A Meeting of the Minds: How Do Companies Distribute Knowledge and Workload Across Board Committees?

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INTRODUCTION

While corporate governance experts pay considerable attention to the composition of the full board of directors, much of the substantive work of the board is carried out by committee. Corporations are required by the New York Stock Exchange (NYSE) to have standing committees for audit, compensation, board nominations, and governance (the last two of which are frequently combined into a single committee). In addition to these, many boards establish committees to oversee specialized areas that are important to the firm, such as strategy, risk, finance, science, legal, or corporate social responsibility.[1] Boards also convene committees on an *ad hoc* basis to study singular events, such as a crisis, acquisition, or succession.

Typically, the nominating and governance committee recommends to the board which directors chair and serve on each committee, under the constraint that listing exchange standards are met.[2] The chairman, lead independent director, and chief executive officer often weigh in on the decision. Still, there is some degree of opacity to the process. A director's background might qualify him or her for a particular committee; however, directors are sometimes required to serve on multiple committees, and it is far less clear what consideration board leadership gives to the distribution of knowledge and workload across committee appointments. According to a survey by Spencer and Stuart (2007), 58 percent of corporate secretaries say that their boards have no explicit policy for committee assignment and rotation.[3]

AUDIT / COMPENSATION OVERLAP

Among standing committees, the heaviest work commitments tend to fall on directors appointed to the audit and compensation committees. The audit committee is responsible for overseeing the financial reporting and disclosure process, monitoring the choice of accounting policies and principles, hiring the external auditor, ensuring regulatory compliance, monitoring internal controls, and (in some companies) overseeing risk management. The NYSE requires that all members of the audit committee be financially literate and that at least one committee member qualify as a "financial expert."[4] According to the National Association of Corporate Directors (NACD), audit committees meet an average of eight times per year either in person or over the telephone, with a typical in-person meeting lasting 2.7 hours.[5]

The compensation committee is responsible for setting the compensation of the CEO, including establishing performance-related goals, monitoring performance relative to targets, advising the CEO on the compensation of other senior executives, and setting board compensation. The NYSE does not require compensation committee members to have specific knowledge or experience, but the work itself is technical and subject to considerable outside scrutiny.[6] Compensation committees meet an average of six times per year, with in-person meetings lasting 2.7 hours on average.[7]

There are potential benefits to creating a board structure where members of the audit committee sit concurrently on the compensation committee. Because compensation contracts are based in part on the achievement of accounting-based performance metrics, a director's understanding of financial accounting might allow for improved compensation contracting. A director with audit committee experience will be in a better position to understand which components of reported earnings are more informative about CEO decisions (and also less susceptible to manipulation), allowing the committee to write bonus contracts with a higher weight on these components. Also, this director will understand how discretionary year-end accounting adjustments allow the firm to "meet or just beat" consensus estimates or internal bonus targets.[8] As a result, compensation committees that overlap with the audit committee may be better able to appropriately compensate CEOs and reduce incentives to manipulate reported accounting numbers. There is some evidence that these benefits do, in fact, manifest themselves. Carter and Lynch (2009) find that concurrent membership on the audit and compensation committees is associated with a lower weighting placed on discretionary accounting accruals that might be more susceptible to manipulation and a greater weight on stock-return metrics in compensation contracts.[9] Similarly, Grathwohl and Feicha (2014) find among a sample of publicly listed firms in Germany that overlap between the audit and compensation committees is associated with higher bonus payments and higher pay-for-performance sensitivity of those bonuses.[10]

Conversely, there are potential benefits to having members of the compensation committee serve on the audit committee. Compensation committee members will have more detailed knowledge about the incentives that executives have to make accounting choices to maximize compensation and to assess the business risk created by the compensation structure. While the research literature in this area is less developed, there is some evidence that this might occur. Chandar, Chang, and Zheng (2012) find that firms with overlapping membership between the two committees are associated, on average, with higher financial reporting quality.[11]

Given the potential benefits of concurrent membership, board leadership might decide to intentionally create overlap between the audit and compensation committees to foster knowledge sharing.

On the other hand, there are potential downsides to creating overlap between the audit and compensation committees. The most important of these is the time commitment involved. The audit and compensation committees are both very time-intensive assignments. Considerable research suggests that "busy" directors (directors that serve on multiple boards) are associated with lower governance quality.[12] It is therefore not unlikely that a director with an excessive number of committee appointments similarly proves to be an ineffective monitor.[13]

Companies exhibit widely varying practices when it comes to audit and compensation committee overlaps. In 2012, 26 percent of publicly traded companies in the United States had no overlapping members between the compensation and audit committees, 33 percent had one overlap, 25 percent two overlaps, and 16 percent three or more overlaps. In approximately one-third of companies (32 percent), the audit committee chair also served on the compensation committee. In a similar percentage of cases (35 percent), the compensation committee chair served on the audit committee. In 6 percent of companies, the audit committee and compensation committees had the exact same members.

Of note, these percentages are lower than they were ten years prior. In 2002, it was much more common that the audit and compensation committees shared members and leadership (see Exhibit 1). It might be that both regulatory changes and increased work requirements discourage overlap between these two committees.[14]

COMMITTEE OF THE WHOLE

In the extreme, companies appoint all independent directors to all standing committees so that every committee effectively has 100 percent overlap. This arrangement is known as a "committee of the whole" and is intended to foster knowledge dissemination across the entire board. Because directors participate in all functional discussions, they have greater exposure to the details of the firm's operations and governance. A committee-of-the-whole structure requires significant time commitment. Still, some of those who have participated in the structure consider it a "best practice" because it encourages joint responsibility and accountability for decisions.[15]

Only a slim minority of companies (3.4 percent) employ a committee-of-the-whole structure. This figure has remained at low levels over the previous ten years. In general, it is more common among small companies. It is also more common among companies in the construction, mining, and wholesale trade industries (see Exhibit 2).

Goldman Sachs, Coach, Nucor, Moody's, and A.H. Belo are examples of companies that have committees of the whole, although their regulatory filings provide little insight into their decision to adopt this structure.[16]

WHY THIS MATTERS

1. Committees perform some of the most important board work, particularly in the areas of audit, compensation, succession, and governance. How exactly do companies decide which directors to assign to each committee? What skills and experiences are required? How equitable is the division of labor across directors?
2. As data in Exhibit 1 suggests, some companies have considerable overlap among committee members while other companies have little or no overlap. Does the board have a rationale for appointing directors in this manner? Do they intentionally create (or avoid) overlaps across committees, or do overlaps occur randomly? What are the costs and benefits associated with this choice?
3. Some committees, such as audit and compensation, have above-average workloads. Do the leaders of the board monitor the "busyness" of individual directors? If so, do they assign a greater weighting to high-work committees? When directors sit on more than one board, should companies keep track of how many other audit and compensation committees are included in that director's workload?
4. The committee-of-the-whole structure allows for maximum sharing of specialized knowledge across the full board. At the same time, it requires a significant time commitment from individual members. Should more companies adopt this structure? How can the board ensure that the benefits of information sharing are not outweighed by excessive workload? ■

[1] According to Spencer Stuart, 31 percent of companies have a committee dedicated to finance, 11 percent to public policy or corporate social responsibility, 8 percent to science and technology, 8 percent to the environment or health and safety, 8 percent to risk, and 6 percent to legal or compliance. See Spencer Stuart Board Index 2013.

[2] The NYSE requires that all members of the audit, compensation, and nominating and governance committees be independent.

[3] See: Julie Daum and Bob Heidrick, "How to Rotate Committee Jobs," *Directorship* (April/May 2007).

[4] A "financial expert" is defined as "[someone who] has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been chief executive officer, chief financial officer, or other senior officer with financial oversight responsibilities." See NASDAQ, "NASDAQ Rule Filings: Listed Companies—2002, SR NASD 2002 141."

[5] National Association of Corporate Directors, 2013-2014 NACD Public Company Survey.

[6] To this end, law firm Fenwick & West emphasizes the importance of compensation expertise among committee members and rotation of compensation committee members across different committees of the board. Pay Governance recommends that at least one compensation committee member have compensation experience and that at least one other member also have related expertise, such as financial expertise. See Fenwick & West, Compensation Committee Best Practices (2011); and Pay Governance, Executive Pay at a Turning Point (2012).

[7] NACD, *loc. cit*.

[8] Kenneth Daly and Robert P. Garrett, "Why Committees Must Coordinate," *Directorship* (September 2006).

[9] Mary Ellen Carter and Luann J. Lynch, "Compensation Committee Attributes and the Treatment of Earnings Management in Bonuses," Working Paper (October 2011).

[10] Julia Grathwohl and Darina Feicha, "Supervisory Board Committee Overlap and Managers' Bonus Payments: Empirical Evidence from Germany," *Schmalenbach Business Review* (October 2014).

[11] Nandini Chandar, Hsihui Chang, and Xiaochuan Zheng, "Does Overlapping Membership on Audit and Compensation Committees Improve a Firm's Financial Reporting Quality?" *Review of Accounting and Finance* (2012).

[12] See Eliezer M. Fich and Anil Shivdasani, "Are Busy Boards Effective Monitors?" *Journal of Finance* (2006); and John E. Core, Robert W. Holthausen, and David F. Larcker, "Corporate Governance, Chief Executive Officer Compensation, and Firm Performance," *Journal of Financial Economics* (1999).

[13] To this end, the country of India restricts public company directors from serving on more than ten committees across all boards, although it does not provide a higher weighting to audit and compensation committee memberships.

[14] The Sarbanes Oxley Act of 2002 requires greater audit specialization and restricts audit committee participation to those with a financial background. Similarly, the Dodd Frank Act of 2010 puts more of a focus on the work of the compensation committee with new rules relating to pay disclosure and the adoption of "say on pay." Together, these acts might have increased the workload or required specialization to a degree that disqualified some directors from serving on both committees.

[15] Source confidential. Interviews with the authors.

[16] Goldman Sachs, Nucor, and Moody's provide no explicit acknowledgement of the structure. Their filings simply list each independent director as serving on all committees. A.H. Belo states that "each of the board's standing committees consist of independent directors… [listed by name]." Coach states that "all of our non-employee directors are members of all board committees." See A.H. Belo form

DEF 14A (April 1, 2014) and Coach form DEF-14a (September 26, 2014).

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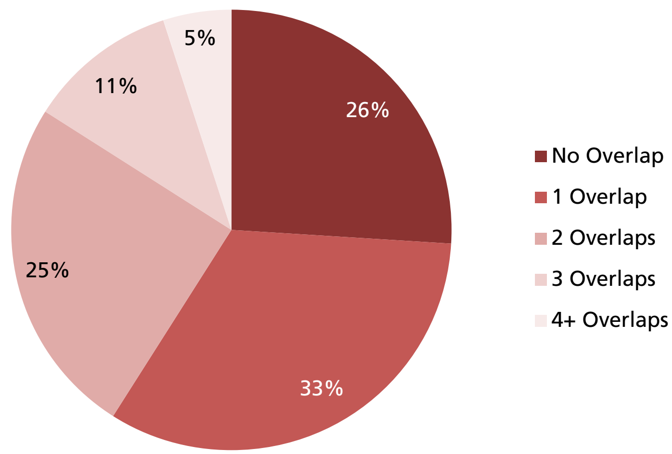
EXHIBIT 1 — COMMITTEE OVERLAPS

OVERLAPPING DIRECTORS: COMPENSATION AND AUDIT COMMITTEES (2012)



OVERLAPPING DIRECTORS: DESCRIPTIVE STATISTICS (2002 – 2012)

(Average)	2002	2007	2012
Total Directors	8.6	8.5	8.7
Independent Directors	5.3	5.8	6.9
Audit Committee Size	3.6	3.8	3.7
Compensation Committee Size	3.5	3.8	3.7
Nominating/Governance Committee Size	3.8	3.8	3.7
Overlap Audit and Compensation Committees	1.7	1.7	1.4
All Compensation on Audit Committee	18%	13%	9%
All Audit on Compensation Committee	14%	13%	9%
Same Directors on Audit and Compensation	10%	8%	6%
Audit Chair on Compensation Committee	36%	39%	32%
Compensation Chair on Audit Committee	32%	42%	35%
Same Directors on Audit, Comp, and Nom/Gov	4%	6%	4%

Note: Data represent 3,011 firms in fiscal year 2012; 4,029 firms in fiscal year 2007; and 3,378 firms in fiscal year 2002.

Source: Data from Equilar. Calculations by the authors.

EXHIBIT 2 — COMMITTEE OF THE WHOLE

COMPANIES WITH COMMITTEE OF THE WHOLE, BY INDUSTRY AND SIZE (2012)

Company Asset Size ($ millions) Industry	$0 to $400	$400 to $1,000	$1,000 to $5,000	$5,000 to $20,000	$20,000+	Total
Agricultural, Forestry, and Fishing	0%	0%	0%	0%	0%	0.0%
Mining	8%	6%	5%	0%	0%	4.2%
Construction	17%	13%	6%	13%	0%	10.5%
Manufacturing	6%	2%	3%	1%	1%	3.4%
Transportation, Communication, Utility	13%	3%	3%	0%	0%	3.0%
Wholesale Trade	0%	13%	5%	0%	0%	4.7%
Retail Trade	4%	6%	0%	0%	0%	2.1%
Finance, Insurance, Real Estate	10%	5%	3%	3%	1%	3.6%
Services	3%	3%	2%	0%	0%	2.3%
Other	0%	0%	0%	0%	0%	0.0%
Total	5.8%	3.9%	2.9%	1.4%	0.7%	3.4%

COMPANIES WITH COMMITTEE OF THE WHOLE (2002 - 2012)

Year	Percent
2012	3.4%
2007	5.6%
2002	2.3%

Note: Data represent 3,193 firms in fiscal year 2012; 4,091 firms in fiscal year 2007; and 3,499 firms in fiscal year 2002.

Source: Data from Equilar. Calculations by the authors.