Rethinking board composition:

Balancing competence and compatibility in director selection

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ABSTRACT

Board composition is critical to board effectiveness. Shaping an effective board begins with the selection of directors. While much attention has been paid to the skills and qualifications directors require, there has been less focus on the necessity for board members to interact and work well together. This exploratory study offers insights into what qualities directors look for when selecting new members and the approach adopted to identify and select them. The findings of 10 in-depth interviews with Australian directors suggest new members are selected both on competencies and compatibility. Yet not all selection approaches adequately assess candidates for these two criteria. As a result many appointments fail to realise the selection criteria reducing capacity to reach its full potential.

Keywords: Board composition, board effectiveness, board of directors, corporate governance

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Organisations across the globe are responding to new challenges by reshaping the way they do things and the way they are organised. The necessity to rethink structure extends beyond management and into the boardroom. To gain and sustain a competitive advantage in a complex operating environment, organisations require strong strategic direction from a dynamic and effective board. The capabilities of those individuals selected onto boards are critical, but skills alone may not be enough to ensure a board functions effectively. Board members must also be able to interact and work well with one another.

Board composition has featured heavily in corporate governance research with many studies addressing the question of *how should a board compose itself to most effectively carry out its role?* A substantial body of literature has considered how the independence, skills and qualifications of individual directors can add value to a board. Most studies of this nature consider board composition from an individual level, seeking to assess board effectiveness by focusing on the qualities of individual directors, often with inconclusive results (Adams, Hermalin & Weisbach 2010).

Director selection is an important yet understudied area of board research. Getting the right people onto a board is critical to board effectiveness. Understanding the influences and processes in director selection is therefore important to board research. Yet this area has received little recent attention in corporate governance literature (Withers, Hillman, & Cannella 2012). Thus while we know much about who sits on a board we know little of why and how they were selected.

This study aims to address the lack of current understanding into director recruitment through explorative research that addresses two important areas of the director selection process; *(1) how are directors selected? And (2) what criteria are considered important when selecting director candidates?*

Two significant themes emerged from this study. Firstly, it is evident organisations do not take a common approach to director selection in Australia but rather selection approaches vary significantly.

Four common approaches to selection were identified by this study using two dimensions; the source of identifying candidates and the involvement of the board in the selection decision. Secondly, while there was evidence of variability in selection approach there was unanimity with regards to what directors look for in new board candidates. Most significantly, candidate 'fit' was a critical criterion. The notion of 'fit' was further classified as *group-fit;* a supplementary fit based on compatibility and value congruence and *role-fit;* a complementary fit based on the board's technical resource needs. While this notion of candidate fit is unsurprising, the results from this study suggests that not all selection approaches adequately assess both aspects of a candidates fit. As a result director appointments may fail to meet their recruitment needs, affecting the ability of the board to perform at its optimum level.

LITERATURE REVIEW

While a number of studies have attempted to link board composition to organisational performance, fewer have delved deeper into the director selection process (Kim & Cannella 2008). In a recent review of the director selection literature Withers et al. (2012) concluded scholars have typically considered director selection through one of two lenses. Firstly, an economic perspective that suggests director appointments are determined by an individual's skills, knowledge and expertise. Secondly, a socially embedded perspective that implies director appointments are decided on the social preferences and biases of those tasked with the selection decision.

Research from an economic perspective assumes the individual judged most able to execute the role of a director through positively influencing governance, aligning shareholder interests and contributing to organisational performance will be selected onto a board (Fama & Jensen 1983). Two theories dominate the corporate governance literature in regard to the function of the board and form the foundations of the economic perspective of director selection. Under agency theory it is assumed that those who are best able to monitor management would be selected as directors (Fama & Jensen 1983). While resource dependence theory scholars assert that directors are selected primarily on how well their occupational and functional experiences match the needs of the organisation (e.g. Hillman, Cannella, & Paetzold 2000; Pfeffer 1972).

There is limited consensus on the types of people make the best directors (Johnson, Schnatterly, & Hill, 2012) although most agree boards require a high level of skill, knowledge and expertise (Finkelstein, Hambrick, & Cannella 2009; Forbes & Miliken 1999). This lack of consensus is confounded by the general recognition that the type of skills and knowledge sought by boards is unlikely to be static but rather changes in response to both internal and external factors (Hillman & Dalziel 2003; Nicholson & Kiel 2004).

Research from a sociological perspective implies the selection of an individual to a board is driven not by their perceived ability to execute the board's governance roles, but rather by other motivations such as relationships and power. Most common in this stream of research is the notion that director appointments are driven by pre-existing relationships. For example, CEOs influence the selection process as a means of building alliances (Mace 1971; Westphal & Zajac 1995). As a result when CEOs have influence over a selection they will select someone from their own network (Johnson et al., 2004) or individuals' known for passive monitoring (Zajac & Westphal, 1996). The principal of similarity-attraction is frequently used to suggest that those with most influence over the recruitment process will favour and appoint individuals' most similar to themselves (Kaczmerek et al., 2012; Westphal & Zajac, 1995).

When considered together the economic and social perspectives suggest there is a disconnect in recruitment motivations; on the one hand boards seek candidates who are best able to monitor management and provide necessary resources and on the other hand boards seek to appoint candidates that they know, like and trust. While in practice director selections are likely to be influenced by both economic and social factors, Withers et al. (2012) highlight a key gap in the literature is the lack of integration between these two perspectives. As such the first research question addressed by this study aims to understand what really matters when boards recruit new members;

RQ1: What criteria are considered important when selecting director candidates?

The literature often refers to director selections as a process that involves four distinct stages: identification, screening, selection and appointment (Lorsch & MacIver 1989; Withers et al. 2012).

Yet empirical research indicates there is no uniform process for identifying and evaluating candidates (O'Neal & Thomas 1995) and that variations exist in how directors are identified and selected (Huse 2007; Moodie 2001). Two well-known early studies into boards of directors, Mace's (1971) *Directors: Myth & Reality* and Lorsch & MacIver's (1989) *Pawns or Potentates* are frequently relied on to describe a director selection process that is informal, reliant on closed networks and dominated by the CEO and Chair. However, decades have passed since these books were first published and much has changed within corporate governance practices.

The frequency and impact of corporate failures at the turn of the century has led to increased shareholder activism and the introduction of legislation and guidelines aimed at improving corporate governance (Adams et al. 2010). Boards are now under increasing pressure to have well-defined recruitment processes in place including nomination committees and a wider candidate pool (Huse 2007; Monks & Minow 2011). In Australia, corporate governance guidelines recommend a formal director selection process by which candidates are identified and selected for their ability to enhance the boards' capacity to govern effectively (ASX Corporate Governance Council 2014). Despite these apparent shifts in recruitment policy, researchers continue to point to informal practices and social influences over board appointments (Parker 2007; Westphal & Stern 2006, 2007).

The inconsistency between regulatory guidelines advocating formal and transparent selection process and the empirical evidence pointing to informal and social influences suggests further investigation is needed into director selection practices. As such the second research question of this study aims to developing a current understanding of the approaches adopted in recruiting new directors;

RQ2: How are directors selected?

METHOD

Recognition that board composition has a critical impact on board effectiveness has led to a vast number of investigations into the characteristics of the directors who make up a board. These studies have generally sought to establish relationships between the board composition and organisational performance by relying on archival data. Considerably less corporate governance research – in

particular board composition research has been explored through qualitative methods (McNulty, Zattoni & Douglas 2013). This study adopted an exploratory research approach, relying on in-depth interviews to gain first-hand empirical data of director selection experiences. A central contribution of this research is therefore to aid the opening of the 'black box' by increasing the understanding of how and why directors are selected onto boards.

Since an objective of this study was to reveal variances from the participant's experiences in director selection, a sample was purposefully selected to include representatives from various organisational sectors, industries and sizes. This sampling strategy allowed greater insight into how director selection practices vary for different organisational settings. To date there have been limited empirical comparisons of this nature (Machold & Farquhar 2013). A second objective of this study was to obtain a rich mix of experiences and impressions from participant perspectives. To achieve this, the sample included participants from both genders, a range of functional backgrounds and age groups.

Initially five participants were purposefully selected based on their experience in director selection and all agreed to participate. A snowballing technique was subsequently applied whereby each interviewee was asked for an introduction to other individuals who met the sample criteria. The final sample set comprised 10 individuals representing 18 organisations from the publically-listed, government and non-profit sectors. Most participants were able to recount more than one selection experience. In total 24 processes were recounted during the interviews and the data from these 24 selections formed the basis of the data analysis. Table 1 provides a profile of participants.

The data analysis followed an iterative process of constant comparison between the data and theory (Isabella 1990; Machold & Farquhar 2013; Suddaby 2006). This process involved taking the data apart and then reassembling it to draw meaning and address the research questions. The data was drawn from 10 interviews describing 24 selections that resulted in 7.45 hours of recordings and 65,236 words of transcripts, subsequently coded into 182 relevant segments.

Data coding was performed at three levels – open, axial and selective. Initially codes were developed around the director selection process. These initial codes were structural and not content specific but

provided an important framework that allowed the data to be broken into manageable sized pieces and provided a logical framework from which a second layer of open codes were inductively developed. This initial process of assigning and revising codes resulted in a final set of 26 different codes. Axial coding was undertaken to reassemble the data fractured during the open coding (Strauss & Corbin 1998). This stage of analysis involved interconnecting codes and providing more abstract names that were more reflective of the essence of the data. Categories were further refined as similarities and differences were identified. Categories with commonalities were consolidated while single incidents or categories with minimal evidence were deemed irrelevant. As themes developed it became clear when theoretical saturation was reached. Once no new insights were revealed it was felt the information had been exhausted and that the coding process had ended (Charmaz 2006). The final phase of the data analysis involved aggregating the codes and categories into overarching themes that reflected the core themes of the study providing the foundations for the study's findings and conclusions. Figure 1 outlines the data coding structure and the themes that have formed the basis of the results.

RESULTS

Director selection is an important yet understudied area of board research leaving a gap in our knowledge of how boards can be more effective. This study set out to address this limitation by gaining a greater understanding of how and why directors are selected. The findings from in-depth interviews suggest that directors are aligned in the criteria they consider important: a balance of complementary skills and an ability to get along well. Yet the process by which boards identify and select new candidates varies significantly, at times limiting a boards' ability to appoint the right person. The key highlights from the findings are detailed below.

Commonality in selection criteria

There was overwhelming unanimity from the study's participants that director selections came down to a matter of how well a candidate would 'fit' with the existing board. The importance of 'fit' as a criteria was reflected in the strong and consistent use of the word 'fit' or similar terminology by all participants describing desired attributes of director candidates. Examples included, *"The ultimate*

criteria is will they fit in"; "(Fit) it's the most important thing"; "It was just who was going to fit" and *"We try to find people that fit the mould".*

While 'fit' clearly emerged as important, it was considered through two distinct lenses suggesting 'fit' is a construct that can be viewed both in terms of similarity and difference. On the one hand the participants revealed a strong preference for directors with similar values and personality traits to those of the existing board members, *"It's about the right personalities and the right capacity to be a member of the group".* At the same time there was recognition that potential directors should to be able to fill a need in current board capabilities, *"The discussion has been around what skill sets are we deficient in; what [is] the future direction of the organisation; what sort of skill sets will we need going into the future".*

In summary, a candidate's perceived fit for the role of director appeared to be multidimensional and considered in terms of a *group-fit* matching the values and characteristics of the current board, as well as a *role-fit* filling a gap in board technical capabilities. Furthermore competence and compatibility were seen as equal in importance; *"you've got to have the right experience and the right personal fit".*

Variation in selection approach

Despite commonality across the two main criteria considered important in director selections, the study indicated significant variability in the approach adopted when selecting directors. While some selection approaches follow a uniform and formal process, many others were ad hoc, informal and heavily influenced by a single decision maker.

Two significant variances in selection approaches emerged from the data. Firstly, whether the source for identifying candidates came from an *open* or *closed* network. A closed network describes instances where candidates have existing relationships with the Chair, CEO or incumbent board members while an open network refers to broader search strategies that include external advertising and the use of recruitment consultants. The second difference was in the level of involvement by the incumbent board in the selection decision. Board participation varied from no involvement by the

board or the Chair, to minimal involvement by a single decision maker (most often the Chair), and high involvement including a nomination committee and/or all of the board.

Using these two dimensions, four common selection approaches were identified from the data and categorised as *traditional, socialised, considered and externally managed.*

Traditional approach

Traditional selection practices are characterised by their reliance on closed networks, informality, a lack of transparency, and a dominant decision maker (typically the Chair) with minimal input from the wider board. In the past such practices have been criticised for an over-reliance on the 'old boys club' and a resulting failure to consider the economic needs of the board (Huse, 2007; Leighton & Thain, 1993; Lorsch & MacIver, 1989).

One quarter of the selections described followed this approach suggesting that while traditional practices continue, they are becoming less frequent. The extent of traditional practices is summed up well by one of the participants, who noted its existence yet also notes a conscious move away from such practices:*"Whilst I'm sure it still goes on that, this sort of old boys' network, more and more so I think companies are realising that, you know, to stay ahead and be competitive you need the right diversity skills and so just asking who you know [to join the board] isn't going to wash."*

When a single person dominates the selection decision, even with good intentions, there is a risk of an ineffective appointment. One participant acknowledged these shortcomings, *"You get a completely mixed bag of skills … it's not good governance"*. The outcome of such an appointment was also highlighted, *"[after the appointment] the dynamics of the whole board just changed."*

Socialised approach

Social selections are characterised by their reliance on social networks to identify candidates. They place a heavy emphasis on group-fit though wide involvement by the board in the selection decision. While the involvement of the board in these selections is likely to result in a group-fit, the narrow source for identifying candidates (limited to those known to the board) may restrict the board from finding the best role-fit. As a result socialised selections may result in a homogeneous board that are

able to interact well with one another on the one hand, but on the other may lack the diversity needed to challenge and question management. As one participant described, *"They're using the old network … doing that sort of find some people who want to be a director you know. You know well that doesn't necessarily get you the right people."*

Considered approach

Selections adopting a considered approach are most in-line with the formal selection approach prescribed by corporate governance regulations and guidelines and are most able to balance role and group-fit requirements.

By adopting open, broad search strategies for identifying candidates who can meet the recognised needs of the board, a considered selection is likely to result in a role-fit, *"We wanted to have a discussion and a fulsome review of the skills and behaviours and competencies that we would want if we brought in someone else"*.

While the involvement of the wider board in the selection decision also increases the ability of the board to assess candidates for a group-fit; *"The chairman came back to each of us and said now that you've met the person what do you think?"*

This selection approach, evident in almost half of those described, was the most common and widely used approach, further illustrating a shift from informal approaches toward more rigorous and transparent practices. Unsurprisingly, *considered selections* were typical amongst organisations with greater accountability. More surprising was the widespread application of this approach across a number of the small and mid-sized non-profit organisations. This indicates a real desire for organisations across the board to identify and appoint individuals who meet both the role and social needs of the board.

Externally managed approach

Externally managed selections have a strong focus on the role requirements and achieving a role-fit. However, the lack of involvement by the incumbent board – both in identifying role requirements and in final selection – means there is no opportunity or ability to test a candidate for group-fit. The likely

outcome is a highly skilled and competent board, but by ignoring consideration for the group-fit there is potential for interaction difficulties. A lack of interaction can mean a board fails to fully tap into the resources and knowledge available and therefore fails to reach its full potential due to process losses (Steiner, 1972).

Overall participants found fault in this approach to selection, primarily due to the absence of an ability to assess the group-fit of candidates; *"The new directors' start next month and the chairman and myself doesn't even know these people, we weren't consulted"*.

The potential problems associated with a lack of ability to assess candidates group-fit were clear; *"This one director, no-one could get along with – he was problematic from the moment he walked in the room."*

The selection approach adopted by boards can have significant influence over the board's ability to assess candidates. For example, when boards use broad open sources to identify candidates they are better equipped to assess a candidate for their ability to meet the board's technical requirements (role-fit). Equally, where all of the board is involved in the selection decision the board as a whole is better able to assess a candidate's group-fit. Table 2 illustrates the ability of each selection approach to assess candidate fit. Of the four approaches to selection identified by this study only one, *the considered approach,* allows for adequate assessment of both role-fit and group-fit.

DISCUSSION AND IMPLICATIONS

The findings highlight commonalities in selection criteria as well as variances in selection approaches. When considered together they suggest the approach adopted by boards to identify and select new members may impact the likelihood of meeting selection criteria and therefore the likely effectiveness of an appointment. The findings are notably consistent across different organisational contexts indicating that regardless of sector or size, boards want candidates who can both fulfil the role requirements and who can also get along with incumbent board members. Of the four common

approaches to selection described in this study, only one allows for adequate assessment of both role-fit and group-fit.

This study has provided evidence of director selection practices that are too rigorous and too distanced from the boards' social needs. By failing to adequately assess group compatibility such practices risk appointing a personality mis-fit and this in turn can limit the ability of the board to reach its full potential. Alternatively other approaches have been described that are informal and overly reliant on closed networks. While these practices may lead to the appointment of an individual who can get along with the group, their skill set may fail to add value to the board. Furthermore recruiting from closed networks may lead to be a homogeneous board that lacks the diversity needed to challenge and question management.

The group-based nature of the board means that where group-fit is absent there is an increased risk of a group mis-fit leading to process losses as incumbent members withdraw or disengage (Steiner, 1972). Group-fit encourages group cohesion that in turn may lead to improved communication and trust between members (Forbes & Milliken, 1999). However on the other hand too much cohesion within a group may also contribute to ineffective group decision-making. Conformity through groupthink can reduce the effectiveness of groups by reducing independent thinking (Janis, 1972). For boards this condition of groupthink is most likely to occur when candidates are selected on group-fit without consideration for the diverse skills and experience needed to fill the role requirements. This suggests an approach that considers both role-fit and group-fit is most likely to result in an effective appointment.

This study makes important contributions to corporate governance research with implications for future research. Firstly it is well recognised in the corporate governance literature that boards require a high degree of skill and knowledge. Less corporate governance research has considered the impact of group dynamics in board research and the importance of group-fit in board composition. While numerous scholars have called for greater attention to the impact of board group dynamics (Dalton & Dalton 2011; Finkelstein & Mooney 2003; Sonnenfeld 2002) it remains a relatively undeveloped area

of corporate governance research. The findings from this study provide evidence that compatibility (group-fit) amongst board members is an important consideration in director selections. Future studies into board composition would therefore benefit from considering how the group dynamics of a board impacts on board performance.

This research has practical implications for boards of directors and governance practitioners. By categorising four common approaches to director selection it has highlighted that some selection approaches fail to adequately assess role-fit and/or group-fit (table 2). The Australian Corporate Governance Council's guidelines for board structure recommend selection procedures that include an open and transparent search for candidates who meet the needs of the board as well as advocating involvement by all board members in the selection decision (ASX Corporate Governance Council, 2014). This research supports these guidelines and emphasises the need for boards to consider all aspects of this advice.

CONCLUSION AND LIMITATIONS

This study has some limitations that deserve to be noted. Firstly this study is based on in-depth interviews. While this was deemed the most appropriate method for meeting the objectives of this study there are implicit limitations due to the subjective nature of this research method. For example the findings are based on the experiences and perceptions of the participants rather than what actually occurred and are therefore subject to bias. Secondly, this study has been set within a context of Australian organisations and therefore its transferability may be limited to countries that share a similar cultural and corporate governance environment.

Finkelstein and Mooney encouraged boards to "get to know and understand the other people on the board, to develop chemistry" (2003: 110). The logical place to begin developing this chemistry necessary for board cohesion is at the selection stage. By casting a broad search net for candidates and involving the entire board in the selection decision, boards are best able to appoint a candidate who is not only equipped with the right technical skills but also functions well enough within the board environment to ensure that their skills are used to make an effective contribution.

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Table 1: Profile of Participants

Non-profit	Sector Public Listed	Government	Position	Gender	Age group
X			Chair	Male	41 – 50
X			Chair	Male	51 +
X			Chair	Male	30 - 40
X		X	Non-executive	Female	41 – 50
	X	X	Non-executive	Female	30 – 40
	X		Non-executive	Female	41 – 50
X			Chair	Female	41 – 50
X		X	Chair	Male	51 +
X			Chair	Female	41 – 50
		X	Non-executive	Female	51 +

Table 2: Categorisation of selection approaches and ability to assess candidate fit

Selection type		Selection approach		Ability to assess candidates	
Type	*Characteristics*	*Identification Source*	*Level of board participation*	*Role-fit*	*Group-fit*
Traditional	Informal, dominated by a single decision maker	Closed	Low	Moderate	Moderate
Socialised	Heavy reliance on social networks	Closed	High	Moderate	Strong
Considered	Open, broad search and high board involvement	Open	High	Strong	Strong
Externally managed	Focus on technical skills, decision removed from the board	Open	None	Strong	Weak

Figure 1a: Data Coding Structure: RQ1

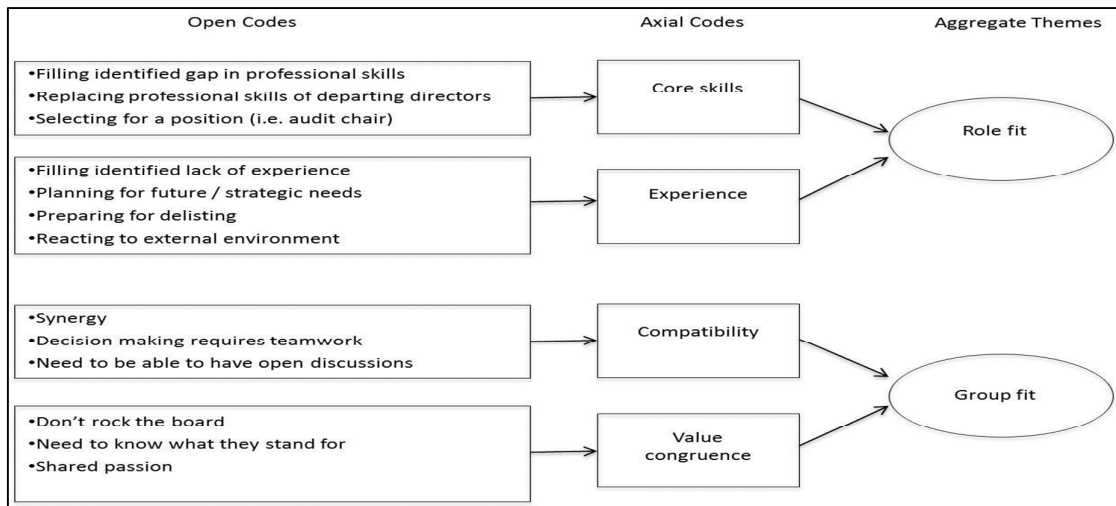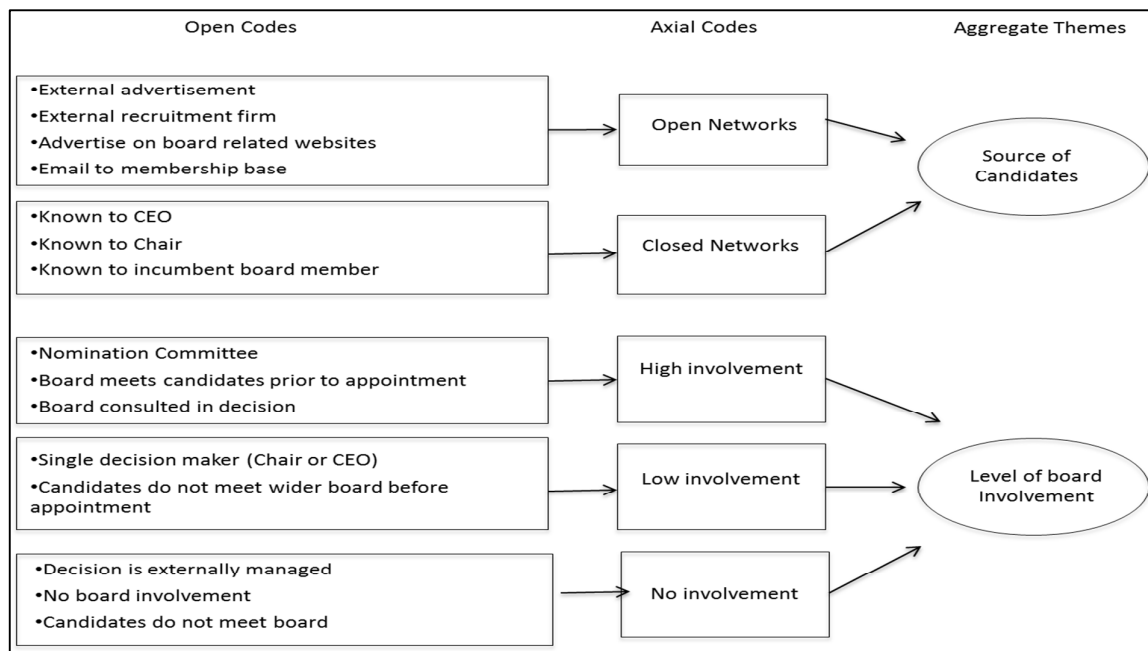**Figure 1b: Data Coding Structure: RQ2**

Appendix 1: Interview question guide

Formal Questions:

1. Is your board currently looking for a director? / Recently selected a director?

   a. What were the selection criteria?

2. If you had 2 candidates that looked the same on paper (i.e. skills, qualifications & required experience) – what would lead you to choose one over the other?

3. How do you find suitable candidates?

4. Who sets the criteria?

5. Who makes the selection decision?

6. Do you think director selection requirements are the same across sectors and industry? – How may they differ?