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Board members are independent, but are they credible?

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By the late 2000s, the goal that boards should be made up of a majority of independent members had been achieved in almost every type of organization. While this achievement may have raised the quality of governance, it turned out that independent boards were not the panacea that some had anticipated.

Events since, in particular the financial crisis of 2008, have shocked the world of corporate governance as impeccably run corporations were cut down one after the other.

Companies, regulators and all savvy observers of governance had to admit that board members' independence and their general management experience in industries with little in common with the firm to be overseen were an insufficient basis for high-performance governance. Boards must also have a high level of expertise and experience about the specific issues and challenges faced by the company. That's what board credibility means.

The more complex the company, the more difficult it is for a director to be credible, as was shown in the financial sector during the years leading up to the crisis of 2008.

A board of directors is only credible to the extent that a significant number of its members are able to interact knowledgeably with management on components of performance and the multiple factors that influence performance. This type of exchange calls for a board's deep and systemic understanding of the company's business model.

In our day and age, board members will not become, nor remain, credible if they do not master the immense reservoir of information available on the internet to fashion their own independent sources of data.

The current, conventional, approach to board-member selection consists of drawing up a list of the different types of professional expertise that would serve the company well. The search will also include a number of (retired or still active) senior managers from diverse corporations. This process will not lead to a credible board. Actually, the weak link of that process lies in the recruitment of senior managers with experience in business sectors with little in common with the industry in which the company to be governed operates.

The selection process should begin by identifying industries with characteristics that closely track those of the industry in which the target company operates: such as, capital intensity, time horizon of investments, industrial vs. consumer markets, international scope of competition, key success factors, generic strategies. The reason for this is obvious. Executives with experience in such industries will more quickly master the essential aspects of a company operating in a “similar” industry and still qualify as “independent.” This recommendation will help reconcile the regulatory need for “independence” and the important quest for “credibility.”

That recommendation applies equally if and when a board is looking to select some new member with, say, an expertise in finance. The selection process should stress that this experience must have been acquired in an industry with comparable characteristics (as defined above) to that of the target company. There is very little transferable expertise, whether in financial management, human resources, risk management or information technology, between the retail business, a resources company, a financial institution or a firm in the aerospace industry.

If, upon joining the board, new members do not have a high level of credibility, have they committed to invest the necessary time, do they have the education and intellectual wherewithal to become credible within a reasonable period of time ... and to maintain that credibility?

The quest for board diversity and “refreshment” has brought about some policies to force automatic termination of board membership. It is now the fashion to impose age limits (70, 72 or 75) and/or tenure limits (15 years on the board).

Those sorts of policies are sub-optimal, but clearly much easier to implement and less emotionally charged, than asking members to leave as a result of his/her performance evaluation. If truly seeking to raise their board’s credibility, board chairs and governance committees should evaluate all board members (whatever their age and the length of their tenure) for their specific knowledge of, and experience with, the type of business or organization they are asked to govern. That’s a tall order, but a necessary step toward more credible boards capable of creating value for all stakeholders of a corporation.

A board’s credibility is the cornerstone of effective governance. Thus, the search for, training and retention of, credible board members has become the dominant issue and inescapable challenge for corporate governance in the 21st century.