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Directors' Tenure and Their Independence: Capital Market Perspective

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Abstract

The independence of non-executive directors has long been a concern. The independent directors are not only required to be independent from management but also free from any other relationships which can interfere with their objectivity. Recently, the concern has been focused on long tenure of independent directors. Regulators seem to believe that long tenure may impair independence, hence attempts to limit the tenure have been recommended, even though it has not been made mandatory. However, theories concerning long tenure are contradictory and empirical evidences are weak. Earlier studies are based on theory-driven approach, which only examines the association between directors' tenure and proxies of financial reporting quality. This study on the other hand, proposes a different approach based on earnings response coefficient model which not only examines investors' perceptions but also their reactions. This is based on the widely accepted independence model where independence should not only be in the form of fact but also appearance. The interaction between directors' tenure and earnings performance is hypothesized to have a significant negative relationship with the cumulative abnormal return. Low perceived earnings quality in financial accounts from long tenure by investors is expected to result in lower coefficient of earnings. This study will provide additional literature and knowledge on the effect of independent directors' tenure. It can assist regulators in revising the requirement for directors' tenure.

Keywords: Capital market, directors, earnings response coefficients, independence, tenure.

1. INTRODUCTION

Released in March 2012, the revised Malaysian Code on Corporate Governance (MCCG 2012) focuses on the independence of independent directors, among other things. One of the recommendations is Recommendation 3.2 which is to limit the services of independent directors to a maximum of nine years. Upon the completion of nine years, the independent directors are then re-designated as non-independent directors. However, Recommendation 3.3 allows for more than nine years but must justify and seek shareholders' approval. The rationale in the limitation of tenure is that long tenure can impair the directors' independence. As argued by Vafeas (2003), long tenure creates close relationships between the independent directors with the management and therefore, is more likely to befriend the managers. The attempt to limit the tenure can also be observed in other jurisdictions and similar to Malaysia, the "comply or explain" model is also applied in many other jurisdictions. For example, the European Commission recommends for three terms or twelve years while, in the United Kingdom, the U.K. Corporate Governance Code sets a maximum tenure of nine years, which is also similar to Hong Kong and Singapore in Hong Kong, but in French, twelve years is the recommended maximum

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tenure. Meanwhile, in India, the Companies Act, 2013 sets a maximum of two tenures of five consecutive years, with a cooling off period of three years. However, in the U.S, public companies do not have specific tenure limits for the independent directors.

As the recommendations set out in MCGC 2012 are not made mandatory, hence long tenure can be considered a common practice in Malaysian public listed companies. This can be observed from a few reports conducted earlier, for example in a study by KPMG Malaysia (2013) of the top 300 companies ranked by market capitalisation in 2013, it had found that 33% of independent directors have served for more than 9 years. It is also reported that the average tenure of independent non-executive directors is 7.6 years, while on the other hand, only 6.6 years by non-executive non-independent directors. In another study, the Bursa Malaysia's Analysis of Corporate Governance Disclosures in Annual Reports of 2012-2013 (2014) of 300 listed companies had found that 55% (165 companies) retains at least one independent non-executive director beyond the 9 years tenure. Based on top 100 Malaysian companies, the Minority Shareholder Watchdog Group (MSWG)'s 2015 survey had found increasing percentage of companies that have directors over 9 years from 34% in 2012 and 38% in 2013 to 46% in 2014. In 2015 about 44% of those companies have directors retained over 9 years. However, average tenure of 6 years for 2013 to 2015 is lower from 7 years recorded in 2012. Meanwhile, based on all listed companies, more than 50% of companies have an independent director with the tenure of more than 9 years, except for 2013 of only 47%. In an earlier report by Hay Group (2012) of 50 largest companies in 2010 by ASEAN countries showed that the median tenure of independent directors of 6 years in Malaysia is longer than 4.5 years in Indonesia and 3 years in Thailand, but shorter than 7 years in Singapore.

The debate on directors' independence or broader aspects; board of directors independence, is not new as can be observed from the literature. This issue can be traced back from the argument regarding the need for the inclusion of non-executive directors as board members (Fama, 1983; Fama & Jensen, 1983) to the recent issue; which is the independence of independent directors. As the highest authority in a company, the board is mandated by the shareholders to protect their interests by ensuring all the activities of the company are for the benefits of the company. The popular belief is that directors whom are truly independent are effective monitors. Currently, Chapter 15 of the Bursa Malaysia Listing Requirements requires at least two or one third of the board of directors to consist of independent directors and for audit committee, the minimum composition is three, consisting all non-executive directors and a majority of independent directors. Consistent with other countries, the Bursa Malaysia has defined the independent director as a director who is independent of management and free from any business or other relationships which could interfere with the exercise of independent judgement or the ability to act in the best interests of the company. More specifically, as in Chapter 1.01 Bursa Malaysia Listing Requirements, an independent director should not be an executive director, an officer within the last two years, a major shareholder, family member of any executive directors, officer or major shareholder, acting as a nominee or representative of any executive director or major shareholder, engage as adviser or is partner, director (except for independent director) or major shareholder of corporation which provides professional advisory services and engaged in any transaction individually or as partner, director or major shareholder of a corporation (other than subsidiaries of the company). However, the Listing Requirements is silent on directors' tenure.

This study examines the effect of independent directors' tenure on the financial reporting quality based on the investors' perspective. By using the earnings response coefficient model proposed by Houlthausen & Verrochia (1988), this study intends to not only examine investors' view but also their reactions. This study is important considering long tenure of directors is common, not only in Malaysia but also elsewhere. It is relevant for the regulators in reviewing the current policy which then may enhance investors' confidence towards the capital market and provides empirical evidence on the currently debated issue on limiting independent directors' tenure.

2. LITERATURE REVIEW

2.1 Board of directors

Managers are appointed as agents to act on behalf of shareholders in managing a corporation. This separation between owners and management causes conflicts of interest between the two parties, where the managers' preferences are not aligned with the shareholders (Jensen & Meckling, 1976; Fama & Jensen, 1983). Board of directors is a market solution to ameliorate this agency problem (Hermalin & Weisbach, 2003), whereby as the highest authority in the corporate structure, the board is discharged with the responsibility of monitoring and controlling the management. Besides that, the board is also responsible to make decisions relating to policy of the corporation, strategic planning and the appointment, dismissal and compensation of management (Fama & Jensen, 1983). They receive those powers from shareholders with the purpose to protect their interests.

Limbasiya (2013) points out the role of board as to maximize the total value for investors, customers, employees, government, society and other stakeholders. It is common nowadays to observe that board of directors consists of a mixture of top management, largest shareholders or its representative and a few individuals unrelated to the company of shareholders. Appropriate composition of members in terms of demographic, skills, expertise, experience, value system enhances the effectiveness of the board and this diversity safeguards them against single minded group thinking (Limbasiya, 2013). As not involved in the management, the inclusion of the outside directors is believed to enhance the monitoring and controlling. The non-executive directors have the incentive to build reputations as expert monitors (Fama, 1980; Fama & Jensen, 1983).

2.2 Directors Independence

Hermalin & Weisbach (2003) argued that the major conflict within the boardroom is between the CEO and the other directors. The CEO is argued to have the incentive to capture the board of directors, so as to secure his position and remuneration. On the other hand, the non-executive directors is expected to provide the relevant “check and balance” to the executives, the off-repeated mantra worldwide. However, with the growing number of corporate scandals, the effectiveness of non-executive directors in monitoring the management has become an issue. One main centre of discussion is the independence of these directors. This is because in discharging their responsibility requires them to have a different perspective from management and sometimes to challenge the management. The traditional two-way classification scheme of insider (management) and outsider (non-management) directors fails to consider the potential conflicts of interest when directors are not employees but have other affiliations with the firm (Byrd & Hickman, 1992). Although non-executive directors are not involved in the management or the company, they may not be independent due to their indirect relations to management which can interfere with their objectivity. Therefore, it is believed that the non-executive directors are only able to perform more objectively if they are free from any personal bias resulting from financial or personal relationships with the management (Beasley, 1996; Carcello & Neal, 2000, 2003). Hence, it can be observed that the current requirement in many jurisdictions has differentiated the non-executive directors into non-independent non-executive directors and independent non-executive directors. The widely practiced, non-executive directors whom are representative of the substantial shareholders or is related to the founder, controlling shareholder or managing directors and the founder of company, have been classified as non-independent directors.

Independence is widely recognized as one of the main criteria for quality monitoring and control. As responsible for oversight, board of directors needs to adopt a probing attitude, questioning management’s judgments and to take positions that variance with the management (McMullen & Raghunandan, 1996). Independence allows the committee to deliver its responsibilities objectively (Mohamad & Sori, 2001). The independent director is expected to play two-fold role; as a strategic advisor and protecting the minority shareholders and other stakeholders’ rights (Limbasiya, 2013). However, Mirvis & Savitt (2016) theorized that the independent directors lack detailed operational knowledge and firm specific commitment. The composition of the committee is one important determinant of its ability to act independently (Scarborough, Rama & Raghunandan, 1998), whereby the inclusion of more independent directors on the board is believed to enhance board independence.

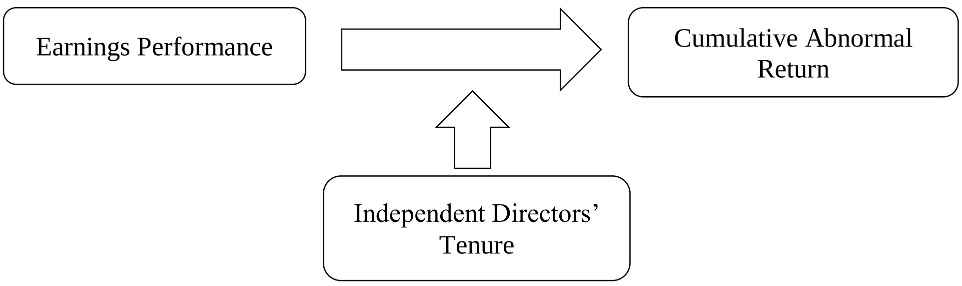
The typical independent director definition ignores the possibility that independence is based on a director’s personal profile and the relationships created in the boardroom over time (Byrd & Cooperman, 2010). Therefore, the current concern on directors’ independence is long tenure of independent directors which have been debated to impair their independence. Regulators’ action worldwide is to relegate the status of independent directors to non-independent after a period. Their action is being related to the belief that long tenure may impair directors’ independence. As noted by Romanchek & Keckley (2014) long tenure directors can become too close to long services CEO (and with other managers), become stagnate in the role or become too comfortable and not ask the difficult questions. Friendliness hypothesis proposed by Vafeas (2003) views long tenure directors as more likely to befriend managers which then can impair their independence and thus, objectivity. Long tenure is an obstacle to achieve board diversity.

3. THEORETICAL FRAMEWORK

It is widely recognized that the independence of monitoring is not only important in terms of fact, but also in appearance. The fact that stakeholders cannot directly observe the work of independent directors, it is important for the directors at least to be seen as independent. It can be observed that predictions regarding the effects of independent director’s tenure on their effectiveness as monitors seem to contradict. Based on the theory of organizational behaviour, longer tenure increases an individual’s commitment (Buchanan, 1974). At the same time, the expertise hypothesis views that longer tenure increases directors' experience and specific knowledge about the corporation (Vafeas, 2003). Sharma & Iselin (2012) argued that in an efficient market for directors, long tenure directors have higher incentives to protect shareholders' interest in order to maintain their seats. Long service directors have high reputation developed over time and therefore, less likely to be associated to anything that will dramatically impair their reputation (Liu & Sun, 2010). At the same time, Persons (2015) argued that lack of seniority has an adverse effect on directors' ability to scrutinize top management. Other versions view that the effectiveness of independent directors deteriorates with the tenure. Friendliness hypothesis proposed by Vafeas (2003) views long tenure directors are more likely to befriend managers which then can impair their independence and thus, objectivity. As noted by Romanchek & Keckley (2014) long tenure directors can become too close to long services CEO (and with other managers), become stagnate in the role or become too comfortable and not ask the difficult questions. Newly appointed directors have also been argued to have incentives to signal their expertise as monitors to the market (Sharma & Iselin, 2012). At the same time, Liu & Sun (2010) postulated that by having new directors can bring fresh ideas and critical thinking to the board. By having a new director may safeguard against single minded group thinking.

Mixed findings can also be observed on the effect of tenure on directors' effectiveness as monitors. A study by Sharma & Iselin (2012) had found that the average tenure of audit committees is positively related to misstatements. It is also found that short tenure (less than four years) and long tenure (more than eight years) are positively related to misstatements and the study concluded that the optimum director tenure is between 4 to 8 years. Vafeas (2003) found that increase in mean tenure is associated with greater incidence of negative earnings avoidance. Meanwhile, Rickling (2014) found that long tenure is positively associated with the likelihood of a firm repeatedly meeting or just beating analysts forecast. On the other hand, Liu & Sun (2010) and He & Yang (2014) both had found that long tenure is negatively associated with earnings management which the studies relate to the increase in directors' expertise.

One main responsibility of independent directors is to monitor the financial reporting process. Even though, financial accounts are prepared by management, the independent directors are responsible in ensuring the quality of the accounts. Quality financial reporting is the key success of a capital market whereby it relieves the fundamental asymmetry of information used in investment decisions. While many have shown that earnings performance is positively related to abnormal return of shares (Mahmoudi, Shirkavand & Salari, 2011; Ismail & Rahman, 2012), Houlthausen & Verrochia (1988) models investors' view on the quality of earnings reported in financial accounts as the strength of coefficients between the earnings and abnormal return. Therefore, it is hypothesized that independent directors' tenure is significant and negatively related to earnings response coefficients, whereby independent directors' tenure act as a moderating variable to the relationships between earnings performance and cumulative abnormal return, as visualized below.



4. RESEARCH METHODOLOGY

Previous studies are based on theory driven approach, which examines association between independent directors' tenure and proxies of financial reporting quality (Sharma & Iselin, 2012; Rickling, 2014). This study used the market approach, whereby both investors' perceptions and actions are examined together. Event study methodology was applied where the effect of independent directors' tenure on the quality of financial reporting is examined based on investors' reactions. This approach is adopted from Holthausen & Verrechia (1988)'s model of earnings response coefficient, where it examines investors' reactions on the earnings reported in financial accounts at the time of release (announce). Low reliability of earnings perceived by investors is postulated to result in lower earnings response coefficients. Conceptually, the model to be tested will take the following form:

ERC = TENURE + AFEE + NAFEE + OPINION + BIG4

Where;

ERC = Earnings response coefficients
TENURE = Independent directors' tenure
AFEE = Audit fees
NAFEE = Non-audit services fees
OPINION = Audit opinion
BIG4 = Auditor type

The detailed model is based on event study methodology and semi-strong efficient market model by Fama (1970) which posits that investors will instantaneously adjust their expectations on assets' value upon receiving new information which in turn is reflected instantaneously in asset prices. While many have shown that earnings performance is positively related to abnormal return of shares (Mahmoudi, Shirkavand & Salari, 2011; Ismail & Rahman, 2012), Holthausen & Verrechia (1988) hypothesized that the earnings response coefficient will increase with the perceived quality of the earnings by investors. Therefore, the effect of independent directors' tenure on earnings response coefficient will be examined using the Ordinary Least Square regression and will take the following form:

CAR = EP + EP*TENURE + EP*AFEE + EP*NAFEE + EP*OPINION + EP*BIG4 + ASSET + BETA

Where;

CAR = Cumulative abnormal return
EP = Earnings performance
TENURE = Independent directors' tenure
AFEE = Audit fees
NAFEE = Non-audit services fees
OPINION = Audit opinion
BIG4 = Auditor type
ASSET = Assets size
BETA = Firm's beta

Significant and negative coefficient of EP*TENURE will provide support to the hypothesis that investors place low reliability on earnings reported by companies with long tenure of independent directors.

5. CONCLUSIONS

Long tenure of independent directors has been a concern in many countries. Regulators view long tenure as impairing directors' independence and has led to tenure's limitation in many jurisdictions. However, the "comply or explain" model is favoured in many countries. Theories concerning long tenure of independent directors are contradictory. On one side, longer tenure is theorized as increasing an individual's commitment towards an entity. Longer tenure has also been hypothesized to increase directors' experience and specific knowledge about the corporation. On the other side, the friendliness hypothesis views long tenure as impairing directors' independence through their close relationship with the management throughout the tenure. At the same time, having a new director has also been postulated to bring in fresh ideas and thus, safeguard against single minded group thinking. Meanwhile, the widely accepted independence model is that independence should not only be in the form of fact, but also in appearance. This study proposes that long tenure of independent directors shall result in lower reliability of earnings reported in financial accounts by the investors due to the concern on directors' independence. Based on the earnings response coefficient model, it is argued that the interaction between long tenure and earnings performance have a significant negative relationship with cumulative abnormal return.

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