Board Interlocks and Company Outcomes: A Managerial Accounting Case

Lucy U. Diala
California State University, Fresno

Board interlocks are formed between two company boards when these companies share at least one common director, resulting in a reciprocal relationship from which both partners expect to benefit. Such conditions imply that directors in these interlocks will be less likely to provide strict monitoring oversight (Beckman, Haunschild, Phillips, 2004). This case examines the ethical and governance issues arising from board interlocks. The analysis examines further how board interlocks are less likely to provide strict monitoring functions on firm operations and financial reporting. Participants noted that since board interlocks imply that companies co-share members on their boards in a reciprocal relationship from which both partners expect to benefit, such conditions lead to less rigorous monitoring oversight. Participants also noted that board interlocks may create openings for operational practices with adverse firm outcomes, such as ineffective internal controls over financial reporting.

Keywords: ethics, internal controls, SOX 404, board interlocks

INTRODUCTION

This study examines the role of board interlock relationships on internal controls. Board interlocks may be defined as “a relationship created between two company boards when they share at least one common director”, (Wong, Gygax, Wang, 2015, page 87). In line with SOX’s enhanced board expertise requirements, there has been a reduced supply of qualified corporate directors as the demand for board interlocks has grown. Withers, Kim, Howard, (2015) outline how SOX has led to an outside-director scarcity, by its formalization of oversight roles and enhanced qualification criteria, exacerbating the interlocking board situation as more firms are forced to draw from existing pools of directors. Previous studies have sought to decipher the impacts of board interlock on firm activities and outcomes. For instance, Wong, et al., (2015) examine 725 large publicly traded firms for a period of three years (2007 – 2010) to determine if board interlocks have any bearing on corporate decision making. They find that board interlocks positively relate to executive compensation packages in interlocked firms, especially regarding options. They also found that board interlocks play a role in defining board characteristics. Other studies document the potential gains by directors who sit on the boards of more than one company, forming the board interlocks, such as gains in prestige and social capital (Fich, 2005; Fahlenbrach, Low, Stulz, 2010). Also, as firms tend to draw outside directors from a pool of their own networks, socially embedded ties result in interlocking boards. Thus, interlocking boards may have the tendency to be less rigorous in their oversight of firm operations in keeping with the preservation of their social capital.
LITERATURE REVIEW

Internal Controls Over Financial Reporting

The Sarbanes-Oxley Act (SOX) (U.S.) is an act of Congress passed in 2002 that mandates the evaluation of a firm’s management practices and independent audits of internal control effectiveness. Internal control is a set of procedures and processes used by a company to safeguard its assets, process information accurately, and ensure compliance with laws and regulations. The passage of SOX was intended to enhance the effectiveness of companies’ internal controls; it came about over great concerns with managerial corporate scandals and malpractices that came to light in the early 2000s. During that period stockholders, creditors, investors, and other stakeholders lost billions of dollars. As a result, Congress passed SOX to help restore public confidence and trust in companies’ public disclosures. This act also improves the reliability of a firm’s corporate governance and financial reporting and applies only to publicly traded companies. Internal controls is a process that is designed to provide external stakeholders with the assurance that firms maintain effective and efficient procedures and processes that safeguard stakeholders’ assets. It is important for firms to have good internal controls for a number of reasons, including, but not limited to, lower cost of debt, reduced forecast and management errors, and more efficiency in investment decisions (Ashbaugh-Skaife et al., 2009; Cheng, Dhaliwal, & Zhang, 2013; Clinton, Pinello, & Skaife, 2014; Costello & Wittenber-Moerman, 2011; Feng, Li, & McVay, 2009). Internal controls over financial reporting (ICFR) is defined as:

“A process designed by, or under the supervision of, the company’s principal executive and financial officers or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes by generally accepted accounting principles…” (Auditing Standard No 2, Public Company Accounting Oversight Board, 2004, para. 7).

Firms lacking in this process are seen as firms with ineffective ICFR. To ensure that firms reduce ineffective ICFR, Section 404 and 302 of the Sarbanes-Oxley Act require that firms track and document the effectiveness of their internal control practices. The Act was instituted by Congress to improve auditing of U.S. public companies and aimed at increasing and regulating auditing oversight (Coates & Srinivasan, 2014). Prior to the passage of SOX, firms were only required to report deficiencies in their internal controls to the U.S. Securities Exchange Commission (SEC) if they changed auditors (Doyle et al., 2007a). SOX improved the information environment on ICFR by requiring disclosure under Section 302 and 404. Section 302 became effective starting in 2002 and requires firm CEOs and CFOs to assess and disclose the effectiveness of their internal controls on annual and quarterly reports, forms 8K, registration statements, and proxy statements. If managers find a material weakness in their firms’ internal controls, they must disclose the material weakness and the material changes in internal controls. Section 302 relies on managers’ judgment and discretion in identifying and reporting material weakness in ICFR, although most firms did employ the oversight of auditors.

While Section 404 also requires that managers document, test, and report on the effectiveness of their firms’ internal controls and issue annual statements on the material weaknesses similar to Section 302, it significantly contrasts from 302 by adding a requirement that auditors issue a separate statement providing an opinion on whether the company has maintained effective or ineffective internal controls in their financial reporting. If there is a material weakness, the auditor provides an adverse opinion on internal controls. If auditors fail to see adequate preparation, infrastructure, policies, and procedures toward sound ICFR, they will likely report ineffective ICFR opinions for defaulting firms. The likelihood of reporting material weakness, if it indeed exists, is more likely if managers are aware that their reporting on internal controls will be audited and opinions by the auditors will in turn, be reported. Ge and McVay (2005) find that firms engaging high-quality auditors are more likely to disclose the incidence of material weakness.
Board Interlocks Under SOX

Since several corporate governance failures led to the passage of SOX, the Act since 2002 has attempted to regulate the dynamics of company corporate governance bodies as evidenced in some of its provisions mandating a majority of independent directors on the boards of public firms and the use of audit committees comprised of independent companies. These rules were implemented with the expectation that executive and non-executive directors should provide different functions to the board. For instance, executive directors who work under the CEO and as such are less likely to confront the CEOs, thereby reducing the monitoring effectiveness, can have a counter effect by using independent non-executive directors providing monitoring functions. As firms have put resources into meeting SOX standards, adherence to SOX regulations have not come without criticism, for instance, Holmstrom and Kaplan (2003) find that SOX’s impact is more costly for small firms when faced with compliance costs, uniform for all firms regardless of size.

Chhaochharia and Grinstein (2007), also find that the benefits of SOX are more frequent on larger firms because of compliance costs. However, despite the emphasis on aversion to costs from regulation, several studies have found that for most firms the benefit from adherence to SOX as affects internal controls outweigh the costs over time (Alexander et al., 2013; Coates & Srinivasan, 2014). Moreover, several studies demonstrate that firms found with high internal control deficiencies are more likely to experience higher equity and debt costs, minimized management and analyst forecast accuracy, and less reliability on financial reporting (Ashbaugh-Skaife et al., 2009; Clinton, Pinello, & Skaife, 2014; Defond & Francis, 2005; Dhaliwal et al., 2011; Doyle, Ge, & McVay, 2007; Feng et al., 2015; Li, Pincus, & Rego, 2008). Considering the benefits of maintaining sound internal controls, more firms have undergone major changes in their corporate structure to meet the Act’s requirements.

Studies on the changes have covered legislative policy, stock exchange policies, intra-firm emphasis on accountability and overall board independence (Hoskisson, Castleton, Withers, 2009; Coates, Srinivasan, 2014). While executive directors are expected to have firm knowledge that equip them to serve competently on their firms’ boards, non-executive directors providing outside board monitoring often may not have the firm knowledge to provide board oversight. This has led to a growing demand of outside boards that have industry knowledge and thus can provide useful contributions on oversight boards, so much so

<table>
<thead>
<tr>
<th>Section 301</th>
<th>Whistleblower Provisions: SOX requires publicly traded companies to provide a means for employees to anonymously report on non-ethical or questionable accounting practices.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 302</td>
<td>CEO &amp; CFO Responsibilities: SOX requires publicly traded companies to put in place internal procedures that would ensure the accuracy of financial statements and internal control structures.</td>
</tr>
<tr>
<td>Section 404</td>
<td>Internal Controls: SOX requires publicly traded companies to annually test the effectiveness of internal controls over financial reporting. External auditors must provide oversight on internal controls.</td>
</tr>
<tr>
<td>Section 906</td>
<td>Penalties. SOX requires publicly traded companies to accurately report their financial positions. False categorizations will be awarded penalties such as monetary fines or prison time.</td>
</tr>
</tbody>
</table>
that firms have had to use non-executive directors who serve on other firm boards to also perform board functions in their own firms (Linck, Netter, Yang, 2009). The board interlock situation, “a relationship created between two company boards when they share at least one common director”, (Wonga, Gygaxb, Wange, 2015, page 87), was then formed.

Following the passage of SOX, and the corporate governance changes accompanying it, firms have recognized the advantages of seeking out-of-network partners from interlocks by increasing their networks and thus providing more access to new linkages and resources (Withers, Kim, Howard, 2018). To expand on board interlocks from indirect networks, consider a case where in making investment decisions, firms A and B agree to co-share members on their boards in a reciprocal relationship from which both partners expect to benefit. Such conditions imply that directors in these interlocks will be less likely to provide strict monitoring oversight creating openings for operational practices that may lead to adverse firm outcomes such as in ineffective ICFR.

Additionally, firms may invite outside board members from other firms building interlocks with them, intended to reinforce inter-firm relationships (Beckman, Haunschild, Phillips, 2004). Beckman et al., discussed this phenomenon by outlining how the alliance partners could be formed from the firms’ direct networks or other pre-existing relationships that the firms already have. This alliance-based relationship emphasizes further how board interlocks are less likely to provide strict monitoring function on firm operations and financial reporting. Abdioglu, et al. (2015) investigate equity holdings of foreign institutions after the passage of SOX. In their investigation, they find that board interlocks reduce governance quality, negatively impacting foreign institutional investments. While that investigation does not address internal controls it implies that management’s reduced monitoring in the presence of board interlocks lead to operating decisions eventually affecting firm outcomes.

CASE STUDY APPLICATION

The case was designed as part of a curricular application of ethical scenarios in teaching students in a managerial accounting class about the Sarbanes Oxley Act of 2002. The case covered management’s governance methods applied by publicly traded companies and examined several company outcomes obtained from peer-reviewed articles. Students provided pre-case survey responses on their knowledge of the subject matter. After the resources were covered in class and through homework assignments, they again provided post-case survey responses.

Case Study Organization

Peer reviewed papers covering board interlocks were used as a framework to examine the effects of their uses on company outcomes. Since a vast body of research exists on board interlocks the case organized available papers into six categories consistent with the literature review on functions of board interlocks (Lamb & Randy, 2016). The categories include, 1) Resource-seeking, 2) Monitoring, 3) Signaling 4) Human-capital Access, 5) Career advancement for Directors, and 6) Social-ties. Students were split into six groups and given research papers covering each category. Students were asked to gather and document data signaling the outcomes of each category based on the research papers. Students organized their findings into governance and ethics categories using data analysis tools including Excel and Google docs spreadsheets. Students then answered the following questions:

1. Perform an analysis on the benefits/drawbacks of the board interlock category you have been assigned
2. Categorize the benefits/drawbacks from the standpoint of ethics and governance using the class resources.
3. Upon performing all the above, what is your opinion on the implications of board interlocks in corporate governance?
In-Class Sessions

Prior to assigning the case, I taught corporate governance related to Sarbanes-Oxley Act of 2002 to provide students some background on company level managerial issues within and beyond company level. Since the case application involved reading of research papers, I integrated paper review proofing to ensure that they could identify salient parts of the literature pertinent to the subject matter allowing them to draw conclusions. This was done in 30-minute sessions instead of a regular class time, twice a week. Students were then split into groups and class discussions on the papers ensued. The case was assigned in the following week and class discussions involved ensuring that students had a good grasp of board interlocks and the categories they would review. Students then began working on their assignments. I provided instructor support over three weeks, covering about 20 minutes per class while students were working on the assigned case.

CASE EFFICACY

A survey instrument was used to assess teaching efficacy, consistent with several research studies who have used this method in case-based accounting education (Apostolou et.al., 2013; Blazovich et. al. 2014; Grim, 2015: Matherly & Burney, 2013). Prior to beginning the introductory classes covering SOX, I applied pre-test surveys and after the case responses were concluded and submitted, but before assigning grades, I applied a post-test survey. Students rated their perceived knowledge on identifying the benefits/drawbacks of board interlocks using a 5-point Likert scale with scoring ranging from strongly agree to strongly disagree. The results of the pre-post surveys indicated that students felt that they gained knowledge on the implications of board interlocks in corporate governance. Their qualitative entries also provided insight into their take on ethics and governance issues of board interlocks. The majority suggested more oversight in cases where board interlocks are the practice in corporate governance. Survey results are outlined in Table 1 below.

<table>
<thead>
<tr>
<th>Response</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting students – upper division</td>
<td></td>
</tr>
<tr>
<td>Session 1</td>
<td>41</td>
</tr>
<tr>
<td>Session 2</td>
<td>35</td>
</tr>
<tr>
<td>Total</td>
<td>76</td>
</tr>
</tbody>
</table>

Q1. Rate your level of knowledge of board interlocks as a corporate governance measure following the passage of Sarbanes Oxley Act of 2002.

<table>
<thead>
<tr>
<th>Response</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Means of student opinion – pre-test</td>
<td>1.510</td>
</tr>
<tr>
<td>Means of student opinion – post-test</td>
<td>2.544</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Response</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>P(T&lt;=t) two-tail</td>
<td>(0.010)**</td>
</tr>
</tbody>
</table>

Q2. Rate your level of knowledge on the cost benefits of board interlocks.

<table>
<thead>
<tr>
<th>Response</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Means of student opinion – pre-test</td>
<td>1.523</td>
</tr>
<tr>
<td>Means of student opinion – post-test</td>
<td>2.722</td>
</tr>
<tr>
<td>Question</td>
<td>Mean Opinion Pre-test</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Q3. Rate your level of knowledge on the primary functions of boards and board oversight of companies.</td>
<td>1.863</td>
</tr>
<tr>
<td>Q4. Rate your level of knowledge on benefits that company directors may gain from board interlocks.</td>
<td>1.710</td>
</tr>
<tr>
<td>Q5. Rate your level of knowledge on issues that companies may face due to board interlocks.</td>
<td>1.690</td>
</tr>
<tr>
<td>Q6. Rate your level of knowledge on the ethics/governance implication of board monitoring</td>
<td>1.693</td>
</tr>
<tr>
<td>Q7. Rate how comfortable you feel using data analysis tools to organize the benefits and drawbacks of board interlocks.</td>
<td>1.720</td>
</tr>
<tr>
<td>Q8. Rate how comfortable you feel using data analysis tools to draw conclusions on the benefits and drawbacks of board interlocks.</td>
<td>1.732</td>
</tr>
</tbody>
</table>

Responses were provided on a five-point scale anchored at strongly disagree (1) and strongly agree (5)
*Significant at the 10% level
**Significant at the 5% level
***Significant at the 1% level

**Student Qualitative Opinions**
Students also provided qualitative or open-ended responses on their opinions on the use of board interlocks. Students commented that board interlocks may allow companies to gain beneficial outcomes.
such as resources to lessen the uncertainties in the market, provide an avenue for lenders to provide company oversight, and access higher quality human capital among others. They also found that ethical/governance issues intertwine with the beneficial outcomes of board interlocks. For instance, students commented on the potential for directors seeking career advancements and that social ties could interfere with rigorous monitoring oversight. Overall students commented that they benefitted from the case.

CONCLUSION

There continues to be a need to integrate ethics issues in accounting curricula. For example, the American Accounting Association Public Interest Section calls for developing new pedagogy in 2024 for teaching ethics to accounting students. The timeliness of this research is therefore evident. As the field of accounting continues to find ways to increase the pipeline of accounting students, incorporating a case study into the accounting curriculum that allows students to engage in practice-oriented matters within a classroom setting provides them with skills that could set them apart when entering the workplace.

To conclude this study, it is also important to note its limitations. The case was conducted over one semester and was applied on managerial accounting students. More studies could include this case application over several stages of accounting education. Such an application would provide more insight into students’ learning and possibly broader perspectives. The study was also limited to one form of learning efficacy, pre and post-surveys. Other forms of efficacy could combine students’ scores and categorized open-ended responses or even focus-groups. Overall, the case provides benefits useful for integrating ethics in accounting education.

REFERENCES


