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

Feature

THE SWEET SPOT

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

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economist, is deputy vice-chancellor (global strategy) at the University of Wollongong and a former dean of the Macquarie Graduate School of Management.

Frino's paper is based on the largest 200 ASX companies between 2004 and 2012. It used the Securities Industry Research Centre of Asia-Pacific's (SIRCA) corporate governance database to calculate the proportion of independents on boards.

The data set is broadly the same as that used by Professor Peter Swan of the University of New South Wales Business School. Swan's controversial research is emphatic that firm performance worsens as the level of board independence increases.

"There is no justification to have 35,000 independent directors governing major Australian companies," says Swan. "There is no credible empirical evidence that supports the notion that independent boards make better decisions."

Frino's findings, in contrast, show that firm performance improves as board independence increases – to a point.

His paper makes an important contribution to the governance debate on the value of independent and non-independent directors. Frino's study is the first of its kind in Australia 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 push from investors for directors to hold more equity in companies they govern. The Australian Council of Superannuation Investors (ACSI) argues that non-executive directors should have more "skin the game" to better align their interests with shareholders.

However, Recommendation 2.3 of the *ASX Corporate Governance Principles and Recommendations* says a director might not be deemed as "independent" if they are a substantial security holder in the organisation (owning 5 per cent or more of its shares) or are associated with one. Having greater equity ownership, particularly in smaller companies, potentially reduces board independence.

Proponents of board independence say it is the most effective model to represent the interests of all shareholders, deliver good governance that contributes to long-term company performance, and provide checks and balances on potential management excess.

The growing number of corporate scandals in the past decade encouraged market supervisors and regulators worldwide to recommend companies have a higher proportion of independent directors on their boards. Recommendation 2.4 of the *ASX Corporate Governance Principles* recommends the majority of the board of a listed entity should be independent directors on an 'if not, why not' disclosure basis.

PROFESSOR PAMELA HANRAHAN

"Excluding substantial shareholders from the current test of director independence is not a good idea."

But some academics believe the pendulum has swung too far towards board independence and that the ASX Corporate Governance Council should relax its definition of independence to include directors who are substantial shareholders in the organisation.

Professor Pamela Hanrahan, of the University of New South Wales Business School, says the test of director independence should allow for substantial shareholders and exclude controlling shareholders. "Excluding substantial shareholders from the current test of director independence is not a good idea. The key question is whether directors have an independent state of mind, not whether they meet a fairly wooden test of independence."

Frino's research will offer new insights to the ASX Corporate Governance Council and could encourage further review of the factors listed by the Council as relevant to assessing director independence.

ACSI research shows that the proportion of ASX board seats held by independent non-executive directors in ASX 100 companies increased from 48.5 per cent of all directors in 2002 to 77 per cent in 2014. That implies ASX 100 companies have slightly too much board independence, based on Frino's research. He says performance drops away as board independence goes past 60 per cent.

The Governance Leadership Centre asked Professor Frino about his research, its implications for boards and potential follow-up studies. The following is an edited extract of that interview:

Governance Leadership Centre (GLC): *What is the key takeout from your research for boards?*

Professor Alex Frino (AF): Quite simply, that balanced boards are best. Having independent directors on boards adds value, as does having non-independent directors who may be executives or have substantial shareholdings in the company. Getting the mix right is what matters.

The data clearly indicates that companies that have boards with a very high proportion of independent directors do not outperform

PROFESSOR ALEX FRINO

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over long periods. By the same token, boards that have very few independent directors also produce below-average returns for investors.

GLC: *Are your findings inconsistent with the prevailing governance orthodoxy that higher board independence is better?*

AF: Yes and no. The study is consistent with the ASX Corporate Governance

The chair's view

Study says director mindset and collective independence are critical.

Are current measures of director independence focusing on the wrong things? Should there 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.

The authors said: "These interviews illustrated a significant mismatch between the general commentary on independence and the way chairs viewed its contribution to both governance and performance."

Those interviewed strongly favoured the separation of the CEO and chair roles – a practice favoured in Australia but less so in the US, where the role of executive chair is more common. One chair commented: "I think power corrupts, and absolute power corrupts absolutely. So why chance it, when we have a system that can work pretty well?"

Chairs were less forthright in their support for boards that have a majority of independent directors. One said: "The idea that you staff the board with a whole lot of independents, who may or may not know about the company or its industry, is, I think, a weakness in some of the governance requirements of the day."

Others were negative on the concept of majority board independence. One commented: "Anyone who calls for a majority of independent directors on a board is an idiot."

Mixed views

The authors said many chairs saw an important role for independent directors on boards and believed they could add considerable value. But the worth of independent directors was highly contextual.

There were mixed views on director tenure and renewal as it relates to director independence. The *ASX Corporate Governance Principles and Recommendations*, while recognising the value that long-serving directors offer boards, recommends boards regularly assess whether a director who has served for more than 10 years has become too close to management to be deemed independent.

One chair commented: "You need a mix of people that have seen the cycles. So you need long-tenured people as well as renewal on boards, and I'm very much against mandatory term limits for directors. I think it's a matter of having an effective director performance evaluation process that will lead you to move people along if they are no longer able to contribute."

A strong theme across the study was the need to consider director independence as a state of mind, more so than a structural characteristic of governance. "I think independence is an attitude of mind much more than anything else," said one chair.

Others spoke of the importance of overall board independence and the need to measure it.

"These interviews illustrated a significant mismatch between the general commentary on independence and the way chairs viewed its contribution to both governance and performance."

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 appear to measure the wrong things, while collective independence is not measured at all.

"In all these respects, 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 research on the inner workings of the board (van Ees, Gabrielsson et al. 2009) and through this forge an evidence-based improvement in the quality of governance."

** A full copy of this paper is available for members through the AICD website in the Governance Driving Performance section of the Governance Leadership Centre.*

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 contemporous 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.

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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.

We wanted to be as open-minded as possible and let the data speak for itself. Some US studies on board independence and firm performance have tinkered with the approach we used, but our study is unique in how it investigates this area.

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.*

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.