New research into board composition has found the ideal balance between director independence and company performance. Tony Featherstone reports.

New Australian research has identified a “sweet spot” in the level of board independence that is linked with company outperformance and meets best-practice governance guidelines).

The groundbreaking study by Professor Alex Frino MAICD, titled The Relationship between Board Independence and Stock Price Performance, found that the largest 200 ASX-listed companies with balanced boards (between independent and non-independent directors) outperformed all others in terms of market-adjusted stock price returns.

Companies with boards that had 40–60 per cent independent directors performed best. “The study reinforces the benefits of boards having a mix of independent and non-independent directors,” says Frino. “Too much independence on boards weighs on firm performance, as does too little independence. The key is getting the balance right between the two.”

The Australian Institute of Company Directors (AICD), through its Governance Leadership Centre, provided a research grant for the study. Frino, a distinguished
Frino's study is the first of its kind in Australia to look at the proportion of independent directors, and among the few globally to compare board independence to stock price returns. Most studies compare board independence to a firm’s return on assets or equity, or its market-to-book ratio. Moreover, Frino’s research sought to understand how performance varies as board independence rises or falls. Most studies take a linear approach that compares independence to performance, but not the shades of independence in between.

Skin in the game
The research is timely. There is a growing view that boards need to be more independent and the way chairs viewed its contribution to both governance and performance. These interviews strongly favoured the separation of the CEO and chair roles. The authors wrote: “These interviews illustrated a significant mismatch between the general commentary on independence and the way chairs viewed its contribution to both governance and performance.”

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Are current measures of director independence focusing on the wrong things? Should there then be a measure of collective board independence? These questions arise from an insightful governance study by Dr Robert Kay MAICD and Dr Chris Goldspink of Incept Labs. The authors’ paper, Rethinking Independence, was published this year as part of a research series for the Australian Institute of Company Directors (AICD) and the Governance Leadership Centre.

The paper draws on data collected for the AICD that involved interviews with more than 100 chairs of Australian listed and private companies, not-for-profit organisations and government authorities. By drawing on qualitative research, the paper adds a useful perspective to academic studies on board independence that are based on quantitative research methods.

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The authors wrote: “Current measures of independence are directed at the individual director and focus on proxies that the chairs in our sample considered had only a limited relationship to the independence needed in the boardroom. This leads to a situation where we have general measures of independence which are used to measure the wrong things, while collective independence is not measured at all. For all these reasons, there is an urgent need to be able to link what boards do and how they do it – their collective ‘mindfulness’ – with performance. We need to open up the ‘black box’ to focus on the inner workings of the board.”

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A deeper debate on board director independence

The Governance Leadership Centre has published a series of stories and a video on board independence. Content includes:

• A discussion by leading governance academics on the pros and cons of board independence.
• How institutional investors and proxy advisers view board independence.
• The full research paper by Professor Alex Frino MAICD.
• The full research paper by Dr Robert Kay MAICD and Dr Chris Goldspink.
• A video featuring the prominent company director, Kevin McCann AM FAICD.

The Governance Leadership Centre is the AICD’s think-tank on governance issues with a focus on governance for performance. To join the monthly subscription list, contact information@companydirectors.com.au.

Council’s view that the majority of board directors of a listed entity should be independent. The study’s findings suggest boards could be comprised of up to 60 per cent independent directors. ASX 200 companies, on average, are just above that now, and a lot of companies already have sufficiently balanced boards in this regard. The findings do not imply a major adjustment is needed to the balance between independent and non-independent directors of ASX 200 companies.

GLC: Why do you nominate 50–60 per cent of directors who are independent as the sweet spot for board independence for ASX 200 companies?
AF: Having at least 50 per cent of directors who are deemed independent meets the ASX Corporate Governance Council recommendation that the majority of directors of a listed entity are independent. The 50–60 per cent range also ensures firms with that board composition are in the bracket of companies that outperformed the market.

GLC: Are your findings predictive? That is, could investors use board composition between independent and non-independent directors to identify potential company outperformance?
AF: No. We investigated if the level of board independence was predictive of future stock price returns, but it is not. There is a contemporaneous relationship between the two, but it is not predictive.

GLC: Do the study’s findings strengthen the case for the ASX Corporate Governance Council’s test of independence to be softened, so that substantial shareholders can be deemed as independent directors?
AF: A lot of board directors would be considered non-independent because they have a substantial shareholding in the company they govern. While some overseas research suggests that companies with substantial shareholders underperform the market, there is no Australian empirical research as yet. A future area of investigation is to dig deeper into why some board members are deemed independent and others are not, and to test whether a sub-set of companies with particular types of independent directors underperform or outperform the market.

Certainly, we have had requests to investigate the relationship between substantial shareholders who are directors and firm performance. A lot of people want to better understand how equity ownership among directors affects firm performance.

GLC: Your research has not yet been published, but what has been the response so far from governance experts who reviewed the paper?
AF: I have done a few presentations on the research to smaller groups and generally the consensus feedback has been good. I sensed that directors, intuitively, felt the research findings made sense and that they could see the merit in having balanced boards between independent and non-independent directors. Boards understand the value of diversity, which encompasses independent and non-independent directors who may bring different perspectives.

GLC: How difficult was this research project?
AF: It was very complex and time consuming. The project took more than a year. Surprisingly, there is not a lot of Australian academic research on this topic, despite its importance. Getting reliable data on board independence over a long period was challenging and we had trouble replicating some previous Australian studies in this field.

GLC: What’s next for your research?
AF: We intend to have the research published in a peer-reviewed academic journal. We would also like to extend the research outside the largest 200 ASX listed companies to see the effect of board independence on smaller company performance. We would like to look at reasons why directors are not considered independent and the relationship of those factors with firm performance. The independence of directors on various sub-committees and how that effects firm performance in the long run, is another area of future research.

* A broader discussion of different academic perspectives on the benefit of director independence is available in the Governance Leadership Centre October update, via the AICD website.