BOARD COMMITTEES

PURPOSE, TASKS, AND VALUE

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Board committees have grown in importance in corporate governance regimes across the UK, USA, and Europe. Yet how exactly they operate, their role and contribution to good governance and sustainable company performance remain insufficiently discussed and researched topics. A 50% increase in committee activities and meeting frequency has been documented over the last 15 years amongst S&P1500 companies.¹ The expanding role and responsibilities of committees in corporate governance are due in part to more tasks being designated to them, but is due also to the financial crisis of 2008 and subsequent increasing pressure from regulation.

There are many types of committees, but our focus will be on audit, remuneration, and nomination committees as mandated by the UK Corporate Governance Code. Other committees are often established to monitor specific areas of company operation or to control areas of special interest,

1 K. D. Kolev, D. B. Wangrow, V. L. Barker, and D. J. Schepker 2019. "Board Committees in Corporate Governance: A Cross Disciplinary Review & Agenda for the Future." *Journal of Management Studies*, 56(6): 1138–1193.

for example, governance, strategic planning, environmental, technology, public affairs, diversity, political contribution, culture, treasury, compliance, and sustainability. The two most common additional committees are corporate social responsibility and risk.² Ethics committees are often set up by businesses to guide and control their development and use of artificial intelligence.

In the UK, the impetus for board committees was initiated with the 1992 *Cadbury Report*³ which mandated the formation of these three committees of the board. This was seen to be a way of perfecting checks and balances and better protecting and serving shareholder interest. The *Cadbury Report* laid out a dual function of committees to “lead” and “control.” Today, there is 90% compliance, with the majority of FTSE350 companies having the three core committees.⁴

The three main committees, audit, remuneration, and nomination, are recommended to be “standing” committees, that is, with regular and frequent scheduled meetings. Terms of reference should exist for each committee which explain the role of the committee and the scope of authority as assigned by the main board. Committees set their own agendas, and both inform and educate the board on the depth and breadth of specific areas of concern. For listed companies, audit and remuneration committees are fully independent, whereas the majority of nomination committees are made up of independent directors. The two main roles of non-executive directors, “monitoring” and “advising,” require significant firm-specific knowledge and often significant personal investment by outside directors. The skills needed on committees are facilitation, engagement, problem-solving, and decision-making, as well as knowledge and experience in the relevant specialism.

This short chapter provides an overview of the purpose and attributes, contribution, and key challenges for each of the three mandatory committees of audit, nomination, and remuneration. The aim is to enable reflection by practising directors through applying the 20 key questions that must be asked with regards to board committees.

2 2019 UK Spencer Stuart Board Index, UK, Spencer Stuart, p. 33.

3 *The Cadbury Report*, 1992. Report of the Committee on the Financial Aspects of Corporate Governance, London, UK, Gee Publishing, pp. 20–36.

4 Grant Thornton, 2019. *Corporate Governance Review 2019*. London, Grant Thornton, pp. 61–62.

Value of committees

Committees set policy and provide both information and decision recommendations to the board. They support the process of governance in helping directors cope with limited time and the complexity of information to review before board meetings. They increase efficiency and accountability, especially to shareholders. It is thought that over half of all board activity takes place at committee level and is then ratified in board meetings. Committees are not only important for the efficiency of the full board but can also contribute to a board culture of cohesion and collegiality. They provide access to resources and act as a potential resource for solving any inherent deficiencies of the full board. Much of the work of the board is prepared by committees, which focus on specific key activities and make recommendations to the board to facilitate decision-making.

The presence of female directors on committees has a positive effect on firm performance, even more so than when female directors are on the main board. This is thought to be due to symbolic integration of women into the governance mechanism. The appointment of women on committees can be a source of competitive advantage and economically more meaningful for firms than if they are on the board.

Committees are often the drivers in emerging markets for increasing the company's attractiveness to international investors. A positive market reaction has been found to firms matching the skills of their directors to committee appointments. When there is a small or largely insider board, then committees positively influence firm performance, whether they are monitoring or advisory in nature. They can also reduce the likelihood of directors "social loafing" or free riding.

Challenges of committees

There is a cost associated with committees, not least non-executive remuneration and expenses, but also time and money spent in engaging, training, and developing them. Their remit to hire outside consultants such as external auditors, recruitment, and compensation consultants also adds to the overall costs of committees. Establishing committees does not exonerate the board from compliance with their legal obligations, and as such, they can face greater scrutiny from shareholders. Larger boards experience

higher costs and risk more individual “social loafing” or free riding by directors.

A problem with committees is the segregation of information from the board which is often spread across several committees. This can be overcome to some extent by multi-committee directors (directors who serve on two or more committees). This usually occurs on aligned committees, for example, audit and remuneration committees, or nomination and remuneration committees. These multi-committee directors tend to be outside or non-executive directors with more expertise and experience. Utilising multi-committee directors in this way allow firms to moderate the costs associated with outside directors; however, there is a risk of overloading when directors serve on three or more committees. Directors can also experience conflict with sitting on two or more committees. For example, a director who sits on nomination and remuneration committees may feel torn between how to nominate the best available talent while keeping remuneration levels in line with stakeholder expectations.

There are certain sensitivities with the CEO sitting on committees, especially remuneration and nomination committees. The presence of the CEO can lead to fewer independent directors on the remuneration committee and with potential conflicts of interest in director selection on the nomination committee. The CEO’s use of ingratiating or persuasive behaviour towards institutional investors has been shown to prevent the formation of an independent nomination committee. In the absence of monitoring by directors, CEOs tend to get awarded higher pay and bonuses when they sit on the nomination committee.

Fault lines or rifts arising from diversity in the composition of committees and between committee directors can lead to conflict and reduced task satisfaction. This disengagement can hinder committee effectiveness. As committees are typically small, turnover of one director can impact the group dynamics, and this change may signal a loss of skills, which can impact committee effectiveness.

Audit committee

The audit committee is the most established and mature of all committees. They ensure robust accounting and financial processes are followed as

well as compliance with disclosure requirements. Audit committees are responsible for the integrity of the financial statements, the performance of internal audit, overseeing financial reporting including disclosure of activities in the annual report, and selecting, overseeing, and improving communication with the independent auditor.

Following the 2008 financial crisis, the *Walker Review* stipulated that all banks, large insurance companies, and other financial institutions should form a separate risk committee. In smaller companies, audit committees may also be responsible for risk management. In the UK, audit committees should comprise at least three independent directors and for small companies outside of the FTSE350, at least two members.

The financial and monitoring expertise of the audit committee chair has a positive influence on financial indicators such as return on assets, return on equity, and the net profit margin. An overlap of the same director on both the audit and remuneration committees can lead to lower executive compensation. The knowledge transfer of tax, risk implications, and accounting practices tends to improve monitoring effectiveness, which is important when managers are less conservative in their accounting choices. The greater the frequency of audit committee meetings, the more corporate risk tends to be disclosed by companies. Committee independence is positively correlated with firm performance; a fully independent audit committee tends to provide more accurate earnings forecasts. For example, independent directors with legal expertise on the audit committee will reduce the likelihood of financial restatements. The greater the expertise on the audit committee, the better the quality and impact of the accounting practices.

Remuneration committee

Remuneration or compensation committees are developing committees, introduced in response to the “fat cat” furore from financial scandals and the 2008 financial crisis. They are responsible for designing and implementing incentives and compensation packages for executive directors and board directors. They should address the six factors of clarity, simplicity, risk, predictability, proportionality, and alignment to culture in remuneration policy and practices.⁴

These committees review and approve the CEO's compensation and senior management compensation one level below the board. Remuneration committees also manage pension rights and are often responsible for policy and approval of employee benefits, bonuses, and salary uplifts. They require the same membership as audit committees in terms of the number of members, and all these directors should be independent. The committee chair should have a minimum of 12 months prior remuneration committee experience.⁴

The presence of a remuneration committee can give greater confidence to investors. The independence of the remuneration committee and the presence of the CEO on this committee don't appear to significantly affect executive compensation. This committee has come under the spotlight with the introduction of shareholder "say on pay," UK legislation which allows shareholders a vote to approve executive long-term incentive plans. This has especially increased public scrutiny of CEO pay according to median pay benchmarks. Maintaining a balance between attractive remuneration for executives and ensuring shareholder and public expectations are met has become a key challenge for this committee.

Nomination committee

As the youngest and least researched committee, nomination or nominating committees are responsible for the selection of both senior executive and non-executive directors with appropriate skills and experience to fulfil their monitoring and advisory roles. They are required to demonstrate formality, rigour, and transparency in the selection objectives and process, including the retention of any independent recruitment consultants or head hunters. This committee increases the likelihood of having effective directors on the board. The nomination committee regularly assesses the performance of the board and the impact the board is having on company and financial performance. It is responsible for board effectiveness via board composition including the process of succession planning.

This committee tends to be chaired by an independent outside director or the main board chair. It should consist of a majority of independent directors. Listed companies have to disclose the activities of nomination committees. The annual report should make explicit any consultants used,

the policy on gender and ethnic diversity, objectives for the year, and what progress has been achieved.

The appropriate education and experiential expertise of the nomination committee chair has been found to positively influence financial indicators of the firm and heighten acceptability of the nomination committee and its output. The independence of the nomination committee leads to more robust monitoring of the influence of the CEO. However, the presence of the CEO on the nomination committee has been shown to lead to fewer independent directors being appointed. When a nomination committee is entirely independent, it tends to have a higher sensitivity between forced CEO turnover and firm performance.

Conclusion

There is still much to learn about what makes a great committee and how their contribution to and impact on the board and firm performance can be enhanced. There are likely to be more committees established, including the less traditional committees specialising in activities pertinent to specific sectors and challenges of the business. There will be a demand for greater agility and resilience, not least, post-Covid-19, and therefore more scrutiny, with a focus on the quality of information and decision-making. Moreover, with the coronavirus and the impact of significant disruptive events, risk committees may assume even more importance. The imminent passing of the governance baton from the Financial Reporting Council to the Audit, Reporting and Governance Authority (ARGA) promotes the professionalisation of the audit function, which will have implications for audit committees.

Questions to ask

- Do you follow best practice with the existence of the three main committees?
- How would you rate the performance of each of your committee chairs?
- Do you have written and explicit terms of reference for each committee?
- Are your committees chaired by independent directors?
- What proportion of independent directors sit on each main committee?

- Does the CEO sit on any of the main committees?
- How well do committees operate in terms of group dynamics and decision-making?
- How well matched are director skills to committee appointments?
- Is your audit committee responsible for risk management?
- Does your audit committee optimise communication with external auditors?
- How transparent and robust are processes around director selection?
- How robust and objective are processes around executive compensation?
- How diverse and inclusive are your committees?
- Do you adequately disclose details about suppliers for audit, remuneration, and director recruitment?
- Can you identify any segregation (or duplication) of information which hinders the operation of the board?
- How well are your committees exercising their “monitoring” and “advising” roles?
- Do you need and can you justify additional specialist committees?
- Do you have multi-committee directors on aligned committees?
- Do you have any directors with potential conflicts of interest?
- How often do you evaluate the composition and effectiveness of your committees?