

Board Function and Risk Management: Literature Review

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(Abstract)

This paper is an attempt to give a short description of theoretical literatures for scholars and papers for practitioners, focusing on a correlation among board (corporate governance), firm performance, and risk management. Do boards play generally accepted legal and academic roles; 1) to establish the basic objectives, corporate strategies, and the board policies of the company, 2) to ask discerning questions to managers, and 3) to select the president in business practice? Does good corporate governance bring higher firm performance? If so, what kind of board composition determine the improvement of the firm performance? Does risk management activity by the board members create firm value? Stewardship Code and Ito report were already formulated in 2014 and Corporate Governance Code is being laid down in 2015 in Japan. Tokyo Stock Exchange announced that two or more outside directors to be included in corporate governance as listing requirement and ratio of female board director is being discussed. These phenomena may become a trigger of influencing on all persons and financial institutions relevant to Japanese capital market. It is worth examining prior literatures on the aforementioned for further argument in Japanese capital market.

Keywords: Board Composition, Firm Performance, Risk Management

1 Introduction

Japanese Financial Supervisory Agency (FSA) launched “Stewardship Code” and Ministry of Economy, Trade, and Industry (METI) announced “Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors”, called “Ito Report” in 2014. FSA schedules to formulate “Corporate Governance Code” in 2015. It is said that these two codes and Ito Report have a possibility influencing on all persons and institutions relevant to capital market, so called investment-chain, overall in the future¹.

Corporate value creation over operational process always accompanies risk-taking in corporate strategy. Board is expected to play a more important role in corporate governance including risk management than ever before since foreign investors are increasing in shareholder proportion. However we have to admit that Japanese capital market is still in a primitive stage in board composition argument, namely beginning to introduce just one or two outside director(s) into board members although a board evaluation by the third party facilitator(s) was already introduced in the beginning of 1990s in Western countries especially UK. Of course Japanese capital market has a unique developmental history under Japanese trading customs, such as main banking system and mutual stockholding but needs to respond to so called global corporate governance required by foreign investors.

There are considerable prior literatures about a correlation or causality between board with various determinants and the firm performance, but has been considerable controversy in the literature. Meanwhile there are fairly limited literatures on the relationship between board function and risk management. Risk management is a management activity to raise company sustainability or resilience. This study is an attempt to survey relevant literatures with the following three key words: “board” as corporate governance, “performance”, and “risk management”. It is worth putting such arguments into shape through literature review for a development of Japanese corporate governance.

This paper is structured as follows: 2. Research Methodology, 3.1 Is there any difference between legislative / expected role and reality of board in function? What determines board makeup? 3.2 What board composition determinants contribute to the performance, if any? 3.3 How does risk management play the role in line with board expected function? 4. Concluding Remarks.

2 Research Methodology

2.1 Literature search

In order to systematically review the literature related to the captioned, my first step was to develop a criterion for including papers in the review. Key words research was made through Social Science Research Network, SSRN; “board” and “performance” or “risk management” in abstract.

Papers were selected top 50 and newest 100, by number of downloaded instead of ISI impact score for quality assessment. Once papers were identified the references reviewed for assist in locating additional papers, which resulting in “snowball sampling effect”.

2.2 Review Framework

Prior literatures are arranged and summarized the following manner: 1) Title, Released year, 2) Research Question, 3) Data & Methodology, 4) Findings (others). In case the literature includes something related to risk management in section 3.1 through 3.3, some more explanation is added after 4) Findings.

3 Literature Review

3.1 Board function

3.1.1 Mace (1971, 1986)

Title, Released: Directors: Myth and Realty, 1971 & 1986

Research Question: A considerable gap between the academic or legal definition of board functions, and what board actually do².

Data & Methodology: Attending board meeting, interviews with executives in unscripted conditions. The study is confined to manufacturing, mining, and retailing companies.

Findings: Although generally accepted roles of boards are 1) to establish the basic objectives, corporate strategies, and the board policies of the company, 2) to ask discerning questions; and 3) to select the president³, most boards do not perform the functions. Indeed, management performs the function, and the board may or may not be involved in approving the policies, strategies, and objectives defined by corporate management⁴. In most of company board of directors serve as a source of advice and counsel, serve as some sort of discipline, and act in crisis situations. President determines what boards do and do not do. A few boards evaluate and measure the

performance of the president and select and de-select the president. Most do not.⁵

There have been no significant changes in business corporation law as during the last fifteen years and no significant modifications in what directors do and do not do. Cosmetic reforms have been instituted, such as the introduction of committees on public responsibility and nominating committees, but these are largely controlled by CEOs⁶.

3.1.2 Adams (2009)

Title, Released: The Role of Boards in Corporate Governance: A Conceptual Framework & Survey, 2009

Research Question: What determines board makeup? What determines board action?

Data & Methodology: Review prior literatures

Findings (valuable reviews for this attempt): 1) Quoted from Demb (1992): approximately two-thirds of directors agreed that setting the strategic direction of the company was one of the jobs they did. Eighty percent of the directors also agreed that they were involved in setting strategy for the company⁷, 2) Besides direct compensation, reputation will cause an agent to act more in his principal's interests than standard approaches to agency might suggest, reputational concerns cause the agent to shy away from risky projects⁸, 3) Research questions are fundamentally intertwined because the makeup affects what the board does and consequently their makeup is influenced by a desire to affect what they do⁹. 4) Firms with staggered boards do worse than firms with annual board elections. Stock market reaction to announcement about whether the board will be staggered or not could be due to the news announcements convey vis-à-vis the bargaining toughness and independence of the board rather than to simply whether the board is or isn't staggered¹⁰.

3.1.3 Charan (2014)

Title, Released: BOARDS THAT LEAD WHEN TO TAKE CHARGE, WHEN TO PARTNER, AND WHEN TO STAY OUT OF THE WAY, 2014

Research Question (theme): Seeking a practical road map for directors. Identifying a distinctive social architecture that is now required of companies if directors are to lead the enterprise along with executives, not just stand guard over it¹¹.

Data & Methodology: Interviews with CEOs, executives, and officers

Findings (suggestion): Chief executives must run the corporation, but directors must also lead the corporation on the most crucial issues. Monitoring is still important.

Director's collaborative leadership: Define the central idea, Recruit directors who build value, Root out dysfunction, A leader of the board, CEO succession, A question of fit, Spotting, catching, or existing a falling CEO, Turning risk into opportunity, and Staying out of the way.

For all the advantage it brings, the increasing leadership by the governing board in major company decisions can create seriously adverse repercussions. Directors who wander too far into day-to-day operations where they have little expertise but strong opinions do an enterprise little good and can cause real damage^{1 2}. To encourage director involvement in critical issues but not beyond, many companies explicitly identify which decisions should be made by directors, either alone or in concert with executives and which should be reserved for executives alone. They typically do so through several devices. The author exemplify the followings done by executives as lines in the sand; 1)Annual Calendars, 2)Committee Charters, 3)Decision Protocols, 4)Decisions Reserved for the Board of Directors and as the no-fly zone: judgment of chief executive and board leader and representing the company to regulators, raters, or reporters (an exception is a well-orchestrated, face-to-face engagement of directors along with executives dialogue with investors)^{1 3}.

3.1.4 Summary

A major finding was that directors of large- and medium-sized companies did not do much to represent their principal constituency, the stockholders. Unhappily, not very much had changed in the decade..., ... As was the case ten years ago, ... C.E.O.'s still control board membership; determine what the board does and does not do...^{1 4}. This is what was published in 1986 and may be still a valid observation on boards because we find almost all the same article in the newest book, Charan (2014). In most of company board of directors serve as a source of advice and counsel, serve as some sort of discipline, and act in crisis situations. Meanwhile approximately two-thirds of directors agreed that setting the strategic direction of the company. Board of directors is expected to play a more strategic decision making than ever before, which depends on firm to firm.

What determines board makeup and board action? These questions are fundamentally intertwined because the makeup affects what the board does and consequently their makeup is influenced by a desire to affect what they do.

Based on the above view, board composition determinants in line with the company performance is continued to review at the next section.

3.2 Board composition determinants and performance

3.2.1 Wessels(2014)

Title, Released: What is the Relation (if any) Between a Firm's Corporate Governance Arrangements and its Financial Performance? 2014

Research Question: How corporate governance and the firm's performance are related with a hypotheses equilibrium view, as firms on average make constrained, optimal allocation choices.

Data & Methodology: A cross-section of 1551 firms in 2000 through 2008, Regression. Variables: Number of members of the board of directors, annual total compensation of the CEO, free cash-flow, number of institutional investors, market-to-book ratio, sum of expenditures on R&D, percentage of total shares owned by the executive officers of the firm, indicator for the membership of S&P's 1500 stock market index, stock return, standard deviation of returns.

Findings: Correlation between governance and performance is statistically zero. Governance policy mandating changes in corporate governance arrangements are more than likely to have negative effects on firm performance. Governance and performance are correlated in a situation in which there is no equilibrium since firms could improve performance by making changes to their governance arrangements. If the constraints imposed by the new regulations are binding from above, such changes imply that in the new optimum performance will be strictly lower than in the optimum prior to the regulatory change.

3.2.2 Gompers(2003)

Title, Released: CORPORATE GOVERNANCE AND EQUITY PRICES, 2003

Research Question: Is there a relationship between shareholder rights and corporate performance?

Data & Methodology: Investor Responsibility Research Center (IRRC) 1,500 firms during the 1990s. OLS
Created "Governance Index" as a proxy for the balance of power between shareholders and managers, five categories; 1)Delay, 2)Protection, 3)Voting, 4)Other, 5)State

Findings: Firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditure, and made fewer corporate acquisitions. An investment strategy that purchased shares in the lowest-G firms ("Democracy" firms with strong shareholder rights), and sold shares in the highest-G firms ("Dictatorship" firms with weak shareholder rights), earned abnormal returns of 8.5 percent per year. Each one-point increase in G is associated with a decrease in

Tobin's Q of 2.2 percentage points. By the end of the decade, this difference has increased significantly, with a one-point increase in G associated with a decrease in Tobin's Q of 11.4 percentage points. However the data do not allow strong conclusions about causality.

3.2.3 Brown(2004)

Title, Released: Corporate Governance and Firm Performance, 2004

Research Question: Which factors (51 factors created by authors) is most highly associated with firm performance.

Data & Methodology: 2,327 firm data provided by ISS as of Feb. 1, 2003

Financial data were obtained from Compusat. , Cross sectional analyses

Created 8 categories: 1)Audit, 2)Board of directors (board is controlled by more than 50% independent outside directors), 3)Charter/bylaws, 4)Director education (at least one member of the board has participated in an ISS-accredited director education program), 5)Executive and director compensation (directors receive all or a portion of their fees I stock), 6)Ownership, 7)Progressive practices, 8)State of incorporation

Findings: Better governed firms are relatively more profitable (ROE), more vulnerable, and payout more dividends to their shareholders and repurchase more shares from shareholders. They find that the governance category, executive and director compensation, is most highly associated with good performance while the governance category, charter/bylaws, is least highly associated with good performance.

13 factors out of 51 measured are associated with good performance; 1)all directors attended at least 75% of board meetings or had a valid excuse for non-attendance, board is controlled by more than 50% independent outside directors, nominating committee is independent, governance committee meets once a year, board guidelines are in each proxy statement, option re-pricing did not occur in the last three years, option burn rate is not excessive, option re-pricing is prohibited, executives are subject to stock ownership guidelines directors are subject to stock ownership guidelines, mandatory retirement age for directors exists, performance of the board is reviewed regularly, and board has outside advisers.

And the identify seven factors are associated with bad performance, namely, consulting fees paid to auditors are less than audit fees paid to auditors, managers respond to shareholder proposals within 12 months of shareholder meeting, board members are elected annually (no staggered board), a simple majority vote is required to approve a merger(not a supermajority), company either has no poison pill or a pill that was shareholder approved, a majority vote is required to amend charter/bylaws

(not a super-majority), and all directors with more than one year of service own stock^{1 5}.

3.2.4 Larcker(2005)

Title, Released: How Important is Corporate Governance? 2005

Research Question: Develop governance indices, 14 factors characterize the dimensionality of 39 individual governance indicators (e.g., board size, directors that are member of other boards or busy, multiple dimensions of anti-takeover devices, etc.)

Data & Methodology: www.SharkRepellent.net by TrueCourse, Inc. n=3,651 2002 - 2003

Data set covered by Equilar, Inc. n=3,000 2002 – 2003

Exploratory principal component analysis, OLS

Findings: “14 factors”(*) out of 39 individual governance indicators are related to future operating performance, have a somewhat mixed association with abnormal accruals, Tobin’s Q, and future excess stock returns, and little relation to class action lawsuit and accounting restatements^{1 6}.

*: 14 factors mentioned above; 1)Active, 2)Block, 3)Affiliated, 4)Insider appointed, 5)Compensation mix, 6)Meetings, 7)Lead director, 8)Ant-takeover 1, 9)Old directors, 10)Debt, 11)Insider power, 12)Board size, 13)Antii-takeover2, 14)Busy directors^{1 7}

Under this dynamic learning view of organizational design, the expected association between the governance residuals and the outcome variables will depend on both the nature of the outcome variable and the nature of governance variable.

For the variables that are increasing in “bad” outcomes (accruals, restatements, lawsuits, and the inverse of Q), we expect to see negative coefficients on both the negative and positive residuals of governance variables that are “good” (Active, Block, Meetings, Lead Directors, and Debt) and positive coefficients on both the negative and positive residuals of governance variables that are “bad” (Affiliated, Insider Appointed, Compensation Mix, Annti-Takeover1, Old Directors, Insider Power, Board Size, Anti-Takeover2, and Busy Directors).As active variables increases the firm has more good governance which would be associated with less bad behavior in the dynamic learning view^{1 8}.

3.2.5 Xie(2001)

Title, Released: EARNINGS MANAGEMENT AND CORPORATE GOVERNANCE: THE ROLES OF THE BOARD AND THE AUDIT COMMITTEE, 2001

Research Question: Relation among earnings management and the structure, background, and composition of a firm’s board of directors with an interest in the role

played by outside directors; their background in corporations, finance, or law; and their membership on two key board committees, the audit and executive committees.

Data & Methodology: Final sample 282 firm-year, from S&P500 100 firms (alphabetically) 1992, 1994, and 1996, OLS

Findings: 1) Earnings management is less likely to occur or occurs less often in companies whose boards include both more independent outside directors and directors with corporate experience. 2) The composition of the audit committee is associated with the level of earnings management and thereby may allow a committee to better perform oversight functions. 3) The proportion of audit committee members with corporate or investment banking backgrounds is negatively related to the level of earnings management. 4) An association between lower levels of earnings management and the meeting frequency of boards and audit committees. 5) Board and committee activity influences members' ability to serve as effective monitors. 6) As a caveat, the authors don't interpret to demonstrate a causal link between board and audit committee composition and earnings management because of the endogeneity problem impacting much of the board literature¹⁹.

3.2.6 Hopt(2004)

Title, Released: Board Models in Europe, Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy, 2004

Research Question: A good corporate governance depends on a balanced interplay between the distinct internal and external control devices?

Data & Methodology: Review European corporate governance history and compare board models and development among Germany, United Kingdom, France, and Italy.

Findings (a trend report): 1) Germany: Two tier board model in comply or explain approach regardless of size or listing. The supervisory board controls the management (not the corporation), its compliance with the law and articles of the corporation, and its business strategies. Committees are less common compared with the UK or the US. However a strongly growing tendency towards nomination, remuneration, and audit committees can be observed. Many companies make use of their former managers' business knowledge by offering them seats on the supervisory board when they retire. In particular, the chairman of the management board often changes over and takes the chair of the supervisory board. An illustrative example for inherent conflicts of interests is the common practice of mandating representatives of banks or of their investment branches. The business relationship, especially the German system of

cross shareholdings, has encountered major criticism by foreign investors. Companies with 2,000 workers or more must have half their supervisory board composed of labor representatives. It takes into account the coalition of interest between shareholders and stakeholders including employees and even the public interests. In the US, members of audit committees must prove their qualification and experience in accounting and finance. In Germany, it is impossible to set a general standard above a certain level of financial literacy. The primary function of audit committees in German companies is the coordination of control, revision, and auditors. The external auditor is elected by the general meeting. However auditor plays a role as a partner of the supervisory board²⁰.

2) UK: One tier board model. The listing rules require a company to annually state how it has applied the principles and as to whether or not it has complied with the code provisions. Building on the review undertaken by Higgs it emphasizes that non-executives should not only monitor management but also contribute to the development of strategy. A core element of the Combined Code is its recommendation to compose at least half the board of independent non-executives, excluding the chairman. All directors have the same powers, non-executive directors can also take the initiative in management decisions, and they are not restricted to post-decision approval like the German supervisory board. The duty of care and skill was debated because, according to the subjective element it employed, directors could escape liability fairly easily. Corporate governance in the UK does not so much rely on enforcing managerial care by directors' personal liability, but rather on the danger of removal by ordinary shareholder resolution, and in particular as a consequence of a change of corporate control. The chairman should be separated from that of the CEO should meet the independence test on appointment. A paradigm of independence and of the no-conflict rule is the position of a nominee director, who specifically serves to represent and to protect the interest of some outside party. The system of internal controls as promoted under the Combined Code includes the group wide supervision of financial, operational, and compliance controls and risk management. Its effectiveness is to be reviewed at least annually, and the results of the review have to be reported to shareholders. The task of the audit committee is to set the scope and to review the results of the audit, its cost effectiveness, and the independence and objectivity of auditors²¹.

3) Convergence: English board has taken a development towards German model, separation of the positions of board chairman and CEO. Shareholder activism clearly is a means of backing up internal controls, and it is surprising that the UK and

Germany are only slowly exploring the potential of derivative actions, which are firmly rooted in the corporate governance concept of the US.

4) Self-regulation and flexibility of board structuring: The merits of soft law, having proved successful in UK, - its adaptability and its power to provide common denominators for investors -, depend on the flexibility granted under the national law. The tendency in Europe points towards an increase flexibility. German law, inflexible government and workers' unions on co-determination, is outdated. Stricter independence is one of the cornerstones for efficient control. However management knowledge and business relations of the board of directors can be highly useful for both the running and the control of the company. Setting the necessary standards of disclosure will be one of the challenges, particularly in regard to cross shareholdings. Continental Europe has been one step behind, but it's making up for lost time. Disclosure is an important interlinkage between internal control by the supervisory board or, in the one-tier board model, by non-executive directors, co-determination by labor unions and external controls by capital markets.

3.2.7 Adams(2008)

Title, Released: Women in the boardroom and their impact on governance and performance, 2008

Research Question: Impact of women directors on observable board inputs: attendance and committee assignments.

Data & Methodology: S&P500, S&P MidCaps, and S&P SmallCap, 1996 – 2003, OLS

Findings: 1) Female directors have better attendance records than male directors. 2) The more gender-diverse the board is, women are more likely to join monitoring committees. 3) CEO turnover is more sensitive to stock performance and directors receive more equity-based compensation in firms. 4) Diversity has a positive impact on performance in firms that otherwise have weak governance, as measured by their abilities to resist takeovers. In firms with strong governance enhancing gender quotas in the boardroom could ultimately decrease shareholder value. One possible explanation is that greater gender diversity could lead to over-monitoring in those firms.

3.2.8 Swan(2014)

Title, Released: Does Board “Independence” Destroy Corporate Value? 2014

Research Question: The effects of board characteristics (the proportion of Regular

and Incentivized Gray (*) directors and board size) on market-based firm performance measures (Tobin's Q and Market-to-Book), and the effect of weaker monitoring on CEO pay and Director fees^{2 2}. (*): "Gray" means regular outside directors with some previous or current affiliation with the firm^{2 3}. The Australian Securities Exchange (ASX) Corporate Governance Council (CGC) has required from the commencement of 2003 that all listed firms either adopt a majority of "independent" board members without links either to management or to substantial shareholders or explain "if not, why not".

Data & Methodology: ASX-listed Australian companies between 2001 and 2012 from SIRCA's Corporate Governance Database, Probit regression, fixed effects regression analysis, and others

Findings: 1) Firms with a high proportion of either regular or incentivized Gray directors are more likely to reduce the overall proportion of Grays, 2) They could find no evidence that a higher proportion of executives on the board improves firm performance and typically the presence of a higher proportion of real independent directors worsens firm performance, 3) The greater is the presence of regular gray directors on the board as a proportion the more favorable is the market reaction to the takeover announcement, 4) The presence of a higher proportion of executives on the board, and a higher proportion of Incentivized executives on the board with 5% or more shareholding, significantly reduces CEO pay. However the proportion of real independent directors on the board had no influence, 5) Non-executive director's compensation is estimated with the lagged proportion of regular gray directors, the lagged proportion of Incentivized Gray directors on the audit committee, the lagged proportion of directors considered to be both regular gray directors and Incentivized Gray directors on the Audit committee, an indicator for whether the CEO is the chairman, and the logarithm of lagged board size, 6) Real Gray directors possessing an intimate knowledge of the firm make better dividend decisions that are in the interests of shareholders, 7) A higher proportion of dual regular and incentivized Gray directors on the board that significantly reduces the leverage ratio, 8) Although Wintoki (2012) shows contemporaneous board structure variables such as the proportion of independent directors depends significantly on lagged ROA, the author shows four (**) of five board structure variables there is no trace of dependence on past performance, as measured by Lag1 LN Tobin's Q. (**): Lag1 Prog. PGs Board, Lag1 IGs Audit Com., Lag1 Prop. Dual RGs IGs Board, and Lag1 CEO Chairman.

Lag1 means one year lagged.

3.2.9 Bhagat(2007)

Title, Released: Corporate Governance and Firm Performance, 2007

Research Question: The relationship between corporate governance and performance by taking into account the endogeneity of the relationship among corporate governance, corporate performance, corporate capital structure, and corporate ownership structure.

Data & Methodology: IRRC, TCL, and CRSP, OLS

Findings: 1) Better governance (G-Index), stock ownership of board members, and CEO-chair separation are significantly positive with contemporaneous and subsequent operating performance. Board independence is negative. 2) None of the governance measures are correlated with future stock market performance. 3) Given poor firm performance, the probability of disciplinary management turnover is positively correlated with stock ownership of board members, and with board independence.

It is plausible that board members with appropriate stock ownership will have the incentive to provide effective monitoring and oversight of important corporate decisions. Board independence is negative with future operating performance but is effective to discipline management of poorly performing firms^{2 4}.

3.2.10 Weir(2001)

Title, Released: An empirical analysis of the impact of corporate governance mechanisms on the performance of UK firms, 2001

Research Question: A code of best practice, the Cadbury Committee (*) proposed, effects on firm performance? They test the hypothesis that the quality of non-executive directors can influence performance, particularly in relation to committee membership. (*): Cadbury recommended a particular model of internal governance based on the assumption that non-executive, or outside, directors and board sub-committees were crucial internal control mechanisms and stressed the importance of the independence and caliber of non-executive directors.

Data & Methodology: 321 companies listed in UK, 1994 and 1996, Data covering director caliber and independence were taken from the Price Waterhouse Corporation Register. , OLS

Findings: 1) The link between internal governance mechanisms and performance is, at best, weak. Although companies are complying with the Code by adopting, they do not appear to impact positively on performance. 2) Neither the independence of the committee membership nor the quality of the committee members has an effect on performance. 3) Take-over intensity is negatively related to performance. This

suggests that external control mechanisms are more effective than internal ones.

Non-executive director independence and the market for corporate control (**) are substitute governance mechanisms^{2 5}. (**): If a company's internal mechanisms fail, the market for corporate control acts as a disciplining mechanism of last resort.

3.2.11 Summary

There has been considerable research that seeks to estimate a correlation between board composition and company performance. Board composition in prior studies are as follows: female director, director board attendance ratio, concurrent director, director age, director independence (relationship with CEO), CEO tenure, CEO's career, CEO-chair separation, staggered board, number of directors, committee, insider to outsider ratio, executive compensation, stockownership of board member, and director expertise, outside director background (banker, venture capitalist, politically connected) etc. However prior literatures have generated a set of contradictory results and a consistent set of result is yet to emerge from academic search since the aforementioned articles, see the Table 1 below, and their prior literature reviews as well.

Table 1 Summary of Board and the firm performance

Author (year)	Signi- ficant	No significant or negative	Remarks
3.2.1 Wessels (2014)		✓	Correlation between governance (number of director and institutional investors) and performance (market to book ratio and stock return etc.) is statistically zero.
3.2.2 Gompers (2003)	✓		With developed G-Index, purchased shares in the lowest-G firms (strong shareholder rights) and sold in the highest-G firms (dictator) earned abnormal returns.
3.2.3 Brown (2004)	✓		Better governed firms are relatively more profitable (ROE), more vulnerable, and payout more dividends to their shareholders and repurchase more shares.
3.2.4 Larcker (2005)	✓		Specified 14 factors out of 39 individual governance indicators are related to future operating performance and little relation to bad outcomes.
3.2.5			No interpretation of causal link between board and audit

Xie (2001)		✓	committee composition and earnings management because of the endogeneity impacting much of the board literature.
3.2.6 Hopt (2004)	NA	NA	A trend report: Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy
3.2.7 Adams (2008)	(✓)		Female director has a positive impact on performance in firms that otherwise have weak governance. In case a strong governance could ultimately decrease shareholder value.
3.2.8 Swan (2014)		✓	No evidence that a higher proportion of executives on the board improves firm performance and typically that of real independent directors worsens firm performance.
3.2.9 Bhagat (2007)	✓		Board member stock ownerships and CEO-chair separation are positive with future performance. Board independence is negative but effective to discern management of poorly performing firm.
3.2.10 Weir (2001)		(✓)	Link between internal governance mechanisms & performance is weak. External control mechanisms are more effective than internal. Director independence and market for corporate control are substitute governance mechanisms.

If board directors in a large portion of companies are rarely involved in company direction decision makings and strategic one, in another word not expected to play a role improving the company performance from the beginning, it is understandable that relationship between board composition (independence, quality, and committee etc.) and firm performance is insignificant or weak. But board independence is effective to discipline management of poorly performing firms. Non-executive director independence representing shareholders is expected to play a role protecting firms, governance mechanisms. Risk management is a core activity to improve the company resilience, the relationship in line with the firm performance is reviewed at the next section.

3.3 Risk Management

3.3.1 Dionne(2005)

Title, Released: Risk Management and Corporate Governance: The importance of Independence and Financial Knowledge for the Board and the Audit Committee, 2005

Research Question: NYSE requires the composition and the financial knowledge of

the directors sitting on the board and on the audit committee. Whether these new rules as well as those set by the Sarbanes Oxley act lead to hedging decisions that are of more benefit to shareholders?

Data & Methodology: Panel dataset of 485 relative to 36 North American gold mining firms in 1993 to 1994, 13-G and 13-G from SEC website.

Findings: The audit committee size and independence are beneficial to shareholders, although maintaining a majority of unrelated directors in the board and a director with an accounting background on the audit committee may not be necessary. Interestingly, financially educated directors seem to encourage corporate hedging while financially active directors and those with an accounting background play no active role in such policy. Directors with a university education on the board is an important determinant of the hedging level, an increasing function of the percentage of directors holding a diploma superior to a bachelor degree.

3.3.2 Tonello(2008)

Title, Released: The Role of the Board in Turbulent Times: Overseeing Risk Management and Executive Compensation, 2008

Research Question: A pragmatic boardroom discussion on how to better align the financial interests and the motivational drivers of executives with the interests of long-term shareholders.

Data & Methodology: Not always mentioned because the essay is for practitioners

Findings (recommendation): The Governance Center recommends that corporate directors reassess gaps and vulnerabilities in existing risk management solutions. The board should 1)review and approve an inventory of risks and fundamental risk management parameters (such as risk measurements, risk appetite, and tolerance levels), 2)be sensitive to the fact that the business may be particularly subject to the effects of interrelated events, 3)regularly determine whether the business strategy is adjusted to the levels of risk tolerance the company can afford, based on indicators such as its capitalization, liquidity, and debt-to equity ratios, as well as the environmental and geopolitical risks that may be difficult to assess properly.

For the purpose of determining the risk oversight structure at the board level, conduct a preliminary assessment of existing corporate governance practices, including: 1)the independence, professional expertise, and time availability of each board members; 2)the workload of existing board committees; and 3)the quality of information flow between board members and management.

The Governance Center believes that board of directors should 1)regularly assess

independence standards and performance of compensation committee members,
2)additional safeguards when the chairman/CEO positons are not separated,
3)understand the nature and scope of compensation consulting services.

3.3.3 Christoph(2013)

Title, Released: The Risk Management Duties of the Board of Directors, 2013

Research Question: Whether the legislative and regulatory framework will improve the equilibrium between entrepreneurship and risk control?

Data & Methodology: Comparison of ERM requirements in European states

Findings: According to an assessment by Dutch Monitoring Commission Corporate Governance, a significant number of companies just pass the minimum requirements, or even do not pass the test. Next, more supervisory boards monitor the strategy and risks than the risk management system²⁶. Managing strategy should not be confused with managing risks. Therefore we would like to advise further developing the legislative risk management programs in distinguishing the risk management requirements between the strategic and operational objectives on the one hand and compliance and financial reporting objectives on the other hand²⁷. European commission emphasized the importance of risk disclosure. ... However, it will be insufficiently for improving the equilibrium between entrepreneurship and risk control as the regulatory framework is too fragmented and insufficiently distinguishes between the business risk management approach and the reporting and the compliance risk approach²⁸.

3.3.4 Kommunuri(2014)

Title, Released: RISK MANAGEMENT, BOARD EFFECTIVENESS AND FIRM VALUE: EVIDENCE FROM S&P/ASX200 COMPANIES, 2014

Research Question: Risk management at enterprise level, the effectiveness of audit & risk committee and the relation of ERM implementation to firm performance and firm value.

Data & Methodology: S&P/ASX200, 2006 and 2009, OLS and correlation by using independence, power, size and expertise of directors in committee. Set up five hypotheses. ROA as a proxy for firm performance and Tobin's Q as a proxy for firm value.

Findings: 1) ERM implementation shows negative impact on firm value, explaining that a mere adoption of ERM by firms has no significant influence on firm performance or value.

2) Association between board effectiveness (BrdEff) and firm performance exhibits positive results during pre and post Global Financial Crisis (GFC). But the relationship between BrdEff and Tobin's Q in the preGFC period indicates committees' ineffectiveness in enhancing firm value in relation to risk management practices. However postGFC results are positive and significant which implies stronger committees and better decision making.

3) ERM shows a negative impact on firm performance, may suggest that for some firms the cost of ERM implementation outweighs its benefits.

4) All independent variables including ERM and BrdEff do not show any significant impact on firm value.

5) Neither firm's ERM nor the audit & risk committee monitoring effectiveness of ERM implementation have visible (significant) effects on firm value. On the other hand, in postGFC, BrdEff and ERM positively and significantly impact firm value measured by Tobin's Q. The results conclude that there needs to be stronger committees, to make management strategies.

3.3.5 Ittner(2014)

Title, Released: The Influence of Board of Directors' Risk Oversight²⁹ on Risk Management Maturity and Firm Risk-Taking,

Research Question: While theory predicts that Board risk oversight can benefit stakeholders by mitigating risk-related agency conflicts, critics argue that changes in Board practices in response to external pressure may simply be window-dressing. The authors examine the influence of board risk oversight responsibilities and processes on the maturity of the firm's risk management processes and risk-taking.

Data & Methodology: A survey conducted by Aon (Insurance broker), 28 countries, 297 public companies, and 16 industries, Pearson correlations

Findings: While firms that fail to formally assign board risk oversight roles experience the lowest level of Board understanding and involvement in risk oversight, the most sophisticated board risk oversight practices are found in firms that have established oversight responsibilities at the board *and* committee levels. More importantly, board risk oversight involvement has a direct positive effect on risk management maturity and significant negative indirect effect on corporate risk-taking provides support for claims that the Board of Directors provides the foundation for effective ERM systems by setting the "tone at the top" and establishing the oversight needed to ensure that the process is embedded in the organization's ongoing activities³⁰.

3.3.6 Tonello(2013)

Title, Released: Risk in the Boardroom, 2013

Research Question: The current corporate practices on risk oversight by directors of U.S. public companies.

Data & Methodology: The Board Practices Survey conducted by The Conference Board, NASDAQ OMX and NYSE Euronext, Manufacturing: N=152, Financial Services: N=73, Nonfinancial services: N=124

Findings: 1)Responsibilities for Strategy Setting: Across industries and size group, senior management is primarily responsible for setting strategic objectives, while the full board tends to be more involved in the process, 2)Frequency of Strategy Review: The board reviews the business strategy on an annual basis, 3)ERM Framework Adoption: Slightly less than three-quarters of companies across industries reported that their risk management procedures are based on a widely accepted ERM framework. The popularity of ERM increase among the largest organizations, 4)Responsibility for Risk Oversight: 24.3% of financial services companies have instituted a dedicated risk committee, compared to 4.8% of nonfinancial services and 2.6% of manufacturing companies, 5)Frequency of Risk Reporting to the Board: Financial companies constitute the only industry group in which more than half of companies report on risk at each board meeting and as part of the regular board agenda as compared to manufacturing 30.7% and nonfinancial 34.4%, 6)Chief Risk Officer (CRO): CRO is typically in charge of articulating the ERM development, however CROs are still uncommon in a large majority of manufacturing and nonfinancial companies, 7)ERM Executive Committee: A total of 40% of companies in both manufacturing and nonfinancial services having an ERM executive committee as compared to financial services 68%. There is a direct correlation between company size and the presence of the ERM executive committee.

3.3.7 Chen(2011)

Title, Released: CHIEF EXECUTIVE OFFICER INCENTIVES, MONITORING, AND CORPORATE RISK MANAGEMENT: EVIDDNC E FROM INSURANCE USE, 2011

Research Question: 1) Whether various forms of managerial compensation, CEO characteristics, and governance monitoring mechanisms affect corporate insurance decisions, 2) Whether firms subject to different levels of monitoring purchases insurance for different reasons.

Data & Methodology: World Bank investment climate survey (2004), 18 cities

across China's different geographical regions and the total number of firm is 2,400.

Multivariate Regressions, Tobit and Probit model analysis

Findings: 1) Both CEO personal incentives³¹ and governance monitoring mechanisms can induce corporate insurance purchase. 2) Firms subject to different monitoring tend to purchase property insurance for different purposes. Specifically, the purchase of property insurance for managerial self-interest is only prevalent in firms subject to lax monitoring, and the determinants of insurance purchase are more in line with the prediction of economic theories in firms with strong monitoring.

Firms that insure are larger, have more capital expenditure and R&D spending and higher tangible asset intensity, export more, have a higher level foreign institutional ownership, and a higher proportion of independent directors and a higher monitoring index. CEO cash compensation is positively and significantly associated with the incidence of property insurance. However the existence of a bonus plan and CEO stock ownership do not exert significant impacts on the likelihood of property insurance. A higher extent of product-market competition only increases the incidence of property insurance use in firms with strong monitoring, suggesting the effect of the interaction between product-market competition and governance mechanisms on the corporate purchase of insurance.

3.3.8 Summary

Although board should review and approve fundamental risk management parameters (risk measurements, risk appetite, and tolerance levels), based on indicators such as its capitalization, liquidity, and debt-to-equity ratios, risk reporting to board meeting is 30%+α in manufacturing and non-financial companies lower than financial 50%. Both CEO personal incentives and governance monitoring mechanisms induce corporate property insurance purchase, meaning financial risk avoidance. Board risk oversight has generated a set of contradictory results and do not always show any significant impact on firm value, see Table 2 below.

We interpret that board plays a defensive role as corporate governance. If risk management with a certain cost worked effectively, the incident frequency and/or loss severity would be contained or not happen.

Board risk oversight involvement has a direct positive effect on risk management maturity and significant negative indirect effect on corporate risk-taking provides support for claims that the board of directors provides the foundation for effective ERM systems

Table 2 Summary of Corporate Governance and Risk Management

Author (year)	Signi- ficant	No significant or negative	Remarks
3.3.1 Dionne (2005)	(✓)		Audit committee size and independence are beneficial to shareholders, although maintaining a majority of unrelated directors in the board and a director with an accounting background on the audit committee may not be necessary.
3.3.2 Tonello (2008)	NA	NA	Board should review and approve fundamental risk management parameters (such as risk measurements, risk appetite, and tolerance levels), based on indicators such as its capitalization, liquidity, and debt-to-equity ratios.
3.3.3 Chris- toph (2013)	NA	NA	Managing strategy should not be confused with managing risks. It should be developed the legislative risk management programs in distinguishing strategic and operational and compliance and financial reporting.
3.3.4 Komm u- nuri (2014)		✓	All independent variables including ERM and Board Effectiveness do not show any significant impact on firm value. But stronger committees are significant for better decision making in post Global Financial Crisis.
3.3.5 Ittner (2014)	✓		Board risk oversight involvement has a direct positive effect on risk management maturity and significant negative indirect effect on corporate risk-taking. Effective ERM is embedded in organization's ongoing activities.
3.3.6 Tonello (2013)	NA	NA	Senior management is primarily responsible for setting strategic objectives and the board reviews the business strategy annually. Risk Reporting frequency to Board: financial 50%+, manufacturer 30.7% and nonfinancial 34.4%
3.3.7 Chen (2011)	✓		Both CEO personal incentives and governance monitoring mechanisms induce corporate property insurance purchase. A higher extent of product-market competition increases property insurance use in firms with strong monitoring.

4. Concluding Remarks

C.E.O. basically controls board members and determines what the board does and does not do (no-fly zone). Some expect board to set the strategic direction of the company, others don't. What if most of board directors are limited to serve as a source of advice and counsel, serve as some sort of discipline, and act in crisis situations? Although a correlation between board composition and firm performance has been analyzed with various determinants based on multi-country and individual country level dataset, prior literatures have generated a set of contradictory results and any consistent set of result from academic research is yet to emerge.

Each country has its own financial market developmental history, trading customs, and regulations. Corporate governance depends on the type of business, the history of a company, the performance level, the corporate culture, and various board composition determinants etc. and is intertwined. However such prior exogenous and endogenous analysis results would be informative for future Japanese capital market and to-be corporate governance, because Japanese corporate governance is being evolved from the aforementioned primitive stage to a next one.

With respect to a board composition determinant "independent director", independence is insignificant or negative with firm performance according to Bhagat(2007) and Swan(2014). However their research results seem to be persuasive and informative for Japanese capital market. A real problem in Japan is that whether board consisting of almost all directors promoted internally being able to utilize that knowledge is not clear. If board independence is effective to discern a management, when a firm gets to worsen in performance, does CEO and/or a nomination committee of poorly performing firm increase independent directors in number or nominate an independent director as a lead director for empowering independent directors? What proportion of real independent director to Gray (a regular outside directors with some previous or current affiliation with the firm) is appropriate in Japan? Future research in corporate governance – performance - risk management area should take into account the issues such as endogeneity and exogeneity.

Board risk oversight does not necessarily show any significant impact on firm value. Actually over-monitoring could ultimately decrease shareholder value. However board is expected to play a more important role in corporate governance including risk management than ever before since foreign investors are increasing in shareholder proportion.

Through the prior literature reviews, the board composition determinant argument is presumed shifting from current formality and numerical matter to a real quality evaluation by itself and/or by the third party facilitator for an effective governance and better firm performance in near future.

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- ¹ 北川 (2014a) p.5
- ² Mace(1986) p.2
- ³ Ditto p.43
- ⁴ Ditto p.68
- ⁵ Ditto p.178, p.205-206
- ⁶ Ditto p.ix
- ⁷ Adams p.7, quoted from Demb and Nuebauer (1992) “The Corporate Board” Oxford University
- ⁸ Ditto pp.41-42
- ⁹ Ditto p.44
- ¹⁰ Ditto p.28
- ¹¹ Charan (2014) p.4
- ¹² Ditto p.187
- ¹³ Ditto pp.190-196
- ¹⁴ Mace(1986) p.vii
- ¹⁵ Brown and Caylor (2004) pp.29-30
- ¹⁶ Larcker (2005) p.48
- ¹⁷ Larcker (2005) Table 3
- ¹⁸ Larcker (2005) pp.43-45
- ¹⁹ Xie (2001) p.20
- ²⁰ Hopt(2004) pp.4-10
- ²¹ Ditto pp.10-15
- ²² Swan (2014) p.13
- ²³ Ditto p.2
- ²⁴ Bhagat pp.29-32
- ²⁵ Weir pp.26-30
- ²⁶ Christoph (2013) p.25
- ²⁷ Ditto p.28
- ²⁸ Ditto p.29
- ²⁹ Ittner (2014) p.6 “Risk oversight” represents the practices used by the Board to determine that the firm has in place a robust process for identifying, prioritizing, managing, and monitoring its critical risks.
- ³⁰ Ittner (2014) pp.37-38
- ³¹ CEO personal incentives are 1)cash compensation (salary and bonus)(a proxy for managerial wealth tied up in the firm), CEO tenure (a proxy for human capital invested

in the firm or managerial entrenchment), whether the CEO was a manager before (a proxy for reputational capital or professionalism), whether the CEO is a secretary of the ruling Communist Party (a proxy for the CEO's political connections and career prospects), and the use of safety of operation as an evaluation criterion in managerial incentive contracts.