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Board structure and role of monitoring committees

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ABSTRACT

Regulators and researchers alike have focused significant attention on the structure of the corporate board. In general, the results of prior empirical studies suggest that larger boards are costly to firms because of communication and co-ordination problems. How firms use committees to mitigate these costs, however, has not received as much attention. Since boards delegate authority for specific tasks to monitoring committees with independent directors, we re-examine the impact of board structure on firm performance by specifically focusing on the number of monitoring committees. Using ROA and EVA, we find that board size is positively associated with firm performance when firms use more than three monitoring committees. We also find that the previously documented negative association between board size and Tobin's Q disappears when a firm uses more than three monitoring committees. Overall, the results suggest that firms use monitoring committees to mitigate the costs associated with larger boards.

1. Introduction

Equity holders and bondholders alike depend on internal corporate monitoring systems to help resolve the agency problems that arise because of the separation of ownership and control. One of the important governance mechanisms available to debt and equity holders is the corporate board of directors. When incentives between managers and stockholders deviate, a board can function as an effective governance mechanism. The effectiveness of corporate boards however depends on several factors, including: independence, size, internal organization, and director stock ownership.

This paper empirically examines whether the internal organization of boards impacts the relationship between board size, board composition and firm performance. Previous studies have emphasized how independence and size increase the co-ordination, communication and asymmetric information problems of the board (Baysinger & Butler, 1985; Jensen, 1993; Yermack, 1996). However, prior studies do not adequately address the powerful role of committees where the bulk of board work is conducted (Platt & Platt, 2011). We consider the presence and number of monitoring committees when analyzing the correlation between board structure and firm performance since boards delegate important responsibilities to monitoring committees (Klein, 1998). The association between board structure and firm performance has been studied before, but few studies focus on the role of committees. A study that examines the board structure and firm performance relationship should also consider board committees since such an arrangement has the potential to reduce certain costs associated with large and independent boards. We therefore study whether firms alleviate some of these costs by establishing monitoring committees.

Klein (1998) has previously considered the use of committees and firm performance. Unlike Klein (1998) who studied only a few committees, this study considers all monitoring committees. Similar to Faleye, Hoitash, and Hoitash (2011), we focus on monitoring committees because these committees have received wider attention, and some were made mandatory by the exchanges. Another point of departure in this study is the emphasis on the operating performance measures of a firm. While the value of the corporate board to equity holders has been studied extensively (Bhagat & Black, 1999, 2002; Hermalin & Weisbach, 2003), its impact on the debt holders has attracted relatively less attention.

Recognizing the objectives of both stockholders and bondholders is important and to overcome some of the limitations of past studies, we use Economic Value Added (EVA) as an indicator of firm performance in addition to Tobin's Q. EVA is an accounting based earnings measure that accommodates the objectives of both capital providers. Garvey and Milbourn (2000) point out that EVA is a superior measure for gauging the impact of managerial effort on firm performance. Murphy and Zimmerman (1993) show that earnings based measures are better predictors of managerial turnover than stock returns. Therefore, we also use an accounting based performance measure because firms routinely use such measures to evaluate managers. For example, the compensation contracts for most chief executive officers (CEO) include some variant of earnings based performance measures (Murphy, 1986). Accounting based performance measures provide more reliable signals than stock returns about a current managers' performance. Stock returns, on the other hand, reflect both present management performance and any expected changes in future management (Hermalin & Weisbach, 1998). We posit that our choice of EVA as a measure of firm performance allows

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us to obtain results that are relatively free from the bias that could arise when using an equity-based measure such as Tobin's Q or a debt-based measure such as yield to maturity.

Using a sample of S&P 1500 firms from 2000 to 2003, we find that firms mitigate the costs associated with larger boards by using monitoring committees. Specifically, we find that when firms have more than three board monitoring committees, the previously documented negative association between board size and Tobin's Q disappears (Yermack, 1996). Extending the analysis to employ EVA and return on assets (ROA) as operating performance indicators, we find a positive relation between board size and firm performance for firms that have more than three monitoring committees. We interpret these results to indicate that firms use committees of boards to mitigate the costs associated with large boards. Since the results are affected by the endogenous relationship between the independent variables and the control variables, we apply standard remedial measures such as 3SLS estimation and find the results to be robust.

Our study contributes to the literature in several ways. First, the findings extend the literature on the relationship between board characteristics and overall corporate performance. Second, we provide evidence that larger and independent boards organized in multiple committees may be positively associated with firm performance. The results in this study complement the study of Coles, Daniel, and Naveen (2008), who argue that complex firms need larger and more independent boards. By focusing on the committee structure, we show that firms balance their costly need for larger and independent boards by organizing their boards in committees. Thus, our results contradict the findings that smaller boards are better and show that even larger boards can be organized effectively to produce beneficial results. Additionally, compared with Tobin's Q, we find a stronger relationship between board size and firm performance when we use the operating performance measures of EVA or ROA, which represent both stockholder and bondholder interests.

The remainder of the paper is arranged as follows. Section 2 discusses the related literature and develops the hypotheses. Section 3 describes the sample data and the key variables. Section 4 provides results and the conclusions follow in Section 5.

2. Prior research

Board composition is viewed as an important issue because independent directors are seen as a critical factor in mitigating collusive behavior of managers. However, the effectiveness of independent directors is limited by many firm specific factors such as the availability of information and costs associated with acquiring firm specific information (Adams & Ferreira, 2007; Baysinger & Butler, 1985; Raheja, 2005). Faleye et al. (2011) find that the monitoring effectiveness of boards improves when a majority of independent directors serve on two or more monitoring committees. However, they also find that this improvement comes at a substantial cost as these directors are unable to spend enough time on advising. Similarly, several studies have examined board size and monitoring effectiveness, however, with conflicting results (Jensen, 1993; Lipton & Lorsch, 1992; Pfeffer, 1972). Since these studies pointed out that board structure could influence firm performance, we revisit this issue with a focus on how firms organize their boards to expedite decision-making of larger and independent boards. Specifically, we analyze the association between board structure and firm performance when firms use board committees to delegate important monitoring functions.

Prior studies suggest that larger boards are generally less effective than smaller boards because of communication and co-ordination problems (Eisenberg, Sundgren, & Wells, 1998; Jensen, 1993; Lipton & Lorsch, 1992; Yermack, 1996). According to the proponents of smaller boards, although larger boards could be more effective as monitors, the costs of including more directors to the board outweigh the benefits of increased monitoring. Others point out that larger boards suffer from social loafing, and propose limiting the number of board directors (Lipton & Lorsch, 1992). Jensen (1993) says that smaller boards are more effective and emphasizes that when a board exceeds six or seven members, it becomes easier for a CEO to control the board, making the board less effective. Using a large sample of United States firms, Yermack (1996) provides evidence of a positive association between smaller boards and performance when measured by Tobin's Q. Jaskiewicz and Klein (2007) examine how alignment of goals of managers and owners impacts board structure and find that in firms with aligned goals, boards are smaller.

In contrast, other studies suggest that firms may be able to mitigate the costs associated with larger boards by assigning directors to important monitoring committees (Klein, 1998; Monks & Minow, 1995; Reeb & Upadhyay, 2010). Firms with complex business models need larger boards (Boone, Field, Karpoff, & Raheja, 2007; Coles et al., 2008; Linck, Netter, & Yang, 2008). Anderson, Mansi, and Reeb (2004) document that firms with larger boards and audit committees have a lower cost of debt. The size of the audit committee or other monitoring committees has an impact on accounting integrity (Anderson et al., 2004) and this in turn would lower the perception of risk. Not all, however, agree with these notions as there is mixed evidence between board size and firm profitability (Zahra & Pearce, 1989).

2.1. The role of board–committees

Klein (1998) and Reeb and Upadhyay (2010) observe that the number of board–committees differs substantially across firms, with boards of directors having anywhere from one to nine committees. Others have focused on the number of committees that directors serve on (Ferris, Jagannathan, & Pritchard, 2003) or the gender of committee members (Bilimoria & Pinderit, 1994). Our analysis centers on the use of committees to define the roles and responsibilities for individual directors and to help mitigate the problems associated with board opacity. Harrison (1987) suggests that committees can help mitigate some of the problems associated with poor attendance of directors because these directors now have a specific task or responsibility. Aiken and Hage (1968) suggest that subgroups may facilitate communication between diverse group members. Realizing the importance of these committees from a monitoring perspective, the SEC asks for greater disclosure about the non-independent members of these committees. Thus, we argue that committee structure serves a dual purpose of reducing the communication and co-ordination problem and increasing the observability of individual director's performance.

Lipton and Lorsch (1992) and Jensen (1993) posit that as boards increase in size, free-riding increases, reducing their efficacy. When committees are smaller and have clearly defined mandates, they are more likely to foster accountability for specific directors, thereby reducing free-riding problems. We expect, however, a positive relationship between the board size and firm performance when a firm uses multiple board committees.

Although we argue that the committee structure of a board helps in mitigating communication costs, Harrison (1987) suggests that managers might select large boards and create many board committees simply to legitimize their corporate governance efforts. To investigate this issue, we examine the relationship between firm performance and board characteristics when boards are organized in multiple monitoring committees.

Previous studies have found evidence that board committees play an effective monitoring role (e.g. Anderson et al., 2004; Beasley, 1996; Carcello & Neal, 2000; Hadani, Goranova, & Khan, 2011). These committees derive their monitoring power from the authority delegated to them by the board. For example, the audit committee is responsible for appointment of external auditors, to monitor the internal audit function and preserve auditor independence; the strategic development committee is responsible for approving and monitoring long-term investments; and the finance committee is responsible for reviewing the firm's financial policies and procedures.