Manager's Journal: The Impression Management Trap

By James Westphal
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WITH THE RECENT accounting scandals, calls for reform in corporate governance have become louder than ever. The criticisms have been remarkably consistent, fixating on the need for corporate boards to become more independent. Critics contend that today's boards are not sufficiently insulated from top managers to guard against self-interested and unethical behavior by executives.

The principles of governance reform issued by the New York Stock Exchange in June and the Nasdaq in July reflect the mindset. To wit: All corporate boards should have a majority of directors without ties to the company; the chief executive officer should not serve as chairman of the board; and the board should have regular meetings without the CEO present. But while debate has centered on these guidelines, there has been almost no discussion of the central idea -- that reform depends on making boards more independent. That's a shame, considering the growing evidence undermining the current orientation of reform. After nearly two decades of academic research, there is little evidence that board independence enhances board effectiveness. There is, however, considerable evidence that board independence can have negative effects on board effectiveness.

Using survey data from top managers and directors at Forbes 500 companies, I found that board independence lowered board effectiveness by reducing cooperative interaction between top managers and directors in the strategic decision making process. Nor did the independence affect boards' propensity to monitor executive behavior, as it is intended to do. The effect was to reduce the level, quality, and timeliness of board involvement in corporate policy.

Worse, under the law of unexpected consequences, increases in board independence actually further politicized the CEO-board relationship. Following increases in board independence, CEOs reported spending more time ingratiating themselves to outside directors. Such communications came at the expense of dialogue about the real decision facing the company.

Why we would expect the results to be otherwise? Many CEOs neither buy the need for board independence nor entirely trust independent directors to assess their performance. It's not surprising that when forced to work with independent boards, CEOs solicit less advice from directors.

Our new notion of independence is relative: Despite calls by the NYSE and others for greater independence, most boards of large U.S. companies are already independent by almost any measure. More than three-quarters of Fortune/Forbes 500 companies have a majority of independent directors based on the currently popular definitions. Even Enron and WorldCom had independent boards according to the general criteria now being touted by reformers.

But as any businessperson knows, the most important contribution to board effectiveness is not independence, but the directors' ability to contribute to strategic decision making. Unfortunately, responses to a recent survey of over 500 Fortune 500 directors showed most feel at least "somewhat uncertain" about their ability to contribute. This is the real trend that should concern shareholders.

We'll be talking for a long time about how companies can create boards that successfully focus on strategic decisions. But one point is especially relevant here: Any policy that restricts the pool of available director candidates makes it more difficult for firms to assemble boards with an optimal configuration of strategic experience. Thus, policies, like the NYSE and Nasdaq proposals, ultimately hurt efforts to appoint directors whose experience best matches the strategic priorities of the focal firm.

At the moment, regulators seem more concerned about the impressions that their policies will create than about formulating policies that are grounded in rational principles and empirical evidence. And corporate leaders seem primarily concerned (justifiably) about the impression that their decisions will make on
institutional investors and other stakeholders.

We need to break out of this impression management trap. If we want the best for our public companies and their shareholders, our leaders and policy makers need to take a stand for long-term reforms, not short-term publicity.

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Mr. Westphal is a professor of management at the McCombs School of Business at the University of Texas, Austin.

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