BOARD RISK OVERSIGHT INVOLVEMENT, THE DEMAND FOR EXTERNAL ASSURANCE, AND FINANCIAL REPORTING QUALITY

Allen Blay
Christina Lewellen
Michelle McAllister
Florida State University

January 6, 2016

EXECUTIVE SUMMARY
In the wake of the latest financial crisis, regulators and investors have expressed growing concern over the adequacy of firm risk oversight practices (COSO 2009; Deloitte 2013). In particular, various stakeholder groups have increased focus on the board of director’s involvement in monitoring the firm’s risk-related policies and procedures (COSO 2009). To assist investors in evaluating the board’s involvement in monitoring the firm’s enterprise risk management (ERM) practices, the SEC mandated that the board of directors must disclose in the annual proxy statement their role in the oversight of firm risk (SEC 2010).¹ Using this new disclosure, we analyze firm risk oversight disclosures from annual proxy statements of the Russell 1000 to examine how board involvement in the risk management process affects the demand for assurance in the financial reporting system and the resulting financial reporting quality.²

Prior research examines how ERM maturity affects firm performance and firm value (Baxter et al. 2013; Ittner and Keusch 2014). Other studies examine how characteristics of the members of the board of directors and the audit committee affect the demand for financial reporting assurance and financial reporting quality (e.g. Carcello et al. 2002; Knechel and Willekens 2006). Recent research directly examines the relationship between board risk oversight and the financial reporting process. However, these studies either rely on unique subsamples which likely do not generalize well to less specific settings (Hines et al. 2015) or form their assertions based on qualitative research (Cohen et al. 2014b).

¹ According to COSO, “enterprise risk management is a process, effected by the entity’s board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within the risk appetite, to provide reasonable assurance regarding the achievement of objectives” (COSO 2009).
² We proxy for actual board involvement using the disclosed level of board involvement. To the extent that actual board involvement differs from the disclosure, this would add noise to our measure and reduce our likelihood of finding an association between the disclosure and realized outcomes.
We develop a composite measure of board involvement in risk oversight based on the risk oversight disclosure information contained in the most recent annual proxy statement for the large, publicly traded firms in the Russell 1000. We use this composite measure to examine the association between the level of board involvement in risk oversight and the firm’s demand for assurance within the financial reporting process. More specifically, we investigate whether the level of board involvement in risk oversight is associated with the demand for external assurance and financial statement quality. We also examine whether the decision to delegate responsibility for risk oversight to the audit committee influences the demand for external assurance.

We choose to focus on a sample of large, publicly traded, non-financial firms for two primary reasons. First, past research examining board risk oversight practices generally focuses on the characteristics of firms within the highly regulated financial services industry (Baxter et al. 2013; Ittner & Keusch 2014; Hines et al. 2015). However, the risks faced by firms within this industry are likely to vary significantly from those faced by publicly traded firms as a whole. Furthermore, these prior studies situate their inquiry during the period following the Global Financial Crisis, but firms within this industry have experienced significantly greater scrutiny concerning risk oversight relative to other industries within this period (Hines et al. 2015). These unique features of the financial services industry make it difficult to extend the associations established in past literature to firms from a broader set of industries. Second, board risk oversight practices are likely to be among the most heterogeneous of observable governance measures across large firms. We expect the readily observable governance characteristics between these firms (board and audit committee independence and size, financial expertise, etc.) to be relatively homogenous. Thus, our sample choice allows us to focus on a specific governance process, board involvement in risk oversight, which may significantly influence a
firm’s demand for greater assurance within the financial reporting system and resulting financial reporting quality.

Our results indicate that the demand for assurance within the financial reporting process is greater for firms where the board is more involved in risk oversight. Specifically, more involved boards are associated with higher audit fees consistent with a greater demand for outside auditor effort. Boards more involved in the risk oversight process are also associated with a greater demand for a higher quality auditor as measured by auditor office size and the use of an industry specialist auditor. In addition to a greater demand for outside assurance, firms with more involved boards are associated with lower levels of discretionary accruals and are less likely to experience restatements. These findings are consistent with the assertion that greater board oversight of the firm’s ERM system helps to reduce risk within the financial reporting process and improves financial reporting quality. Importantly, we find these results after controlling for numerous firm risk and complexity proxies as well as controlling for the firm’s overall voluntary disclosure behavior. Thus, differences in the level of involvement by the board of directors in the risk oversight process, and its subsequent effect on the demand for external assurance, are not driven by cross-sectional differences in risk or complexity. Furthermore, cross-sectional differences in the disclosure of board involvement in risk oversight do not simply proxy for the firm’s overall voluntary disclosure propensity.

Prior research contains mixed theory and evidence concerning whether it is preferable to retain the responsibility for risk oversight at the full board level or to delegate this responsibility to the audit committee. We inform this debate by examining whether firms which delegate risk oversight responsibility to the audit committee differ from those which retain responsibility at the full board level in the demand for external assurance. Our results indicate that while greater
board involvement in risk oversight is associated with a greater demand for assurance, the
demand for outside assurance is lower for boards who delegate risk oversight responsibilities to
the audit committee. In particular, firms who choose to delegate responsibilities for risk
oversight to the audit committee experience lower audit fees and on average engage smaller audit
offices. We argue that the choice to delegate oversight responsibility to the audit committee
represents a greater demand for internal assurance relative to external assurance. Consistent with
this, we find that the choice to delegate risk oversight responsibility to the audit committee is
associated with firm characteristics which prior research suggests are indicative of a demand for
greater internal monitoring relative to external monitoring (Anderson, Francis, Stokes 1993).
We further find no evidence of a significant difference in financial reporting quality across these
two groups. Thus, our evidence suggests that the internal monitoring associated with the audit
committee’s involvement in risk oversight leads to a lower demand for external auditing that is
not associated with a decrease in financial reporting quality.

Our study makes several contributes to the corporate governance, auditing, and financial
reporting literature. We develop a measure of board involvement in risk oversight based on
publicly available data which captures the processes by which boards monitor a firm’s risk
profile. This measure helps to extend researchers’ understanding of the relationship between
what the boards of Directors actually does and its impact on the financial reporting system. To
this end, our study answers the call for more research which extends beyond readily observable
governance characteristics in explaining financial reporting outcomes (Carcello, Hermanson, &
Ye 2011). Secondly, we introduce a newly available disclosure to the literature and demonstrate
how information contained in this disclosure sheds light on corporate governance processes.
Finally, our study adds to the emerging area of enterprise risk management research by
examining how board involvement in this process influences the firm’s demand for external assurance and financial reporting quality.
REFERENCES


