity. As we have seen from Principle 1 of ASXPR2014, and in previous discussion, boards must define their role and that of management (in the operational sense) so that roles and responsibilities and required capabilities are all clearly understood and executed. Most important is clear understanding of what directors will be required to decide and do compared with what management decides and does.

One key misunderstanding in this relationship between boards and managers relates to the issue of the board 'setting' strategies and policies. This is not often understood by directors – or senior managers. ASXPR2014 states that boards are responsible for "setting the strategy". It does not say boards create strategy – nor does it say that executives are responsible for creating strategy. The issue is left open.

What does this mean and how does it apply in respect to choosing the best director? In fact, while boards set strategies and policies, seldom will they actually create these strategies and policies. The extent to which directors will be involved in 'creation' varies. It depends on the approaches decided by the company, that is, the board, the relationship between the board and management and, quite importantly, the time frame relevant to the decision. Longer term decisions can be expected to have more boardroom input as the directors can be expected to have a 'longer term' view. That is, after all, one key reason for having a board – its ability to make relevant long-term strategic and policy decisions. Where shorter term strategies are involved less board input is probably needed – indeed it may be undesirable as short-term decisions can be regarded correctly as being part of the 'day to day implementation' by operational management of the board's longer term set strategies.

Even so, it is unusual for a board to fully create and document strategies and policies from the ground up. A common approach is that management (comprising the CEO and other executives under her/his personal leadership) is given more or less specific overall ambitions regarding general 'outcomes' desired by the board in relation to strategy, policy, risk, and so on. Based on these general ambitions, management commonly is then delegated the duty to create and document corporate strategy, corporate policy and 'risk appetite'. Creation does not equal 'setting the policy', however.

Management, normally led by the CEO ('managing director'), will create and submit these high-level strategy and policy documents to the board in semi-final form, including with information regarding the extensive preparation and analysis by management. Ideally, there will have been strong consultation between management and the board (or board committees) so that management maintains awareness of the board's views as it proceeds.

The relevant semi-final documents commonly will then be made available to the board for consideration. The board will analyse the documents and, importantly, further suggest development and modifications as necessary before final approval. So, after what is likely to be an iterative development process, the strategies, policies and risk appetite for the entity are finalised by management based on board advice. Somewhat like a dessert trifle that has been created, modified and improved with new ingredients, re-mixing and stirring then finally 'set' by chilling, finally formal board

approval 'sets' these important matters as long-term strategies and policies that are capable of dissection and implementation operationally by 'day to day' management.

In the practical world of commerce, there is of course also the inevitability of processual (or 'emergent') implementation of strategies and policies so that review and amendment by the board is also essential even as management implementation occurs. **It is here that new thinking and constant innovation may be the most important skills for directors as new responses to new environments and new competitors are often the key to successful sustainable competitive advantage.**

It is apparent that ongoing implementation of strategies and policies requires a board that is capable of undertaking active and informed analysis and review of its policies and strategies, and of management and its approaches to implementation. **In particular, board members must have the skills required to recognise, and make decisions in relation to, changes in the entity's external or internal environment insofar as these relate to strategies and their implementation – and be ready to make changes to settings and direction as appropriate.** It is also important to note that the model stated above is one of many – another strategy and policy setting model is that a board chooses a new CEO whose primary duties include the selection and documenting of entire new strategies wherein the board as strategy 'setter' may have a far less pro-active role. It is very important (as seen in Principle 1 of ASXPR2014) that the actual approach is clearly documented publicly – perhaps this would be best in the entity's Corporate Governance Statement.

Key board activities will only occur appropriately where the board skills, knowledge and experience are appropriate to the required decision making. We can conclude that the board as a whole **requires a strong understanding of the corporate sector generally, and of the specific requirements of an industry and, foremost, the specific organisation**. Additionally, board members must have a clear grasp of strategy, fully understand the significance of board implemented policies and also be aware of the importance of leadership within the organisation. Obviously, any new board member may doubt his or her knowledge in respect of what boards actually do – but this should be rectified speedily by appropriate processes, including specific education.[15] Indeed, ongoing relevant information and skills updates are vital for all directors. Notwithstanding other weaknesses, **strength of character of an independent director is also a key attribute.**

Obviously, board responsibility in relation to operational management involves informed knowledgeable oversight[16] and review by the board. Importantly, this is not a static one-time activity – it is an ongoing responsibility. This is the same as the board's ongoing accountability to shareholders and other external stakeholders. The directors, including those who are independent, must have the skills and be sufficiently informed so as to appropriately understand management and operations. They must be sure that operations take place according to approved strategic direction, that risk is appropriately monitored and managed and that shareholders and other stakeholders are appropriately informed.

The question of directors being correctly aware of the entity and its management is obviously very important. In the case *Australian Securities and Investments Commission v Healey* [2011] FCA 717 (para. 581) Justice Middleton stated the following in relation to directors' duties not being satisfied: "… he is not thereby taking all reasonable steps, if the director … is not focussed for himself upon the task and considering for himself the statutory requirements and applying the knowledge he has of the affairs of the company". Justice Middleton was speaking specifically of accounting understandings held by directors – but his words are capable of application to any failure by directors to appropriately understand and act according to expected duties. The duty to be informed is critical.

Accordingly, one particular capability or 'skill' is very important with respect to every director – especially those who are not executives. This is the **capability to seek full information and then to achieve full understanding of information required by the board – including information from management.** Beyond this, and as is discussed further below in relation to independence, is the important requirement that the board as a whole should be able to debate with, and where valid oppose, management – including, sometimes, their fellow director, the CEO (managing director).

15 Recommendation 2.6 requires a program to ensure directors' skills are built and/or reinvigorated. Further, and as previously noted, the Commentary to Recommendation 2.1 states there should be formal induction and continuing professional development programs for directors. The Australian Institute of Company Directors runs a range of relevant courses.

16 Recommendation 1.7 specifically requires periodic evaluation of executives and disclosure regarding this evaluation. The evaluation itself may not be done by the board but the board is nonetheless responsible for it being undertaken appropriately – and the board will be required to be informed and to ensure that issues emerging are being or have been addressed.

4. DIRECTOR INDEPENDENCE

We previously saw that Recommendation 2.4 of ASXPR2014 requires the majority of the board to be independent. Recommendation 2.5 requires the board chair to be independent – it also states emphatically that "… in particular, *[the chair]* should not be the same person as the CEO of the entity".

The important reasons for independence within the board can be stated quite succinctly. Independent directors will enable:

- more objective evaluation of strategic issues;
- more objective oversight of management and management operations;
- more reliable arms-length negotiation of remuneration of executives including executive directors;
- greater ability to make decisions that are intended as being in the best interest of the company rather than according to some prevailing bias;
- increased trust by 'ordinary' small shareholders.

It is the board's responsibility to consider each director and whether the director is independent. If any non-independence factors emerge then the board is required to consider whether the issue is minimal and therefore does not compromise independence. Recommendation 2.3 also is quite specific in respect of independence obligations within boardrooms (emphasis added):

Recommendation 2.3 of ASXPR2014
A listed entity should disclose:

A. The names of the directors considered by the board to be independent directors

B. If a director has an interest, position, association or relationship of the type described in Box 2.3 but the board is of the opinion that it does not compromise the independence of the director, the nature of the interest, position, association or relationship in question and an explanation of why the board is of that opinion; and

C. The length of service of each director.

The Commentary to Recommendation 2.3 provides:

To describe a director as "independent" carries with it a particular connotation that the director is not allied with the interests of management, a substantial security holder or other relevant stakeholder and can and will bring an independent judgement to bear on issues before the board.

It is an appellation that gives great comfort to security holders and not one that should be applied lightly.

A director of a listed entity should only be characterised and described as an independent director if he or she is free of any interest, position, association or relationship that might influence, or reasonably be perceived to influence, in a material respect, his or her capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally.

Box 2.3[17] is part of the framework approach of ASXPR. Accordingly, it is not to be interpreted as either complete or alone in defining independence. Even so, Recommendation 2.3.b is quite clear in stating the requirement that if an aspect of Box 2.3 affects a director adversely then that director is not to be considered independent unless the board decides, based on good reasons, that the specific director is nonetheless independent. Having made this decision the board must report and explain this decision, providing reasons why independence is maintained for the director notwithstanding the *prima* facie Box 2.3 'transgression'.

The full content of Box 2.3 is provided next. It provides highly instructive insight to independence within ASXPR.
Box 2.3 also shows the evolution of ASXPR2014 compared with the previous version – for example the second last point specifically addresses the fact that family relationships compromise independence. This means that any director who considered independence previously (i.e., before the 2014 edition) should reconsider this in light of the changed ASXPR2014 independence criteria.

BOX 2.3: FACTORS RELEVANT TO ASSESSING THE INDEPENDENCE OF A DIRECTOR

Examples of interests, positions, associations and relationships that might cause doubts about the independence of a director include if the director:

- is, or has been, employed in an executive capacity by the entity or any of its child entities and there has not been a period of at least three years between ceasing such employment and serving on the board;
- is, or has within the last three years been, a partner, director or senior employee of a provider of material professional services to the entity or any of its child entities;
- is, or has been within the last three years, in a material business relationship (eg as a supplier or customer) with the entity or any of its child entities, or an officer of, or otherwise associated with, someone with such a relationship;
- is a substantial security holder of the entity or an officer of, or otherwise associated with, a substantial security holder of the entity;
- has a material contractual relationship with the entity or its child entities other than as a director;
- has close family ties with any person who falls within any of the categories described above; or
- has been a director of the entity for such a period that his or her independence may have been compromised.

In each case, the materiality of the interest, position, association or relationship needs to be assessed to determine whether it might interfere, or might reasonably be seen to interfere, with the director's capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally.

[17] The 'Box' approach within ASXPR2014 is designed to bring together in one place a number of matters, each of which is relevant to decisions relating to a key concept. As is obvious the key concept addressed by Box 2.3 (within Recommendation 2.3) is independence.

4.1 Types of Directors

ASXPR2014 and Box 2.3 permit identification of three types of directors based on the relationships involved and the resulting independence likely to be present, or at least apparent, in boardroom decision making:

1. **'Executive'** directors. In Box 2.3 (see first bullet) it is apparent that current and past (within three years) employees can never be independent. It is therefore convenient to say that a current **executive director of the corporation is a separately identifiable type of director in that they are employees and therefore never independent**. Current executives of the entity are never independent so the silly description 'non-independent executive director' would not only be in part redundant it would probably confuse.
2. **'Non-independent non-executive'** directors (hereafter 'NINE'). Such a director will not breach the first independence bullet but will not satisfy one or more of the subsequent bullets. The difficulty with a NINE director is that while we know that they do not have the specific detailed personal contact and relationship that exists for an employee they can have a range of other relationships, any or all of which may compromise the NINE's ability to make decisions that are, or are considered to be, independent with respect to shareholders in general.
3. **'Independent'** directors are fully independent in that they satisfy all aspects of Box 2.3 or otherwise are considered independent by the board. It is important that we know whether a person is independent. Independent directors are required to comprise a majority of the board. Further ASXPR2014 requires enough independent directors for them to comprise the majority of all four recommended board committees.

Sometimes, and including within ASXPR2014, independent directors are described as *'independent non-executive directors'*. This is potentially confusing as it is not possible for a current executive of an entity to be independent. Sometimes the term 'non-executive director' is used (including within ASXPR2014). The term 'non-executive director' ignores the very important element of 'independence' and, therefore, should be used very cautiously. Indeed it should be used only to discuss ALL directors (regardless of independence) who are NOT executive directors. If independence is relevant it is the descriptor 'independent' that should be used.[18]

One further issue is important beyond consideration of the 'three types of director' discussed above. **The reality is that in some boardroom settings, regardless of apparent independence, there may be a director, or group of directors, who exercises strong or even overwhelming 'power'**. This may result from publicly known shareholding dominance. If this is the case the market is likely to be aware of the reality of the share powerbase. This market awareness itself reduces concern as investors are informed. Even so, power may be wielded in ways that can be surprising and even ruthless.

In other circumstances there may be power or power structures about which the market knows nothing. Individuals may have unknown power in relation to shares and/or finance structures. Shareholder or boardroom alliances may dominate decisions. Sometimes a highly dominant individual may overwhelm a more timid board. Whatever the source of the power, it can result in board decisions that are not genuinely balanced independent judgments.

The CEO, often called 'the managing director' may be the dominant personality. This person may lay claim to 'best knowledge', which, when added to this person's operational control, can easily result in flawed strategy and policies – biased toward operationally relevant outcomes rather than longer term shareholder considerations. In the past, including in prominent corporate failures, the CEO (contrary to current ASXPR2014 principles) has often also been board chair. The unbalanced knowledge and control of such a person can create threats to valid long-term board decisions.

In conclusion, it is vital that boards have individual directors whose interpersonal skills and strength of character are such that 'power' influences are contained so that correct performance and conformance judgments are involved in every board decision. Michael Chaney (previously quoted) demonstrates that these power issues must be correctly understood and appropriately managed by boards.

4.2 Director Independence: International Approaches

THE UNITED STATES

The United States corporate governance approaches also display a strong emphasis on independence. For example, the board's audit, remuneration and nomination committees must be fully 'independent committees' under precise Sarbanes Oxley Act requirements and definitions. This requirement in part explains why US boards are larger than in most jurisdictions – with an average size of 11 directors. Not all international approaches are the same, however, and in the US one significant difference is evident. Arguably, there is an elevated risk that in the US the 'power director' problem will arise. This is because, unlike ASXPR2014 and the UKCGC 2014, there is no recommendation that the CEO should not also be the chair. Indeed, in most US corporations the CEO and chair are the same person. Sometimes (but not always) the term 'president' may be used.[19]

This US approach allows the 'real boss' to be seen and removes any ambiguity in relation to the role of chair and CEO and where power really resides. It allows changes to take place with minimal organisational resistance. In short, it is an effective way to do things according to the wishes of the power director. In the US the culture of 'the buck stops here' is fully satisfied. It appears that boardroom balance is less important and implies that a genuinely cooperative board matters less as executive power in the boardroom is stronger. To redress the balance, the Sarbanes Oxley legislation demands, as a legal requirement, that the independent committees must exist – and also empowers and defines the operations of these committees. In the US committee functions can overrule board decisions – an interesting way of addressing potential executive power. It is also interesting to note that both a director in the US and a director in Australia is required to have high levels of capability – but there are important differences resulting from different corporate governance approaches in boardrooms in the two countries.

[18] The acronym 'NED' is also commonly used, particularly in the UK, and demonstrates similar confusion around the important issue of 'independence'.

[19] Indeed the term president can be very confusing in the US – while the president may be the CEO and chair, the president in some corporations reports to the CEO (or COO) and in some corporations each division has a president … this causes lack of clarity within the US and often substantial misunderstanding for international stakeholders.

THE UNITED KINGDOM

The importance of independence (notwithstanding ongoing widespread use of the confusing term 'NED') has become more significant in the UK since the global financial crisis (GFC). In Australia, NINEs are allowed on audit committees (but not executives) and executives are permitted on remuneration committees (both must have a majority of independent directors, however). A major change took place in the UK in 2010 (now in UKCGC2014), however, in which audit committees and remuneration committees alike are required to have ONLY independent directors as members. Interestingly, since the GFC, in Singapore remuneration committees are allowed to have NINEs as members but are not allowed to have executives as members. Before the GFC, Singapore allowed executives as members of remuneration committees. In the UK, GFC failures have commonly been described as resulting from too generous remuneration and related failure to understand or appreciate risk. Ensuring fully independent remuneration and audit committee membership in the UK is one mechanism designed to reduce the likelihood of self-interested executives influencing remuneration, audit and risk-related decisions. Independence is itself therefore a partial solution – but the new complement of independent directors must also possess other capabilities!

4.3 Director Independence: Challenges and Tensions

The increasing issue of independence raises a very important tension. It is a fact, including at law, that all directors need to have an awareness of independence and its importance in board activities and decision making.[20] Even so, a director who does not meet independence requirements must not engage in some activities – for example, conflicted decision making and membership of committees where relevant independence criteria are not satisfied.

At the same time, essential capabilities within the required 'skills matrix' are vitally important. Boards with the correct skills and knowledge are required to make the best decisions for shareholders and other stakeholders. In addition (and hopefully not 'instead'), regulators, shareholders and other stakeholders demand 'independent directors' – directors who really do think independently and who really do 'look' independent.

Setting the correct balance between knowledge, skills and independence is potentially a matter of ongoing tension – and one that must be addressed by the board regularly. It is not necessarily resolved by any particular rules – it requires thoughtful processes by well-balanced boards. Ultimately, in Australia and the UK it is the board that decides who is 'independent' based on guidelines already seen.

In the US independence is a legislatively driven prescription. A practical tabular analysis is provided by US law firm Weil, Gotshal & Manges LLP[21]. Their table summarizes these prescriptions for boards of corporations listed on the New York Stock Exchange (NYSE) or the Nasdaq Global Market (Nasdaq). The rules are complex and manifold – and being legislatively driven are subject to strong enforcement. Weil (2013)[22] identify the sources as being:

- the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* ("Dodd-Frank"),
- the *Sarbanes-Oxley Act of 2002*, as amended ("SOX"),
- the *Securities Exchange Act of 1934*, as amended (the "Exchange Act"),
- the rules of the U.S. Securities and Exchange Commission (the "SEC"), and
- the corporate governance listing standards of the NYSE and Nasdaq (the "Listing Standards"), which are very similar but not identical.

US approaches will not be discussed further – but the business or practitioner dealing with US corporations should be aware of the very detailed focus on this issue in the US.

The balance between skills/knowledge and independence becomes especially important where independent directors are dealing with the influence of 'power directors'. In this case independent directors will need to be especially careful in making sure that their skills and abilities are up to the task of ensuring that independent advice and opinions are properly reflected in board decisions.

[20] All directors are required to make decisions in the absence of a conflict of interest – and indeed it is crucial that any such conflicts are handled correctly and lawfully or directors can be personally liable … if discovered.

[21] http://www.weil.com/

[22] Weil, 2013. Public Company Advisory Group. *Requirements for Public Company Boards Including IPO Transition Rules* December 2013 (pp1-32) p1. http://www.weil.com/~/media/files/pdfs/Chart_of_Board_Requirements_December_2013.pdf

5. BOARD DIVERSITY

Under ASXPR2014 board diversity is in relation to "… age, disability, ethnicity, marital or family status, religious or cultural background, sexual orientation and gender identity".[23] The more detailed words of ASXPR2014 suggest that, in fact, gender diversity is at the heart of ambitions for new corporate governance thinking within Australia. The wording of Recommendation 1.5 – and there is no other recommendation in relation to any other diversity issue – proves this point. Arguably, this singular focus is somewhat limited and it is therefore possible that ASXPR2014 should indeed be more definitive in respect of broader diversity demands.

In any event, it is apparent that women are under-represented in boardrooms and in management.[24] Accordingly, the ASXPR2014 focus on ensuring that approximately half the population should expect fair representation on boards and in management is more than explicable – and indeed more than simply a good idea. Arguably, it is crucial for corporate success and certainly is essential for corporate credibility. The required approach to diversity is stated as follows:

Recommendation 1.5 of the ASXPR2014
A listed entity should:

A. *have a diversity policy which includes requirements for the board or a relevant committee of the board to set measurable objectives for achieving gender diversity and to assess annually both the objectives and the entity's progress in achieving them;*

B. *disclose that policy or a summary of it; and*

C. *disclose as at the end of each reporting period the measurable objectives for achieving gender diversity set by the board or a relevant committee of the board in accordance with the entity's diversity policy and its progress towards achieving them, and either:*

   1. *the respective proportions of men and women on the board, in senior executive positions and across the whole organisation (including how the entity has defined "senior executive" for these purposes); or*
   2. *if the entity is a "relevant employer" under the Workplace Gender Equality Act, the entity's most recent "Gender Equality Indicators", as defined in and published under that Act. [note that this Act applies to any non-public sector employer with more than 100 employees]*

It can be seen that Recommendation 1.5 is a positive step towards rectifying the failure to promote women to management and to appoint them to boardrooms. This positive step is far more than just an 'imposition' on corporate freedoms. It is also far more than a matter of addressing unfairness to an entire gender.

The reality is that the positive contributions of women to better management and better boardroom decisions are identifiable as related to essential capabilities needed in the boardroom and in management.

[23] ASXPR2014, Item 3 of Box 1.5, "Suggestions for the content of a diversity policy".
[24] Many prior studies conducted in Australia indicate that the proportion of women in Australian boardrooms is in the 12–14% range as at 2012. See the following links for further details:
http://www.deloitte.com/assets/Dcom-Tanzania/Local%20Assets/Documents/Deloitte%20Article_Women%20in%20the%20boardroom.pdf
http://www.catalyst.org/knowledge/women-boards
http://www.theaustralian.com.au/business/companies/boardroom-progress-with-a-quarter-of-new-directors-female/story-fn91v9q3-1226727210956?nk=f70c649e15cf4052a64619243057ff25

The Commentary to Recommendation 1.5 ASXPR2014 notes (identifying relevant research) that

> *… increased gender diversity on boards is associated with better financial performance. The promotion of gender diversity can broaden the pool for recruitment of high quality employees, enhance employee retention, foster a closer connection with and better understanding of customers, and improve corporate image and reputation.*

There is a great deal of literature on this issue[25]. The summary of a research report by the Credit Suisse Research Institute[26] concludes:

> *The key finding is that, in a like-for-like comparison, companies with at least one woman on the board would have outperformed stocks with no women on the board by 26 percent over the course of the last 6 years.*
>
> *… the evidence suggests that a bit more balance on the board brings with it a bit less volatility and a bit more balance through the cycle.*

It proceeds to provide seven reasons why corporations 'outperform' as a result of having women on their boards. Amongst these seven reasons it identifies skills that women bring to the boardroom. Reason 2 identifies the interesting skill of 'challenging the male directors' to improve their own performance:

> ***2. Greater effort across the Board***
> *Evidence suggests that greater team diversity (including gender diversity) can lead to better average performance. Research conducted by Professor Katherine Philips at Columbia University has shown that majority groups improve their own performance in response to minority involvement producing better average outcomes in more diverse environments.*

Women are also identified (Reason 3) as having greater ability to define responsibility and to mentor and coach – all characteristics that are important for leaders, including in the boardroom:

> ***3. A Better Mix of Leadership Skills***
> *McKinsey and NASA have conducted various studies on leadership skills and have shown that women are particularly good at defining responsibilities clearly as well as being strong on mentoring and coaching employees. Hence, the idea that a degree of gender diversity at the board level would foster a better balance in leadership skills within the company may hold merit.*

The rising quality of women graduates and women in business means that there is simply a far larger overall talent pool than in the past. Any business entity that chooses to ignore this larger pool is simply giving away the opportunity for talent – and by implication leaving that talent to its competitors. While Reason 4 does not go this far it is abundantly clear that any board ignoring female talent is highly likely to cede competitive advantage to those in their industry more robust with regard to the future:

[25] See: http://www.womenonboards.org.au/pubs/articles/1112-why-women-are-good-for-business.htm; https://www.blackrockinvestments.com.au/individual/literature/market-commentary/blackrock-australia-femaleless-boardrooms-en-au.pdf.
[26] Credit Suisse Research Institute, July 2012. 'Does gender diversity improve performance?'. Report of a multi-year analysis of 2400 international business entities. Available at: https://www.credit-suisse.com/au/en/news-and-expertise/research/credit-suisse-research-institute/news-and-videos.article.html/article/pwp/news-and-expertise/2012/07/en/does-gender-diversity-improve-performance.html , accessed August 2014

4. *Access to a Wider Talent Pool*
Data from UNESCO shows that by 2010, the proportion of female graduates across the world came to a median average of 54 percent. This compares to a median average of 51 percent female graduates in 2000. The trend towards an even greater proportion of female graduates looks set to continue if female success at primary and secondary school level is any guide. Hence, any company that achieves greater gender diversity is more likely to be able to tap into the widest possible pool of talent that is implicit in these graduation statistics.

It is apparent on any sensible view of competition that a board that understands the market and the consumer and the real meaning of 'customer value' will be a far superior board. In Australia, as is the case globally, women are more than 50% of the population. In many consumer areas, women as customers are the dominant decision makers. Accordingly, from research, women on boards (and in management), in broader population-relevant proportion, have an extremely important contribution to make in ensuring that strategies are on target and remain that way over time. Reason 5 emphasises this skill of understanding the market and customer value:

5. *A Better Reflection of the Consumer Decision Maker*
To the extent that women are responsible for household spending decisions, it makes sense that a corporate board with female representation may enhance the understanding of customer preferences. Not surprisingly, consumer-facing industries already rank among those with the greater proportion of women on the board.

Another skill that women bring is the tendency to have a greater sense of caution allied with longer term views regarding success. Insofar as this results in slightly less willingness to accept risk it is seen to result in less exposure to the vicissitudes of fluctuating markets. This 'skill' or 'attribute' of less acceptance of risk is seen to provide measurable long-term benefits, as outlined in Reason 6:

6. *Improved Corporate Governance*
There is unusually strong consensus within the academic research that a greater number of women on the board improves performance on corporate and social governance metrics.

The Research Institute's analysis of the MSCI AC World constituents showed that stocks with women on board are more likely to have lower levels of gearing than their peer group where there are no women on the board. Lower relative debt levels have been a useful determinant of equity market outperformance over the last four years, delivering average outperformance of 2.5 percent per annum over the last 20 years and 6.5 percent per annum over the last four years.

It is significant that the report observes that gender diversity is, in fact, already becoming more balanced. It suggests that while there is a distance yet to be travelled, 'legal requirements' (as in Norway and forthcoming in France) mandating gender participation will, in the end, not be required:

> *… debate around the topic has shifted from an issue of fairness and equality to a question of superior performance. If gender diversity on the board implies a greater probability of corporate success then it would make sense to pursue such an objective regardless of any government directive.*

Gender diversity is the subject of mandatory requirements in some jurisdictions.[27] For example, in Norway, the imposition of mandatory female board membership was at first the cause of furore. Proposed by a conservative male politician in 2003, and with the 40% target becoming mandatory in 2008, it has now been accepted broadly for a number of reasons. Among these reasons include the fact that the focus on 'who should be a director' was generally VERY positive. The concept that old directors just stayed in the job was removed by force – women had to replace some directors. This resulted in new focus on the real capabilities of directors – old and new.

The history of women having no opportunity to be directors – or even senior managers – meant that there was a paucity of older women ready to be directors. As a consequence many of the new female directors were under 40 years of age – resulting in boardrooms with new energy and new ideas. The more diverse boards (in terms of gender AND age) were better equipped to understand key stakeholders – including customers and the strategic approaches required to reach and satisfy these customers. In short, gender diversity has been accepted in Norwegian boardrooms and also in France. The French 40% target will become mandatory in 2017 but by the end of 2013 French corporations had achieved approximately 25% female board membership, compared to approximately 7% in 2007.

As stated previously, ASXPR2014 does identify, albeit briefly, other aspects of diversity. It would be valuable to know more about whether cultural and ethnic characteristics are, in fact, restrictions to board membership in Australia. Equally, it would be valuable to know if there are similar restrictions to board membership in relation to physical disability. It is important that boards (and management) do not exclude strong contributions from 'disabled' persons based on the biased assumption that one limitation implies that the individual therefore cannot be a valuable contributor to value and to strategy.

Internationally, local socio-cultural variations appear to make some aspects of diversity more important than is the case in Australia. In the US, for example, which has a complex history regarding ethnic groups, there are strong positive discrimination approaches in place to ensure that boardroom diversity includes relevant recognition of socio-cultural and ethnic backgrounds.

This complex topic is not addressed further here. It is, however, relevant to observe that those who should be directors must, to some degree at least, reflect the communities that they serve. Diversity on a board can enrich debate, foster creativity, broaden perspectives and limit the danger of 'group think' that is inherent when a group of individuals from overly similar backgrounds dominates a board. This would be the real benefit of diversity on the board. Obviously, far more debate and valid solutions are necessary in relation to diversity issues generally – especially for areas extending beyond gender diversity.

27 See, for example, the discussion at http://www.womenonboards.org.au/pubs/articles/norway_bigpicture.htm

6. CONCLUSION

This paper has addressed some of the important issues affecting boards, their directors and board renewal. It has considered what directors do and what they should do. It has considered directors' capabilities and how directors can and should develop these capabilities. It has considered the role of independence and what directors should be in terms of independence.

Appreciation of these concepts is essential to understanding 'who should be a director?' Every corporation is different and faces different circumstances from time to time. The individuals who manage these corporations, and in this we include the role of the board as the senior 'managing' body, must understand the particular corporation, its environment and what will create future success. They also must apply this knowledge as well as the general corporate governance expectations implicit in ASXPR2014. Critically, they must attend to the needs of the corporation, its shareholders and other stakeholders.

To attend to these needs, and to achieve stakeholder satisfaction through corporate success, two key requirements encapsulate the approach that boards should follow as they approach the complex set of tasks discussed previously:

1. **The board must set the 'tone' for the whole corporation.** Boards must ensure that the 'tone from the top' is fully communicated throughout the entire organisation – including appropriate communication of strategy and policies. All personnel must appropriately understand and work according to the collegiate views of the board as the key long-term decision-making body within the organisation. This tone arguably should not be a reflection of only a single current executive – although of course the CEO will be a vital part of the communication process. Indeed, the CEO must ensure that communication of board intent and strategy is understood correctly at all operational levels. This matter of 'tone' and its effective communication to all is intimately engaged with the idea that the whole organisation will correctly understand and achieve corporate objectives.
2. **The tone communicated needs to ensure an ethical and responsible organisation.** Reinforcing the issue of 'tone' set by the board are new concepts and thinking about the way that corporations should behave and how they 'see themselves' in society. Obviously the vision of the board needs to include ethics and responsibility as a core ambition of the whole organisation. To act otherwise in a modern, information-based economy is almost certainly a recipe for disaster.

In case there are any doubts about the need for the corporate tone to meet this second requirement we note that it is compliant with modern thinking within stakeholder theory, briefly discussed in the next paragraph. The concept also is addressed specifically within ASXPR2014.

Stakeholder theory suggests that all stakeholders matter, not least because society is constituted by these stakeholders and corporations exist with the permission of society (all stakeholders). This theory states that corporations have reciprocal obligations to all stakeholders and not only to shareholders who provide finance and reap dividends.

Without entering into legal arguments about 'direct legal duties', boards of corporations clearly have a duty to lead on ethics and ensure proper behaviour is understood and followed throughout the organisation.

This requirement for board policies in relation to ethical conduct, the 'Code of Conduct', is dealt with succinctly by advisory Box 3.1 of ASXPR2014.

[17] The 'Box' approach within ASXPR2014 is designed to bring together in one place a number of matters, each of which is relevant to decisions relating to a key concept. As is obvious the key concept addressed by Box 2.3 (within Recommendation 2.3) is independence.

BOX 3.1: SUGGESTIONS FOR THE CONTENT OF A CODE OF CONDUCT

1. Express the organisation's commitment not only to complying with its legal obligations but also to acting ethically and responsibly.
2. Clearly state the organisation's expectation that all directors, senior executives and employees will:
   - act in the best interests of the entity;
   - act honestly and with high standards of personal integrity;
   - comply with the laws and regulations that apply to the entity and its operations;
   - not knowingly participate in any illegal or unethical activity;
   - not enter into any arrangement or participate in any activity that would conflict with the entity's best interests or that would be likely to negatively affect the entity's reputation;
   - not take advantage of the property or information of the entity or its customers for personal gain or to cause detriment to the entity or its customers; and
   - not take advantage of their position or the opportunities arising therefrom for personal gain.
3. Describe the organisation's processes for preventing the offering or acceptance of bribes and other unlawful or unethical payments or inducements. This might include how the listed entity regulates the giving and accepting of business courtesies and facilitation payments.
4. Describe the organisation's processes for handling actual or potential conflicts of interest.
5. Identify the measures the organisation follows to encourage the reporting of unlawful or unethical behaviour. This might include a reference to how the organisation protects "whistleblowers" who report violations in good faith.

In conclusion, directors must have extensive capabilities and strength of character. They must have a willingness to look forward and grasp new challenges and complexities.

One recent addition to corporate activity that illustrates this is the concept – becoming reality - of Integrated Reporting. Boardrooms must understand how this will affect entities and create new success scenarios. It will affect all levels of the organisation from operational activity to the highest levels of strategy and reporting compliance. Boardrooms must be leaders in making the changes understood.

The 'triple bottom line' (also 'Corporate Social Responsibility' or 'Sustainability') has developed over some time but the modern Integrated Reporting concept of clear reporting of financial, social and environmental matters in a systematic and succinct way is very new. At the forefront of this speedily evolving area is South Africa and its 'King Code', which requires Integrated Reporting approaches. It does not permit a reporting approach that lists financial reports and then simply 'adds on' some social and/or environmental matters. One commentator notes that in South Africa (under King Code version 3, as amended by the mandatory inclusion in 2014 of the International Integrated Reporting Council's (IIRC) reporting framework):

> *Companies looking at the King III code have been starting to wrap their heads around social and ethics committees, integrated risk committees, and managing societal and environmental risks. Integrated Reporting is taking it a layer further.*[28]

The complexities of genuine Integrated Reporting and its relationship to corporate social responsibility, financial reporting and full risk understanding and assessment will be vital knowledge for all directors in the not too distant future.

It is not the task of this paper to explain the multitude of complexities Integrated Reporting will bring to strategy setting, policy setting, compliance and reporting. That will be YOUR future learning task as a director. This illustration alone underlines the need for any new director to be a person who is not restricted by an existing skill set and who can look forward.

So, who should be a director? The person who can learn and apply new knowledge that relates to strategic planning, performance and reporting compliance. The person who can be a strong leader appropriately attending to the interests of shareholders and other stakeholders. This attention at its heart is the construction of value for all stakeholders employing a vast array of capabilities that must be learned, nurtured and then re-created as and when needed. The very best directors will do all this and create the space and the people who will in time to come do this work even better. This latter is the true indication of the director who is a genuine leader.

[28] Karin Ireton, Director of Group Sustainability Management, Standard Bank. Quoted at http://www.accaglobal.com/an/en/member/accounting-business/south-africa.html

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