



IMPROVING CORPORATE GOVERNANCE – BOARD DIVERSITY CAN HELP

*Prof. Andrew Kakabadse

Professor Nada Korac Kakabadse, Rita Goyal

Introduction

Good corporate governance facilitates long-term value creation for owners and other stakeholders (Randøy et al., 2006). Effective Boards contribute towards improving corporate governance significantly, and hence Boards' effectiveness in their role-performance is sought by various stakeholders in the corporate world (Kesner and Johnson, 1990). The effectiveness of Boards is measured with reference to their success in role-performance as a group (Forbes and Milliken, 1999; Minichilli et al., 2012).

Scholars broadly suggest three models of Board composition for their effectiveness – reducing CEO–Chair duality, a majority of Non-Executive Directors (NEDs) on Boards, and Board diversity (Johnson et al., 2013). The UK Corporate Governance Code (Financial Reporting Council, 2016 or *the Code*) recommends all three measures for improving Board effectiveness. In FTSE 150 companies, 99% of companies have unitary Board leadership, i.e., separation of CEO and Chair roles (Spencer Stuart, 2016). Similarly, 72% of Board directors (excluding the Chairs) are NEDs in FTSE 150 companies and, out of these, 94% are considered independent (Spencer Stuart, 2016).

However, empirically, none of the above two tools is seen to promote Boards' effectiveness unequivocally (Daily and Dalton, 1997). Hence, we explore the third aspect of Board composition – Board diversity. We investigate the role of Board diversity in improving corporate governance through its impact on Boards' role-effectiveness. Houle (1990) claims that a Board's effectiveness is a function of its ability to put its members' diversities to efficient use. Thus, in this study, we investigate how corporate leaders of FTSE 350 companies perceive the role of Board diversity in improving Boards' role-performance.

The findings of the study reveal that Board directors define Board diversity broadly and consider it significant for the successful performance of multiple roles on Boards. While the regulatory emphasis has been on gender and ethnic diversity on Boards, companies need to encourage more functional diversity to be able to perform a range of their Board roles effectively. Functional diversity is obtained by nominating people with diverse educational, industry-/sector-specific and role-specific experiences. These attributes on Boards improve Boards' ability to monitor and mentor the executive and also establish networks with significant stakeholders for their companies.

We now discuss the background of our research and explain the research gap.

Background

Diversity on corporate Boards is now considered a significant factor in their effectiveness (Randøy et al., 2006). Diverse Boards are also sought

by governance practitioners, pension funds creditors, shareholders / shareholder activists, other investors, customers and employees (Anderson et al., 2011). Diverse Boards are also recommended by legislative authorities, regulators, and courts (Huse et al., 2011). Scholars argue that diverse Boards improve monitoring and control of the executives (Ferreira, 2010), enrich Board interactions and improve Board processes (Milliken and Martins, 1996).

In the UK, the Higgs Review (Higgs, 2003) and Tyson Report (Tyson, 2003) recommend that Boards have a more open recruitment process for Director nominations and appoint NEDs from a diverse pool. The Code (2016) also recommends that Boards nominate NEDs from a wider talent pool and promote diversity on Boards. In the UK, regulatory agencies encourage top public listed companies (PLCs) to improve gender diversity on their Boards. Whitehead and Normand's Women on Boards report (known as the Davies Report, 2011) and the Women on Boards review (referred to as the Davies Review, 2015) recommend that FTSE 100/350 companies voluntarily assign and achieve targets (25% and 33% respectively) for improving gender diversity on their Boards.

FTSE 100 companies have achieved these recommendations – also referred to as 'voluntary targets' – and there is now 26% gender diversity on their Boards, which is the sixth highest gender diversity on Boards in the world (Davies Review, 2015). Moreover, there is not one all-male Board in any of FTSE 100 companies, and three FTSE 100 Boards are chaired by women (Spencer Stuart, 2015). The recently issued Parker Review suggests a voluntary target of at least 'one by [20]21'. There seems to be an ever-increasing emphasis around the subject of Board diversity in business schools (e.g. Henley Business School, 2016), among corporate leaders (e.g. 30 Percent Club, 2016), and practitioners (e.g. Korn Ferry, 2016).

However, the impact of Board diversity on Boards' role-performance and decision-making is still not known, as most of the research on Board composition is input-output study, exploring the impact on firm performance with the help of secondary data with inconclusive results (Johnson et al., 1996). It is increasingly suggested that behaviour, interactions and relationships in boardrooms may not be optimally understood by using only proxies for these constructs, and by using statistical means of analysis (Gabrielsson and Huse, 2004). More emphasis needs to be given to motivation, interactions, relationships and abilities of Board members. Research on Boards needs to adopt a different theoretical perspective and research methods to reach results which are unequivocal and conclusive (Daily et al., 2003). We conduct this study with the objective of addressing these limitations. We now explain the theoretical underpinning of the study.

Theory guiding the study

The Strategic Leadership theory fits the remit of the study as it

acknowledges the unique position on Boards in the strategic decision-making process and suggests that the background, values and experiences of Board directors influence their actions (Finkelstein et al., 2009). Decisions taken in organizations are the products of decision makers' characteristics and their interpretations of situations (Hambrick and Mason, 1984). These interpretations and characteristics are in turn influenced by the experiences, values, social connections and other human aspects of the decision makers which regulate their cognitive information processing (Finkelstein and Hambrick, 1990). Hence, a broad set of attributes influencing leaders' perspectives may impact their actions and decision-making.

Thus, the findings of the study contribute towards Strategic Leadership theory. The findings also contribute towards the application of several other governance theories which explain various roles of Boards in corporate governance.

The study and findings

We interviewed 42 Board members including Chairs, CEOs, Executive Directors and NEDs. The sample of the study has respondents from eight ethnicities, six nationalities, both genders, different age groups, varied socio-economic-cultural backgrounds and diverse functional expertise. Board members are interviewed for 60–90 minutes at their workplace; interviews are tape-recorded and transcribed. The transcripts are coded and analysed thematically.

The participants in the study claim that one of the significant aspects of Board diversity which often gets overshadowed by the requests for higher gender and ethnic diversity, but is nevertheless critical for Board effectiveness, is the diversity of functional experience. An elaborate explanation with supporting quotes from respondents in the study along with theoretical explanations are given below.

Diverse functional experience on Boards and improved role-effectiveness

Boards spend a considerable amount of time imparting advice to the Executive on a range of strategic issues such as acquisition, restructuring and preparation, and analysis of strategic alternatives (Forbes and Milliken, 1999). This role impacts firm-level performance directly and is influenced by a Board member's ability to provide advice and counsel (Forbes and Milliken, 1999). Heterogeneity of functional and educational background – such as experience in non-profit organizations, law, academia, investment banking – enriches Boards' ability to offer counsel to the executives (Zahra and Pearce, 1989).

Workgroup literature on diversity claims that diverse functional experience is enhanced by cross-cultural exposure and learning about processes which result in a healthy conflict and an exploration of diverse views (Ely and Thomas 2001). Our respondents in the study not only support the notion but take it further, claiming that Board members with diverse functional experience often demonstrate a different perspective in boardrooms which improve Boards' role-effectiveness collectively. Diverse functional competencies are considered to be the most significant component of an effective Board.

As has been mandated in many countries, certain functions of Boards (including Board committees) are expected to be performed by members with specific skills and expertise. Thus, Boards must have those skills present among its members to perform those responsibilities effectively.

“Effective Boards have people with different skill-sets and with the range of different experiences. [It helps] the direction of

business that could lead to better outrun performance because you have got that different range of skill sets.” (Resp. 33)

It is suggested by the research that the corporate elite, having similar functional experiences, often take similar positions on business problems as they share a common perspective (Jensen and Zajac, 2004). Hence introducing a range of functional backgrounds will enable the Board to have a diverse perspective, thus ridding the Board of groupthink.

Functional diversity on Boards is critical

Heterogeneity of functional expertise enables a Board with oversight and equips it for any eventually. Sectors which have traditionally nominated their Board members from within suffer on account of a lack of professional wisdom and thus compromise their role-effectiveness. The respondents suggest that, while composing the Boards, care needs to be taken to ensure critical skill-sets are represented because diverse functional roles and industry experience impacts Board members' thinking style.

“You can't make decisions based on gender or ethnicity. What you can and you must do is to make your decisions on the basis of their skills.” (Resp. 5)

Functional competencies are considered to be the most significant aspect of an effective Board. Diverse functional backgrounds of directors can help the Board reduce dependencies. The set of skills relevant in Boards may vary depending on the requirement of the Board and the sector concerned.

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One of the most relevant experiences which enable Board members to contribute to Boards' effectiveness, and as a result corporate governance, is a diverse skill-set developed through the professional experience and expertise of Board members. The participants in the study acknowledge that often Boards are composed with disproportionate representation of members with expertise in finance-related matters.

“One thing that has been legislated in the United States is that people serving on your audit committee have to have finance and audit background. That is a functional question, but you have to have such competencies on Boards.” (Resp. 23)

Scholars of corporate governance also claim that demographical attributes are not the only influence on Board members' perspectives and their functional experience, such as governance roles, gives them diverse experiences as well (Finkelstein and Hambrick, 1990; Jensen and Zajac, 2004).

Functional diversity and improved decision-making

Boards need expertise in the industry, its networks and customers' preferences in order to make better strategic decisions and advise the executive accordingly.

“It is important to have people who know the business area, the industry and have the technical experience and understand the connectivity between the business and its customers and its supply chain. The wider question is one of having people who think differently.” (Resp. 32)

Learning which takes place with the help of a variety of professional

experiences plays a crucial role in Board members' actions in the boardroom in evaluating executives' proposal, and in advising/mentoring them. Such learning may occur with diverse education as well. One participant articulates this learning as the intellectual capital.

“I believe in the Intellectual capital. Whatever is your learning, it is going to play some role. It may be just building up your skill base or proficiency or your competency or your common sense. It colours your thinking.” (Resp. 23)

The significance of a diverse educational exposure among team members is claimed to provide the group with the skill-set and knowledge which enables them to have a different perspective, be more innovative and strategic in their decision-making (Hambrick et al., 2001).

Functional diversity and improved monitoring role-effectiveness

Participants in the study claim that the main impact of diverse Boards with a variety of skills-sets is their ability to question the executive and challenge their assumptions on strategic matters. Thus, the diversity of perspective acquired through diverse skill-sets and functional experience improves Boards' monitoring effectiveness.

Participants acknowledge that, though supervision of the executive is not a pleasant role, Boards need to perform it because of their fiduciary accountability towards the shareholders. The presence of various skills and competencies around the Board table enables Boards to monitor the executive more effectively and examine their proposals more credibly.

“If you have a person with a deep insight in, for example, human management, then you have another competency around the table. Or if you have somebody who understands technology, they are able to challenge some assumptions. That's not always the popular thing. But that is the fiduciary role of the Board member.” (Resp. 23)

New Boards are expected to have innovative skill-sets such as cybersecurity and digital strategy which will usher in a wide range of thinking styles on the Board—including deductive-thinkers, intuitive thinkers, visionaries, and pragmatists—which can dramatically raise a Board's impact.

Functional diversity and service role-effectiveness

Professional networks provided by Board members with their significant stakeholders improve the resource dependence role of Boards. Diverse functional backgrounds of directors can help the Board reduce dependencies. One participant explains this with the help of personal experience of functional diversity resulting in better networks and role-performance for Boards.

“There is generally someone [on our Board] who has connections into government - politicians, diplomats. These people add value through their networks, not necessarily through their competencies. People with networks across the industry. There are also people from various professional backgrounds.” (Resp. 27)

Participants further assert that many other skills which were not valued conventionally have gathered significance for Boards' ability to supervise the executive more effectively. Due to developments in technology, Boards composed without expertise in technological matters may

compromise their monitoring effectiveness.

“There is a shortage of such people who have served on a technology company or know everything that is happening. Boards that don't have someone with a technological background are really gonna be disadvantaged in the future.” (Resp. 23)

Thus, a range of functional expertise and experience improves the role-effectiveness of Board members in multiple Board roles. This diversity attribute was claimed to be the most significant aspect for improving Boards decision-making and performance. Group-diversity-based literature suggests that minority members in Boards may stimulate divergent thinking and offer unique perspectives which can alter the outcomes (Westphal and Milton, 2000). Similarly, Board members with a diverse functional background can help others to alter their conventional strategic choices (Westphal, 2000). Functionally diverse Board members bring “diverse perspectives, talents, and problem-solving skills to corporate deliberations” (Anderson et al. 2011, p. 9). Such Board members also may alter the orientation of opinions and strategic action (Golden and Zajac, 2001). Our research helps put the focus on functional diversity on Boards for improving their effectiveness and corporate governance.

Conclusion and contribution

Thus, in this study, we observe that while the emphasis of regulatory authorities in the UK has been on promoting gender and ethnic diversity with the help of soft targets, Boards need to explore other attributes of diversity for higher role-effectiveness. Functional experience adds value to Boards' effectiveness by improving Board members' ability to support and mentor the executive and by giving better strategic direction to the company. Additionally, it is also observed that while respondents seldom mention their monitoring role of controlling the executive, the diversity of functional experience does enable them to monitor executives' proposals more rigorously. The diversity of functional experience – including that of industry, sector and roles – gives Board members more confidence to take better decisions in a range of situations.

The study primarily contributes to corporate practices as companies endeavouring to promote their Boards' effectiveness may be encouraged to look for other attributes of Board diversity beyond gender and ethnicity. Secondly, though Strategic Leadership theory is a more focused approach to guide Board diversity research, it is seldom used in academic studies. This study is guided by Strategic Leadership theory and strengthens it by presenting the evidence of Board members' experiences influencing their decisions. Lastly, the study may be useful for future policy formulation relating to Board composition for improved corporate governance. ■

Professor Andrew Kakabadse is Professor of Governance and Leadership at Henley Business School and Emeritus Professor at Cranfield School of Management.

Professor Nada K. Kakabadse is Professor of Policy, Governance, and Ethics, at Henley Business School. She is the Head of School (Marketing and Reputation) at the University of Reading.

Rita Goyal is a Doctoral Researcher at Henley Business School, University of Reading. Her research is on Board diversity and its impact on Boards' role-effectiveness.