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How Many Simultaneous Audit Committee Memberships Are Too Many?

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Title Page (must be a Word file)

How Many Simultaneous Audit Committee Memberships Are Too Many?

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SUMMARY: Recent research by Sharma, Sharma, Tanyi, and Cheng (2020) provides new insight into directors serving on multiple public company audit committees. Specifically, they investigate how an individual audit committee director serving on multiple audit committees is related to companies' cost of equity capital. Their evidence suggests that serving on multiple audit committees is viewed positively by investors up to a certain point, but beyond that point investors become concerned. This turning point, on average, is 3.5 audit committees for retired directors and 1.5 audit committees for directors in full-time employment. These results have implications for numerous stakeholders including investors, proxy advisors, boards, nominating committees, stock exchanges, and policymakers. They also have implications for future research.

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I. INTRODUCTION

Mae West famously said, "Too much of a good thing can be wonderful!" While she may have been right in some cases, serving on too many audit committees turns out not to be so wonderful. Until Sharma, Sharma, Tanyi, and Cheng (2020), there was no research on individual directors serving on multiple audit committees. The debate on directors serving on multiple boards and board committees is yet to be resolved because practitioners and academics generally fall in two camps. One side contends that simultaneously holding a few directorships provides directors with unique opportunities to garner experience and expertise that fosters effective governance (BRT 2003; Deloitte 2012; Sharma et al. 2020). The other view is that simultaneously holding multiple directorships can overburden and distract directors, thereby resulting in ineffective governance (Ferris, Jagannathan, and Pritchard 2003; Fich and Shivdasani 2006; Sharma and Iselin 2012; Sharma et al. 2020). These contentions also apply to key director responsibilities such as serving as the chair of the audit committee or a designated financial expert.

In informing this debate, Sharma et al. (2020) identify a serious disconnect between practice and academic research. While stakeholders in practice primarily focus on an individual director's simultaneous multiple director positions, academic research has largely focused on the average number of directorships held by the entire board or board committee. Sharma et al. (2020) investigate whether investors are concerned about an individual director simultaneously serving on multiple audit committees, and whether their concerns vary dependent on the employment status of the director and indicators of the firm's governance effectiveness.

II. BACKGROUND

The impact of service on multiple audit committees could be positive or negative based on two equally dominant yet opposing theoretical perspectives: the reputational perspective and the busyness perspective. The reputational perspective suggests that the effectiveness of the audit committee increases through knowledge, experience, and expertise directors garner from serving on multiple audit committees (Fama and Jensen 1983; BRT 2003; Ferris et al. 2003). A major task of the audit committee is to monitor and oversee the quality of a firm's financial reporting and serving on multiple audit committees could increase this specialized knowledge base and enhance directors' governance capabilities and effectiveness (BRT 2002; U.S. House of Representatives 2002; NACD 2010, 2011). If investors interpret a director's service on multiple audit committees in this vein, then they might reward a firm with a lower cost of equity capital for a perceived increase in the audit committee's governance effectiveness.

The busyness perspective suggests that service on multiple audit committees decreases the governance effectiveness of directors because the directors are overburdened and distracted (Ferris et al. 2003; Fich and Shivdasani 2006; Field et al. 2013). If investors perceive this to be the case, then they could penalize a firm for a perceived decrease in audit committee effectiveness with a higher cost of equity capital.

Sharma et al. (2020)'s investigation is directed at determining which theoretical perspective dominates investors' perspectives. Although a modest number of studies examine the impact of multiple directorships of board and audit committee members, their results are unclear and conflicting, and they generally do not consider the impact of the effects of corporate governance effectiveness. For example, Beasley (1996) and Sharma and Iselin (2012) find that multiple directorships reduce board and audit committee governance of financial misreporting, but

Barua, Rama, and Sharma (2010) and Dhaliwal, Naiker, and Navissi (2010) observe no such effects. In addition, while Ahn, Jiraporn, and Kim (2010) and Field, Lowry, and Mkrtchyan (2013) report that service on multiple boards has a positive impact on firm performance, Fich and Shivdasani (2006) and Cashman, Gillan, and Jun (2012) observe detrimental effects.

Following a comprehensive review of the related literature, Sharma et al. (2020) identify that none of the prior multiple director studies adopt a design to examine an individual director's other board or audit committee seats. Notably, Sharma et al. (2020) is the first academic study to emphasize that investors and other stakeholders typically focus on an individual director's capacity to serve on multiple audit committee and board positions, as opposed to the focus of extant research being a board's average capacity (please see Sharma et al. (2020) for details). This is most apparent during director elections and from the demands of activists and governance advisors calling for limits to the number of board and audit committee seats occupied by an individual director (Glass, Lewis & Co. 2018). Even the stock exchange rules refer to an individual director's capacity to serve in directorial roles (NYSE 2014). Further, Sharma et al. (2020) use firms' cost of equity capital to measure investor sentiment regarding multiple audit committee appointments. Prior to their study, only one other academic study evaluated the relationship between average board-level measures of multiple directorships and investor sentiment using cost of equity capital as a proxy (Dao, Huang, and Zhu 2013).

III. RESEARCH METHOD AND RESULTS

Research Method

Using a sample of over 34,000 directors spanning 12 years (2004 to 2015), Sharma et al. (2020) employ regression analysis to evaluate the relationship between the cost of equity capital and the number of audit committees an individual audit committee member serves on. Sharma et al.'s (2020) regression equation includes a comprehensive set of control variables to account for other relevant factors that may be associated with the cost of equity capital. They also specifically control for the number of boards an audit committee member serves on because not all board members serve on audit committees, which helps isolate the effects of multiple audit committees from multiple boards. The regression equation takes the form:

Cost of equity capital = number of public company audit committees an audit committee member serves on + number of public company boards an audit committee member serves on + (firm risk proxies (e.g., size, stock price return, leverage, growth) + audit committee characteristics (e.g., size, number of financial experts) + corporate governance proxies (e.g., board independence, CEO duality) + financial reporting quality proxies (e.g., restatements, internal control weaknesses, auditor size).

Sharma et al.'s (2020) data of the sample firms suggest on average, audit committee members serve on 1.35 audit committees, are 63 years of age, have nearly eight years of tenure, 14 percent are female, and 30 percent are retired.

Results

Estimating the regression equation they find a consistently negative relationship – greater number of audit committees served on is associated with a lower cost of equity capital. The implication of this result is consistent with the reputational perspective that investors perceive directors derive knowledge, expertise, and reputation from multiple audit committee memberships. The regression results are also practically meaningful because serving on one additional audit committee is associated with a 14 to 42 basis points reduction in cost of equity capital across the various cost of equity measures. Serving on two additional audit committees would result in a greater effect.

Sharma et al. (2020) probe further to explore whether at some point investors begin to view additional audit committee directorship responsibilities as a potential threat to good governance.

They discover that, there is a turning point when a director serves on more than 2.5 audit committees; three audit committees are too many. Sharma et al. (2020) next explore whether the turning point varies based on the director's employment status. Directors are categorized as either retired or non-retired, where retired directors are individuals who do not hold an active full-time employment position, other than as an independent director. Arguably, retired directors should have more time to devote to their governance duties compared to directors who have fulltime employment commitments.

Their results reveal that investors perceive the optimal number of audit committees a retired director on average should serve on is 3.5, and is 1.5 for currently employed directors. These numbers suggest that investors perceive four audit committees are too many for retired directors, while two committees are too many for currently employed directors. This discovery suggests that both the reputational and busyness perspectives are at play when investors react to individual directors simultaneously serving on multiple audit committees.

Further analyses indicate that investors also differentiate the role each director plays on the audit committee. Sharma et al. (2020) examine three roles of directors on the audit committee – financial expert, committee chair, and other members. Their results substantiate earlier findings and suggest that audit committee experts and chairs drive the negative relationship between multiple audit committee service and cost of equity. Investors are more concerned about directors serving on multiple audit committees when they hold a key role on the committee that can influence its effectiveness.

It could be that boards and nominating committees attempt to offset the potential negative impacts of busy directors by appointing directors who are less busy. In other words, consistent with the methodology of prior academic research, the average audit committee or board busyness may be more important to investors than is individual director busyness. Sharma et al. (2020) test for this possibility by replacing their individual director-level measures with overall audit committee and board-level measures. The overall measures are based on the average number of audit committees and boards across all directors on the audit committee and board, respectively. They find that none of the measures of average multiple directorships is significant. They conclude that investors are mostly concerned with the workload of individual directors and not with the overall average for the audit committee or board of directors.

Conditions Affecting Relationship

Importantly, Sharma et al. (2020) also find that the negative relationship between an audit committee director's service on multiple audit committees and cost of equity capital is more pronounced when financial reporting quality is high. In other words, when investors observe firms with higher financial reporting quality have audit committee members that serve on multiple audit committees, then they perceive that greater audit committee experience fosters relevant governance experience, which manifests in investors demanding lower cost of equity capital. They also observe that the negative effect of multiple audit committee memberships on cost of equity capital is more evident when firms do not have a powerful CEO and the firm's overall governance environment does not compromise investors' rights. Such findings suggest that investors perceive an ineffective governance environment diminishes the governance experience directors gain from serving on multiple audit committees. Collectively, these findings suggest that investors are aware of the beneficial effects of a director serving on multiple audit committees and the conditions that could enhance and undermine the effectiveness of the audit committee's governance responsibilities.

IV. IMPLICATIONS

Over the last two decades, the implementation of the Sarbanes-Oxley Act of 2002 (U.S House of Representatives 2002), the global financial crisis, and the Dodd-Frank Act of 2010 (U.S. House of Representatives 2010) significantly increased the responsibilities of the audit committee. To overcome the scarcity of qualified independent audit committee directors, many firms appoint directors who serve on multiple audit committees. Some observers and commentators have called for regulators to limit the number of audit committees an independent director can serve on. Moreover, little is known of the capital markets' perceptions of the ability of individual independent directors to discharge their governance responsibilities when they serve on multiple audit committees. Sharma et al.'s (2020) study informs these issues.

First, their results suggest that investors generally view service on multiple audit committees as consistent with good governance. Because directors serving on multiple audit committees garner knowledge, experience, and insights that can enhance their governance effectiveness, investors reward such companies by demanding lower cost of equity. Second, when directors serve on more than two audit committees, investors begin to become concerned, measured as an increase in a firm's cost of equity capital. Additionally, the number of audit committees on which a director serves is less of a concern when the director is retired, and more of a concern when the director is currently working. Too many audit committees is four for retired directors and is two for currently employed directors. Sharma et al. (2020) further observe that investors are more concerned when the designated financial expert or the chair of the audit committee appear overburdened.

There are currently no regulations limiting the number of audit committees a director can simultaneously serve on. Each individual board is responsible for ensuring directors have the time to devote to their governance responsibilities. This self-regulation has led to variations in practice and strong investor and proxy advisor activism against directors holding multiple board seats. Most existing guidelines of boards and the NYSE recommend serving on a maximum of four audit committees simultaneously, but do not impose a limit (NYSE 2014). From the perspective of investors, the findings of Sharma et al. (2020) relating to the employment status of the directors, the position held on audit committees, and the effectiveness of the firms' governance, suggest that blanket board and audit committee limit guidelines should be revisited.

The third important implication is that adopting a strategy of balancing individual audit committee busyness does not appear effective, at least in terms of counterbalancing its negative impact on the cost of equity capital. Investors are focused on an individual directors' various directorships and governance roles, and not on the committee and board as a whole.

Finally, Sharma et al.'s (2020) results have implications for researchers interested in investigating the impacts of board and audit committee member characteristics on various market outcomes. Rather than strictly considering overall or average board and audit committee characteristics, researchers should also evaluate the impact of individual directors' characteristics. As proxy advisors and investors have begun to express concern about board member age, tenure, ethnic diversity, and relevant expertise (e.g., Institutional Shareholder Services 2020) investigations of these characteristics on the issues investigated by Sharma et al. (2020) and other issues are ripe for exploration. As the regulations and board practices evolve, the findings from prior multiple director studies and Sharma et al. (2020) warrant new research evidence to inform policy makers and capital market participants.

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