

# JOURNAL OF ASIA ENTREPRENEURSHIP AND SUSTAINABILITY

REFEREED EDITION - ISSN 1176-8592

EDITORS: ROSEL FONACIER & JENS MUELLER

VOLUME II, ISSUE 3

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## **The Tsunami of Independent Directors - How to Handle the Demand -**

Jens Mueller (Waikato Management School, Hamilton, New Zealand)  
Leo Paul Dana (University of Canterbury, Christchurch, New Zealand)  
Gael McDonald (UNITEC, Auckland, New Zealand)  
Sanford Maier (Auckland, New Zealand)

### Contact Information:

Associate Professor Dr. Jens Mueller  
PO Box 3100 Greerton/Tauranga New Zealand  
[m@usainfo.net](mailto:m@usainfo.net) +64 21 516 326

## Abstract

Good governance is recognized as a fundamental indicator of the success of a company. For a small- mid-sized company, this is particularly so, as such companies must be able to competitively demonstrate their flexibility in the face of market forces. This flexibility is the primary advantage they hold over larger firms (Dalton, Daily, Ellstrand and Johnson, 1998).

Such companies, however, can find it difficult to attract good directors (Daum and Neff, 2003) and this makes developing improved strategies of governance a challenge. Taylor, Chait and Holland suggest top directors are not attracted to small/ medium companies because “the stakes remain low, the meetings process-driven, the outcomes ambiguous, and the deliberations insular” (Taylor, Chait and Holland, 2001). We suggest that the attraction of quality directors is a uniquely impacting situation for small and mid-size firms, as it is there where additional management resources should be needed most urgently.

Directors on the boards of small-medium sized businesses are often lagging behind directors of large companies in that they are less likely to be independent external directors and are less likely to represent a diversity of attributes (Dalton, Daily, Ellstrand and Johnson, 1998). Arthur Levitt, former United States Securities and Exchange Commission Chair, describes the culture of medium sized business directorships as a “kind of a fraternity of CEOs who serve on one another's boards” (Stainburn, 2005). In addition, evidence suggests directors of small- medium businesses are often insufficiently trained for the role. Uncertain directors may, for example, be unwilling to ask crucial questions of managers before making major decisions. “Board members sometimes are made to feel that asking a thorny question or advancing an alternative opinion is disloyal to the administration” (Taylor, Chait and Holland, 2001).

Small and medium businesses, however, are a growing contributor to the national economies of countries internationally. In New Zealand, small and medium-size firms recording large GDP values, ahead of many large businesses, which makes our investigation into good governance practices of

SMEs relevant to suggest areas in which these firms can improve their governance policies and practices.

We have reviewed more than 2,000 directors, executives and investors in New Zealand, making this one of the largest non-government surveys in governance. Supported by 16 large corporate organizations, such as KPMG, Business New Zealand, Simpson Grierson, Brook Asset Management, Porter Novelli, Sheffield and 'Management' Magazine, this work suggests that the current processes through which directors are selected and trained to serve on Boards of small and medium businesses needs to be altered. We are also concerned over the lack of director education and the close involvement of the Chief Executives as members of the Boards. There is a general concern over the lack of director independence and whether directors are effective in their roles.

We are recommending an alternative process for SMEs to select directors, which will hopefully expand the available pool of directors in quantity and quality.

### Overview

Small and Medium Enterprises (SMEs) are the drivers of the economy in many countries, yet fall behind larger companies in the area of corporate governance (Dalton, Daily, Ellstrand and Johnson, 1998). We believe that the focus on governance processes and policies has been incorrectly placed on the relatively few large globally active firms where extensive governance regimes are established and monitored, overlooking the large group of GDP-driving small and mid-size firms in each country. Likely, this top-down approach has tainted the discussion and created an environment where governance is largely an audit and compliance tool, rather than an accepted component of long-term strategy for any sustainable business and warmly embraced by owners, operators and directors.

The failing of large corporations in recent years (such as Enron) has brought the issue of corporate governance into prominence and boards are being asked to improve their performance (Nicholson and Kiel, 2004). Due to the

lack of financial and organizational resources, this call to arms for business operators of any size represents a new challenge, and we are wondering how executives, directors and investors will approach this opportunity to improve the leadership resources of their firms.

The boards of smaller companies are far less likely to comprise independent outside directors (Daum and Neff, 2003; Stainburn, 2005). SMEs can find attracting quality directors difficult, research suggests, because such directors tend to be repelled by the insularity of meeting procedures and the “low stakes” involved (Taylor, Chait and Holland, 2001). Whether it is the glamour of large corporations with the large compensation packages and the news headlines, or the ability to influence operating results on a large scale, smaller firms seem to have to work harder to attract quality directors. We have asked directors for the reasons of joining a smaller firm, and it is clear that remuneration and glitz are not very high motivators for directors in New Zealand (Mueller, Dana, Taylor and Maier, 2006).

As you would imagine in smaller firms, people work closer together and in many cases the leadership also performs management tasks – and vice versa. In many firms the CEO is also a board member. In a smaller but still significant number of firms, the CEO is also the Chairperson of the board. This raises some obvious issues of independence and conflicts. How many CEOs, working closely with staff every day, can make tough staff layoff decisions without thinking about colleagues and friends? To what extent does a CEO vote for his own pay check and stature associated with the position, rather than for the shareholder interest (as a director would be obligated to do...). Notwithstanding the fact that many CEOs in smaller firms will also be shareholders and thus be expected to be aligned in their personal interests with those of their shareholders, we are mindful that a certain degree of schizophrenia is expected from CEOs who are expected to disassociate themselves from their day-to-day managerial duties when they enter the board room. Is this overlap of obligations helpful, or should board members all be independent, drawing on the CEOs expertise as a ‘consultant’ to the board, rather than being a full voting director?

Most research indicates that Boards function best when the CEO is not also the Chair of the board (Standard and Poor, 2004; Damodoran, 2004; Petra, 2005; Whitehead Mann Group, 2005). “Many CEOs don’t have the skills to be Chairman and certainly not in their own organisation, because they can’t

let go” (Whitehead Mann Group, 2005). Inexperienced directors can feel unconfident about talking thorny issues for fear of appearing disloyal (Taylor, Chait and Holland, 2001). SME Boards tend to lack the diversity of skills and attributes to “enable companies to evaluate key strategic issues more fully and monitor their performance more effectively” (Henderson Global Investors, 2003). The training and induction of new directors is also a cause for concern among SME boards. Boards also need to be prepared to submit their own performance, both as a whole and as individual directors, to self-analysis on a regular basis (Colin, 1994; Wilkes, 2004; Behan, 2004; Petra, 2005). The CEO of a smaller business may find it very difficult to step back enough to allow the Board to effectively function, and potential conflicts of interest can arise when the CEO is also the Chairperson of the Board (Petra, 2005). A CEO’s inability to let go makes them unsuitable candidates for chairship of their Boards as they do not always have the skills they need to overcome this and successfully guide the Board. (Whitehead Mann Group, 2005). The Chairperson should be able to run the Board rather than the organisation, have a positive working relationship with the CEO, and a clear separation of responsibilities (Whitehead Mann Group, 2005).

## Methodology

With the help of an MBA team from the Waikato Management School, consisting of six international managers in the final months of their MBA program, we have developed an online survey ([www.worldsurvey.info](http://www.worldsurvey.info)) with questions based on more than 100 of the most recent governance studies and academic reports in this area. To reach a widespread level of feedback, we developed questions suitable for company executives, corporate directors and investors and packaged all of those into one survey, mitigating confusion through clear separation of the three segments and instructions. The survey questions were reviewed and edited by leaders and executive staff of some of the most prominent firms, government departments and industry organizations in New Zealand, such as KPMG, Simpson Grierson, Business New Zealand, Brook Asset Management, Sheffield, Bank of New Zealand, Porter Novelli, NZ Venture Capital Assn, Crown Company Monitoring Advisory Unit, Business New Zealand, New Zealand Shareholders Association, New Zealand Institute of Chartered Accountants, New Zealand Institute of Management, several Chambers of Commerce and Management Magazine. This group represents one of the largest collectives

of leaders and corporations ever in New Zealand to investigate the status of governance. In addition to editing and editorial guidance, all of these supporters distributed an e-mail with the link to the survey to their respective client mailing lists. We have reviewed more than 2,000 responses to this ongoing survey to date, from directors, executives and investors.

The survey results were received anonymously, with some of the respondents completing all sections of the survey (executives, directors, investors), and others only completing the parts which applied to them. The survey has sensitive branching sections which only showed pages with questions applicable to the specific respondent.

The survey was also described on a daily morning business show on the largest TV station in the country and had long write-ups in national business magazines (Management Magazine and Director Magazine), business sections of daily news papers and industry magazines, further encouraging participation and creating a compelling call to participate.

We conclude that this is a representative sample of New Zealand business, without material bias as to geographic location, industry, size or other key demographics.

## Results

We take notice of the fact that nearly 39% of respondents were women, as that indicates a reasonable participation of women, who are underrepresented as leaders of business organizations in New Zealand but seem to be better represented as members of a management team and as investors.

With 75% of the respondents requesting a copy of the summary report and 63% of the respondents volunteering to make additional 1-on-1 time available on the telephone to discuss their thoughts about governance, this topic clearly is of more than just passing interest. We believe this high level of interest in the topic, beyond the simple completion of a survey, indicates the importance of this discussion, and since 72% of the respondents were from small and mid-size firms, this issue has certainly now penetrated the business community beyond the large, publicly listed firms.

Possibly as a reflection of the large number of small and mid-size firms in this sample comes the report that 50% of the firms have no independent directors. Nam and Nam point out that a Board will function best where there is a good spread of inside/executive and outside/independent directors in order to provide objective judgments of managerial performance (Nam and Nam, 2004), and it is by now well documented that independent directors are favoured by investors and regulatory agencies worldwide. Independent directors can likely not be recruited with traditional means. As a CEO or as a board director, the tendency in recruiting a new director is often to focus on individuals where there is an existing personal relationship or on the stature of the candidate (Conger and Lawler, 2001), and this inward-looking approach likely excludes competent independent directors. Arthur Levitt, former United States Securities and Exchange Commission Chair, describes the culture of medium sized business directorships as a “kind of a fraternity of CEOs who serve on one another's boards” (Stainburn, 2005), something that may enable less effective monitoring (Shivdasani and Yermack, 1999).

A search process that is rigorous and takes in a wider range of possible candidates can offer SMEs access to directors with greater diversity in “background, experience, age, gender, ethnicity and nationality” (London Business School, 2003). Nominating committees comprising such independent NEDs are more likely to nominate NDEs to the Board who will challenge the decisions of the CEO (Shivdasani and Yermack, 1998), and we can confirm that investors are interested in directors who can vigorously debate issues at board level.

The call for more independent directors seems to have been heard loud and clear by the business community in New Zealand. In this study alone, respondents have indicated a need for more than 2,200 independent directors over the next five years, placing the total number of directors needed in New Zealand at much more than 10,000. This raises the issue how those directors are recruited, and where executives and their investors can find qualified directors to take on this important role.

For SME Boards, there may soon be no choice but to introduce improvements to the standard of governance. The pressure on Boards to improve their corporate performance and the ways in which they oversee the company's management has led to what Nicholson and Kiel describe as “a

series of inquiries and reports” advocating corporate governance reform (Nicholson and Kiel, 2004).

For a SME, the task of selecting independent directors becomes crucial to the credibility of the company, and we will propose alternate ways for SMEs to identify suitable new directors.

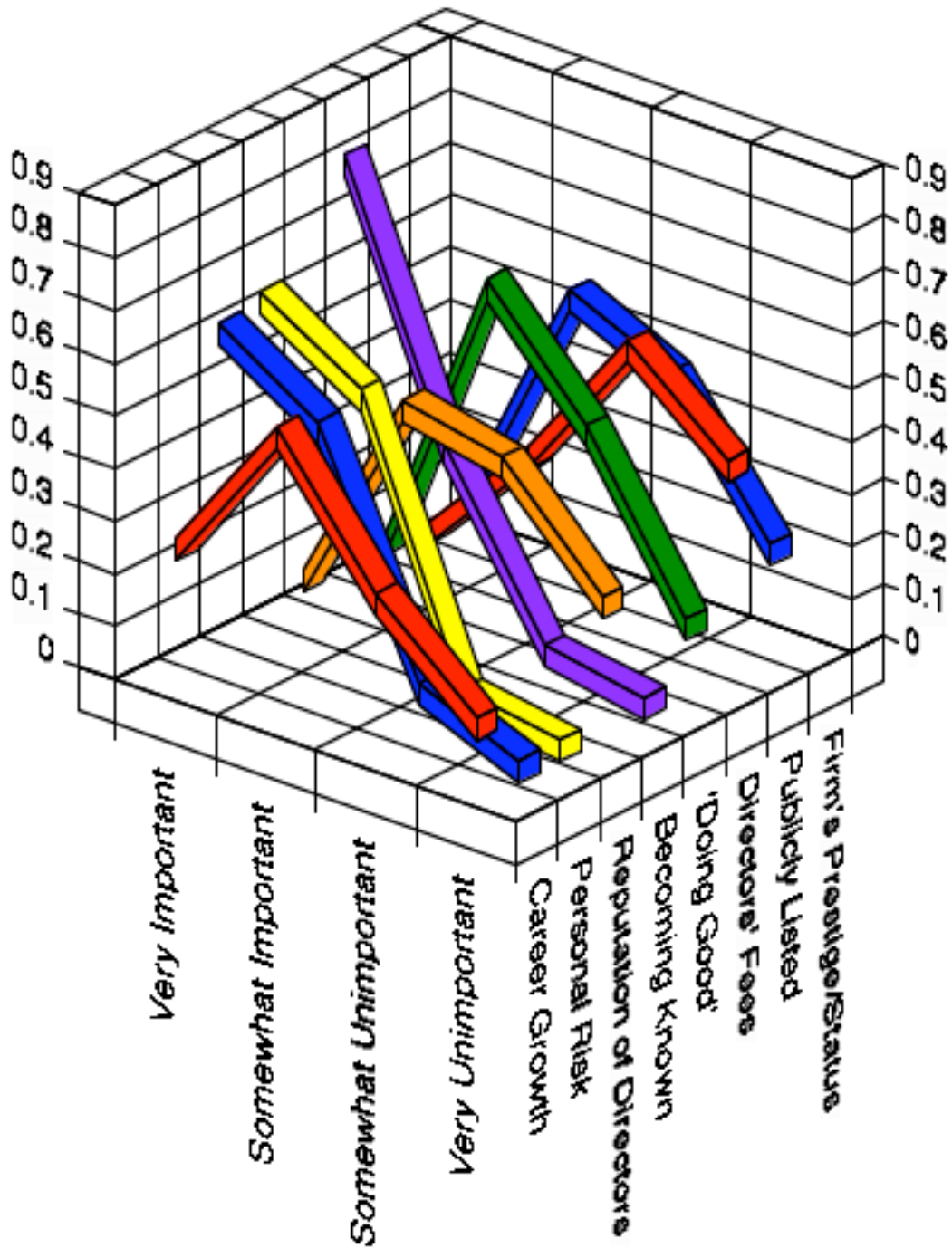
What makes these high quality directors join a Board?

Taylor, Chait and Holland suggest top directors are not attracted to small/medium companies because “the stakes remain low, the meetings process-driven, the outcomes ambiguous, and the deliberations insular” (Taylor, Chait and Holland, 2001), and this raises concerns over how expectations of directors can be met by firms.

We now know from our work that it is not the money or the prestige associated with serving as a director of a publicly listed firm. Potential directors want to ‘do some good’, and presumably want to be able to use their talents to help shape the firm towards achieving better performance. They also are very concerned about the level of personal risk attached to their directorship position. The backdrop for this level of importance could be the more stringent personal liability risks for directors in New Zealand than in many other industrialized countries, and we speculate that firms with an interest in new independent director will need to demonstrate stable financial performance with a high degree of transparency and accountability – and access to director liability insurance.

Of greater concern to us is the reflection of 66% of our respondents that the reputation of the fellow directors is ‘very important’ to them (Graph 1). This raises the issue of how firms create diverse boards, bringing in new independent directors, if these new candidates use the existing make-up of the board as one of their key determinants for participation. Clearly, investors, executives and directors must begin to craft a board which is not only effective internally, but also signals to the pool of prospective directors outside an attractive environment created through reputable directors.





Graph 1: If you were offered a Board position now, how important would each of the following factors be for you?

Where can we find these thousands of newly needed directors?

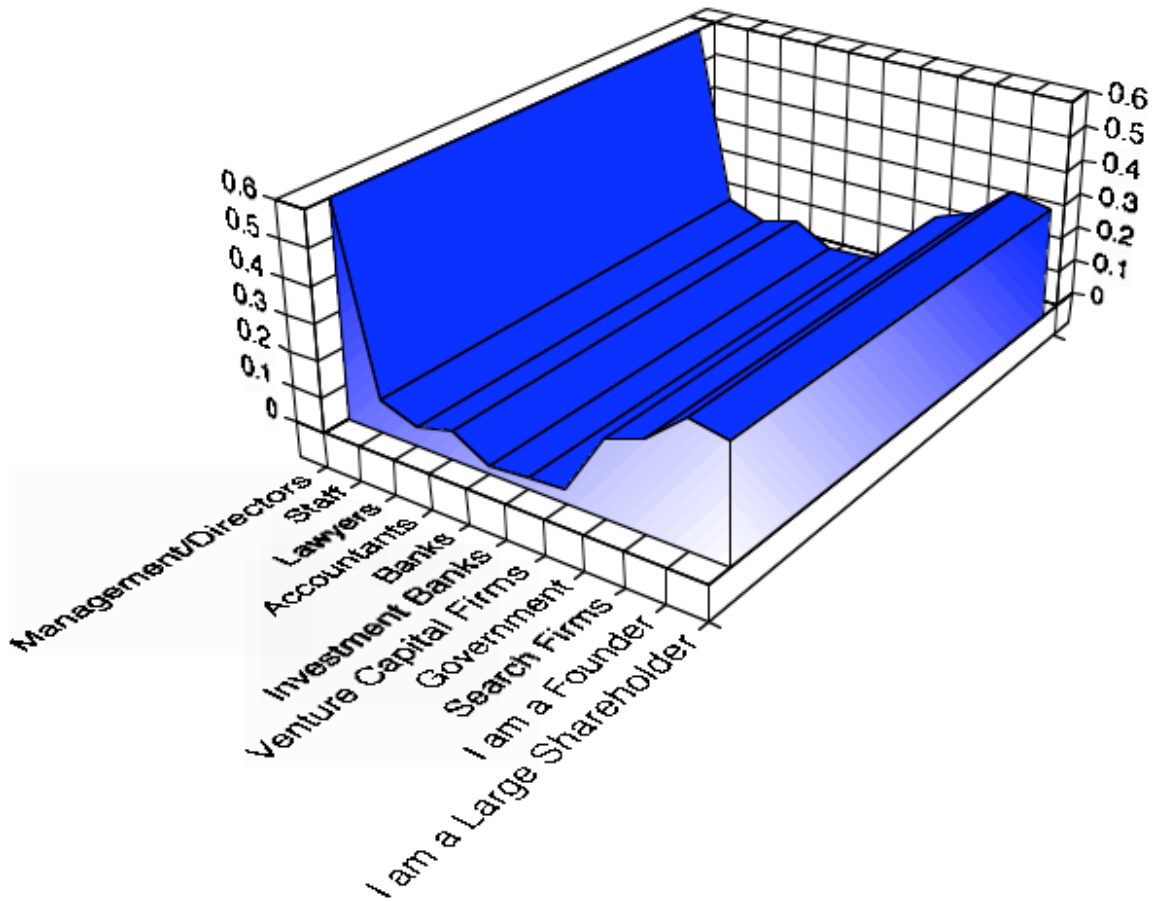
It has been advocated that a board of directors is the best bargain in modern business because it represents a cadre of expert consultants to management, with a level of talent and experience the company could never hire on a per diem basis (Charles and Caroline, 2003), and many small business owners will agree that consultants can be horrendously expensive and may not easily be available to smaller and less visible firms. If directors might now be available with a motivation other than of pure income, business leaders and investors might be able to re-position their needs and objectives to merge their long-term interests of achievement with those of prospective directors. The process of assembling the right mix requires a disciplined approach involving a careful assessment of the needs and challenges of the company (Charles and Caroline, 2003; London Business School, 2003) and this includes demonstrating to stakeholders that the company is committed to a rigorous selection process (London Business School, 2003). “Sharing information with shareholders, employees and other customers demonstrating that a company is committed to such a selection process is likely to foster greater trust in its NED appointments” (London Business School, 2003). We know from our work that the current selection process is primarily centered around recruiting friends and colleagues, rather than opening the funnel wide for the exposure to new categories and talents of directors.

Diversity and independence of the company are agreed key considerations in appointing a good mix of directors (Henderson Global Investors, 2003; Petra, 2005; London Business School, 2003; Nam and Nam, 2004), but there is less accord over what qualities the individual director should have. For some researchers, the ideal candidate will be a proven leader who has already addressed the kinds of issues the company is facing and will have financial acumen (Charles and Caroline, 2003; Petra 2005) while others say/believe a diversity of candidates, including those without a business background, bring with them different perspectives to apply to business problems and “enable companies to evaluate key strategic issues more fully and monitor their performance more effectively” (Henderson Global Investors, 2003; Taylor, Chait and Holland, 1996). Petra notes the recommendation that that the mix of talents and skills required be set down in writing in advance of appointing directors and include “business, finance, accounting, marketing, public policy, manufacturing and operations, government, technology, and other areas the board deems desirable” (Petra,

2005). Nicholson and Kiel point out that corporate governance will rarely be a function of one component (such as social capital or human capital) and the challenge for a Board arises from its understanding of the roles required and its ability to match the intellectual capital of the board to those roles (Nicholson and Kiel, 2004).

We are concerned that in our population of directors in New Zealand, a large number of those directors (60%) learned of directorship openings through other directors (Graph 2), or were large shareholders themselves (32%) or one of the founders (34%). Although the debate over the suitability of founders and shareholders to also be effective directors is far from over, it is clearly restrictive that the vast majority of directorship positions are 'marketed' through the existing directors. This may very well tap into the diverse and rich network of professional friends and colleagues who otherwise might not respond to invitations from strangers, but it begs the question whether the recruitment of new directors through existing directors gives the firm access to the talent set it needs.

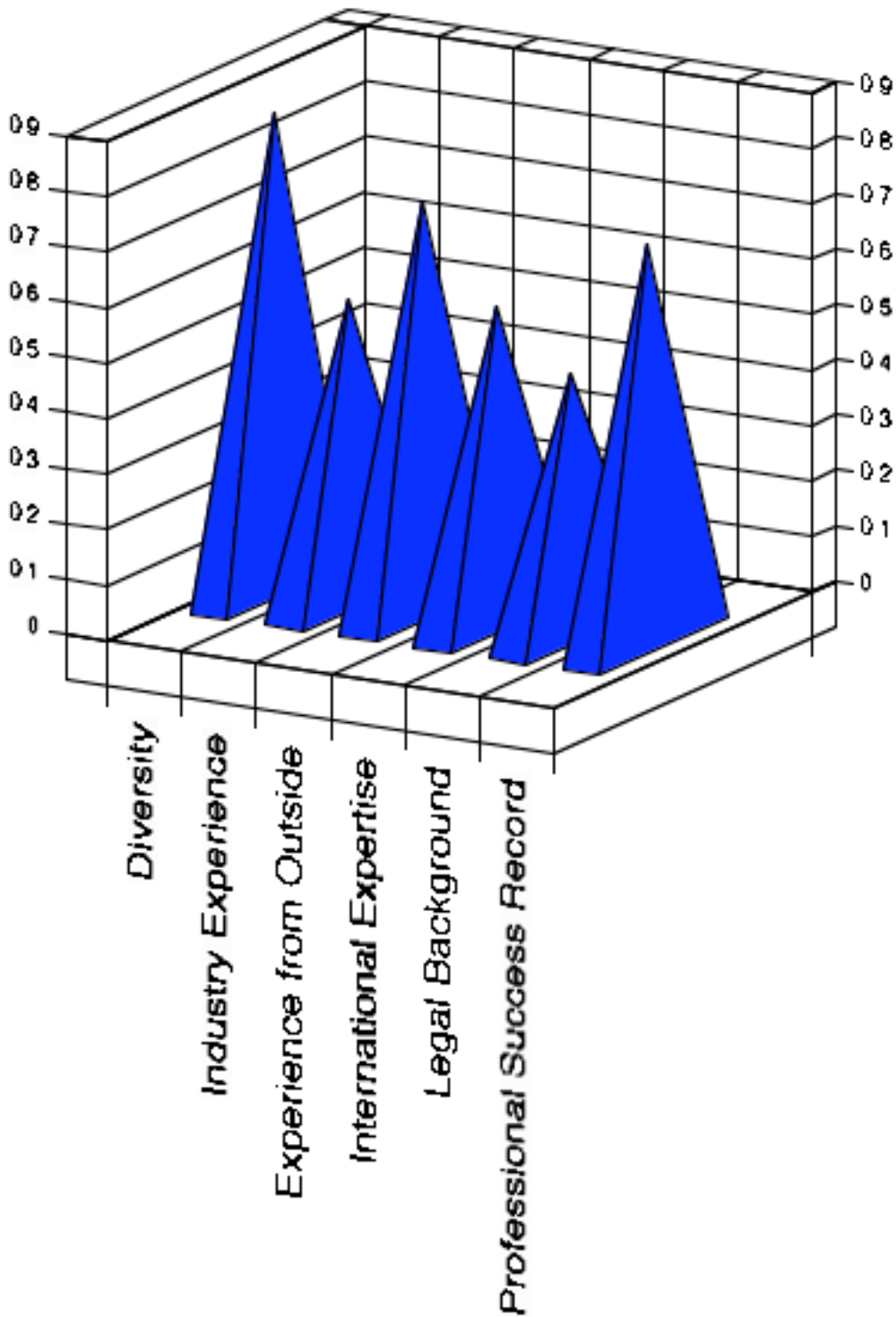
Early indications from our continuing work are that there is a large differential of competence between directors on the same board, and we wonder if the new directors are recruited more for their compatibility with existing directors than for their demonstrated competence. In the best case, this recruitment process yields directors of good competence and similar reputation. In the worst case, this process restricts the addition of directors which might not 'fit' for other than competence reasons.



Graph 2: How did you hear about openings for directorships?

Assembling the right mix of directors is the key to ensuring good governance (Charles and Caroline, 2003; Conger and Lawler, 2001; London Business School, 2003; Nicholson and Kiel, 2004). Knowing the appropriate mix of directors is not necessarily a matter of best practice, but depends on the needs of the particular Board (Felton and Watson, 2002; Nichols and Kiel, 2004). Felton and Watson describe the process as not a “ ‘checklist’ of the ten best practices” but a “state of mind – a considered balance between the need for the board to represent shareholder interests and the need to ensure management feels sufficiently free to focus on value creation” (Felton and Watson, 2002). In our sample, industry experience and a professional legal background scored low with investors. Investors want individuals as representatives with proven, preferably international, business accomplishments, which experience from outside the industry and diversity to the board table. Directors who sit on many boards are less likely to win

investor votes than those who bring a fresh perspective to the party, focused more on long-term strategic planning than on compliance policing.





## Summary

"In the final analysis, it is our view that the best boards comprise high quality, committed, independent directors; every board has room for more of these types of directors" (Felton and Watson, 2002).

Our work has shown that thousands of new directors are needed in New Zealand over the next five years, and investors are predominantly looking for independent directors with a proven track record outside the industry, creating a diverse board. Directors are also considering the reputations of the existing board and their own personal level of risk, before they commit to a directorship where they largely wish to 'do some good'.

We are left with the conclusion that the selection process for directors in New Zealand is inadequate to supply these thousands of independent directors, many of which would likely not have served as directors before and might be well-performing executives in other firms. There is a need for a 'market' where prospective directors and firms' investors and boards can 'meet', to connect and recruit. We propose that the Directions work in several countries can establish criteria which may guide investors and executives in their search for directors, and that we can establish a globally valid benchmark score which can easily compare governance accomplishments across borders.

Note to readers: We are looking for interested academics and institutions who wish to be the research leaders for this work in their countries. Please contact the author at [m@usainfo.net](mailto:m@usainfo.net) for more details.

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