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# Systematic Review on the Effects of Multi-Committee Directors on the Monitoring Effectiveness of the Boards of Directors and its Implications for Risk Governance

## AGENDA

1. Introduction
2. Methods: systematic review
3. Review findings
4. Discussion

# 1 INTRODUCTION

- Series of corporate **accounting scandals** in the early 2000s
- Need for a more strategic and holistic **approach to risk** (Majone, 2010)
  - Board of directors assumes a monitoring role → in reducing principal agent problems
  - Resulting from the separation of “corporate ownership” and “managerial control”
  - Criticism on the monitoring quality of the board of directors (Pirson and Turnbull, 2011)

    → since they had been made responsible for downfalls
- **Risk governance**
  - aims to support companies’ long-term value optimization *and*
  - links the core principles of corporate governance to the context of risk-related policy making (Stein and Wiedemann, 2016)

# 1 INTRODUCTION

- **Board of directors** has a prominent role in implementing risk governance practices
  - Group of individuals (with primarily two responsibilities)
    - monitoring the management *and*
    - providing advice to top management
  - Board members: ensure executives are engaged in risk management (Lipton *et al.*, 2011)
- Board of directors often distributes responsibilities among **board committees** (sub-groups)
  - **Examples**: compensation, audit or nomination committee
  - **Committees** → **Effects** (Reeb and Upadhyay, 2010)
    - coordinate oversight function
    - make the process more comprehensible
    - increase the accountability of each member
    - preventing the frequent free-rider problem

# 1 INTRODUCTION

- Oftentimes, the same board members serve on **multiple committees** of the board

  → This is defined as **overlapping membership** or **overlap**

- Overlapping board members
  - have a prominent and more influencing position in the board (Zheng and Cullinan, 2010),

    but → variety of possible effects on the board effectiveness:
    - beneficial ("Knowledge Spillover Effect" and "Information Sharing")
    - harmful ("Over-Commitment" and "Compromise of Decisions")

  → High importance to gain a deeper understanding of the resulting effects

- **This systematic review**

  **aims** to address this paucity of knowledge and illustrates the state of empirical research

  → the effects of overlap on the monitoring effectiveness of the boards of directors

# 2 METHODS: SYSTEMATIC REVIEW

- A “systematic literature review” is divided into **three basic steps** (Tranfield *et al.* 2003)

  1. Planning the review
  2. Conducting the review
  3. Reporting and disseminating the review

- **Planning the review**
  conceptual discussion of the research problem and the motivation of the review
- **Conducting the review**
  identify relevant research by performing a comprehensive database analysis

  a) EBSCO Business Source Complete
  b) Emerald Insight
  c) ECONIS
  d) Web of Science

# 2 METHODS: SYSTEMATIC REVIEW

- **Reporting and disseminating the review:** we used the defined criteria and performed a search by title
  - **we excluded:** book reviews, editorial notes, comments and eliminated duplicates
  - **June 2017:** latest search resulted in an initial basic population of 870 articles
  - **Screening** with the objective of including only papers relevant
  - Found **17 adequate empirical studies**

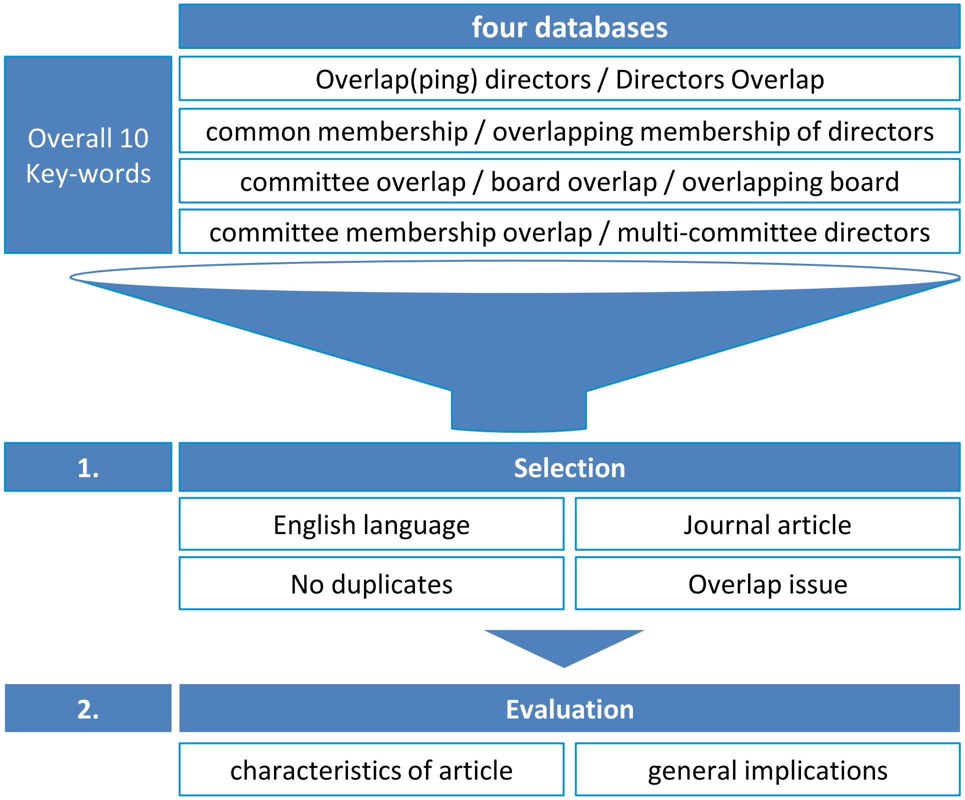


**Figure1: Process of selection and evaluation of relevant articles**

# 3 REVIEW FINDINGS: CHARACTERISTICS

- Four studies are **working papers**, the other 13 articles were published in 13 different **journals**
- To analyze the **primary field of journals**, we use the Academic Journal Guide (ABS) 2015 (Falkner and Hiebl 2015)
  - Most of the studies have been **published in**
    - Accounting-Journals (5), followed by Finance (4)
    - Strategy (1), Operations Research and Management Science (1)
    - General Management (1), Ethics and Social Responsibility (1)
- **Geographical spread**

  US (*11 articles*), mixed (US, Canada, Bermuda, China) (*1 articel*), Australian (*2 articles*), European countries (Germany, Spain) (*2 articles*) and Asia (Singapore) (*1 article*)

# 3 REVIEW FINDINGS: MONITORING EFFECTIVENESS

| Proxy for monitoring effectiveness | Abbreviation | Explanation |
|---|---|---|
| Reporting quality / Earnings Management | RQ | One task of the board of directors and the audit committee respectively, is to oversee the financial reporting process in order to reduce the magnitude of earnings management (Laux and Laux, 2009).<br>In research, the typical proxy of earnings management is discretionary accruals (Peasnell et al., 2005). |
| Executive compensation | EC | Board of directors sets the executive compensation and its structure.<br>The corporate governance research argues that CEO of companies with weaker board-monitoring receive higher executive pay (Core and Guay, 1999). |
| CEO turnover / CEO turnover-sensitivity | CT | A key task of the board of directors is to evaluate the CEO and his performance.<br>If boards monitor effectively, the CEO should be fired for poor performance (Coles et al., 2014). |
| Audit fees | AF | Feldmann *et al.* (2009) show that auditors consider companies reporting quality in their audit pricing, which means that earnings management activities increase auditor's risk of litigation and auditors spend longer hours on audit.<br>With respect to the reporting quality / earnings management above, a good monitoring effectiveness should have a negative effect on audit fees (e.g. Abbott *et al.*, 2006). |
| Qualified audit opinion | QAO | Investors see qualified audit reports as an indicator of weaknesses in financial accounting and react negatively to this information (Dopuch *et al.*, 1987).<br>The research assumes, that the auditors issuing a qualified audit opinion due to a low monitoring effectiveness of the board of directors (Fernández Méndez et al., 2015). |
| Investment/ overinvestment | INV | Following Jensen (1986) managers have incentives to cause their firms to grow beyond the optimal size.<br>Growth increases managers' power by increasing the resources under their control (empire building).<br>Therefore, a higher investment (overinvestment) may be a sign of weaker monitoring (Coles *et al.*, 2014) |

**Table 1: Explanations and abbreviations of the proxies for monitoring effectiveness**

# 3 REVIEW FINDINGS: OVERLAP DEFINITIONS

| Definition of overlap | Abbreviation | Explanation |
|---|---|---|
| **Audit-Compensation-Overlap 1** | ACO1 | Total number of audit committee members who also sit on the compensation committee divided by the audit committee size. |
| **Audit-Compensation-Overlap 2** | ACO2 | Total number of compensation committee members who also sit on the audit committee divided by the compensation committee size. |
| **Audit-Compensation-Overlap 3** | ACO3 | Number of directors serving on both audit and compensation commit-tees divided by the total directors on the board. |
| **Overall-Overlap** | OOL | Proportion of overlapping directors sitting on two committees. |
| **Overlap-Dummy 1** | OLD1 | 1, if a board member serves on at least two of the three principal monitoring (audit, compensation, nominating/governance) commit-tees. 0 otherwise. |
| **Overlap-Dummy 2** | OLD2 | Dummy variable that is 1 if the director sits on 2 (3) or more commit-tees and 0 otherwise. |
| **Overlap-Dummy 3** | OLD3 | Dummy variable that takes value 1 if at least one audit committee member sits on compensation committee, and zero otherwise. |

**Table 2: Explanations and abbreviations of overlap definitions**

+ overlap is beneficial for board effectiveness
– overlap is detrimental for board effectiveness
O overlap is only beneficial for board effectiveness on certain conditions
/ no clear statement

# 3 REVIEW FINDINGS

| Author(s) (year) | Journal | Primary field of the journal (ABS 2015) | Firms/ Firm-year Observa-tions | Time-frame | Country | Overlap define-tion | Determinants of monitoring effectiveness | | | | | | Research findings (direction of the overlap effect) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | RQ | EC | CT | AF | QAO | INV | |
| Brandes et al. (2016) | Strategic Management Journal | Strategy | -/ 7,058 | 1998-2009 | US | ACO2 | | X | | | | | + |
| Carter and Lynch (2012) | Working paper | - | 1,359/ 5,841 | 2006-2010 | US | OLD3 | X | | | | | | – |
| Chandar et al. (2012) | Review of Accounting and Finance | Finance | 399/ 1,032 | 2003-2005 | US | OLD3/ ACO1 | X | | | | | | O |
| Chang et al. (2012) | Working paper | - | -/ 4,355 | 1999-2004 | US | OOL | X | X | | | | | – |
| Chen and Wu (2016) | Working paper | - | 6,539/ 44,184 | 2001-2013 | US and other | OLD2 | | | | | | | / |
| Coles et al. (2015) | Working paper | - | -/14,579 -/8,451 -/18,289 | 1996-2014 | US | OOL | | X | X | | | X | O |
| Faleye et al. (2011) | Journal of Financial Economics | Finance | 2,051/ 10,636 | 1998-2006 | US | OLD1 | | | X | | | | – |
| Fernández Méndez et al. (2015) | Pacific-Basin Finance Journal | Finance | -/ 2,798 | 2001-2011 | Austra-lia | ACO3 | | X | | X | X | | – |

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| | | | | | | | RQ | EC | CT | AF | QAO | INV | |
| Fernández Méndez et al. (2017) | Spanish Journal of Finance and Accounting | Accounting | 122/ 804 | 2004-2011 | Spain | ACO3 | X | | | | | | O |
| Grathwohl and Feicha (2014) | Schmalenba-ch Business Review | - | -/ 376 | 2006-2010 | Germa-ny | ACO2 | | X | | | | | + |
| Habib and Bhuiyan (2016) | Australian Accounting Review | Accounting | 1,500/ 7,915 | 2001-2011 | Austra-lia | OLD3 | X | X | | | | | + |
| Hoitash and Hoitash (2009) | Group Decision and Negotiation | Operations Research and Management Science | 1,751/ - | 2004 | US | OLD3 | | X | | | | | – |
| Kalelkar (2017) | Asian Review of Accounting | Accounting | -/ 5,595 | 2007-2012 | US | ACO1 | | | | X | | | + |
| Karim et al. (2016) | Journal of Accounting, Auditing & Finance | Accounting | -/ 11,422 | 2000-2011 | US | ACO1 | | | | X | | | – |

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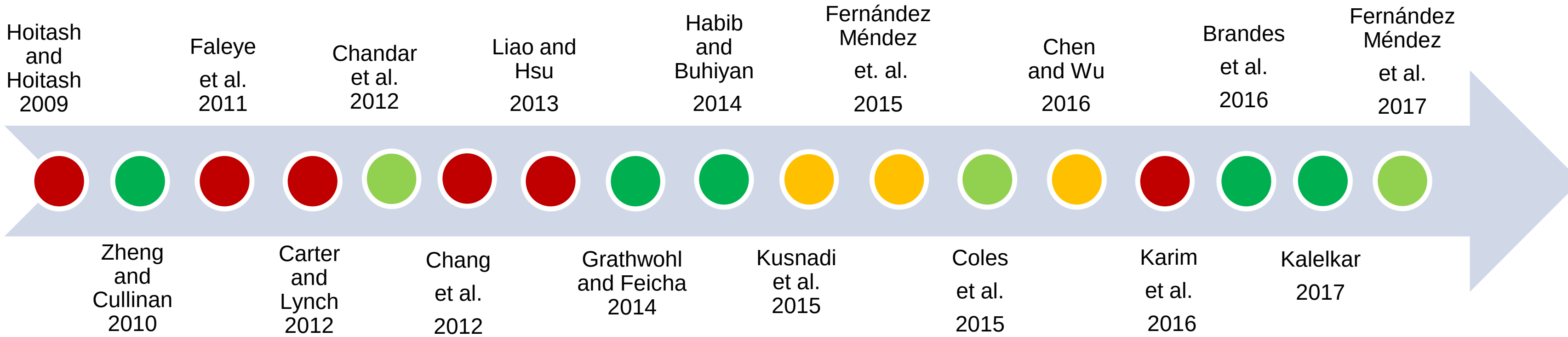
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | RQ | EC | CT | AF | QAO | INV | |
| **Kusnadi et al. (2016)** | Journal of Business Ethics | General Management, Ethics and Social Responsibility | 423/ - | 2010 | Singa-pore | OLD3 | X | | | | | | / |
| **Liao and Hsu (2013)** | Corporate Governance: An International Review | Finance | 1,319/ 4,572 | 2004-2008 | US | OLD3 | | X | | | | | – |
| **Zheng and Cullinan (2010)** | International Journal of Disclosure and Governance | Accounting | -/ 2,678 | 1997-2005 | US | OLD3 | | X | | | | | + |

**Table 3: Bibliographical sources and research designs of article included in the systematic literature review**

# 3 REVIEW FINDINGS




- Authors found that overlap is beneficial for board effectiveness
- Authors made no clear statement regarding the advantages of overlap or task separation
- Authors found that overlap is only beneficial for board effectiveness on certain conditions
- Authors found that overlap is detrimental for board effectiveness

**Figure 1: Timeline of the Paper´s Years of Publication and underlying assumptions**

# 4 CONCLUSION: SYSTEMATIZATION OF OVERLAP EFFECTS

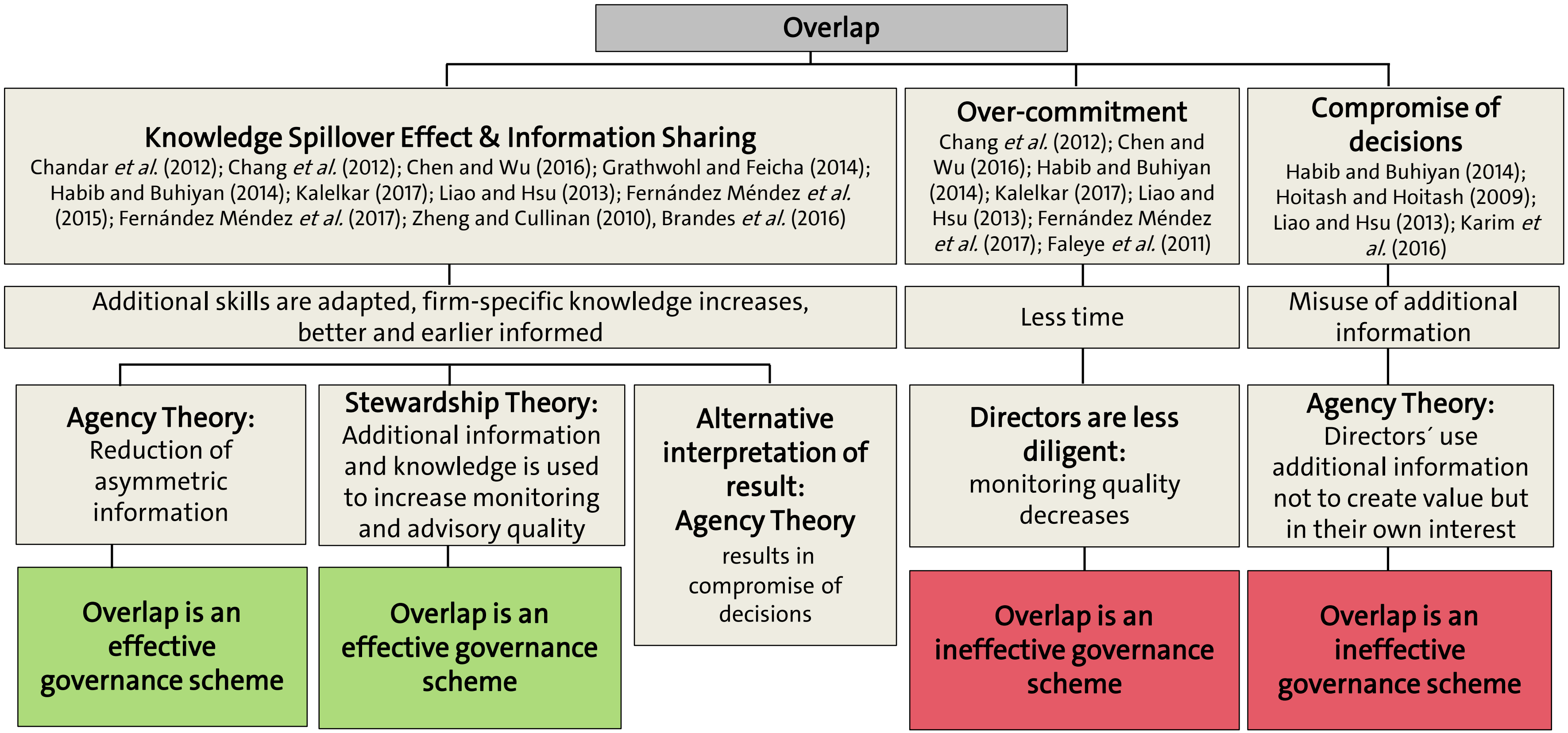



**Figure 2: Systematization of Overlap Effects**

# 4 CONCLUSION: IMPLICATIONS FOR RISK GOVERNANCE

- **Overlap** has a significant **influence** on the performance of the **board´s risk oversight role**
  - Thus influences the risk governance frame of a company for better or for worse
  - Important to set adequate incentives *and* develop a legal framework for directors
    - to use additional knowledge and information on behalf of the shareholder´s interest
    - hence, to create value for the company
- **(1) Legal requirements**
  - Since the agency conflict is much multilayered
    - important that board´s risk oversight responsibilities are clearly defined *and*
    - directors are liable for a responsible task performance

# 4 CONCLUSION: IMPLICATIONS FOR RISK GOVERNANCE

- Main source **responsibilities** (Lipton *et al.*, 2011)
  1. primary state law fiduciary duties;
  2. stock exchange listing requirements;
  3. federal and state laws and regulations
  4. so-called "best practices" on a domestic and global scale
- Financial scandals in the early 2000s
  - Numerous acts that aim to improve corporate governance and accountability introduced
  - Since the examined empirical research was conducted primary in subsequent years, the need for further regulations became obvious
- Agency conflicts (shareholders vs. directors) caused by additional information received by overlap have influence on firm performance
  - policy makers discussed the high demand for professional supervisory
  - Should be taken into consideration: requirements concerning independence of directors that work in certain committees *and* methods to evaluate directors´ objectivity

# 4 CONCLUSION: IMPLICATIONS FOR RISK GOVERNANCE

- Kusnadi *et al.* (2015) doubt that the requirement that solely independent directors are allowed to work in the audit committees is beneficial
  - empirical research on Singapore firms without the requirement gave indicators therefor
  - In cases where board members show irresponsible attitudes at the expense of their monitoring and thus of the shareholders and investors
    → they must be held responsible for potential losses
- Chandar *et al.* (2012): evidence for the correlation "overlap" and "financial reporting quality"
  - correlation is not linear, but U shaped (optimum of about 47%)
  - future requirements for firms with multi-committee directors´ could include a cap and a floor percentage for the relative overlap of these committees
    → to ensure that the benefits outweigh the costs

# 4 CONCLUSION: IMPLICATIONS FOR RISK GOVERNANCE

- **(2)** Internal company policy → **actions that support** an **overlap** structure (that serves as an effective governance scheme)
  - Board and **relevant committees** have: (Lipton *et al.*, 2011)
    - to work with the management to promote and actively cultivate a corporate culture *and*
    - environment that understands and implements enterprise-wide risk management
  - Includes: raising the awareness of all directors that other members' personal incentives *and* risk aversion preferences → impact decisions inside and outside the committee
  - Internal board composition and committee assignments must be designed accordingly
  - Risk oversight: mainly delegated to **audit committee** → directors should tackle risk management outside aspects of financial statements and accounting compliance (Lipton *et al.*, 2011)

# 4 CONCLUSION: IMPLICATIONS FOR RISK GOVERNANCE

- Implement a **separate risk committee** (already common in the financial sector)
  - Each board with sufficient human resources should consider appointing one
  - Audit committee members could reduce their time commitment
    → work more diligently and effectively
  - Balance the percentage of:
    committees with monitoring responsibilities **vs.** committees focus on strategic advice
  - Since intense monitoring leaves directors with less time for their advisory role…
    - like required in nomination, audit and compensation committee
    - it is important that boards implement committees with a strategic focus

# 4 CONCLUSION: FUTURE RESEARCH DIRECTIONS

- Beyond the **contradicting results**, there are also **limitations** concerning the results of the used **approach** and the discussed primary papers
- **(1)** Majority of the papers consider **US companies**
  - US litigation rates are higher than in the other countries (Fernández Méndez *et al.* 2015)
    - Additional non-monetary incentive for board members to monitor
    - Not taken into consideration in the empirical models
  - Results by Grathwohl and Feicha (2014) are based on **German** companies
    - two-tier board structure
    - one-tier system might have a superior flow of information
    - additional information spillover from overlap → relatively greater impact on the results
    - Explanation why the authors are strong supporters of the beneficial effect of overlap

# 4 CONCLUSION: FUTURE RESEARCH DIRECTIONS

- **(2)** Due to a lack of **small companies** in the data, the assumptions and findings on overlap might be predominantly applicable for large companies
  - different legal requirements or structural conditions in their boards
  - the effect of overlap might be different
- **(3) Company characteristics** might have affected the findings
  - Since the different components of CEO compensation were a crucial aspect for the interpretation of overlap effects,
  - financial status of the companies might have exerted influence *and*
  - thus complicates its interpretation

# 4 CONCLUSION: FUTURE RESEARCH DIRECTIONS

- (4) Research focused on the most **popular committees**
  - that all have a predominantly monitoring role
  - thus only the results for overlap of audit and compensation committees could be compared
  - Future research
    - should also analyze overlap effects that not only includes different committees
    - but particularly includes committees that focus more on the strategic task (e.g. risk committee)
  - Studies aiming at an interrelationship between overlap and corporate performance
    → should be based on an adequate measure for the overlap operationalization

# 4 CONCLUSION: FUTURE RESEARCH DIRECTIONS

- **(5)** The choice of the **overlap definition** is of crucial importance and should always be guided by the objective of the research question
  - currently no uniform measure for the operationalization of overlap in the literature
  - overlap definition should be guided by the objective of the research question
  - uniform definitions various for research issues (more comparable research findings)
- **(6) Proxy** for monitoring effectivness
  - E.g. total executive comepensation is no adequat proxy for inefficient contracting
  - Excess/abnormal pay should be used

# 4 CONCLUSION: FUTURE RESEARCH DIRECTIONS

- **(7)** Majority of researchers used **linear regression models**
  - Might be an insufficient empirical approach
  - Evidence that correlation of overlap and firm performance is U shaped (Chandar *et al.* 2012)
  - Instead of giving a clear suggestion, further research should analyze...
    - potential tradeoffs and intervals in which the overlap effect is positive or negative
    - the turning point(s)
  - Main cause of the contradictory results since the opposing effects neutralize each other
- **Overall**, the possibilities for future research are extensive, and especially the magnitude of overlap should be analyzed in further studies

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