



# The meaning of independence

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- *The limitations of the definition of independence offered in the ASX Corporate Governance Council guidelines*
- *Understanding how independence might be exercised in the boardroom*
- *How to assess whether independence in the boardroom matters*

The Australian Stock Exchange (ASX) Corporate Governance Council created a conundrum of ambiguity last year when it called for listed company boards to be composed of a majority of independent directors but declined to define what it means to be independent.

By stopping short of developing the concept of independence as a form of individual behaviour or as a code of conduct, the Council (and the ASX) opened a proverbial can of worms.

Its failure to control the discussion about what it means for a board member to be independent means the ASX has passed the power of influence to factional interest groups, and opened the possibility for a so-called 'lack of independence' to be used as a factious argument for ousting a board member.

The board of the National Australia Bank, in its implosion late last year over the inability of former chairman Graham Kraehe and non-executive director Cathy Walter to resolve the responsibility for its foreign exchange scandal, could have used this argument to great effect. On a larger stage, the issue of independence has already been used by a group of some of Australia's most influential business leaders as the central argument for promoting so-called 'pre-nuptial' agreements for board members.

This article outlines the current debate on independence in the boardroom and offers a definition of independence beyond that proposed

by the ASX Corporate Governance Council. It proposes a range of perspectives that board members may find useful in understanding how independence might be exercised in the boardroom. Finally, it debates whether independent behaviour is possible and, if so, why it should be pursued as the Holy Grail of 'good corporate governance'.

## The ASX Corporate Governance Council guidelines

In its *Principles of Good Corporate Governance and Best Practice Recommendations*, the ASX Corporate Governance Council says 'an independent director is a non-executive director [who] is independent of management and free of any business or other relationship that could materially interfere with — or could reasonably be perceived to materially interfere with — the exercise of their unfettered and independent judgment'.

The independence guideline, enshrined in Principle 2, lists seven ways of 'assessing' a board member's independence. This list is essentially a collection of potentially compromising liaisons, such as the board member's length of tenure on the board or whether they have been in a commercial relationship with the company, as a supplier or advisor.

The guidelines provide a useful framework for assessing a board member's independence from obvious commercial interests, but nowhere do they define what it means to behave independently.

An attempt to redress this deficiency was made earlier this year by the ASX Corporate Governance Council Implementation Review Group (IRG), which was formed to examine the response to, and implementation of, the guidelines.

'Determining director independence is not an exact science, and is open to the subjective interpretation of the board, provided that the board can effectively communicate its reasoning,' the IRG reported in March this year. 'Further guidance (should) be given to the market to clarify the difference between a director's conflict of interest in relation to a specific area of decision

making, and an impediment to the broader ability to exercise unfettered and independent judgment.'

In its response to the IRG report, the ASX said it 'recognised the problematic nature of determining independence of directors'. It continued: '(The guideline) offer[s] a central frame of reference for the determination and relevant disclosure by companies and is designed to ensure that corporate disclosure in this area is meaningful and comparable by investors. However, it is not intended to be applied in any mechanistic sense. The Council acknowledges that notions of objectivity, responsibility and ethics cannot be effectively judged according to purely objective data. The determination of independence remains a matter for the board's judgment, provided that it can explain its reasoning to investors by reference to the framework (of the guidelines).'

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In identifying independence as a desirable attribute in the boardroom, the ASX Corporate Governance Council and the group it formed to assess the guidelines raised an important area of debate. But it limited its discussion by adopting a circular argument: the onus is on the board to independently assess its own independence. Clearly further investigation is required.

### The antecedents of boardroom independence

To be independent means to be free of subjection, or from the influence of others, and to be exempt from external control or support. By its dictionary definition, independence is also a competency.

The debate about independence in the boardroom can be dated to 1932 when Adolph Berle and Gardiner Means published their classic study on the separation of ownership from management in public companies, which was to become known as 'agency theory'.

Agency theory holds that the separation of ownership is an efficient division of labour in large organisations. It is the dominant approach to contemporary corporate governance research and has underscored the debate about what constitutes good corporate governance practice.

Much later, corporate governance doyen, Sir Adrian Cadbury, called for board members to illustrate 'an independent mindset'.

We are no closer, however, to understanding what 'an independent mindset' means and, as a result, we are in danger of pursuing arguments that will lead to confusion, anxiety and paradox. This trend is already evident in a recent 'CEO Report' by Ralph Evans, published in the journal of the Australian Institute of Company Directors (AICD). In this article, Mr Evans called for 'an independent-minded board'.

With due respect to the AICD's chief executive, this phrase is an example of corporate governance jargon which is unfortunately gaining popularity, and fails to serve a robust debate about what it means for a board member to exercise independence. In short, the phrase 'an independent-minded board' is an unwarranted reification.

A board comprises a group of individuals who should each act independently. To say that the board is of 'independent mind' implies that the group has conformed and, worse, it has fallen prey to what group dynamics scholars call the phenomenon of 'group think'.

It is unlikely that Mr Evans wished to convey this impression and, in fact, he probably hoped to do just the opposite. Such is the danger of ambiguity and the conundrums in which language can confound us.

### Exercising independence in groups

It was the US academic, Irving L Janis, who popularised a discipline of academic research on group behaviour known as 'group dynamics'.

Janis argued that people in groups act predictably. The more competent the group is perceived to be, the more likely it is that it will act as a single entity. If a group becomes so preoccupied with maintaining the status quo, it can easily fall victim to 'group think', a term used to describe a mode of thinking that group members engage in when they become engrossed in seeking and maintaining unanimity. As a result, the ability to think critically is rendered ineffective.

In fact, group think can be so insidious that critical questioning by members of the group is discouraged, either by way of perceived collective pressure, or by using certain people to circumvent and prevent emerging criticism.

Janis says groups which have succumbed to 'group think' typically:

- depict smug illusions of invulnerability, manifesting in a belief that the leader has a Midas touch and that the group cannot fail
- develop a rationale that allows members to justify their actions and to reject or ignore contrary evidence

- are stereotypical in decision making and will apply a form of self-censorship of arguments that are critical.

When this research is applied to board members' interactions, one can predict that conformity will be a feature of Australian boards, given their homogeneity, as characterised by the similarity of age, education, sex and work experience of directors.

But it would be wrong to conclude that group conformity implies that board members necessarily yield to group pressure. It is much worse than that: in a group, members tend to agree with people whom they think are subject experts, or who are perceived to be generally competent. In the case of boards, this tendency is expressed in directors allowing themselves a false sense of security in their belief that one of their colleagues, perhaps a former partner in a law firm or an accountancy practice, is competent in all matters of law or finance.

Instead, the onus should be on every member of the board to develop relevant competence in all aspects of corporate governance rather than defer to the 'pressure' of expert opinion. Intelligent enquiry requires a board culture that encourages independent opinion.

But other academic research shows that where group members rate their nominated leader as an authority figure, they will conform more and debate less. Board members are also likely to take riskier decisions if problems are perceived to be unimportant, and will become more cautious when the decision and its outcome are deemed to be more significant.

The propensity for groups to conform to the group norm, to a subject-matter expert, or to the person perceived to be the authority figure, has an obvious relationship to the exercise of independence in the boardroom.

### A call for further investigation

It is one matter to identify independence as a desirable attribute in the boardroom, but quite another for it to be defined, judged and acted upon. How do we know when a board

member is behaving independently? How might an individual judge their capacity to act

independently, and conversely, how do their colleagues make this determination of themselves and of each other? How can an individual, and their fellow board members, judge themselves free from the influence of others?

In order to answer these questions, it is imperative that the problem of independence is further refined to ask, *independence from what, and from whom?*

Whether board members have exercised their duty of independence can be resolved by asking if board members would have reached the same decision if they were free from influence from senior executives, shareholders, customers, employees, suppliers and other stakeholders.

This simple question fosters a range of potential contexts in which independence in the boardroom can be examined. These include the company's financial performance, executive compensation, executive turnover and the strategic orientation of the company.

One line of inquiry may be whether board member's independence is challenged in financially-distressed or bankrupt companies. How do board members make decisions in environments of acquisition or takeover?

In the area of board composition and appointment of management, questions can be asked as to whether interlocking directorships unduly influences a board member's behaviour. Or does a board member feel a sense of obligation to the CEO or other senior executives if they were elected to the board during that individual's tenure?

### The ties that bind can also blind

In our ongoing research into boardroom relationships, The Boardroom Consulting Group has conducted a qualitative research study into how independence is exercised by nominee directors.

Nominee directors are appointed by various interests to represent them on the board of a company. This practice is usually supported by the company's constitution, which allows groups of shareholders to have the right to appoint one or more directors. Nominee directors are most commonly engaged to represent investors of start-up and emerging entities requiring venture capital investment.

The crucial point is to remember that the duty of all board members is to the company as a whole. Under the *Corporations Act*, directors are required to 'exercise their power and discharge their duties in good faith in the best interests of the corporation, and for a proper purpose'. A nominee director is no exception to this rule. But

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surely even the very nature of being nominated compromises individual independence?

Our study, 'The Ties That Blind?', investigates how nominee directors cope with their dual roles as board members and as representatives of investors in the company. Nominee

directors by definition operate within a framework of potential conflicts of interest.

Unfortunately, the *Corporations Act* does not define a 'conflict of interest', because each breach is circumstantial and is therefore attended to by common law. (The exception is s 187 that applies to directors of wholly-owned subsidiaries).

In order to separate their duties as directors from any influence or pressure exerted by the investors they represent, survey respondents say that they 'play a role', 'erect Chinese walls', or 'put on a different hat'. But once again, this language is ambiguous because it does not explain how

nominee directors behave and how they make decisions in order to separate their duties and deal with potential conflicts.

As I wrote in my corporate governance opinion column for *CFO* magazine, academic research indicates that by occupying multiple roles with potentially incompatible expectations to the nominator (be it a supplier, customer or investor), board members experience a type of 'inter-role conflict'.

North American academics Karen Golden-Biddle and Hayagreeva Rao studied this problem in a non-profit medical research organisation whose directors are elected by members and volunteers. The study concluded that the board members put the governance of the entity under duress because they were unable to separate their duties from their obligations to the interests of the organisation's membership. The researchers offered an alternative explanation for the problem as being 'conflicts of commitment'.

This is also a form of inter-role conflict, but one that stems from the incumbent's own commitment to various competing interests. Conflicts of commitment occur when the board member is divided between a choice of behaviours and decisions that influence the image and reputation of the organisation. In academic parlance, they are in conflict with the organisation's identity. Organisational identity concerns those matters

which affect the company's reputation and its brand.

Board members who experience a conflict of commitment are likely to operate on a kind of theatrical sphere of 'on stage' and 'backstage'. They work on stage by acting publicly in a manner appropriate to the social order and to group conformity, while simultaneously working backstage to fix problems or potential threats to their own reputation and to that of the company.

This study highlights the complex nature of the work of a board member and in particular how board members define their role, how they relate to their fellow board members, and how they separate their personal interests from those of the company, their colleagues in the boardroom, and any outside parties that may exert influence on their behaviour.

Independence in the boardroom is, therefore, only a convenient catchall phrase to summarise the much broader topic of boardroom relationships which sadly remains under-researched and misunderstood.

### Is independence a desirable attribute in the boardroom?

In addressing the topic of boardroom independence, it is perhaps useful to ponder a more fundamental question — does independence matter?

International corporate governance research indicates that the emphasis on independence of board members is shortsighted and futile. A range of studies indicate that independence, even if it is able to be adequately defined in the board context, does not ensure superior company performance.

'Most of the types of reforms and changes that regulatory agencies have enacted, and which corporate governance scholars have called for in the past...make no difference to general board performance,' academics Richard Leblanc and James Gilles wrote in the September/October 2003 issue of *Ivey Business Journal*. '(The research) has not been able to find a positive relationship between good corporate governance, as currently defined, and corporate financial performance.'

This does not mean, however, that a connection cannot be made by employing another premise, hypothesis or framework. Nor does it mean that independence should only be correlated to corporate financial performance. What this research does indicate clearly is that independence is an area of research that requires further investigation.

### Conclusion

There are primarily two governance structures that support the concept of independence in the

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boardroom: the non-executive chairman and a majority of independent, or non-executive, directors.

Australian corporate history attests to both these attributes in our listed company boards. Unlike the United States, Australian corporations have traditionally supported the UK model for an independent chairman. The annual *Boards of Directors Study in Australia and New Zealand* conducted by Korn/Ferry shows that non-executive directors comprise, on average, 70 per cent of directorships in the Top 50 company boards.

It would be fair to ask, then, what's all the fuss about?

I propose that the debate about what it means to be independent in the boardroom is a worthwhile line of inquiry but only if it is broadened to consider issues that lie at the heart of boardroom behaviour — how board members are nominated and selected, how their performance is monitored and the methods by which a board refreshes its membership.

In other words, how board members define their role and how they behave inside and outside the boardroom.

As discussed in my book about boardroom dynamics in Australia, *The Twenty First Century Board: Selection, Performance and Succession*, (AICD, 2001), board members behave in a way that

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implies a degree of elitist cronyism and do little to defend this rather unattractive, if not false, impression to those outside the boardroom.

The dearth of academic research on how board members operate (due primarily to the lack of access given to researchers to examine board members *in situ*) exacerbates the problem.

Corporate governance research, dominated by the agency theory proposed by Berle and Means over 70 years ago, has until recently been restricted to fiduciary and legal models. My own doctoral research, along with those of my colleagues in North America, aims to redress this deficiency by examining how board members interact as individuals, and as members of a group, in structural, political, cognitive and cultural contexts.

Thus, independence can be considered an academic research topic that delves into the related topics of homogeneity, conformity and group think. This begs the question of whether board members, through a desire to examine their work in the boardroom, will be prepared to support this research and, even more significantly, to debate it in public.

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**"...Corporate Governance International wants the gene pool of directors broadened."**

Australian Financial Review, 4 February 2004

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