Why we need independent board members

Recent financial scandals underscore the dangers of CEOs having too much power. IESE Prof. Guido Stein and research assistant Salvador Plaza weigh the merits of having independent members on the board: what should their role be, and how to preserve their independence?

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A CEO with too much power and too little supervision by the board of directors can put a company in danger, as recent financial scandals attest. This is why independent board members are vital.

In their paper, IESE Prof. Guido Stein and research assistant Salvador Plaza analyze the features and functions of independent board members.

These include resolving conflicts of interest, making sure social interests are factored into decision making, increasing the executive team's efficiency and improving how a company is run.

As well as highlighting these important functions, the authors stress there should be more to their appointment than mere formality. Ticking all the right boxes is no guarantee of independence. Indeed, independence is a personal characteristic that stems from virtues and qualities developed over time.

The Ideal Board Member

Ultimately, the goal of any board member is to defend shareholder interests. Doing this requires that board members exercise objective, sound, professional judgment. In this respect, being independent is crucial.

Ideally, this role should be filled by someone who is loyal, able to avoid conflicts of interest, diligent, dedicated and who has a professional reputation that boosts the team's confidence.

Schools of Thought

Major companies tend to appoint independent board members based on their contacts and knowledge of the sector.

While there is a lack of solid evidence to prove that the presence of independent board members boosts company earnings, there is some indication that simply padding the board with your allies does not serve shareholder interests, either.

For some, the fact that executives dislike the presence of independent board members is proof that they are more likely to follow the codes of corporate governance, so as to avoid their interference.

A third school of thought suggests that hiring independent board members after the board is formed can actually have negative effects on the company's bottom line.

Certain Gains

Boards in which the majority of members are independent are able to create greater value for shareholders in certain situations, say the authors.

For instance, the presence of independent board members enhances company reputation and boosts shareholder gains when the company is sold.

Also, companies with higher numbers of independent board members are more inclined to replace the CEO when the CEO fails to live up to expectations.

The Price of Independence

At what point does a salary compromise independence? This depends on the personal characteristics of each board member, say the authors.

Independence will be jeopardized, they warn, if board members' pay from the company represents a major chunk of their total income.

For this reason, the authors suggest stock options be excluded from independent board members? pay, in line with E.U. recommendations.

To avoid conflicts of interest, most governance codes say there should be no ties between independent board members and the executive team or with controlling shareholder groups.

Appointing former executives, relatives or anyone with direct economic ties to the company to the executive team or as auditors should also be avoided.

In addition, external board members should outnumber the executive ones, as this helps to maintain independence.

Under Spanish guidelines, independent board members should make up at least a third of the total of those who sit on the board.

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