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Introduction

Diversity in the boardroom has been a hot topic in recent years. Does the traditional boardroom of a fairly homogenous group of individuals really produce the most effective decisions and strategy for a company?

Does such a boardroom have exposure to a wide enough range of perspectives to facilitate robust discussions of issues that arise?

Is there something missing?

The King IV Report on Corporate Governance for South Africa 2016 (King IV) emphasises the need for the board to comprise the appropriate balance of knowledge, skill, experience, diversity and independence for it to discharge it's governance role and responsibilities objectively and effectively.

The discussion below seeks to understand the concept of board diversity and the case for and against heterogeneity in the boardroom. Furthermore, we will explore practical steps that a company can take to embrace board diversity.

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What is *board diversity?*

Diversity takes various forms in a boardroom and can be broadly categorised into the following elements:

Skills, expertise and experience

Having the optimal mix of skills, expertise and experience is paramount to ensure that the board as a collective is equipped to guide the business and strategy of the company. Traditionally, boards recruit from C-suite executives. According to the Deloitte US 2014 Board Practices Report[1], C-suite experience was found to be one of the top three desired board skills and experience in US public companies. While the experience from C-suite individuals is invaluable, it may be beneficial for boards to broaden their definition of "board-ready talent". Business unit heads, regional leaders, academics, entrepreneurs, government leaders, and other non–C-suite executives can create a wider, more diverse pool with some very talented individuals that could bring interesting and insightful perspectives into the boardroom.[2]

Directors are usually selected for their leadership qualities - they often have experience with generalised management or leadership experience rather than narrow expertise or technical acumen.[3] However, a move towards having niched technical experience in the boardroom does not appear to be implausible. Currently in South Africa, directors of listed companies who sit on audit committees are expected to have keen financial expertise with an understanding of financial reporting standards, integrated reporting practices and the execution of a well-functioning combined assurance model. Furthermore, given the increasingly digital environment that businesses operate in, having a technology expert sitting in the boardroom could prove to be a strategically advantageous decision for a company. The importance of the board's involvement in technology is reiterated by the King IV Report on Corporate Governance for South Africa 2016 (King IV) which recommends that the board should govern technology and information in a way that supports the organisation in setting and achieving its strategic objectives. In order to appropriately discharge this responsibility, the board would need to have a keen insight into the IT environment of the company, further emphasising the need for specialised skills on the board in this regard. Another example of niched board skills would be human capital management. Most organisations argue that their workforce is their most valuable asset, yet very few boards have an individual with expertise in this area. According to a US survey[4], only about one board in five had a member with expertise in human capital management. This is even more concerning in light of the fact that when the surveyed board members were asked who they rely on for expert knowledge pertaining to human capital management, the most common response was "other board members".

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Gender

This element is one of the more emphasised forms of diversity in the boardroom. Historically, corporate boardrooms have largely been a male consortium. In recent years, this practice has been challenged as many companies, boards and shareholders have recognised the benefits of having a gender-balanced boardroom. According to a recent Deloitte global survey[5], South Africa ranks fourth globally for the percentage of board chairs that are women at 7.8%, against a global average of 4%. The 2014 Board Practices Report[1] found that, on average, 18% of the 250 US public companies surveyed had increased the number of women on their boards in the preceding year. Females are increasingly sitting shoulder to shoulder with their male counterparts in the boardroom, bringing with them a unique style of management and perspective.

Ethnicity

Ethnic diversity pertains to having a mix of individuals from various racial, cultural and religious backgrounds. The ethnic mix of a board should ideally represent the area in which the company operates. In South Africa, legislation such as the Broad-Based Black Economic Empowerment Act promotes ethnic diversity in the workplace.

Age

Age diversity is an often overlooked element in the boardroom. Board members tend to be older, as many boards equate age with experience. The 2014 Board Practices Report[1] found marginal evidence of generational diversity in boardrooms, with so-called “younger” directors being in their fifties. While older directors do provide a wealth of knowledge, having younger directors introduces a fresh perspective to the boardroom which should not be underestimated.

Geography

Geographic diversity refers to having a mix of individuals from various geographic locations on the board. Ideally, the geographic mix should align to the areas that the company operates in. In an increasingly global workplace, neglecting this element of diversity would be particularly imprudent for a multi-national company as it may result in boardroom perspectives lacking a robust understanding of the company’s operating environment. According to a recent study, nearly 90% of European boards include at least one director from a country other than where the company is headquartered. In 2014, roughly a third of all directors serving on major European boards were non-nationals.[6]

Independence

Many argue that achieving the right balance of independent directors is crucial to a well-functioning board. The European Confederation of Directors’ Associations (ecoDa) Principles view the involvement of independent non-executive directors on the board as a key step in the governance evolution of a company. Independent directors bring a balanced perspective to the boardroom as they assess matters in a more objective fashion. The ecoDa Principles also indicate that the board should determine if a director is independent in character and judgement after considering all relevant factors. These factors may include having regard to the relationship of the individual or his/her close family ties with the company, board and shareholders. In South Africa, approximately 60% of non-executive directors of listed companies are deemed to be independent. This is largely due to the regulatory requirements in terms of the Companies Act, King IV and the JSE Listing Requirements to have such individuals on the board.

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Are there external pressures driving diversity into the boardroom?

In recent years, there has been an influx of regulatory reforms globally encouraging diversity in the boardroom – specifically, gender diversity. King IV proposes that each company set and publish race and gender targets for board membership. The European Commission (EC) has introduced a Directive on improving the balance of males and females among non-executive directors of companies listed on stock exchanges. The EC Directive's purpose is to significantly increase the presence of women on corporate boards throughout the European Union by setting a binding minimum target of 40% females among non-executive directors of companies,[7] with a focus on public limited companies. These measures aim to promote gender equality in economic decision-making, and to take full advantage of the talent pool of candidates for a more equal gender representation on company boards. Gender quotas have also been promoted via legislation in many European countries. In 2005, Norway became the first country to introduce board gender quotas when the Norwegian Public Limited Liability Companies Act was amended to require 40% representation of both genders on boards. Similar law reforms have also been adopted in Spain, France and Italy.

Although gender diversity on boards has increased in South Africa over the past 10 years, the change is happening very slowly. Currently, it is estimated that women occupy approximately 20% of directorships on boards in South Africa.[5] Furthermore, although there are a number of initiatives to improve the gender representation in the corporate sector, the government's proposal[8] to institute a 50% quota for women on boards lapsed in parliament. There are, however, other programme in place to encourage the appointment of more women to boards, which has contributed to a steady increase in the numbers.

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One of the largest influencers of diversity in South Africa has been the Broad-Based Black Economic Empowerment Act. The Act embodies government's efforts to situate black economic empowerment within the context of a broader national empowerment strategy focused on historically disadvantaged people, and particularly black people, women, youth, disabled, and rural communities. One of the Act's many objectives, specifically focused on women, is to increase the extent to which black women own and manage new enterprises and facilitate their access to economic activities, infrastructure, and skills training.

With regards to independence, mechanisms such as the Companies Act, King VI and the JSE Listing Requirements include requirements to bring the objective view into South African boardrooms. For example, King VI recommends that the board should comprise a balance of power, with a majority of non-executive directors, that majority of whom should be independent. Having a majority of independent directors on the board is a notion echoed by various internationally recognised governance codes including those in the US, Canadian, Australian and UK as well as the Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance. King VI also recommends that the chairperson of the board is an independent non-executive director. King IV further recommends that a lead independent director should always be appointed. Functions allocated to this role includes leading in the absence of the chairman, serve as a sounding board to the chairman , strengthen independence of the governing body if the chairman is not independent and lead the performance appraisal of the chairman. The aforementioned internationally recognised governance codes include similar principles to promote objective decision making in the boardroom. Furthermore, in South Africa, to allow for the proper functioning of the audit committee, both the Companies Act and the JSE Listing Requirements have strict eligibility criteria for members of the committee to ensure that these directors are independent of the company.

It is important to note that King IV specifically deals with diversity and board composition. King IV proposes that the board should promote diversity in its membership across a variety of attributes relevant for promoting better decision-making and effective governance, including field of knowledge, skills and experience as well as age, culture, race and gender. Specifically, King IV now requires the board to disclose targets for race and gender representation in its membership.

The International Corporate Governance Network (ICGN) encourages the adoption of a policy on diversity which should include measurable targets for achieving appropriate diversity within a company's senior management and board (both executive and non-executive) and report on progress made in achieving such targets.7 Countries like Australia have encouraged disclosure of diversity policies and objectives by adopting an "apply or explain" approach. Australian listed companies are required to benchmark their corporate governance practices against the Recommendations developed by the Australian Corporate Governance Council, including the Diversity Recommendations which became effective in 2011. In South Africa, the JSE is currently considering the requirement for listed companies to disclose their policy on the promotion of gender diversity at board level in the annual report.

Shareholder activism has increased significantly in recent years, with shareholders being more vocal about the changes they would like to see in a company's board composition. In light of the many benefits of having a diverse board, an opportunity arises for activists to put pressure on a company to achieve a more balanced and diverse board composition. According to Stephen Murray, the president and CEO of CCMP Capital, a major private equity firm: "The whole activist industry exists because public boards are often seen as inadequately equipped to meet shareholder interests."

Why would a company consider board diversity?
The principal argument in favour of a diverse board is the wide range of perspectives that each individual would bring to the boardroom table. Principle 3.1 of the ICGN Global Governance Principles supports this view and states that the composition of the board should reflect a sufficient mix of individuals with relevant knowledge, independence, competence, industry experience and diversity of perspectives to generate effective challenge, discussion and objective decision-making.

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A diverse board better understands its customer base and the environment that the business operates in. As a result of this enhanced understanding, the board is better placed to find and seize opportunities for innovation, which ultimately creates value for the business. For example, Walmart appointed 30-year-old Kevin Systrom, former CEO and co-founder of Instagram, to its board of directors. The company considered Kevin's technical and digital expertise to be invaluable as they planned to further connect with customers and deploy new capabilities through e-commerce and mobile channels.[11] The enhanced understanding also means that the board is able to react faster to changes in the environment. Where directors don't properly understand the market and applicable business environment, it can take a long time before the board is convinced and comfortable enough to make important decisions. This delayed reaction time to market changes can be paralysing in highly competitive markets where a company's longevity depends on its ability to respond and adapt quickly.

Having a wide range of perspectives in the room also means that the status quo is constantly challenged and critically reassessed, which guards against the notorious "group think". And although this may initially lead to "storming" around the boardroom table, it is likely to yield a more favourable result for the company ultimately. Interestingly enough, experts believe that due to group bias, "homogeneous groups don't come to better solutions - they're simply convinced that they did. Heterogeneous groups, on the other hand, come to better solutions - they just don't think that's the case."[16] Research by Columbia University's Katherine W Phillips and others revealed that diverse groups outperformed more homogeneous groups not because of a flurry of new ideas, but rather that the heterogeneity prompted a more careful evaluation of the information at hand, which was absent in homogeneous groups.[12] For example, research by Professor Aaron Dhir of York University into the experiences of a group of Norwegian corporate directors post the introduction of the 40% gender quota revealed that female directors are "more likely than their male counterparts to probe deeply into the issues at hand"[11] by asking more questions, leading to more robust intra-board deliberations.[16] Another insightful finding from Professor Dhir's study was that the gender quota eroded at cliques being formed amongst the directors and forced people to tap outside of their own networks. Consequently, the more diverse a board becomes, the wider the networks and business connections that such a board has access to.

A spectrum of diverse perspectives in the boardroom, specifically with regard to skills and expertise, also aids to counteract "silo thinking" when the board is faced with a challenge. A board that is equipped to consider an issue from many angles (e.g. financial, economic, legal, generational, geographic, etc.) is far more effective at assessing the risk of such an issue than one that adopts a one-dimensional approach.

Incorporating independence into the boardroom also has its own specific advantages. Independent directors bring an unbiased view distinct from that of shareholders and management which provides reassurance to external parties that the company is being run in an effective manner. Due to their perceived distance from the company, they act as a balancing element in boardroom discussions between different shareholder representatives and managing conflicts of interest affecting board members. Their objectivity also allows them to safeguard the interests of minority shareholders and other stakeholders who may not be represented on the board and who may be unable to speak with a strong voice at shareholder meetings.

Having considered the above, the question is whether there is evidence of enhanced company performance as a result of incorporating diversity into the boardroom. Currently, studies of this nature are largely focused on the benefit of gender diversity in the boardroom, but the same arguments may equally apply to all forms of diversity. According to the World Economic Forum[13], compelling findings regarding the benefits of gender equality are emerging from companies. It says companies that include more women at the top levels of leadership tend to outperform those that don't. Findings from studies performed by Catalyst[14] showed that companies with a higher representation of women in top management, outperformed their counterparts with respect to Return on Equity and Total Return to Shareholders. More recent studies[15] have supported this, not only when looking at women in the boardroom, but also women executives and senior management.

A further benefit of having a diverse board is the external perception that may be created. A company that embraces diversity in the upper echelons of the organisation may be perceived by outsiders to adopt a top-down approach to being a good corporate citizen. Such a view may inspire investor confidence in the organisation which ultimately creates value for the company.

Lastly, seeing the positive impact of having a diverse board as mentioned above, in itself creates an incentive for companies to continue incorporating diversity in the boardroom. Boards that strive for effectiveness and embrace diversity as a mechanism to deliver that effectiveness are likely to perform better than boards who incorporate diversity with compliance in mind ("tickboxing"). It remains important for boards to strive to create a balance between conformance and performance. While it remains necessary to ensure compliance and adherence to various statutory prescripts (which may differ from jurisdiction to jurisdiction) and applicable governance codes, the focus should always be on the performance of the business. A tick-box approach to compliance or conformance will not necessarily yield positive results. Rather, companies should strive for a balance and determine how conformance can be viewed in a positive light to enhance the performance of the business. For example, consider a company that appoints a single director who possesses various elements of diversity to a fairly homogenous board - purely as a conformance exercise so the board can "tick a few diversity boxes". Such a director may be outvoted by the other board members, thus diminishing the performance benefit of having the diverse member on the board. In the above situation, the company should carefully consider how best to incorporate diversity in the boardroom in a way that will effectively improve the performance of the business. This might involve including other members on the board with elements of diversity (bearing in mind the necessary skill, experience and expertise requirement) to result in a more balanced board which makes effective decisions for the company.

It remains important for boards to strive to create a balance between conformance and performance.

Why might a company not adopt diversity in the boardroom?
The benefits of having a diverse board must be weighed up against the costs of doing so. Finding the appropriately skilled individuals who also match other desired elements of diversity can be a difficult, time consuming and expensive task. This is especially true for boards operating in niche industries where highly specialised skills are required, causing the pool of potential board candidates to be reduced. Where a company places a greater emphasis on other aspects of diversity rather than the skills and expertise of an individual, it could run the risk of fronting or making such individuals feel disenfranchised from the greater board.

Where a company does manage to find appropriately skilled individuals to constitute a diverse board, it may initially find that board members need to earn each other's trust in decision making as each person comes with a unique approach and perspective. This may result (at least initially) in more prolonged decision-making, reduced cohesion and additional conflicts initially and, if improperly managed, could lead to distrust and dissatisfaction in the boardroom.[16]

A further argument against heterogeneity is that it reduces over time as members become more familiar with each other. The more board members interact, the more similarly they think which takes one back to the initial problem of "group think". Given this phenomenon, regular board refreshment is of paramount importance. The board should be refreshed often enough to ensure that the appropriate level of debate and challenge is maintained in the boardroom, but not so often that it prevents synergies from being created between directors. In this regard, the King IV recommendation that at least one third of nonexecutive directors be rotated annually provides an ideal opportunity for the board to ensure regular refreshment.

Lastly, particularly in smaller family-owned companies, there may be a reluctance to introduce diversity into the boardroom as it may require the inclusion of "outsiders" into the company. For example, a company may be hesitant to introduce a larger proportion of independent directors to the board as major shareholders as may feel that they are relinquishing ultimate control of the board. However, this may not be the case where the majority shareholder can influence the appointment or removal of directors. Major shareholders can ensure that they only approve the appointment of independent directors that share their vision for the company - the involvement of outstanding independent directors can then only enhance boardroom capabilities and the likely success of the enterprise. In such a scenario, one has to caution against the appointment of "puppet directors" as one should not ignore the obligation of each director to continuously comply with their fiduciary duty, i.e. to always act in the best interest of the company.

How does a company create the optimally diverse board?

Creating the optimal framework
An optimally diverse board is primarily built on the foundation of a skills-based framework, taking into account the appropriate skills, expertise and experience necessary for the proper functioning of the board. In other words, the first element of diversity explained above should be the single largest consideration for the optimal board.

The skills, expertise and experience of individuals should be the single largest consideration for the optimal board.

Once the appropriate skills, expertise and experience have been identified, other elements of diversity should then be woven into the framework to allow for effective and robust decision-making and discussion in the boardroom.

We recommend that the optimal framework is formulated by the nomination committee and approved by the board. Shareholders can influence the framework through stakeholder engagement with the board. They can also express their preferences by including board composition requirements in the Memorandum of Incorporation or other founding documents of the company.

Maintaining the optimal framework
Once the board composition framework has been established, it should be periodically reviewed and refreshed as the company develops. The framework should always reflect a composition that will introduce the appropriate level of challenge and discussion in the boardroom to effectively cope with the company's ever-changing landscape.

To this end, the framework should be seen as dynamic and tailored to the environment that the company operates in at a given point in time.

Assessment against the optimal framework
The current composition of the board should be regularly evaluated against the optimal framework. Ideally, this should be done on an annual basis however, in practice, it is likely to happen every 3 years to coincide with board refreshments. The board should however consider the risk and opportunity cost of operating with a sub-optimal board for any given period, if the assessment is performed on a triennial basis. King VI supports the establishment of arrangements for periodic, staggered rotation of its members so as to invigorate its capabilities by introducing members with new expertise and perspectives while retaining valuable knowledge, skills and experience and maintaining continuity.

Assessing the board composition against the optimal framework should be inextricably linked to board refreshments, director tenure, succession planning and board recruitment initiatives. According to the Deloitte Board Practices Report[1], an overwhelming majority of companies turn to their own directors for board-member recommendations when recruiting. Given the lack of heterogeneity in many boardrooms, this means that the network of individuals that are recommended to the board are fairly limited and homogenous, which further exacerbates the lack of diversity in the boardroom.

The ICGN[7] provides guidance on practically incorporating gender diversity in the boardroom. This guidance has been adapted as below to reflect a wider diversity context:

- The Nomination Committee should conduct a structured evaluation of the board of directors on an annual basis to identify ways to strengthen the board's effectiveness, to assess the diversity in the boardroom, and to highlight gaps between the skills and background of existing directors and their optimal mix. This exercise will help inform the recruitment of new directors whose diversity of skills and experience should address any gaps.

- The Nomination Committee should also develop a succession plan for the board, recognising that new director recruitment should be conducted strategically to help replace the skill-sets of retiring directors.

- The Nomination Committee should report to the full board on how it takes diversity into account when nominating candidates to the board.

- The Nomination Committee should identify and recommend candidates for new board members and the committee should seek a candidate slate taking into account multiple elements of diversity. This will ensure that new directors are chosen from the widest possible group of qualified candidates.

- The board should consider requiring the Nomination Committee to address diversity and talent management as an explicit element of its oversight work, and to report to shareholders specifically on this.

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Conclusion

To remain relevant in an increasingly competitive world, directors cannot ignore the crucial role that diversity plays in governance, particularly in the boardroom. Companies that fail to dip into the ever-deepening talent pool of diverse, well-educated and ambitious individuals run the risk of limiting value creation, compromising sustainability and undermining their long-term competitiveness.

Although there are some challenges associated with having a diverse board, many of these may be viewed as temporary and will be far outweighed by the overall benefits of having a rich melting pot of diverse perspectives around the boardroom table. The King IV proposal that race and gender targets be disclosed will go some way to promote the principle of diversity on boards.

For further information, visit the Deloitte Centre for Corporate Governance: http://www.corpgov.deloitte.co.za

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