

## BOARD

# Selecting a new director

Appointing a new director is a very important function for those boards who can either make or influence this decision. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*<sup>1</sup> (ASX Principles) state in Principle 2 Structure the board to be effective and add value that:

*The board of a listed entity should be of an appropriate size and collectively have the skills, commitment and knowledge of the entity and the industry in which it operates, to enable it to discharge its duties effectively and to add value.*

A board needs to have directors who possess a broad mix of skills and experience to be effective.

Similarly, the Australian Institute of Company Directors' *Not-for-Profit Governance Principles*<sup>2</sup> under Principle 3 Board Composition state:

- 3.1 *Directors are appointed based on merit, through a transparent process, and in alignment with the purpose and strategy*
- 3.2 *Tenure of directors is limited to encourage renewal and staggered to retain corporate knowledge*
- 3.3 *The board reflects a mix of personal attributes which enable it to fulfil its role effectively*
- 3.4 *The board assesses and records its members' skills and experience, and this is disclosed to stakeholders*
- 3.5 *The board undertakes succession planning to address current and future skills needs in alignment with the purpose and the strategy.*

The key goal in selecting directors is to build a mix of individuals that can work as a well-rounded team. A formal and transparent procedure for the selection, appointment and re-appointment of directors to the board helps promote investor understanding and confidence in that process. It can be difficult to remove a poor choice of director, so it is worth investing in the process. A well-perceived appointment can enhance a company's reputation and market standing, which may have flow-on effects for the organisation such as easier access to finance.

1. ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th Edition, February, <https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf>, (accessed 7 August 2019).

2. Australian Institute of Company Directors, 2019, *Not-for-Profit Governance Principles*, February, <https://aicd.companydirectors.com.au/~media/cd2/resources/director-resources/not-for-profit-resources/nfp-principles/pdf/06911-4-adv-nfp-governance-principles-report-a4-v11.ashx>, (accessed 7 August 2019).

## What are general key competencies for directors?

There is no absolute list of competencies that apply to all boards. Each board must review its own special requirements. The competencies required will be impacted by factors such as:

- size of the board;
- committee structure of the board;
- whether the organisation is for-profit, not-for-profit or a government instrumentality;
- size, nature and financial position of the company;
- the organisation's strategy;
- complexity of operations – lines of business, subsidiaries, geographic spread of operations, etc;
- shareholder/member structure;
- the competencies of senior management; and
- risks and challenges of the business.

However, there is one competency which, following the *Centro* case<sup>3</sup>, is considered that all directors should possess: sound financial and accounting knowledge. This means the ability to read and comprehend the company's accounts, financial material presented to the board, financial reporting requirements and an understanding of corporate finance. In the *Centro* case, Justice Middleton made the observation that this is a key requirement that a director cannot delegate to other directors, board committee, advisors or management.<sup>4</sup>

Other competencies which are considered to be important for many boards include:

- **Strategic expertise** – the ability to understand, develop and review the strategy;
- **Legal** – the board's responsibility involves overseeing compliance with numerous laws as well as understanding an individual director's legal duties and responsibilities;
- **Risk management** – experience in enterprise risk management systems;
- **Managing people and achieving change** – including experience as either a CEO or senior member of a management team in a similar or larger sized organisation;
- **Industry knowledge** – experience in the industry.

## What personal qualities should board members have?

While different directors can bring different technical skills and knowledge to a board, there are personal qualities that are desirable in all directors:

- **Integrity** – fulfilling a director's duties and responsibilities, putting the organisation's interests before personal interests, acting ethically;
- **Curiosity and courage** – a director must have the curiosity to ask questions and the courage to persist in asking or to challenge management and fellow board members where necessary;
- **Interpersonal skills** – a director must work well in a group, listen well, be tactful but able to communicate their point of view frankly;
- **Genuine interest** in the organisation and its business;
- **Instinct** – good business instincts and acumen, ability to get to the crux of the issue quickly;
- **An active contributor** – there is no room on boards today for those who do not contribute; and
- **Time** – sufficient time to devote to board and committee work.

## How does a board analyse its specific needs?

The board is responsible for ensuring that the skills, knowledge and experience needed to effectively steer the organisation both now and in the future are represented on the board. An analysis of the current board's skills and experience in relation to organisational strategy and future goals will help in identifying gaps in knowledge and targeting selection criteria. Directors should be appointed for their special skills and knowledge that will assist with the issues and opportunities the company is facing.

This is done using a board skills matrix. In a board skills matrix the board sets out the specific skills it requires. These skills include industry related competencies, specific technical skills such as accountancy or legal, specific work-related experience such as being a CEO or risk manager, governance related skills such as having completed the Australian Institute of Company Directors' *Company Directors Course*, diversity attributes and behavioural skills. The skill set of exiting directors

3. *ASIC v Healey* (2011) 196 FCR 291; [2011] FCA 717.

4. *ASIC v Healey* (2011) 196 FCR 291; [2011] FCA 717 at 174-175.

is then mapped against this matrix, identifying any current gaps as well as allowing a specification for new directors when a vacancy arises. The ASX Principles' Recommendation 2.2 now makes this a specific recommended requirement for all listed companies.

If an organisation has special needs or exposure to a particular stakeholder group, it makes sense to include a director who has experience in that area. For example, a company that spends a great deal of time doing business with government may need someone with firsthand experience of the political process. This will be included in the skills matrix.



Expanding operations into new product/service or geographic areas, planning acquisitions, staving off a growing competitive threat etc, will impact on the skills and knowledge required by the board.

The board's needs will alter as an organisation reaches a new stage in its lifecycle. Therefore, when defining needs, consider where the organisation is heading as well as where it is now. Expanding operations into new product/service or geographic areas, planning acquisitions, staving off a growing competitive threat etc, will impact on the skills and knowledge required by the board.

The desired time commitment must also be quantified. The board should consider the number and nature of other directorships and commitments that a potential director has to ensure that they can effectively fulfil their legal duties and responsibilities for this organisation.

The board should also review the provisions in the organisation's board charter, which may have a bearing on the selection of directors, and the constitution, which will outline appointment procedures.

Listed companies have additional considerations, such as complying with the requirements of the ASX Principles. For instance, the ASX Principles recommend that the majority of the board be independent and that the board consider diversity as a key component of its skills matrix. In addition, for listed entities the ASX Listing Rules now require that each director is of "good fame and character".<sup>5</sup>

Financial services companies (including banks, building societies, credit unions, life and general insurers, friendly societies) also face special requirements from their regulator, the Australian Prudential Regulation Authority (APRA). These requirements are outlined in APRA's Prudential Standards on Governance (for example CPS 510), Fit and Proper (for example CPS 520).

Finally, under the Australian Charities and Not-for-profits Commission (ACNC) Governance Standards, registered charities are required under standard 4 to ensure that 'responsible persons' (such as board or committee members or trustees) are not disqualified from managing a corporation under the *Corporations Act 2001* (Cth) or disqualified from being a responsible person of a registered charity by the ACNC Commissioner.<sup>6</sup>

### What are the gender diversity requirements for listed companies?

Diversity of membership of a board is acknowledged as an important element in achieving a balance of ideas. While diversity covers a range of human attributes, the major type of diversity currently discussed in contemporary corporate governance is gender diversity. Regarding gender diversity, the percentage of women serving on boards worldwide remains low. In Australia, the percentage of women on boards of ASX 200 companies and the proportion of women comprising new appointments is slowly increasing. As at the end of June 2019, women represented 29.7 per cent of directors on ASX 200 boards.<sup>7</sup>

5. Australian Securities Exchange, *ASX Listing Rules*, Chapter 1: Admission, Listing Rule 1.1 Condition 20, p 105, <https://www.asx.com.au/documents/rules/Chapter01.pdf>, (accessed 7 August 2019).

6. Australian Charities and Not-for-profits Commission Regulation 2013 (Cth), s 45.20.

7. AICD, *Gender diversity progress stalling on ASX 200 boards*, 2019, [media release], 25 July, <https://aicd.companydirectors.com.au/media/media-releases/gender-diversity-progress-stalling-on-asx-200-boards>, (accessed 7 August 2019).

For listed companies, the ASX Principles require companies to establish a diversity policy that includes measurable objectives in relation to gender diversity. Companies are required to report their achievements against their measurable objectives on gender diversity in their annual report. The specific requirements of Recommendation 1.5 are:

*A listed entity should:*

- (a) have and disclose a diversity policy;*
- (b) through its board or a committee of the board set measurable objectives for achieving gender diversity in the composition of its board, senior executives and workforce generally; and*
- (c) disclose in relation to each reporting period:*
  - 1. the measurable objectives set for that period to achieve gender diversity;*
  - 2. the entity's progress towards achieving those objectives; and*
  - 3. either:*
    - a. the respective proportions of men and women on the board, in senior executive positions and across the whole workforce (including how the entity has defined "senior executive" for these purposes); or*
    - b. 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.*

If the entity was in the S&P/ASX 300 Index at the commencement of the reporting period, the measurable objective for achieving gender diversity in the composition of its board should be to have not less than 30 per cent of its directors of each gender within a specified period.

While only applying to listed companies, many other boards of large organisations have adopted similar diversity policies and are conscious of the need to ensure gender diversity, among other types of diversity, on their boards.<sup>8</sup>

## What does a nomination committee do?

Many larger organisations have established a board nomination committee to manage succession planning for the board and executives.<sup>9</sup> This ensures that a list of potential candidates relevant to the organisation's strategy and future goals is always on hand. The committee's responsibilities will be outlined in a charter and will usually include identifying strengths and weaknesses, skills and experience gaps in advance of anticipated vacancies such as retirements and preparing strategies to improve the board.

The ASX Principles provide good guidance on the role of a nomination committee. Recommendation 2.1 advises that listed companies should establish a nomination committee. They see the committee's role as being:

- board succession planning generally;
- induction and continuing professional development programs for directors;
- the development and implementation of a process for evaluating the performance of the board, its committees and directors;
- the process for recruiting a new director, including evaluating the balance of skills, knowledge, experience, independence and diversity on the board and, in the light of this evaluation, preparing a description of the role and capabilities required for a particular appointment;
- the appointment and re-election of directors; and
- ensuring there are plans in place to manage the succession of the CEO and other senior executives.

While a nomination committee is not essential in smaller or non-listed organisations, many larger non-listed organisations find that they most helpful to undertake what can be a demanding workload.

8. Refer to J Bourke, 2016, *Which Two Heads Are Better Than One?*, Australian Institute of Company Directors.

9. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* acknowledge that it may not be efficient for a small board to establish a nomination committee. Companies without a formal nomination committee should ensure they have other processes in place to raise the issues that would otherwise be considered by a nomination committee.

### How does a board find candidates for a board position?

In the past, boards have typically relied on their informal networks to find suitable candidates to fill board positions. The demand for accountability is now making the selection of directors more open and transparent. Boards can no longer rely on personal networks and retiring senior executives from their own industry to provide the range of skills and experience they need. A good professional search firm will suggest candidates from further afield. The issue of using search firms is discussed further below.

One technique for both the board and the potential director to determine whether they might be a suitable person for the board is to have the potential director attend one or two board meetings as a guest before a final decision is made. Normally the candidate will be asked to sign a confidentiality agreement before board materials are supplied and the person attends the meeting(s).

### How to deal with shareholder request for board seat?

There have been recent prominent examples of a shareholder seeking a seat on the board. Often in Australian companies, a shareholder with 15 per cent or greater ownership will get a seat on the board. However, there are examples when a board has rejected such a shareholder where it is not considered to be in the best interests of the company as a whole.

Usually, the shareholder will approach the chair of the board and then the matter is discussed by the board as a whole. The board can appoint the proposed director and then endorse his or her election at the next annual general meeting. If this does not happen, any shareholder with five per cent of a public company can requisition an extraordinary general meeting to consider the position of directors.

### What is the Australian Institute of Company Directors' Directorship Opportunities?

The Australian Institute of Company Directors has developed a customised program to better assist members looking for directorships and connecting them with organisations seeking board members. This directorship search service has been designed to specifically address the issues of greater visibility and control over finding new directorships.

More information can be found at <https://aicd.companydirectors.com.au/membership/directorship-opportunities>

The AICD has also published the book *Developing Your Director Career* by Elizabeth Jameson.<sup>10</sup>

### Should search firms and specialist recruitment consultants be used?

Boards may find search firms useful when seeking a new director with the right skills and experience for their business. Search firms can make recommendations from a huge array of contacts, from highly experienced directors to new directors with a breadth of practical experience. They can introduce candidates whom the board might not have considered and can increase success in finding a director with the right skills.

However, the use of such advisors depends on the nature of the business and the skills that are needed on the board. If a search firm is used, the board must actively manage the involvement of the search firm in the process. Boards will either use the nomination committee, if one exists, or appoint a small group of directors to liaise with the search firm and then in conjunction with the firm to develop the initial list of potential candidates to a short list of three to five persons. The whole board should be involved in the selection of the final person. The search firm can then do a thorough background check to ensure that the person has not embellished their curriculum vitae and meets any other requirements, as set out below, required by the board.

While very valuable, these services can be very expensive and may be beyond the reach of SMEs and smaller not-for-profit boards.

### Should personal networks be used?

Personal networks can be a valuable source of information about potential candidates. The chief advantage of using a network is that there is first-hand knowledge of a candidate's background and working style. This will assist in determining whether a director will be able to work in a collegial manner with other directors.

Caution is needed, however, to ensure that the board is not filled with 'mates'. A key feature of an effective board is independence of mind. A board full of directors always agreeing with each other will not function efficiently.

10. E Jameson, 2017, *Developing Your Director Career*, Australian Institute of Company Directors.

The board must be comprised of people who fill a defined need, challenge the status quo, ask appropriate questions and are persistent in getting answers. Just relying on the contacts of exiting directors has been identified as a major reason for the historic lack of diversity of many boards of major companies.

### Should the board do background checks?

As mentioned above, there are now standards which are required of directors of different classes of companies such as listed companies and charities. Also given the legal responsibilities that directors face and the collegial nature of an effectively functioning board, directors must trust and respect each other. Therefore, it is advisable to substantiate information provided by a candidate about themselves.

Some people are unable to act as a director. This includes people who are undischarged bankrupts or who have been convicted of certain types of offences.<sup>11</sup> Both ASIC and the ACNC can disqualify a person from being a director. The court also has discretion to disqualify individuals from being directors if the individual breaches certain civil penalty provisions of the *Corporations Act 2001*.<sup>12</sup>

As a starting point, boards should devise a policy on selection and appointment procedures that includes the minimum level of background checking the board views as necessary. For larger organisations using a search or recruitment firm, part of the firm's brief will include an instruction to verify the CV's information to the level suggested by the policy statement.



It is also becoming more widely accepted for police checks to be conducted for a potential director.

Smaller organisations can use a variety of free or fee-based services to confirm information. At a minimum, they can check information with the Australian Securities and Investments Commission (ASIC) using the sources below, speak with the candidate's referees and verify employment dates.

Free sources on the ASIC Connect website include:

- National Names Index (an index of registered companies in Australia); and
- Register of Banned or Disqualified Persons.

ASIC also has an online Enforceable Undertakings Register.

Note that there are limitations on the information offered by each of these searches.

An ASIC service centre or an information broker listed on ASIC's website can, for a small fee, search on a director's name and provide a list of all their directorships and terms of office.

People are disqualified from managing corporations if they are insolvent. The Insolvency and Trustee Service Australia (ITSA) maintains the National Personal Insolvency Index (NPII) and this can be searched through information brokers listed on their website, again for a small fee.

The Australian Charities and Not-for-profit Commission (ACNC) also maintains a register of disqualified 'responsible persons'. However, as at April 2019 no person has yet been disqualified by the ACNC.

It is also becoming more widely accepted for police checks to be conducted for a potential director. In addition, if the organisation involves work with children, it is possible that special working with children clearance will be required. Potential directors should be advised that these background checks will be undertaken and their approval, in writing, sought before the enquiries are made.

11. Under s 206B of the *Corporations Act 2001*, an individual is automatically disqualified from being a director if they have been convicted of certain types of offences. These include offences involving dishonesty which are punishable by at least three months imprisonment and offences involving a contravention of the *Corporations Act 2001* which are punishable by imprisonment for greater than 12 months.

12. Under s 206C of the *Corporations Act 2001*, the court may disqualify a person from being a director if the person has breached certain provisions of the *Corporations Act* and the court is satisfied that disqualification is justified.

### What areas should a board consider when reviewing potential candidates?

- Does the candidate have skills that would add value to the board or fill a gap?
- Does he or she understand the organisation's business?
- Can the candidate work as part of this team of directors?
- Does he or she have sound business instincts and judgment?
- Does he or she have a proven track record?
- Is the candidate genuinely interested in the organisation, its business and people?
- Is the candidate honest and a person of integrity?
- What other directorships and commitments does the candidate have?

### How does a board communicate its expectations to new directors?

Executive directors will normally receive and sign an executive service agreement or contract. Non-executive directors generally receive and sign letters of appointment. Examples of current good practice are provided by the ASX Principles in this area. Recommendation 1.3 states that a listed entity should have a written agreement with each director and senior executive setting out the terms of their appointment. Recommendation 2.6 states that a listed entity should have a program for inducting new directors and for periodically reviewing whether there is a need for existing directors to undertake professional development to maintain the skills and knowledge needed to perform their role as directors effectively.

## About us

The Australian Institute of Company Directors (AICD) is committed to strengthening society through world-class governance. We aim to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society. Our membership includes directors and senior leaders from business, government and the not-for-profit (NFP) sectors.

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