Australian Institute *of* Company Directors

BOARD

Succession planning

Boards must plan for orderly succession and renewal as well as be prepared for everything from sudden departure to sudden illness or death of a board member or chief executive officer (CEO). Considerable disruption can occur when companies are required to abruptly change their CEO or chair.

Succession planning enables an organisation to refresh its leaders in order to continue meeting the challenges of a constantly changing business environment. While it is usually discussed in terms of CEOs and senior executives, succession planning is equally beneficial for boards. The aim is to have the right person able to fill a vacancy at the right time. The ongoing nature of this planning means that the board has the opportunity to manage its future needs.

Succession planning is closely connected with the processes for selection, appointment and appraisal of directors and executives. The ASX Corporate Governance Council (ASXCGC) advises that board renewal is critical to performance. Specifically, in Recommendation 2.1 of the *Corporate Governance Principles and Recommendations*[1] (ASX Principles), the ASXCGC recommends that a nomination committee be established to undertake activities in relation to:[2]

- *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.*

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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 8 August 2019).
2. Ibid, p 12.

Of note, this recommendation provides that the nomination committee, or the whole board in the absence of such a committee, should focus on succession planning for board, CEO and other senior executives.

In considering succession planning for both the board and senior executives, the latest version of the ASX Principles places emphasis on planning for diversity. Specifically, Recommendation 1.5 states:[3]

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% of its directors of each gender within a specified period.

The AICD's latest Gender Diversity Quarterly Report reveals that, as at the end of June 2019, women represented 29.7 per cent of directors on ASX 200 boards. In 2015, the AICD called for ASX 200 companies to achieve 30 per cent women on boards by the end of 2018. In that time gender diversity climbed more than 10 percentage points but the target of 30 per cent has not yet been reached.

The AICD's Amber O'Connell GAICD presents a good summary of the current thinking on the question of how long a director should remain on a board.[4] The issue revolves around the impact of extended director tenure on performance. There are conflicting results on the relationship between tenure and performance.

Wertheim et al. suggest there are two distinct strands of investigation that address director tenure and effectiveness – these are the 'expertise hypothesis' where directors are considered to become more effective as their understanding of a business improves, and the 'entrenchment hypothesis' where they become complacent and stagnant in their role after some time. The paper concludes that companies are benefited by increased board tenure only up to a certain point, and beyond that point, incremental increases in tenure no longer have a significant effect on corporate governance.[5]

In a 2018 paper looking at the relationship between director tenure and firm value, Huang and Hilary demonstrated that having a higher proportion of directors with tenure greater than 11 years measurably decreased firm value and found that "[f]irm value reaches a maximum when the average tenure of outside directors is approximately 10 years".[6]

3. Ibid, p 9.
4. Amber O'Connell, 2017, *A fresh pair of eyes*, Governance Leadership Centre, 18 April, **http://aicd.companydirectors.com.au/advocacy/governance-leadership-centre/practice-of-governance/a-fresh-pair-of-eyes**, (accessed 8 August 2019).
5. P Wertheim, J D Neill and C E Clements, 2016, "Director Tenure and Leadership Effectiveness over Internal Controls", *Journal of Leadership, Accountability & Ethics*, vol 13, no 2, pp 61-73.
6. S Huang and G Hilary, 2018, "Zombie Boards: Board Tenure and Firm Performance", *Journal of Accounting Research*, vol 56, no 4, pp 1285-1329.

With respect to board tenure and organisation innovativeness, research by Ning Jia concluded that long-serving directors are less effective in advising management on innovative activities, and (when looking at US listed company boards) that entrenched boards – those with a higher proportion of directors with board service exceeding 10 years – produce significantly fewer patents and these patents receive significantly fewer subsequent citations. These firms also exhibit lower R&D productivity and exploratory innovation intensity.[7]

O'Connell notes that anecdotally, long average director tenures are more common in not-for-profit or member-based organisations, such as registered clubs, charities and customer owned banking institutions. For example, average director tenure in the customer-owned banking sector is 10.42 years while the major banks sit at around five years.

Some of the reasons driving board entrenchment are explored by Beck and Tunny:[8]

Convincing long-serving directors to retire from the board can be difficult where there is no policy or constitutional reason for doing so. There are two reasons for this. First, for some directors, their directorship has become the last source of any income outside of a superannuation or public pension. They do not want to leave because the money is important. Second, but not necessarily mutually exclusive, the directorship may have become the last link the director has with their previous professional or business life. At the same time, they might have become emotionally bonded with the organisation – it has become such an important part of their life that it is a major 'reason for being' – giving purpose to their existence. In these circumstances, seeking to have the director step down from the board can be fraught with difficulty.

Managing this 'difficulty' is one of the arguments for constitutionally set term limits.

In summary, regular refreshment of the board is seen as essential to ensure new skills, experiences, diversity are being introduced to the board and the board remains fit for purpose.

Succession planning for the board

In medium to large organisations, succession planning has become strategically important to Australian boards due to the high average age of directors at 57 years old[9] (and hence a high number of upcoming retirements) and a shortening of the average tenure of directors, which is now 6 years for non-executive directors in ASX 100 boards and 5.5 years in ASX 101-200 boards[10]. Board refreshment with younger directors, is a real phenomenon in Australia and globally, however, research by board data provider Equilar indicates that having younger directors on boards does not necessarily lead to better company performance.[11] Governance trends such as board performance appraisals and transparency of selection policies reinforce the idea that an organisation must have the optimal mix of people, skills and knowledge to ensure its continued success.

The skills, knowledge and experience required to effectively steer an organisation will change over time in response to market developments, opportunities and challenges. Board succession planning allows directors to match the organisation's future needs based on long-term vision with the best qualified directors available.

7. N Jia, 2017, "Should Directors Have Term Limits? – Evidence from Corporate Innovation", *European Accounting Review*, vol 26, no 4, pp 755-785.
8. J Beck and J Tunny, 2014, *Director Tenure Discussion Paper*, July, Effective Governance, **http://www.effectivegovernance.com.au/wp-content/uploads/2014/07/Director-Tenure-Paper.pdf**, (accessed 8 August 2019).
9. A Lumsden and L Knight, 2015, *ASX 200 Boards are Getting Younger*, May, Corrs Chambers Westgarth, **https://corrs.com.au/news/2015/05/asx-200-boards-are-getting-younger**, (accessed 8 August 2019).
10. C Sullivan 2016, *Board Composition and Non-Executive Director Pay in ASX200 Companies: 2015, 15 November*, Australian Council of Superannuation Investors.
11. E Carroll, 2018, *How Director Age Influences Corporate Performance*, Harvard Law School Forum on Corporate Governance and Financial Regulation, **https://corpgov.law.harvard.edu/2018/01/04/how-director-age-influences-corporate-performance**, (accessed 8 August 2019).

A regular skills audit of the current board and comparison with future needs will highlight any gaps and assist in targeting succession plans. Indeed, the ASX Principles Recommendation 2.2 states:

> *A listed entity should have and disclose a board skills matrix setting out the mix of skills that the board currently has or is looking to achieve in its membership.*[12]

It is recommended that boards of larger organisations should maintain a list of potential candidates and monitor it regularly. The availability of highly sought after directors will vary so directors should keep in touch with all potential candidates. Larger organisations might have ongoing relationships with executive search firms to help in this process.

Succession planning for the chair

The chair's role should be included in succession plans. Often, the incumbent's retirement date is announced well in advance to allow the board to plan selection and appointment of the new chair. There are, however, some circumstances where a sudden departure may occur, for example death or resignation. This may affect market confidence and the share price so being able to communicate policies and procedures will minimise negative consequences.

Common ways in which boards deal with chair succession are to appoint a deputy chair, identify likely successors from within the board or to appoint a new director with the expectation that they will become chair within a specified time horizon. The advantages of these methods are that the new chair is already familiar with the organisation and has hopefully gained the respect of the other directors by the time they become chair. However, if poorly handled, having an 'heir apparent' may alienate the other directors.

For organisations which have performed poorly, often appointing a new chair from outside the existing board can be used as a signal to shareholders and other stakeholders that considerable change can be expected, including significant change to the board.

Succession planning for the CEO and senior executives

Boards are more familiar with succession planning for CEOs and senior executives. With respect to CEO succession, this is important due to the high turnover of CEOs in Australian companies, with the average tenure of CEOs in 2016 being 5.5 years, a "result that has been trending upwards since 2012".[13] Again the skills and knowledge needed by the executive team to drive the organisation forward will change over time, so succession planning must be a regular agenda item.

The succession plans for the CEO and senior executives should consider short- and long-term scenarios. In the short term, it must be clear to everyone who will step in to manage the organisation when the CEO takes planned or unplanned leave and in times of crisis such as the immediate unexpected departure of the CEO. Appointments in the short-term are acting appointments.

Long-term succession planning concerns permanently filling a vacancy when the current CEO leaves. Vacancies can be unexpected or be known well in advance.

There are in essence two options to long term CEO succession planning – making an internal or external appointment. Most boards of larger organisations keep both options open but may have a preference for an internal or external appointment. Smaller organisations often lack the depth in the senior management team to have even one, let alone a number of potential internal candidates who are suitable for the CEO position.

12. ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th Edition, February, p 13, **https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf**, (accessed 8 August 2019).
13. MinterEllison, 2016, *Strategyand's Latest CEO Succession Study*, 12 December, **https://www.minterellison.com/articles/strategyands-latest-ceo-succession-study**, (accessed 8 August 2019).

The advantage of internal appointments is that the successor is already familiar with the organisation so can step up immediately. Boards should also regularly review with the CEO the performance and development plans of potential CEO candidates to ensure that they are gaining appropriate skills, knowledge and experience to be a CEO. A good way for the board to monitor or evaluate potential internal CEO candidates is to occasionally invite the senior executives to present to the board.

While it is by no means a settled issue, current evidence suggests that internal appointments are on average more likely to outperform external appointments, are less often forced out office and have slightly longer tenures than external appointments.[14]

External appointments are often made when the board wishes to significantly change the strategy and culture of the organisation. Often in these circumstances the company will be underperforming and the board wishes to see major change, often starting with the composition of the senior management team and the portfolio of businesses owned by the company. While such change is often necessary, there is potential to alienate key staff – possibly forcing them out of the organisation – and in doing so decrease confidence in the organisation by shareholders and other key stakeholders.

Succession planning in a family company?

There are succession and transition planning issues specific to family businesses. First is the question of whether succession by a family member is the right option for the business. Commercial implications need to be balanced against the desire to keep control in the family. Second is the possible need to consider management and ownership transitions separately. Well before retirement, family business owners should consider the following key questions:

- Does the preferred successor really want to take over?
- If there is more than one family member in a senior position, how will it be determined who will take the CEO position?
- Does he or she possess the necessary skills and qualifications?
- Is there someone else within or outside the business who would be a better choice?
- Will nominating a preferred successor create conflict: for example, sibling rivalry or conflict with other employees?
- Will family succession provide sufficiently for the future?
- Are there are ownership issues to resolve?
- Is the current business structure appropriate for the future?

14. Ibid.

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.

For more information **t:** 1300 739 119 **w:** companydirectors.com.au

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