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Second Thoughts On Board Independence

Corporate scandals have stirred widespread outrage and finger pointing, but everyone agrees on one response—corporate directors need to become more independent of management. James Westphal presents some solid research to suggest that director independence is an oversold panacea. Independent board members may have little to do with corporate success.

Corporate governance has been a topic of growing concern among corporate leaders, regulators, academics, and a range of corporate stakeholders. With the latest accounting scandals at major U.S. corporations, calls for governance reform have become louder than ever. Much of the blame for apparent failures in corporate governance, moreover, has been ascribed to boards of directors. The criticisms are remarkably consistent. According to most critics, the problem is that boards are not sufficiently independent from top managers to guard against self-interested and potentially unethical behavior by executives.

This mindset is reflected in the principles of governance reform issued by the New York Stock Exchange in June. Among the highlights: all corporate boards should have a majority of independent directors (a lack of business ties to the company, or other ties to inside directors); the CEO should not serve as chairman of the board; and the board should have regular meetings without the CEO present.

Debate about these guidelines has centered mainly on issues of implementation. How should independence be defined, and how severe should the repercussions be if firms fail to abide by the guidelines (delisting from the exchange vs. a public reprimand)? There has been little if any debate about the central message of the NYSE proposal: board reform rests on making boards more independent of top management.

I take issue with this central tenet of board reform proposals, and suggest an alternative model of board effectiveness. Drawing upon a large body of academic research on corporate boards, I contend that high levels of board independence have unanticipated, negative effects on board effectiveness. Also, the most important determinant of board effectiveness relates to director capabilities, not independence.

[Nearly two decades of research find little evidence that board independence enhances board effectiveness. Studies have, however, found a negative effect.](#)

After nearly two decades of academic research in multiple disciplines (finance, accounting, and management) on the consequences of board composition, there is little evidence that board independence enhances board effectiveness. This is generally true regardless of how board

independence is defined (the ratio of outside to inside directors, lack of director business ties to the firm, lack of director friendship ties to the CEO, etc.).

This lack of relationship is also generally true whether board effectiveness is measured by the perceptions of corporate leaders in survey questionnaires, by the relationship between board independence and firm performance, or by the effects of independence on a variety of decisions and behaviors that are presumed to harm shareholder interests (adoption of poison pills, unrelated acquisitions, evidence of illegal activity). A number of studies, however, have documented negative effects of board independence on board effectiveness.

In my own research, I have sought to examine why board independence might have such negative effects. Using survey data from top managers and directors at over 200 Forbes 500 companies, I found that different sources of board independence lowered board effectiveness by reducing cooperative interaction between top managers and directors in the strategic decision making process.

At the same time, board independence did not affect boards' propensity to monitor executive decision making and behavior. The overall effect of independence was to reduce the level, quality, and timeliness of board involvement in strategic decision making.

In addition, increases in board independence (increases in the ratio of outside to inside directors, removal of the CEO from the chairman position, or reduction in the number of directors who have friendship ties to the CEO or business ties to the firm) appeared to have the unexpected effect of politicizing the CEO-board relationship. Analysis of the survey showed that, following increases in board independence, CEOs spent more time ingratiating themselves with outside directors and trying to sell them on the merits and success of their strategic decisions. Such politically motivated communications came at the expense of constructive dialogue toward formulating and revising strategic decisions, and neutralized the effect of independence on the level of board monitoring activity.

Why do CEOs respond this way to board independence? Human nature. If personally-important outcomes like pay and employment are tied to outcomes over which you lack complete control (like assessments of your performance by an independent boss), then you feel compelled to influence that assessment. Given their social status, CEOs can be very influential.

In addition, many CEOs do not buy into the presumed need for board independence, and do not entirely trust the ability of independent directors to assess their performance. There is plenty of evidence that when organizational changes of almost any variety, including changes in board composition, are thrust upon managers without their buy-in, those changes will fail.

There is also abundant evidence from research in organizational behavior that managers typically seek work-related help and advice from their boss only if they have a high level of personal trust in that person. High levels of board independence from top managers would reduce the tendency for those managers to solicit advice from directors in the process of making strategic decisions.

[Despite calls by the NYSE and others for greater board independence, most boards of large U.S. companies are already independent by any measure.](#)

One implication of this research is that board effectiveness can be enhanced by reducing board independence. The ironic fact is that despite calls by the NYSE and many others for greater board independence, most boards of large U.S. companies are already independent by almost any measure. More than three-quarters of Fortune/Forbes 500 companies have a majority of independent directors, whether independence is defined by: not being a manager at the firm; not being appointed during the current CEO's tenure; not having business ties to the focal firm; not having friendship ties to the CEO (my large sample survey data indicated that—on average—CEOs considered only about one third of outside directors on the focal board to be personal friends).

Enron and WorldCom had independent boards according to at least two of these criteria. Thus, given the negative effects of board independence discussed above, there would appear to be considerable

scope for improving board effectiveness at many companies by reducing the level of board independence.

However, my research also suggests that while less board independence would tend to improve corporate governance, an even more important influence is the capability of directors to contribute to strategic decision making. With less board independence, CEOs may be more likely to engage outside directors in the strategic decision making process, as discussed above. Yet that does not necessarily mean that directors are able to provide valuable information or advice.

Responses to a survey of over 500 outside directors from Forbes 500 companies showed most outside directors feel at least "somewhat uncertain" about their ability to contribute to strategic decision making. Two major studies of corporate boards in the late 1980s likewise found that directors often refrained from challenging management proposals or otherwise participating in strategic decision making, not because they felt obligated to support top managers or because management excluded them, but because they had little to contribute.

So what predicts the extent to which directors feel able to contribute? I have examined this question by analyzing questionnaire data from two different samples of outside directors at large and medium-sized U.S. companies collected at two points in time (1996 and 1999).

[The most important predictor of director effectiveness is not independence, but strategic experience that matches the company's needs.](#)

In both cases the results were similar. The most important predictors of directors' perceived ability to contribute to strategic decision making, as well as overall board effectiveness, are variables that indicate the extent to which directors have management experience at companies with similar corporate strategies to that of the board firm; and prior or current board appointments at companies with similar strategies. Board effectiveness is measured not only with responses to survey questions, but also with multiple measures of firm performance (return on assets, stock returns, and market-to-book value).

Moreover, in assessing directors' experience with related strategies, I examined several dimensions of corporate strategy. These include: related product-market diversification; unrelated (conglomerate) diversification; internationalization; the level of alliance and joint venture activity; and the level of acquisitions. My findings indicate that the greater the extent to which outside directors have management or directorial experience at similar companies, the greater directors' perceived ability to contribute to strategic decision making and the greater the board's effectiveness.

Moreover, there is value in having at least one director with experience in a particular dimension of corporate strategy. If several directors have experience with similar product market diversification strategies, but none have experience with similar international strategies, then board effectiveness is particularly enhanced by adding a director with the latter background. Such experience fills a gap in the board's aggregate experience profile.

These effects are very strong. The director experience variables explain 35 to 44 percent of the variance in directors' perceived ability to contribute and 34 to 42 percent of the variance in survey measures of board effectiveness. Director experience explains between 13 percent and 19 percent of the variance in firm profitability and stock market returns, which makes these variables among the strongest predictors of firm performance that have been identified in the management literature.

Do firms tend to appoint directors who have such relevant experience? The answer, at least for large and medium-sized U.S. firms, is a resounding no. None of the experience variables described above is a significant predictor of where managers get board appointments.

This goes a long way toward explaining why most outside directors in my sample reported feeling at least "somewhat uncertain" about their ability to contribute to strategic decision making. The director labor market is inefficient, in that it fails to match director experience with the strategic priorities of particular firms.

Past studies suggest that the most important predictors of getting a board appointment are the number of board seats you already hold; and shared board appointments and/or a similar functional background (finance, marketing, etc.) with a large portion of incumbent directors on the board.

The implications of these findings for corporate leadership are straightforward. Director selection should be guided by the relevant strategic experience a candidate brings to the board, especially on strategic dimensions where director experience is currently lacking. Although this assessment could be done subjectively, it should ideally be guided by quantitative analysis.

This involves rating director candidates on how well their appointment to the board can be predicted to enhance board effectiveness. The requirements for conducting such an analysis include comprehensive historical data (going back at least ten years) on the corporate strategies of public companies, and the changing identities of top managers and directors of those companies, as well as data on the financial characteristics and corporate strategy of the focal firm. The more complete the data, the better the estimates. Given that few firms currently consider the relevance of strategic experience in selecting directors, there is a significant opportunity for firms to differentiate themselves by doing so.

Two other implications of this research are worth mentioning. First, it casts doubt on claims that managers who sit on multiple boards add less value to any one board because their time is divided. If a director at company A takes a second board appointment at company B that is strategically related to A, then the director may become more valuable to A through synergies or “economies of scope” in board responsibilities.

Another implication is that any policy or norm that restricts the pool of director candidates makes it more difficult to assemble boards of directors with the most relevant strategic experience. Thus, aside from the negative consequences discussed above, policies such as the NYSE proposal mandating a certain level of board independence would hinder efforts to appoint directors whose strategic experience best matches the needs of the firm.

[A board candidate could be excluded if we mandate a certain level of independence—even though the candidate's strategic experience might be a valuable asset.](#)

Perhaps a director candidate has business ties to the firm or friendship ties to the CEO, but also has managerial or board experience at a firm with an international presence similar to that of the focal firm. That director could be excluded under policies that mandate a certain level of board independence from management—even though the candidate's strategic experience would be a valuable asset to the firm.

Rather than imposing restrictions on director selection, policy makers should help firms to identify director candidates who have relevant strategic experience. One option would be a database that includes the requisite information (historical data on the corporate strategies of public companies and the identities of top managers and directors).

Evidence that director experience is critical to board effectiveness is relatively new. However, evidence that board independence has neutral to negative effects on board effectiveness is not. The first research casting doubt on the value of board independence appeared in the late 1980s. Since then, not only have advocates of governance reform in the U.S. continued to focus on this issue, but the board independence mantra has spread to other countries, including Canada, the U.K., and Germany.

[Why do corporate leaders, policymakers and investors ignore this evidence on director effectiveness? There are several causes.](#)

This raises a very important question: Why have corporate leaders, public policy makers, institutional investors, and other corporate stakeholders ignored academic research on corporate boards?

There are several causes. First, business schools have done a poor job communicating their research to the business community. This is unfortunate, because there is a trend toward research that is more directly relevant to the problems and concerns of managers. However, at least some leaders of the

governance reform movement are familiar with the findings of academic research. Why have they elected to ignore the evidence?

In part, perhaps, because they have already chosen board independence as a rallying cry or unifying theme of the governance reform movement, and to change the message now would diminish the focus, unity, and credibility of the movement. A focus on board independence may also attract more attention to the movement, as it taps into popular suspicions about corporate leaders and concerns about apparently "excessive" CEO pay and perquisites. A focus on director capabilities may be less effective as a lightning rod to mobilize the governance reform movement.

Why then have regulators paid little attention to academic research on corporate boards? Again, part of the problem is poor communication of research findings by business schools, but part of the blame also lies with regulators, who are often not receptive to academic research in formulating policy.

This lack of influence is representative of a larger trend. Policy makers have been little influenced by social science (or other academic disciplines, for that matter) in formulating policy. This is regrettable, not only because there is an increasing volume of research on the concerns of policy makers, but also because the quality of empirical research, including research conducted in business schools, has improved considerably.

It is critical, then, to establish a stronger link between public policy and empirical research, including research on corporate governance. One has the sense that corporate governance is now at the center of a public relations game. Regulators seem more concerned about the impressions that their policies will create than about formulating policies grounded in rational principles and empirical evidence.

Institutional investors and advocates of governance reform are sticking to principles that appear likely to garner enthusiasm for the reform movement. Corporate leaders, in making governance-related decisions, seem primarily concerned (though justifiably) about the impression that their decisions will make on institutional investors and other stakeholders.

It is imperative that we break out of this impression management trap. We need leaders of the corporate governance reform movement and public policy makers to rise above the fray and make a stand for rational and empirically-grounded corporate governance principles.

[Independent? No. But Effective? Yes.](#)

What does not increase board effectiveness:

- Increasing the ratio of outside to inside directors.
- Appointing directors who lack business ties to the firm or personal ties to the CEO.
- Separating the CEO and board chair positions.

What does increase board effectiveness:

- First, defining critical dimensions of corporate strategy, including:
 - The level of market diversification;
 - The level of internationalization;
 - Product markets which the firm has recently entered or plans to enter;
 - Geographic markets which the firm has entered or plans to enter;
 - Mode of product market entry (if relevant): acquisition, alliance, joint venture, internal development;
 - Mode of geographic market entry (if relevant).
- Determining the extent to which existing directors have experience at companies with similar corporate strategies. Identifying gaps in experience.
- Developing a database (or access an existing database) that identifies top managers and directors of public companies and key characteristics of those companies over (at minimum) the

prior ten-year-period.

- Identifying managers and directors who fill gaps in board experience as candidates for current and future board appointments.
- Ensuring that the strategic decision-making process takes advantage of the growing reservoir of relevant experience:
 - Top managers should know the strategic experience of each outside director on the board;
 - Individual directors should be engaged in decision-making on particular issues based on their relevant strategic experience.

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