



How diverse should boards be?

WHAT WE THINK: A DIALOGUE IN CORPORATE GOVERNANCE

NEW CHALLENGES INITIATIVE

The ICAEW thought leadership initiative *Dialogue in Corporate Governance: New challenges* is considering five questions arising from recent events and seeing how they affect the foundations of existing corporate governance frameworks. We intend to explore these questions in a series of bite-size thought leadership projects.

While accepting that there are no easy solutions, we hope to bring greater clarity to people's thinking through dialogue with a range of interested parties and stakeholders including boards, investors, and academics.

Five questions

1. What should companies be responsible for?
2. What are the overarching principles of corporate governance?
3. When is comply or explain the right approach?
4. **How diverse should boards be?**
5. Who should be covered by codes?

A number of major changes have taken place in capital markets over recent years. These include: the growing importance of non-equity financial instruments; new types of equity owners; changes in the services offered by, and the use of, intermediaries; and pressures to harmonise internationally diverse practices in corporate governance.

Furthermore, a number of major business controversies are discussed as corporate governance issues, for example: state bail-outs of failing financial institutions during the economic crisis, public outcry over executive remuneration, and the lack of diversity on boards.

These changes and controversies present significant challenges to existing models of corporate governance built around the agency theory which sees boards of listed companies acting as agents of absent equity owners. Moreover, the changing nature of capital markets tests the validity of existing models of corporate governance.

Rather than treat current controversies as topical and fleeting matters, we intend to explore them as symptoms of misalignment between today's markets and corporate governance frameworks. We invite anyone interested in corporate governance to join our dialogue at Talk Accountancy www.ion.icaew.com/talkaccountancy or email corporategovernance@icaew.com

How diverse should boards be?

Discussion of question 4

In recent years, governments, regulators and corporate governance groups around the world have been taking initiatives to increase representation of women on boards. Debate continues about the effectiveness of measures to address this and other board diversity issues. However, rather than simply reacting, what should boards themselves be doing?

This paper considers the principal drivers of diversity to help boards set and assess diversity objectives to promote long-term business success.

WHAT IS THE PROBLEM?

Following the financial crisis that began in 2007, calls for more diverse boards have grown louder in many countries. This has happened against a backdrop of bank failures and bail-outs, and a more general questioning of business, for example as a result of concerns about executive remuneration and tax avoidance.

The public and politicians have looked at boards and taken the view that shortcomings in the companies they run might be connected to a lack of diversity in board membership. This phenomenon is not unique to the corporate world; it applies to many important institutions facing criticism and a loss of trust. Indeed, governments and parliaments have faced similar challenges from public opinion to increase the representation of women and other groups so that they better reflect the diversity of the societies they serve.

Board diversity has therefore become a corporate governance issue on which there is pressure for change. Commentators and interest groups around the world seek to analyse board membership on the basis not only of gender, but also of other characteristics such as age, colour, race, social and occupational background, nationality, religion and sexual orientation. This analysis creates expectations to increase diversity either by applying quotas and targets or by requiring board reporting against specific diversity policies.

To acknowledge the importance of diversity and to pre-empt potentially simplistic diversity demands, boards need to be ready to take the initiative.

A WAY FORWARD

Corporate governance thinking in relation to board composition has historically emphasised the need for an appropriate balance between executives and non-executives and for procedures to ensure that boards have the skills, experience, independence and

knowledge of the business to enable them to discharge their responsibilities effectively.

This paper recognises that more is now expected. As discussed in our earlier paper *What should companies be responsible for?*, company responsibilities are more inclusive today. Companies are expected to:

- achieve a business purpose;
- behave in a socially acceptable way;
- meet legal and regulatory requirements; and
- state how responsibilities are met.

Boards need to formulate and explain their objectives on board diversity to help them address a range of responsibilities. This paper provides a way of doing this, based on four drivers that help boards set objectives for diversity that enhance board effectiveness.

PRINCIPAL DRIVERS OF BOARD DIVERSITY

1. Apparent lack of diversity raises doubts about effectiveness

Because boards mainly operate behind closed doors, people outside the boardroom will use external signs to assess board effectiveness. Boards should accept this and understand that a board with members whose individual profiles look very similar will raise doubts about its ability to think outside the box. Boards should also be prepared to explain their policies for setting priorities for diversity based on the arguments set out below relating to social acceptability, achievement of business purpose and decision-making rigour.

2. Diversity can help social acceptability

In a diverse society, a company whose board members look like each other rather than like society can undermine people's belief that the company supports social norms of equal opportunity and fairness and will conduct itself in a socially acceptable way. In our earlier paper on what companies should be responsible for, we identified the importance of such behaviour.

3. Diversity can strengthen understanding of the business

Our paper on company responsibilities also emphasised how businesses need to achieve a business purpose. For a company to do this, it helps if it is in tune with its key internal and external stakeholders and can see business opportunities and threats through their eyes. Board diversity can help boards understand customer, supplier, employer and other relevant perspectives. As companies become more international this adds another dimension to the need for diversity.

4. Diversity can enhance rigour

Although a tightly-knit group of like-minded people with common experiences can take decisions quickly and efficiently, problems associated with groupthink are well documented. An overriding objective of sticking together may mean that common limitations and biases go unchallenged. Better decisions are made by a board that contains people who are prepared to consider a wider range of alternatives, to be critical or to simply say 'Hang on a minute' or 'Why?'

BENEFITS OF OUR APPROACH

Acknowledging and addressing the drivers of board diversity should help boards become more effective in promoting their companies' long-term success. Most importantly, one size does not fit all. The answer to the question 'How diverse should boards be?' will depend on the company, its business purpose, its position in society and its stage of development. After all, companies themselves are diverse and should develop their own diversity policies and report against them.

Our approach recognises that boards need to consider and balance many drivers of diversity and realistic limits on the size of effective boards. It will be neither practical nor desirable for boards to accommodate all stakeholders who are relevant to their business purpose and all elements of the societies in which they operate. Therefore, one of the main objectives of addressing boardroom diversity should be to find ways to take account of different perspectives even when these cannot be mirrored in the boardroom.

There should also be wider benefits for enhancing trust in business if companies take ownership of diversity issues rather than seeing them in terms of initiatives to respond to outside pressures, compliance and ticking boxes specified by others. Indeed, where companies adopt our approach it should reduce the likelihood of policy-makers feeling compelled to introduce quotas and other requirements to overcome perceptions that, when it comes to diversity, companies simply don't 'get it'.

CHALLENGES

Boards embracing our suggested approach will nevertheless find that they face a number of major challenges.

Board composition is not the end of the story. Diverse boards need to realise their potential and be diverse in substance not just in appearance. We cannot expect a diverse board automatically to allow diverse viewpoints to shape its behaviour and decisions. There is a need for a robust board process that enables different views to be expressed, heard and considered. However, the board still needs to work as

a team serving the interests of the company and sharing responsibility for its decisions. It will take effort and commitment from the chairman and board members to develop mutual respect and recognise that an open exchange of diverse viewpoints can help the board reach better shared conclusions.

Even if a lack of diversity is most obvious to outsiders in the context of board composition, companies cannot just see diversity as a board issue. Building a pipeline of diverse and talented individuals across an organisation is important and more difficult than introducing diversity through board appointments. For example, companies are reported to find it more challenging to increase the proportion of women taking up executive rather than non-executive positions on boards.

This paper recognises that at a company-wide level, there is a limit to what can be done because many diversity challenges have deep roots in societies and their institutions. For example, if certain groups are fundamentally disadvantaged in the education system, it will be difficult in the short term for companies to identify suitable members of those groups for board positions or to make sure that they are properly represented in the company's talent pipeline. However, companies are in a good position to draw public attention to such issues and they might be able to take collective action to mitigate them.

There may be tension between the different drivers of board room diversity. Companies need to balance them in the light of achieving a business purpose. Companies and commentators should also recognise that diversity is not an end in itself and it creates its own demands. That is why too much emphasis on diversity can become dysfunctional. Boards need to be mindful of the pitfalls of diversity that serves no business purpose and simply makes the job of building a strong board team more difficult.

SUMMARY

Diversity is now a mainstream corporate governance issue that is not going to go away anytime soon. It is a natural consequence of questions being asked about companies. Despite the historical emphasis in corporate governance on the need for boards to be balanced and have the right capabilities to be effective, there is a perception that boards are generally made up of too many similar individuals.

Boards need to respond to this new reality by recognising how diversity can contribute to board effectiveness. It can help companies enhance their social acceptability and decision-making rigour and achieve their business purpose. By developing policies on diversity and reporting against them, companies can pre-empt initiatives which may promote diversity in appearance rather than substance.

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