BOARD COMMITTEE OVERLAP AND CEO COMPENSATION

The board's audit and compensation committees play crucial roles in monitoring managerial financial reporting behavior and aligning incentives between management and shareholders. Recent research in the Strategic Management Journal suggests that the effectiveness of these two committees may be interrelated through directors who serve on both committees. The authors suggest that overlapping directors between the committees can enhance the degree of knowledge transfer between the two committees, increasing the effectiveness of committee decision making.

Key Takeaways:

- Overlaps between compensation and audit committee directors lead to lower total CEO compensation and a higher percentage CEO compensation comprised of base salary.
- When new overlaps are created, CEO compensation is lower and base salary is higher as a percentage of compensation.
- Committee overlap effects on compensation are greater for companies with more conservative accounting practices.

The researchers examined the CEO compensation decisions of public companies from 1998 to 2009, investigating whether overlapping directors between the audit and compensation committees influence CEO compensation. Results indicate that companies with a greater proportion of compensation committee members who also served on the audit committee had lower total CEO compensation and a greater percentage of the CEO's compensation in base salary. This finding was identified during changes in overlaps between the committees, as new overlaps led to lower CEO compensation and greater reliance on base salary immediately, while removing an overlap led to a spike in compensation and drop in base salary. Finally, the authors noted that these effects were most pronounced for companies with conservative accounting practices (e.g., greater reliance on accruals), which they suggest is evidence of knowledge sharing by audit committee members to the compensation committee.

In summary, the authors suggest that directors serving on both the audit and compensation committee play a critical linking role in sharing information between the two committees to enhance decision making effectiveness. The authors suggest that while serving on multiple committees may increase the director's demands, such service can improve incentive alignment.

Source: Brandes, P., Dharwadkar, R., & Suh, S. 2016. I know something you don't know!: The role of linking pin directors in monitoring and incentive alignment. Strategic Management Journal, 37: 964-981.