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The Trouble With Too Much Board Oversight

New research suggests that the most favorable conditions for innovation occur when boards do not monitor the CEO intensely but focus on strategic advising.

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THE HIGH-PROFILE SCANDALS of the late 1990s have transformed the corporate governance landscape. One of the most notable effects has been increased oversight duties of independent directors. For example, in the United States, under the Sarbanes-Oxley Act of 2002, a public company's audit committee is now responsible for appointing, compensating and overseeing the work of the external auditors as well as maintaining procedures for whistle-blower protection. The committee itself must be made up entirely of independent directors. Moreover, under rules set by the U.S. stock exchanges, independent directors are supposed to have similar sway over compensation and nominating committees.

These mandates have had substantial effects on corporate boards. First, they have dramatically increased the workload of directors serving on audit, compensation and nominating committees. In a sample of 40 randomly selected Standard & Poor's 500 companies, these committees held a combined average of 12 meetings in 2000. By comparison, in 2011 those committees met an average of 19 times.[1] In addition, the number of independent directors serving on multiple committees has expanded greatly. In 2000, the percentage of S&P 1500 companies in which a majority of independent directors served on at least two monitoring committees was 48%. That percentage increased to 65% in 2004 before settling at 61% in 2011.

The shift toward increased monitoring raises two important questions. First, has the increased focus on board oversight helped to improve the quality of board monitoring?

THE LEADING QUESTION

Have increased oversight duties of corporate boards improved the quality of board monitoring at the expense of innovation?

FINDINGS

- Board oversight improved when independent directors devoted more time and resources to it.
- Innovation suffered when the board monitored intensely.
- Overall company value was lower when the board devoted greater time to oversight.

Second, can board oversight become excessive and ultimately detrimental to desirable objectives?

The Benefits of Oversight

The goal of board oversight is to ensure that executives manage their companies in the best interests of shareholders in light of the fact that CEOs and other top executives typically own only a minuscule percentage of their companies' shares. Effective board oversight can help to achieve this goal by reducing the opportunities for managers to pursue their self-interests at the expense of shareholders. Since board oversight has many facets, we focused on three distinct aspects of oversight responsibility: design and implementation of suitable executive compensation packages; removal of underperforming CEOs; and disclosure of earnings that reflect the company's true financial conditions. We found that boards were able to perform these functions most effectively when they devoted significant resources to managerial oversight. In particular, companies whose boards monitored intensely (defined as those at which a majority of independent directors served concurrently on at least two of the three monitoring committees) were more likely to compensate CEOs fairly in relation to their performance and other company characteristics (such as size, growth opportunities and risk), as opposed to compensating excessively. Such companies were also significantly more likely to dismiss their CEOs when they underperformed relative to peers and less likely to manipulate reported earnings.[2] In sum, board oversight improved when independent directors devoted the time and resources envisaged by the new regulatory regime.

The Downsides of Intense Monitoring

However, oversight of management is just one of a board's functions. Directors are also expected to participate in strategy formation and helping management create value. Their role in strategic advising is highlighted in a recent report by the New York Stock Exchange Corporate Governance Commission, which identified value creation as the leading principle of corporate governance.[3] In a survey that followed the introduction of the Sarbanes-Oxley Act, directors pointed to this strategic role, speaking of "their desire to move beyond their 'compliance' (monitoring) role to a more 'value-added' (strategic) role."[4]

Although it is true that monitoring performance helps independent directors provide input into strategic decisions, it can also be distracting. Outside directors have limited time; the additional time they devote to oversight can reduce their time available for advising. Heidrick & Struggles International Inc., a leading executive search firm based in Chicago, reported that 84% of directors of the 2,000 largest publicly traded companies in the United States agreed that "they are now spending more time on monitoring and less on strategy";[5] a survey by PricewaterhouseCoopers LLP, the large professional services firm, found that 75% of directors wanted to devote more time to strategy discussions.[6]

Intense monitoring can also strain relationships between directors and top management. Governance scholars have argued that CEOs will shy away from interacting and communicating with boards that are too involved in monitoring.[7] Recent survey evidence supports this view: Independent directors received less strategic information from management if such directors devoted significant time to oversight duties.[8] Increased focus on oversight can also color the CEO's perception of board support, which can undermine his or her eagerness to commit to risky but value-enhancing ventures such as corporate innovation.

We evaluated the impact of intense board oversight on the quality of board advising by examining events and decisions in which board support and the input of independent directors can make a difference. (See "About the Research.") First, we looked at investments in corporate innovation because such investments are risky and require boards to be tolerant of experimentation and potentially costly failures. We found that the most favorable conditions for innovation occurred when the board did not monitor the CEO intensely but focused on strategic advising, thereby encouraging the CEO to pursue valuable but high-risk innovation projects.[9] Conversely, corporate innovation suffered when the board monitored intensely. Companies with such boards invested less in R&D, received fewer patents overall and received fewer influential patents as measured by the frequency of citations of the patents they received. Moreover, we found that companies in which direc-

tors were more focused on oversight had poorer short- and long-run acquisition performance.

Boards are responsible for increasing value through oversight and strategic input. Clearly, there is tension between these two roles, and there is no way to know in advance whether more oversight will help or hurt the board's overall ability to build value; the answer depends on whether the gains a company gets from better board oversight exceed the reductions in the directors' effectiveness as strategic counselors. We examined the impact of intense board monitoring on overall company value by comparing the market-to-book ratios of companies with boards that monitored intensely and those that did not. We found that company value was lower when the board devoted greater time to oversight. This suggested that the reduction in the quality and efficacy of board advising exceeded the benefits of improved monitoring. We also found that the adverse impact that increased oversight had on corporate innovation, acquisitions and company value was more pronounced in companies with more complex operations, which typically require higher levels of board advising.

Overall, our findings challenge the widely held assumption that more board oversight is always desirable, and they confirm the concern raised by the NYSE Corporate Governance Commission that "good corporate governance should be integrated with the company's business strategy and objectives and should not be viewed simply as a compliance obligation separate from the company's long-term business prospects."[10] Thus, each board must devise means of balancing its obligation to oversee top management with its duty to assist management in creating, shaping and implementing long-term strategy.

Suggestions for a Balanced Board

So how does a corporate board go about balancing its competing objectives? One solution is to enlarge the board and increase the number of independent directors. This would give the board more freedom in allocating committee assignments so that individual independent directors are not overly burdened with compliance/oversight duties. Although other research has suggested that larger boards are less effective in general, our comparisons of market-to-book ratios suggest that expanding the board can be an appropriate solution in this instance. Specifically, we found that U.S. companies that enlarged their boards in response to Sarbanes-Oxley requirements for increased board oversight became more valuable relative to those that did not expand their boards.

A similar solution that does not involve increasing the overall size of the board is to increase the ratio of independent directors versus employee directors. This allows the board to tap additional directors to share the board's oversight burdens. General Electric Co. appears to follow this strategy. In 1998, GE had 15 directors, six of whom were independent; two-thirds of the independent directors served on multiple oversight committees. By 2006, 11 of GE's 15 directors were independent, and only one-third served on multiple oversight committees. Of course, there's a downside to this strategy: In having fewer employee directors, boards have less direct input from top-level executives, and fewer executives have firsthand exposure to board-level discussions of strategy that will help them in their careers.

Another approach is to reduce the size of oversight committees, thereby requiring fewer independent directors to serve on these committees and reducing

ABOUT THE RESEARCH

We examined the consequences of the increased focus on board oversight of top management after the financial reporting scandals of 2001-2002. Our sample consisted of more than 10,000 observations of 2,051 S&P 1500 companies during 1998-2006. We excluded banks, other financial services companies and utilities because of differences in regulatory oversight that can limit the board's role. We used information on the committee assignments of directors at these companies to construct a measure that captures the devotion of board resources to managerial oversight based on whether a majority of independent directors served on two or all three principal oversight committees. Our analysis of committee memberships showed that most directors served on two or fewer committees in total and that those serving on two or more oversight committees were much less likely to serve on other committees dedicated to strategic issues (such as strategy, innovation or finance committees). Therefore, we regarded those directors as concentrating primarily on managerial oversight because virtually all of their committee responsibilities were oversight-related. We classified the board as monitoring intensely when the majority of independent directors fell into this category. This allowed us to divide companies into two groups: those whose boards were intimately focused on managerial oversight, and those that were less so. We then compared the two groups along several dimensions, including CEO compensation and dismissal, financial reporting quality, investments in corporate innovation, acquisition performance and overall value creation. Our tests employed careful econometric methodologies to account for the impact of potentially confounding issues and other factors that may affect board effectiveness, corporate innovation and value creation.

the need to have people serve on multiple committees. One company that chose this approach is Sysco Corp., the Houston-based food distribution company. In 2000, Sysco's audit, compensation and nominating committees had nine, seven and eight members, respectively. Most independent directors served on more than one of these committees. By 2006, Sysco's audit committee had five members, and the compensation and nominating committees had four members each. This created the flexibility for independent directors to serve on fewer oversight committees.

Finally, boards can divide up the responsibilities, assigning the lion's share of oversight duties to one set of independent directors and freeing others to focus more on advising. In this manner, independent directors would, in effect, specialize either in board oversight or strategic advising in ways that are similar to the dual board structure prevalent in several European countries, including Germany, France, the Netherlands and Austria.[11] We have found that this approach would mitigate the negative consequences of intense board monitoring without diminishing its positive impact on the quality of board oversight, thereby enhancing overall value creation.[12]

Ultimately, the question of how to structure the board optimally to maximize business value must be evaluated by individual companies based on their own circumstances and characteristics. Different companies will have different needs for strategic advising and board oversight, so boards should carefully consider our recommendations and their potential consequences before making significant changes. Nevertheless, we hope that our research will encourage companies to think about how to balance the desire for intense board monitoring against the benefits of having a supportive board. As our results suggest, such a board is needed as a counterweight to managers' shortsightedness and their dislike for high-risk but value-enhancing strategic undertakings, such as corporate innovation.

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